KNOSSOS ASSET MANAGEMENT
AN AFFILIATED COMPANY OF MIURA

Venezuela/PDVSA Monthly Report
November 2017

The most incomprehensible credit event in the history of international financial markets, and the collapse of bonds down to fresh all-time lows, set the tone for Venezuelan debt in November. In total disconnection with the solid performance of WTI oil futures, bonds nosedived on Friday, November 3, after President Maduro declared on national television that he would "order a restructuring and refinancing of all of the Republic and PDVSA's external debt", while at the same time reaffirming the willingness to pay the commitments owed in the short term. Investors ran for the exits, triggering declines of up to -45% in the securities in an incessant flow of selling during the month that especially hurt VENZ short- and medium-term debt (*See Chart N ° 1*).

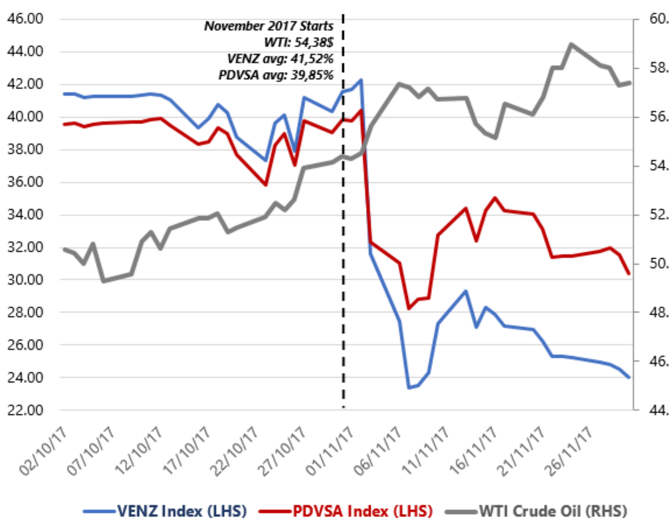


Chart N°1: VENZ and PDVSA avg. bond prices vs prices of WTI Oil (Oct-Nov 2017). ***Source: Bloomberg BGN, own calculations.***

Only the holders of PDVSA 17n notes escaped the debacle, as the state oil company paid down the principal due (USD 1.12 Bn) a week after Maduro's announcement; however, the payment landed 4 business days after the expiration date stated in the prospectus. On the other hand, the holders of the Electricity of Caracas bond (ELECAR 18) were surprised by a *notice of default* from the fiscal agent of the issue, Wilmington Trust Company, after the grace period on USD 27.6 mm coupon expired. CORPOELEC denied the announcement on Twitter and said that it was making arrangements to process the payment, but as of the end of the month it has not materialized. The pattern of grace periods expiring, in conjunction with an unsuccessful meeting with creditors (held on November 13 and led by OFAC-sanctioned leaders Tareck El Aissami and Simón Zerpa) and unfulfilled promises that 'the transfers are on their way' continued during the month, and imposed volatility on bond prices; every reassuring statement from public entities were greeted with a bounce in prices, and each day where payments due failed to land in accounts led to all bids in the complex getting hit.

Selling pressure accelerated in the final fortnight of the month, prompted by worsening newsflow at the local economic and political level. The National Assembly's inflation gauge is forecast to pierce through the 50% threshold at the end of November, marking the formal beginning of the first hyperinflation crisis in the hemisphere since the 1980s. In parallel, the price of the dollar in the the black market rose exponentially and ends up close to the 100,000 VEF/USD mark, amid increasingly clear signals of a generalized balance of payments crisis and an unprecedented collapse in the oil industry; According to the monthly OPEC report, Venezuela's crude production (based on private sources) fell to 1.8 mm bbl/d, the lowest level in 28 years.

