Venezuela/PDVSA Monthly Report
October 2016

Venezuela and PDVSA bonds end the month of October with price declines of 10% on average. Except for the PDVSA 2017 maturities, all bonds lost the advances of the late September rally. The negative behavior began after the first deadline extension for the debt reprofiling (October 6th), when PDVSA mentioned that the tendered amount represented "substantially less" than its stated minimum goal of 50% (See Chart N°1).

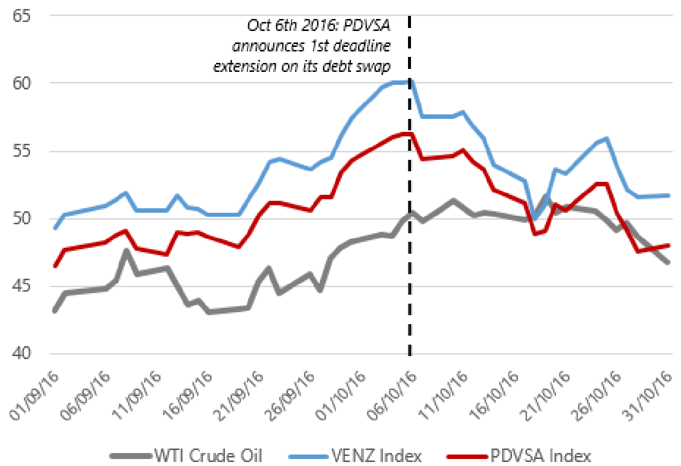


Chart N°1: VENZ and PDVSA avg. bond prices vs prices of WTI Oil (sep-oct 2016). ***Source: Bloomberg BGN, own calculations.***

Two additional deadline extensions took place alongside threats coming from the state oil company that it would consider "all options at hand" with respect to their debt commitments if investors didn't participate in the exchange. On the other hand, holders that tendered their positions found themselves "kidnapped" during the whole process, unable to trade or withdraw the bonds for over three weeks. The weakness, nonetheless, was remarkably lower in the PDVSA 2017s and higher in the rest of the bonds, especially in the short and medium tenors of the Venezuela Sovereign curve.

Finally, PDVSA announced on Monday 24th that it would undertake the debt exchange operation for USD 2,799mm, or 39,43% of the aggregate outstanding amount of the 2017 maturities, delivering in return the PDVSA 2020 senior secured bond in an issue size of USD 3,367mm. The exchange settled on Friday October 28th, together with the payment of over USD 1Bn plus interest on the 2016 maturity. In line with their previous communications to the market, Standard & Poor's downgraded PDVSA's issuer rating to 'Selective Default' and assigned the 'D' rating to the PDVSA 2017s and 2020s shortly after the official announcement of the debt exchange.

Together with the noise generated by credit rating agencies and political instability in the country caused by the indefinite suspension of the Recall Referendum, another negative driver took form in a USD 900mm fall in International Reserves (to a new 14-year low of USD 10.9Bn) at the last days of the month; it's not evident whether it was attributable to the PDVSA maturity payment coming straight out of reserves, or it would be related to the payment – for a similar amount – owed by the Republic to the Canadian mining company Gold Reserve, scheduled for Monday, October 31.

Performance in the month

Security	30/09/2016	31/10/2016	Total Return
VENZ 13 5/8 08/15/18	81.35	**74.00**	**-7.38%**
VENZ 7 12/01/18	71.05	**60.35**	**-13.76%**
VENZ 7 3/4 10/13/19	62.20	**51.40**	**-15.39%**
VENZ 6 12/09/20	54.20	**45.00**	**-15.49%**
VENZ 12 3/4 08/23/22	65.25	**58.35**	**-8.76%**
VENZ 9 05/07/23	51.20	**46.80**	**-6.60%**
VENZ 8 1/4 10/13/24	49.55	**44.80**	**-7.55%**
VENZ 7.65 04/21/25	48.25	**43.90**	**-7.19%**
VENZ 11 3/4 10/21/26	59.70	**55.75**	**-4.57%**
VENZ 9 1/4 09/15/27	55.15	**50.75**	**-6.46%**
VENZ 9 1/4 05/07/28	51.85	**47.10**	**-7.14%**
VENZ 11.95 08/05/31	60.30	**55.65**	**-5.74%**
VENZ 9 3/8 01/13/34	52.25	**47.20**	**-7.84%**
VENZ 7 03/31/38	46.65	**42.95**	**-6.64%**
PDVSA 5 1/8 10/28/16	97.24	**100.00**	**+3.20%**
PDVSA 5 1/4 04/12/17	85.60	**80.65**	**-5.12%**
PDVSA 8 1/2 11/02/17	86.40	**73.00**	**+0.93%**
PDVSA 8 1/2 10/27/20	77.00	**72.55**	**-5.72%**
PDVSA 9 11/17/21	56.50	**49.70**	**-10.00%**
PDVSA 12 3/4 02/17/22	66.30	**59.00**	**-9.13%**
PDVSA 6 05/16/24	42.65	**37.80**	**-9.67%**
PDVSA 6 11/15/26	41.95	**37.30**	**-9.35%**
PDVSA 5 3/8 04/12/27	41.70	**36.75**	**-10.17%**
PDVSA 9 3/4 05/17/35	51.80	**44.60**	**-11.47%**
PDVSA 5 1/2 04/12/37	41.35	**36.45**	**-10.09%**

