KNOSSOS ASSET MANAGEMENT

AN AFFILIATED COMPANY OF MIURA

Venezuela/PDVSA Monthly Report
October 2017

The VENZ / PDVSA bond market is going through a crisis without precedent in the international capital markets, and October 2017 will be remembered as one of the episodes of greatest volatility in the history of Venezuelan debt. With a daily standard deviation of 3.3% in VENZ bonds and 2.8% in PDVSA (annualized volatilities of 52.7% and 43.7%, respectively), the erratic behavior of the securities reflected the unprecedented uncertainty experienced by the investors while the Republic and the state oil company faced its toughest challenge to date in terms of debt payments. Unprecedented financial stress is evident when we compare the increasing disconnect of bond prices with respect to WTI oil futures (*See Chart 1*).

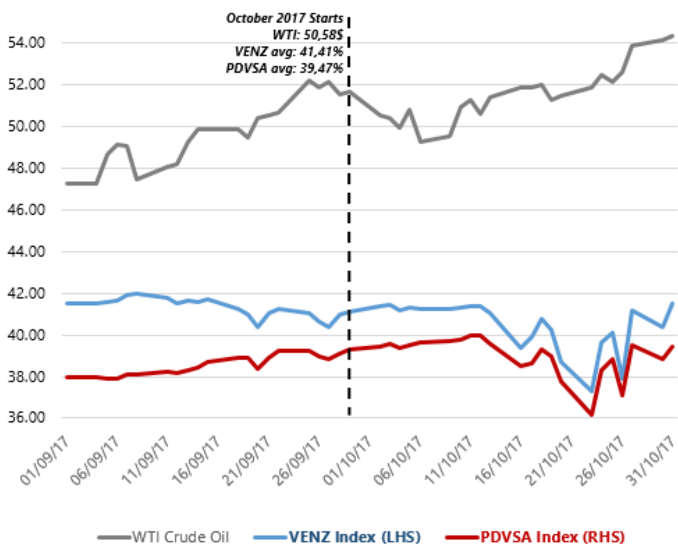


Chart N°1: VENZ and PDVSA avg. bond prices vs prices of WTI Oil (Sep-Oct 2017). ***Source: Bloomberg BGN, own calculations.***

October's debt service amounted to around USD 1640mm between the amortization of the PDVSA 20 senior and the coupons of ELECAR 18, VENZ 19/24/25/26 and PDVSA 22/27/37. To date, only the P20 principal payment and the interest due on P37 have been paid. PDVSA and the Republic went into a grace period on the remaining payments, totaling USD 750 MM.

The price action during the month was almost exclusively linked to the investors' perceptions of capacity and viability of debt payments by Venezuela. An information gap by the authorities since October 10 (the payment date of ELECAR 18, the first payment due in the month) send the market into a cycle of rumors and misinformation. According to the news agencies covering the story, the Maduro government faced a situation of extreme illiquidity entering into October, but to a greater extent maintaining the willingness to pay their external commitments. Therefore, they focused their efforts on negotiating loans of last resort with the governments of Russia and China, presumably offering operational control of the Amuay and Cardón refineries as collateral, in order to source the capacity to honor upcoming payments.

As a result of the sanctions imposed by the US government on Venezuela, the operational viability of the payment was an additional factor of uncertainty. It was known since last month that Delaware Trust Company had relinquished its role as a payment agent for several bonds of the state oil company, including the PDVSA 17 "new" that matures on November 2. What wasn't made public until the end of October is that Delaware Trust also served as payment agent for the PDVSA 20 (after acquiring Law Debenture Trust Co., the previous agent) and that it refused to process the principal payment for unknown reasons. The lack of a payment agent led investors to ponder the possibility of a scenario that almost nobody expected: PDVSA might have the ability and willingness to cancel its debt, but could be unable to process payments and would be exposed to the risk of technical default

Given the climate of extreme opacity, the first ray of clarity finally reached the market on the morning of Friday 27th, when PDVSA made its first official statement in the month and reported that "the bank transfers pursuant to the principal payment of the PDVSA 2020 bond have begun, for a total amount of USD 841.88 million sent to JPMorgan". The statement reassured investors and ignited a rally along the curve that led bond prices to close in October at their highs.

The payment finally materialized on the afternoon of October 31, according to a DTC statement informing that it had received the funds from the payment agent and that it proceeded to send them to Euroclear for distribution to the final investors.