In this context, the government's reaction has been worrisome: instead of taking quick measures to attack the macroeconomic imbalances or seek a broad political agreement, Maduro has focused his efforts on an internal purge of PDVSA and Citgo Petroleum, imprisoning more than 100 workers of the company. The arrests include the two main leaders with experience and knowledge of the industry (Eulogio Del Pino and Nelson Martínez). To replace them, Maduro named Manuel Quevedo, an active member of the National Guard recently employed as Minister of Housing and with no experience in oil- or finance-related roles. The underlying reasons behind the purge are unknown, but military sources say that the government wants to convey the idea that public corruption will not be tolerated, facing a new stage of militarist government and preparing for external isolation.

Monthly Performance

Venezuela and PDVSA bonds had their worst monthly performance in recorded history, accumulating an average fall of -32% in prices and a total return of around -30.5% including interest. This negative performance far exceeds the oil price crisis (Dec-2014: -16.5%) and the global financial crisis (Oct-2008: -26.35%).

As mentioned above, the PDVSA 17n holders received their principal at maturity (although the interest remains in default), accumulating a total return of +3.5% in the month. It is followed by the PDVSA 20 senior secured, which fell by -7.4%; the bond was well bid throughout the month, since creditors would be compensated with 50.1% of the equity shares of Citgo Holding in a hypothetical liquidation process. PDVSA low-dollar value fell about 7 points (-20% approx.), a relatively small drop as the bonds were trading at levels close to the recovery value consensus estimate. Finally, the most affected securities were short-term VENZ bonds, which represented a binary bet that the government would continue paying the debt next year, and lost almost half of its value after the announcement of the restructuring of Maduro at the beginning of November.

Security	31/10/2017	30/11/2017	Total Return	Total Return (2017 YTD)
VENZ 13 5/8 08/15/18	71.40	36.75	-45.10%	-37.26%
VENZ 7 12/01/18	64.00	35.25	-42.09%	-34.53%
VENZ 7 3/4 10/13/19	48.65	25.40	-46.09%	-39.68%
VENZ 6 12/09/20	39.65	20.75	-43.80%	-44.64%
VENZ 12 3/4 08/23/22	45.55	24.15	-42.41%	-38.14%
VENZ 9 05/07/23	35.80	22.60	-31.04%	-33.83%
VENZ 8 1/4 10/13/24	35.40	22.15	-35.10%	-33.93%
VENZ 7.65 04/21/25	34.70	22.40	-33.30%	-33.17%
VENZ 11 3/4 10/21/26	42.25	24.70	-38.87%	-34.55%
VENZ 9 1/4 09/15/27	37.85	24.25	-32.89%	-34.02%
VENZ 9 1/4 05/07/28	35.00	22.90	-28.73%	-31.91%
VENZ 11.95 08/05/31	41.60	22.10	-41.55%	-36.90%
VENZ 9 3/8 01/13/34	35.75	22.15	-33.29%	-31.61%
VENZ 7 03/31/38	33.90	21.00	-35.63%	-34.94%
PDVSA 8 1/2 11/02/17	96.50	100.00	+3.49%	+32.90%
PDVSA 8 1/2 10/27/20	85.45	78.40	-7.42%	+16.87%
PDVSA 9 11/17/21	46.70	28.90	-33.49%	-28.60%
PDVSA 12 3/4 02/17/22	47.30	29.05	-34.41%	-30.37%
PDVSA 6 05/16/24	29.35	22.60	-19.48%	-27.19%
PDVSA 6 11/15/26	28.90	22.40	-18.97%	-26.33%
PDVSA 5 3/8 04/12/27	30.05	23.65	-19.60%	-23.59%
PDVSA 9 3/4 05/17/35	37.10	27.30	-21.58%	-23.99%
PDVSA 5 1/2 04/12/37	30.10	23.60	-19.89%	-22.45%

