Venezuela/PDVSA Monthly Report
March 2018

Venezuela and PDVSA bonds had a positive performance in March and are currently trading at 2018 highs. According to the JPMorgan EMBI+ Venezuela Index, Venezuelan debt has amassed a 23.9% return year-to-date and leads the Emerging Markets sector. The uptrend in oil prices and the growing possibility of political change in the country were the main catalysts for the sharp rise in bond prices (*See Chart N ° 1*).

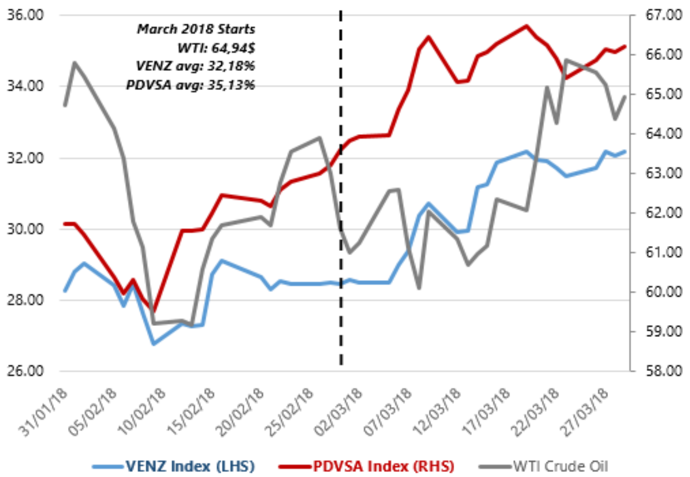


Chart N°1: VENZ and PDVSA avg. bond prices vs prices of WTI Oil (Feb-Mar 2018). *Source: Bloomberg BGN, own calculations.*

The main highlight of March was the growing discontent in the armed forces that threatens the stability of Maduro's government. More than twenty active and retired militarymen, including former Interior Minister Miguel Rodriguez Torres, were arrested for alleged conspiracy. The military crisis represents the critical driver of the moment for Wall Street analysts. Specifically, they consider that the army can influence the development of political events in three ways: by forcing fair electoral conditions; by enforcing the election results, especially if Falcón is the winner; and as an option of last resort, by undertaking a military coup and a transitional junta.

On the other hand, a series of events in the month made clear that external debt service has been suspended for months now. Earlier in March, the Russian Depository of National Settlement Depository (NSD) bonds announced that it received a Default Notice regarding the VENZ 31 bonus, after the last coupon's grace period expired on March 10. Later, a message by custodian Clearstream to holders of Venezuelan debt leaked to the market, providing an update with respect to the coupon payments due. It is worth noting that the custodian has received almost none of the pending payments, save for the coupons for ELECAR 18 and PDVSA 6% 22, which were sent to the custodian but are being held for an investigation by the compliance department, allegedly for violating Executive Order # 13808 of the US Department of the Treasury, which prohibits credit transactions between American entities and the government of Venezuela.

The negative news on the debt service front did not tarnish the optimism of the investors on the back of the presidential campaign of Henri Falcón taking off during the month. A triad of opposition parties (COPEI, MAS and Avanzada Progresista) and former presidential candidate Claudio Fermín joined the team of Falcón and Francisco Rodriguez, representing the only opposition force for the presidential elections on May 20. In parallel, the MUD has reinvented itself and has included a wide range of social, religious and political groups to form the Frente Amplio Venezuela Libre (FAVL), an institution with a still incipient political trajectory (it was created on March 8).