Monthly Performance

Venezuela and PDVSA bonds closed the month with an average price increase of + 1.15% and a total return of + 2.90% including interest. The bonds oscillated in an average range of 11 percentage points over the course of the month and all sections of the curve closed in positive territory, except for the "low dollar value" (PDVSA 24/26) and the Venezuelan bonds without Collective Action Clauses (VENZ 18/27). The best performance was observed in securities that traded at significant discounts in terms of relative value (due to the perception of a high default risk in the short term, which implied a compression in the prices of the entire curve towards recovery value levels). Once the payment of the PDVSA 20 was confirmed and fears of an imminent default went down, the market aggressively demanded these securities, concentrating the interest in VENZ 19/26 and PDVSA 21/35.

Security	29/09/2017	31/10/2017	Total Return	Total Return (2017 YTD)
VENZ 13 5/8 08/15/18	74.65	71.40	-2.63%	+0.41%
VENZ 7 12/01/18	65.70	64.00	-1.57%	+8.69%
VENZ 7 3/4 10/13/19	45.10	48.65	+8.59%	-0.37%
VENZ 6 12/09/20	38.90	39.65	+3.20%	-6.82%
VENZ 12 3/4 08/23/22	46.65	45.55	+0.09%	-7.92%
VENZ 9 05/07/23	35.45	35.80	+2.96%	-8.78%
VENZ 8 1/4 10/13/24	34.25	35.40	+4.91%	-8.06%
VENZ 7.65 04/21/25	34.00	34.70	+3.68%	-8.47%
VENZ 11 3/4 10/21/26	38.85	42.25	+10.01%	-6.71%
VENZ 9 1/4 09/15/27	39.90	37.85	-2.93%	-10.63%
VENZ 9 1/4 05/07/28	34.85	35.00	+2.50%	-8.88%
VENZ 11.95 08/05/31	40.50	41.60	+5.10%	-7.07%
VENZ 9 3/8 01/13/34	35.85	35.75	+1.94%	-7.14%
VENZ 7 03/31/38	33.50	33.90	+2.97%	-7.99%
PDVSA 8 1/2 11/02/17	94.45	95.65	+2.00%	+28.50%
PDVSA 8 1/2 10/27/20	82.95	85.45	+3.78%	+25.21%
PDVSA 9 11/17/21	41.35	46.70	+13.68%	+2.56%
PDVSA 12 3/4 02/17/22	46.65	47.30	+3.68%	-4.84%
PDVSA 6 05/16/24	30.75	29.35	-2.52%	-11.64%
PDVSA 6 11/15/26	30.50	28.90	-3.25%	-11.11%
PDVSA 5 3/8 04/12/27	30.55	30.05	+0.06%	-8.50%
PDVSA 9 3/4 05/17/35	34.25	37.10	+9.88%	-6.25%
PDVSA 5 1/2 04/12/37	30.40	30.10	+0.68%	-6.93%

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

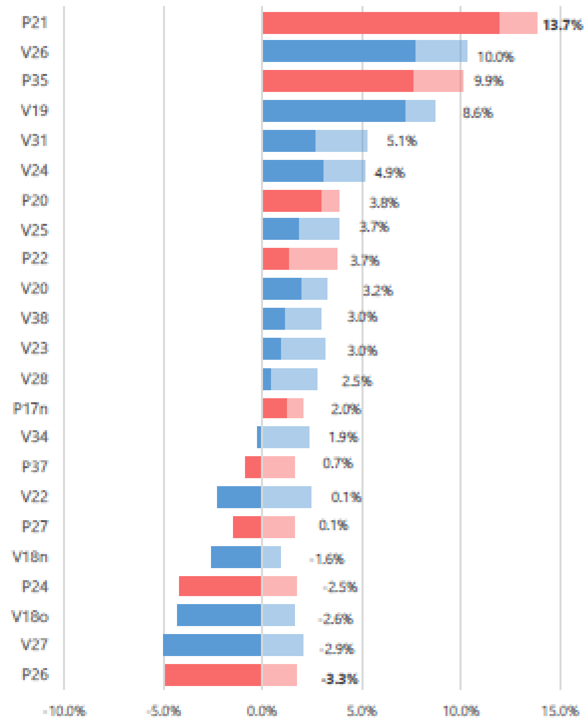
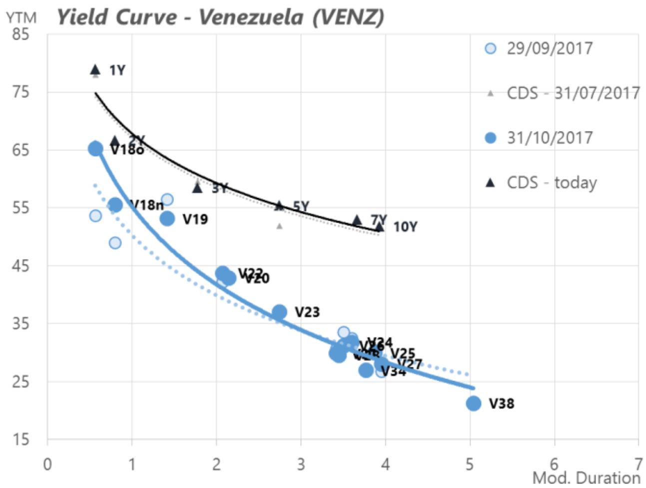