Table N° 1: Performance of Venezuela and PDVSA bonds, November 2017

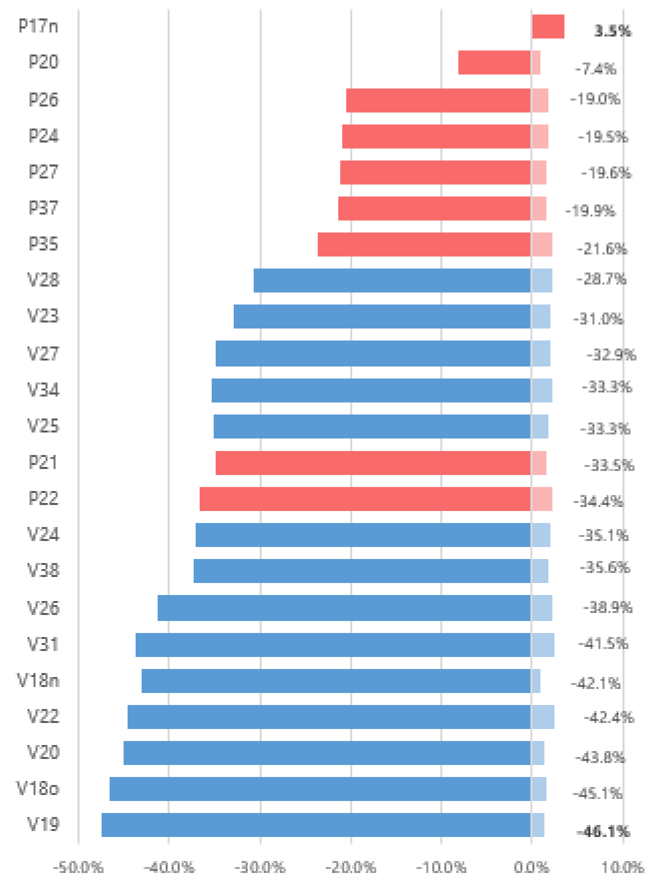
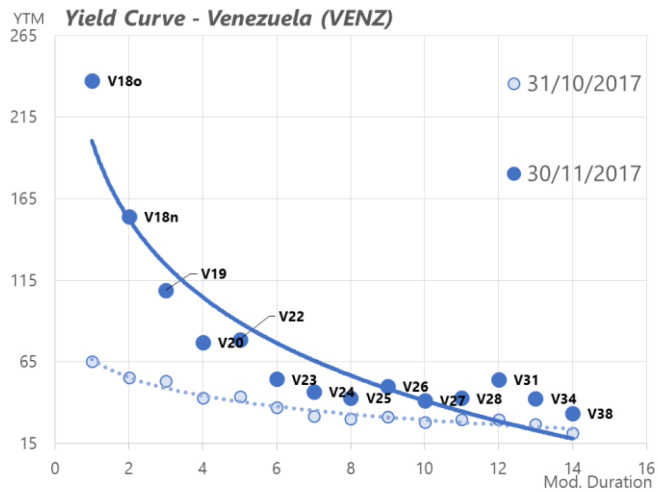


Chart N°2: VENZ/PDVSA bonds by Total Return, November 2017.
NOTE: total return separated by changes in market value (dark) and accrued interest (light section); return figures do not assume coupon reinvestment
Source: Bloomberg, Knossos Asset Management.

Evolution of the curves

Charts N° 3 and 4 show the evolution of the yield curves of Venezuela and PDVSA bonds in November 2017. Due to the credit event declaration by ISDA, the CDS on both reference entities stopped trading in the OTC market, so the CDS curves were removed from the chart. It should be noted that the credit derivatives market had assigned systematically higher yields than cash bonds since the beginning of the year; in other words, the 'smart money' was betting on the occurrence of a credit event in 2017.

After the announcement of restructuring and bonds nosediving to recovery-value prices, the VENZ curve inverted aggressively (VENZ 18o's yields rose +17,200 bps to a record high of 237%). The deeply inverted shape is typical of issuers subject to financial stress, since it shows that investors stopped considering the YTM as a relevant driver of bond values. Everything points out that the market is pricing in a restructuring with low recovery values for Sovereign debt.