Monthly Performance

Security	28/02/2018	29/03/2018	Total Return	Total Return (2018 YTD)
VENZ 13 5/8 08/15/18	38.85	39.20	+0.86%	-9.92%
VENZ 7 12/01/18	33.95	37.75	+11.19%	-2.62%
VENZ 7 3/4 10/13/19	26.40	29.90	+13.36%	+30.94%
VENZ 6 12/09/20	25.95	29.40	+13.20%	+29.12%
VENZ 12 3/4 08/23/22	29.35	33.65	+14.51%	+51.12%
VENZ 9 05/07/23	27.05	29.60	+9.41%	+39.29%
VENZ 8 1/4 10/13/24	27.00	29.60	+9.54%	+41.81%
VENZ 7.65 04/21/25	26.90	29.90	+11.05%	+43.19%
VENZ 11 3/4 10/21/26	29.15	33.50	+14.92%	+48.87%
VENZ 9 1/4 09/15/27	28.25	32.35	+14.50%	+45.14%
VENZ 9 1/4 05/07/28	26.85	29.85	+11.28%	+42.71%
VENZ 11.95 08/05/31	29.00	33.75	+16.30%	+61.96%
VENZ 9 3/8 01/13/34	28.35	34.35	+21.19%	+61.03%
VENZ 7 03/31/38	27.00	30.70	+13.63%	+47.56%
PDVSA 8 1/2 10/27/20	82.65	85.70	+3.68%	+5.43%
PDVSA 9 11/17/21	28.30	33.75	+19.21%	+18.42%
PDVSA 12 3/4 02/17/22	29.60	33.70	+13.90%	+20.12%
PDVSA 6 05/16/24	25.35	27.20	+7.44%	+19.01%
PDVSA 6 11/15/26	24.95	27.00	+8.14%	+19.85%
PDVSA 5 3/8 04/12/27	25.75	28.05	+8.87%	+17.52%
PDVSA 9 3/4 05/17/35	27.50	31.15	+13.22%	+15.53%
PDVSA 5 1/2 04/12/37	25.45	27.80	+9.20%	+17.50%

Table N° 1: Performance of Venezuela and PDVSA bonds, March 2018.
***NOTE: VENZ bond returns were adjusted to account for the accrued interest lost, per the EMTA resolution of January 5th 2018.**

Venezuelan debt returns were broadly positive throughout both curves; gains in VENZ (+12.5%) were on average larger than in PDVSA bonds (+10.5%), and VENZ 2034 in particular returned over 20% in the month. In contrast, short-end bonds underperformed, with the VENZ 18 "old" up less than 1% and securing the month's worst performance, followed by the PDVSA 20 (+3.7%) and low-dollar-value bonds, which couldn't break double-digit returns (See Graph No. 2). After the positive performance in March, Venezuelan bonds are trading at similar levels as right before the credit event, precipitated by Maduro's speech on November 2.

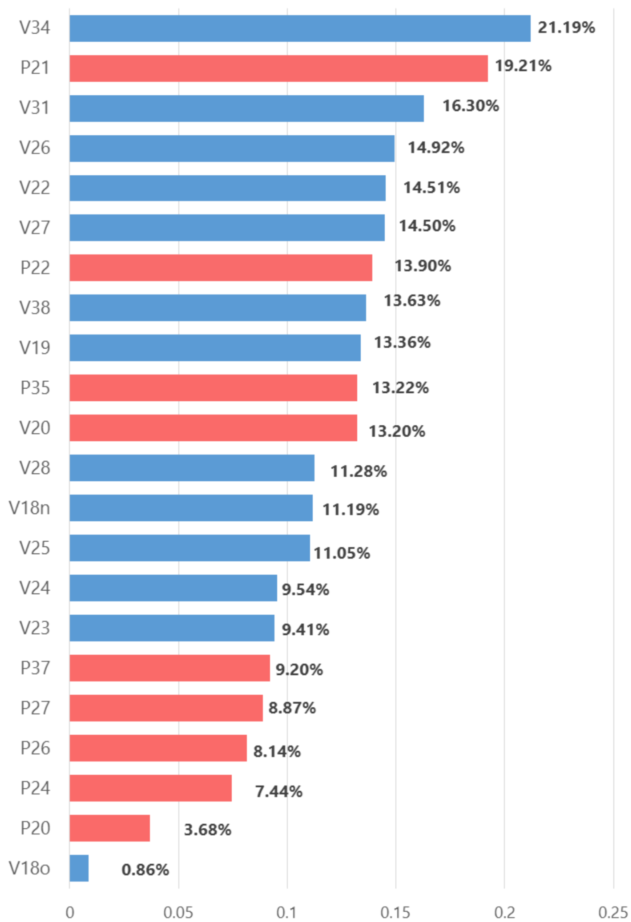
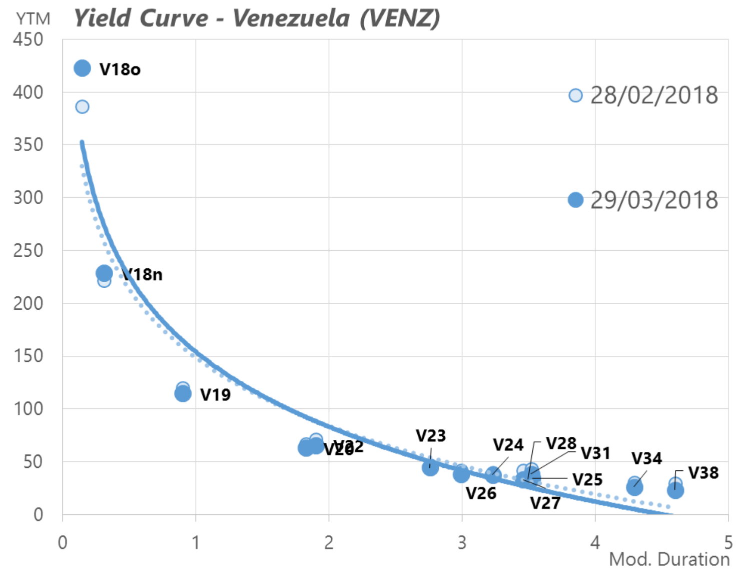