Table N° 1: Performance of Venezuela and PDVSA bonds, October 2016

Venezuela and PDVSA bonds finished October with an average -9.05% fall in prices and an average -7.85% total return (including interest). The best performance was seen in the bonds that matured during the month: PDVSA 2016 (+3.20%) and PDVSA 8.50% 2017 (+0.93%, based on the payment of the Nov 2nd amortization and the price of the remaining bond trading 'ex-amortization''). The weakest performers are in the short end of the Sovereign curve: VENZ 2020 (-15.5%) and VENZ 2019 (-15.4%). On average, VENZ bonds (-8.60%) underperformed PDVSA (-6.95%).

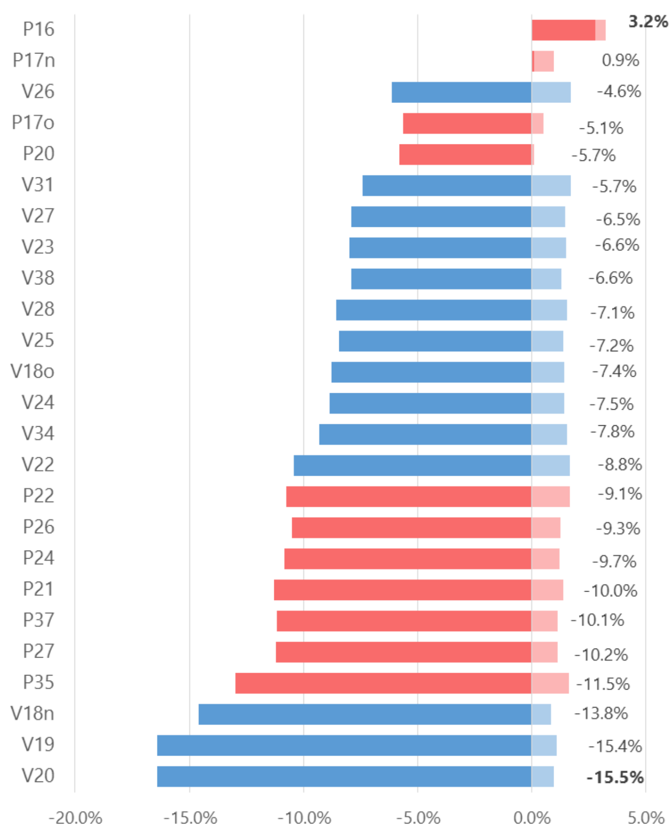
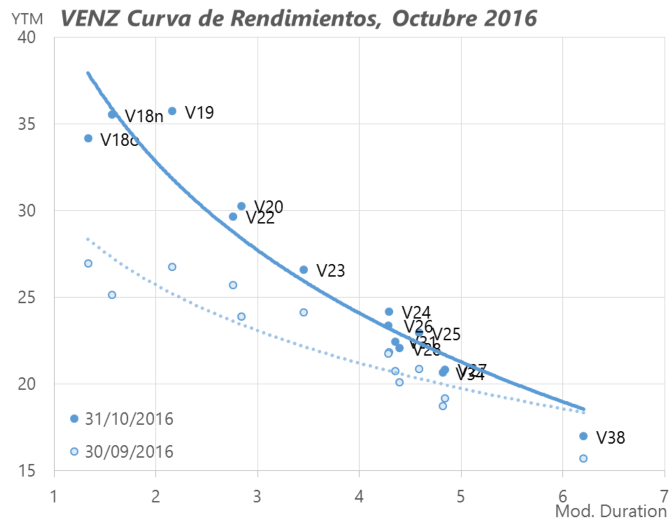


Chart N°3: VENZ/PDVSA bonds by Total Return, October 2016. NOTE: total return separated by changes in market value (dark) and accrued interest (light section).
Source: Bloomberg, Knossos Asset Management.

Evolution of the curves

Graphs N° 4 and 5 below show the evolution of Venezuela sovereign and PDVSA yield curves during the month. In the case of Venezuela, the curve inverted once again, erasing the recovery seen in September (yields went up by +385bps on average; up to +1036bps in the case of VENZ 7% 2018).

The PDVSA curve had two major changes in the month: the exit of the matured PDVSA 2016, and the inclusion of the new PDVSA 2020; because of their senior secured rank, the new notes are trading at a substantially lower yield than the rest of the issuer's curve. Yields on PDVSA debt increased +507bps on average, and up to +2210bps in the PDVSA 5.25% 2017, the new 'first-in-line' bond in the curve.