Graph N°3: Venezuela Yield curve changes, November 2017.
Source: Bloomberg CBBT.

The PDVSA curve, in contrast, remains relatively flat. The contrast between the low yields of PDVSA 2020 (+ 603bps to 23.75%) and the rest of the unsecured debt (for example, the PDVSA 2022 had an increase of + 2,920bps to yield 45.95%) suggests that the capital structure is the main driver behind the risk premiums on the debt of the state oil company. Additionally, the relatively lower yields suggest that the market is forecasting a slightly longer survival period for PDVSA, or higher recovery values before a hypothetical restructuring.

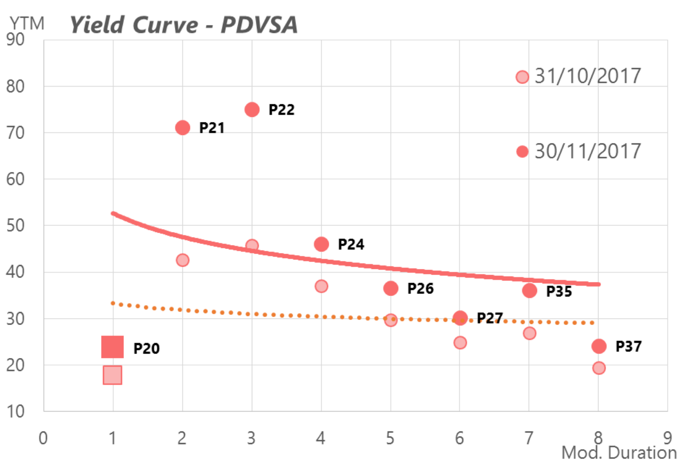


Chart N°4: PDVSA Yield Curve changes, November 2017.
***Source: Bloomberg* CBBT.**

The most incomprehensible default in history

After 3 years of trading under the expectation of an imminent default, the market seemed as it had adequately priced the risks, but the Event caught (almost all) investors off guard. The strategy of betting on the willingness to pay at all costs ordered to get exposure on the shortest-term securities to capitalize on what many analysts considered a systematic mispricing: they had to ignore the 'jump to default risk' and buy the next bond in line to outperform their peers. This strategy required ignoring the increasingly precarious economic situation of the nation, and assuming that the government would not change course in its external debt policy in an unexpected way. The massive outperformance of the 'short-end trade' in 2016 encouraged many investors to bet on a repeat this year. The result: an extreme contrast between having been in the 'first row' (PDVSA 17n) or just behind (VENZ 18o). The former received their full capital in November, the latter saw it cut in half.

If an issuer is unable to pay its debts on time but remains fully willing to honor them, has it fallen in default or not? This question was first answered by the Emerging Market Traders' Association (EMTA), which ruled on November 15 to clarify how to operate Venezuelan securities after the default. EMTA decided to trade the bonds with accrued interest, since the Maduro government has not formally declare the cessation of payments. In contrast, on the following day (November 16), the ISDA's Determinations Committee, the highest authority in the financial derivatives markets, ruled the occurrence of a credit event both in the Republic and in PDVSA, due to the expiration of the grace periods on the interest payments of several bonds. The ruling implies the activation of the CDS or 'default insurance' payments, for an approximate amount of USD 2.19Bn between contracts referencing VENZ, PDVSA and the CDX.EM index (which to date included 3% of Venezuela in its composition). There's a total of about USD 1.5Bn of coupons that remain either in grace period, default or in transit at the time of publication. It should be noted that the US sanctions regime has led to stricter AML procedures in all transactions related to Venezuelan debt, which has led to coupons of the PDVSA 2020, 2022 and 2027 bonds to be held by the payment agents, alleging irregularities in the payment chain currently under investigation.