Chart N°2: VENZ/PDVSA bonds by Total Return, March 2018.
Returns were adjusted to account for the accrued interest lost, per recent EMTA resolutions.
Source: Bloomberg, Knossos Asset Management.

Evolution of the curves

Graphs N° 3 and 4 show the evolution of the yield curves of Venezuela and PDVSA bonds in March 2018. In the case of VENZ, the curve strongly inverted, with an increase of +3700 bps in the VENZ 18 "old" (to yield 423% annualized); in contrast, all maturities after 2019 showed an average reduction of -420bps in March. This movement in yields is consistent with a price equalization pattern, which suggests that debt is being increasingly quoted in terms of the Recovery Value under a hypothetical scenario of debt restructuring; however, significant price discrepancies between CAC and non-CAC bonds remain.



Graph N°3: Venezuela Yield curve changes, March 2018.
Source: Bloomberg CBBT.

The PDVSA curve compressed for the second consecutive month, led by PDVSA 21 (-943bps, to yield 75.94%); additionally, and in contrast to the Sovereign, the curve flattened significantly, since the returns in the low dollar value segment fell by -140bps on average, much less than in the short end. The PDVSA 20 kept its systematically lower yield with respect to the unsecured curve (the YTM went down -135bps to 23.4%).

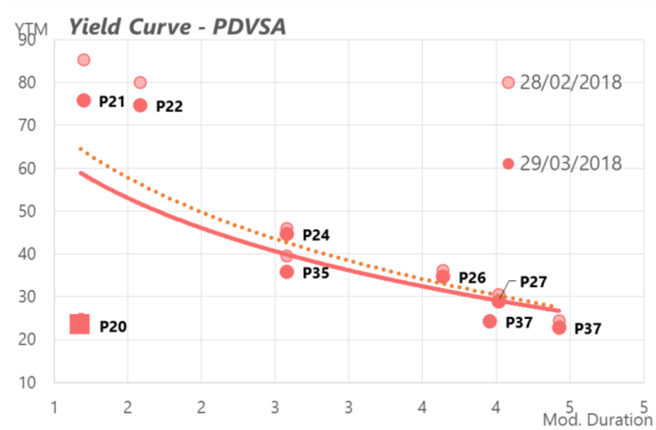


Chart N°4: PDVSA Yield Curve changes, March 2018.
***Source: Bloomberg* CBBT.**

Transition: from Impossible to Inevitable

The Clearstream disclosures helped investors understand the conditions that precipitated last year's credit event. A surprising finding was that not a single payment on either PDVSA or Sovereign debt was received, save for two outliers (ELECAR 18 and PDVSA 6% 22), which were paid one month late and, in one instance, after the fiscal agent made the notification of Default. Most worryingly, both cases allegedly involve the Venezuelan government evading the chain of payments legally established and making transfers through "irregular" channels. These findings confirm rumors that circulated in the months prior to the default where it was claimed that multiple financial institutions, including Deutsche Bank (BCV's main correspondent and payment agent for almost all VENZ bonds) had resigned their roles, refusing to process additional payments from both PDVSA and the Republic. This wave of forfeitures was influenced by the sanctions of the Trump administration and resulted in the end of the regime of "willingness to pay at all costs" that Maduro had sustained since coming to power.

The Falcon campaign has ignited investor optimism, but its electoral success is still uncertain. As we mentioned in the previous report, Falcón's presidential bid represents a small but real possibility of a change in government and its success critically depends on its ability to call upon the vast majority of the population seeking a rapid response to the economic crisis. According to a Datanalisis survey last month, more than 90% of the country negatively assesses the situation of the country (including 60% of the group calling itself "*Chavista*"), but the most recent probe by the same pollster shows that Falcón would only have 41.4% of the vote, versus 34.5% for Maduro. The main challenge facing the opposition candidate is to convince a critical mass of the rest of the country to vote against the government as a necessary condition to solve the crisis, and its main objective is to generate a sufficiently broad advantage, in such a way that grey-area tactics to