Graph N°4: Venezuela Yield curve changes, October 2016. *Source: Bloomberg CBBT.*

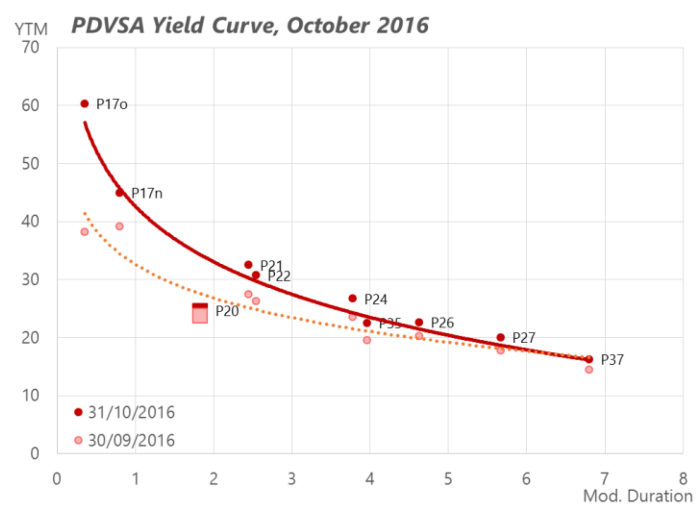


Chart N°5: PDVSA Yield Curve changes, October 2016. *Source: Bloomberg* CBBT.

What lies ahead?

The PDVSA liability management operation was finished at the last minute, with a high degree of uncertainty and under an increasingly hostile backdrop. Despite the fact that the final outcome was positive for investors who agreed to participate (to the extent that the issue size was relatively small, which implies a higher collateralization rate in the PDVSA 2020s, and hence a higher-than-expected present value), the operation yielded a lower-than-expected benefit for the state oil company in terms of short-term liquidity savings. Roughly speaking, PDVSA would pay USD 1Bn less in November 2016 and April 2017, in exchange for additional payments of USD 900mm each year in 2018-2020. Therefore, it's possible that PDVSA would need to pursue further voluntary swaps of short-end maturities. However, we think that a market-based operation of this nature will have a very low probability of success (at least under the current administration), as we consider most investors won't be willing to assume the operational and legal risks that would arise if the company maintains the negotiation strategy applied by Eulogio Del Pino on this debt exchange.

The domestic context was marked by the efforts of both sides to impose their agendas amid a worsening political crisis. On Thursday October 20th, the National Electoral Council, based on the ruling of five PSUV-controlled regional courts, suspended indefinitely the 20% signature collection drive, and hence the Recall Referendum altogether. The market reacted negatively to these developments, as well as to the opposition-led protests summoned in response. In a shocking contrast, reports surfaced that the leaders of the main opposition parties initiated – in parallel - a dialogue process with the Maduro administration, mediated by representatives from the Vatican, UNASUR, and Hispano-American ex-presidents. In the first meeting, the parties agreed to follow a common agenda that contemplates the creation of working groups to tackle issues linked to the opposition's long-standing demands: peace and respect to the rule of laws; human rights, truth, justice and reconciliation; socioeconomic situation; and the electoral roadmap for 2017.

Behind this process underlies the willingness of the MUD of resolving the political standoff in a peaceful manner, which is in our view an essentially positive factor for the political-economic situation. The dialogue process implies that the Recall Referendum will not take place; in return, there could be general elections for 2017 which would open the door to a negotiated government transition, focused on strengthening the state institutions and reestablishing the rule of law. There are serious doubts over the credibility of the commitment of both parties, and the capacity of the mediators to translate the negotiations into concrete measures in the political and electoral fronts. Only time will tell if this initiative is successful, and signs of hostility coming from government officials in recent days don't paint a particularly optimistic outlook.

Until the political situation unravels, we think that the market will trade alongside the trends oil prices and investor fund flows. We estimate that the payment of the 2016 and 2017n maturities represents up to USD 1.5Bn of cash that's susceptible of being reinvested in the curve, at relatively attractive levels after the October correction. Nevertheless, we also consider the risk of a further fall in oil prices, given that the physical market remains oversupplied and there are lingering doubts over the capacity of OPEC to coordinate a significant, credible and sustainable plan to curb output.

In this context, we consider that the PDVSA 2020 bond is undervalued at current levels and offers the best risk/reward relationship in the curve. Under different valuation methods and a conservative value assigned to the collateral (1 to 1.75Bn USD), and taking into consideration the prices of PDVSA unsecured and CITGO senior debt -as well as market-implied default probabilities derived from CDS contracts-, we estimate that the PDVSA 2020 should be trading in a 77-85 price range, at least four points higher than its October closing level (72.5). More importantly, nonetheless, is the defensive nature of the bond (due to its collateralization), which would be a key factor to minimize downside risk in a bear market, which can't be ruled out in a scenario of a continued domestic political crisis, a fall in oil prices, and lack of market access to finance the external deficit.