What does the order of Maduro to 'restructure and refinance the external debt' mean for bondholders? Almost a month after the restructuring announcement has passed, and the lack of clarity persists among investors; it almost seems as if the ambiguity of the statement by Maduro was intentional. If the government sought a voluntary swap of short-term bonds, the appointment of officials sanctioned by the US government voids any possibility of issuance under New York law. If the idea is a restructuring of all debt with a haircut, the idea is even more inconsistent with the facts: the Maduro government has no macro stabilization plan, nor any intention to end the internal political crisis. Worse still, all signs point to his government preparing for a future of isolation from the rest of the world, possibly tied to a repudiation under the pretext that the sanctions regime of the Trump government prevented him from remaining solvent with debt service.

Can we expect a preferential treatment on PDVSA over VENZ, as the market currently anticipates? One hypothesis spread during the month among investors is that the government would be preparing a selective default, maintaining PDVSA's debt payments (so as not to risk the suspension of the oil trade, which represents the only significant source of foreign currency earnings for the country) but declaring default on the debt of the Republic, which is in theory easier to restructure due to the presence of Collective Action Clauses and the principle of Sovereign Immunity. Although the argument is convincing at first glance, it does not take into account the complex - and sometimes conflicting - network of interrelations between the different entities of the Venezuelan State. It may be true that the alter ego argument between PDVSA and the Republic is difficult to prove in a court in the short or medium term. However, the idea that the oil industry survives intact while the rest of the state faces an unprecedented legal crisis seems overly optimistic. Additionally, the risk that PDVSA is stripped from the State-issued monopoly on crude oil exploration and production (and therefore becomes an 'empty shell' without intrinsic value and charged with a multi-million dollar debt) is ever-present.

Is Venezuela 'too big to fail'? What are the implications of default and triggering of CDS for the nation? It was curious that, although several bonds of the Republic and PDVSA officially fell into default during the month as per the terms of the indenture, the payment agent did not formalize the declaration; but in the case of the ELECAR titles, the notice of default was published right on time. This selective treatment is linked to the fact that a credit event in a small, USD 650 mm issue without explicit cross-default clauses with the Sovereign has minimal repercussions beyond the affected bondholders. On the other hand, the declaration of default of two of the biggest issuers in the Emerging Markets sector (with a total outstanding amount of more than USD 55 Bn), combined with the presence of more than USD 2 Bn in credit derivatives publicly registered (and a potentially larger amount of privately negotiated 'Credit Linked Notes') implies systemic risks not negligible for the Venezuelan and global financial sector.

For now, it seems that the incentives of the bondholders are aligned to open the Pandora's Box of triggering acceleration clauses. Investors are expected to be inactive - perhaps with the exception of the PDVSA 20 - until there is more clarity on whether the payments in transit can be cashed in; this implies a drop in trading volumes and little price volatility. The American holders are trapped, their only small exit door is the market. They can only hope in the short term for a political agreement between the government and the opposition that allows for the appearance of legality to a debt restructuring; a low probability scenario. It seems that the only solution for the government and the holders is a fix within the framework of the current sanctions regime, which entails a lot of financial creativity and probably requires the participation of strategic non-American partners.

Disclosure concerning 'Debt Research Reports'

This debt research report and the debt research analyst responsible for the content is not independent of the firm's propietary trading activity and is not subject to all of the independence and disclosure standards applicable to debt research provided to retail investors. While the author believes its sources are reliable neither the author nor Knossos Asset Management represent the information to be complete or accurate. Any views expressed in this message are those of the individual sender at the time of publication and do not represent the views and strategy of Knossos Asset Management, except where the message states otherwise and the sender is authorized to state the views of such entity. This is not an offer to buy or sell, or solicitation of an offer to buy or sell the securities mentioned. The Firm may have positions in the securities mentioned and may make purchases or sales of such securities from time to time in the open market or otherwise and may sell to or buy from its authorized counterparties such securities on a principal basis; such transactions may be contrary to recommendations in this material. This material is intended for Institutional Use only and should not be distributed, forwarded or otherwise disseminated. Under no circumstances is this material intended for use by any retail investor. Additional information is available upon request.