provide electoral advantage for Chavismo were not enough to reverse the final result. In this sense, the support of former candidate Henrique Capriles to the campaign could be decisive for his success in terms of mobilizing the opposition population, strongly demotivated at present; however, an explicit alliance between Henri Falcón and Capriles and / or the Broad Front has not yet materialized. Finally, Falcón must refine his reaction function to unexpected changes in the date and / or the conditions of the presidential elections, taking into account that it has the advantage of being able to boycott the elections (and thus undermine the legitimacy of the Maduro government) if the Electoral Council does not establish minimum conditions to have fair elections.

The change in the expectations of change of government comes hand in hand with an upward revision of oil price forecasts. The recent upswing in oil prices has joined the optimism on the political front and justifies the sharp rally in bond prices during the first quarter of the year. In particular, the increase in oil prices (present and future) has offset the sharp fall in oil production and has substantially improved the *Recovery Values* of Venezuelan debt, all this under the assumption of a government transition and that the fall in production is transitory (so it could recover to levels close to historical averages swiftly). Another positive factor for the bondholders is that US sanctions have prevented a greater buildup in the external liabilities of the Republic; On the contrary, PDVSA's liabilities have even been reduced in recent months. To the extent that the evolution of events suggests that a debt restructuring is possible, we will investigate in detail the incentives and limitations faced by investors with respect to the different strategies for the negotiation process with a new hypothetical government.

The strong recovery in debt prices and the persistent price differentials between high and low coupon bonds suggest that investors are fine-tuning a strategy for restructuring. The bonds are currently trading at levels close to their 3-year average and with differences of more than 6 points (more than 20% difference in market value) between the low dollar value and high coupon bonds, such as the PDVSA 12.75 % 22. Beyond the change in expectations, there has been no substantial improvement in the economic front and no progress in the hypothetical restructuring process. Our reading of this disparity is that a legal strategy based on the recognition of the Venezuelan debt including interest accrued and in default (Past Due Interest, or PDI in English) may be taking shape.

In this case, it would make sense to position in high coupon bonds, knowing that the size of the liability will continue to grow until the official restructuring date; a process that could extend for several years). However, at current prices, the binary risk of the elections cannot be ignored, since a Maduro victory completely rules out the optimistic scenario of restructuring and macroeconomic adjustment in the short term. In addition, the risk scenario of maintaining the status quo for longer further worsens, since the longer the transition is delayed, the greater the likelihood that the damage to the oil industry will go from being a transitory phenomenon to a permanent crisis in the sector. In that case, Recovery Values would be substantially lower.

Credit Research and Strategy
Daniel A. Urdaneta Z.
+56 9 7990 8342
daniel.urdaneta@knossosfunds.com
Knossos Asset Management