Chart N°2: VENZ/PDVSA bonds by Total Return, October 2017.
NOTE: total return separated by changes in market value (dark) and accrued interest (light section); return figures do not assume coupon reinvestment
Source: Bloomberg, Knossos Asset Management.

Evolution of the curves

Charts N°3 and N°4 below plot the evolution of the yield curves of Venezuela and PDVSA in October 2017, both for cash bonds and CDS. The Venezuelan curve shifted upwards in the short end (increases of +900bps on average in the bonds maturing on 2018). Together with a slight decrease in medium and long-term yields, the average movement was + 94bps across the curve.

The PDVSA curve flattened significantly after the PDVSA 17N went out of circulation (matures on November 2nd). Yields had an average compression of -110bps along the curve, with PDVSA 20 (-540bps) and PDVSA 21 (-520bps) outperforming. The CDS are quoted with a record yield differential versus the bonds, which suggests that the protection against defaults continues to be strongly bid.



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

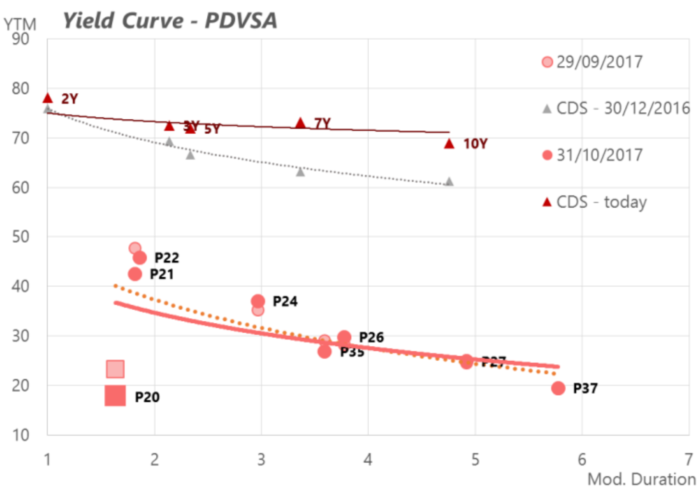


Chart N°4: PDVSA Yield Curve changes, October 2017.
***Source: Bloomberg* CBBT.**

'¿To Default, or not to Default?' Part II

The PDVSA 20 principal payment temporarily eased the fear of an imminent default among investors and brought two positive signals for credit. First, there was no fall in International Reserves for an equivalent amount, confirming the hypothesis that PDVSA was successful in obtaining the resources to cover the payment on its own account, without tapping the liquidity position of the Republic, either by reserving part of its sales revenue of crude oil or through bridge financing with its strategic allies. On the other hand, and despite the difficulties raised at the last minute to coordinate an *ad hoc* payment agent, PDVSA demonstrated that the financial sanctions imposed by the US did not impede it from continuing to service its debt maturities, casting doubt on the hypothesis of a technical default brought by operational unfeasibility.

However, in a shocking twist that caught the market off-guard and despite the fact that PDVSA 20 was paid, President Maduro ordered to restructure all external debts after paying the PDVSA 17N. The selective treatment between capital and interest payments (and across issuers) seemed to be due to an attempt by the authorities to avoid the credit event at all costs in the context of a severe liquidity constraint, forcing them to use grace periods to the extreme. As a proof, the PDVSA 20 payment wasn't recognized by DTC until the afternoon of October 31, the last day of the grace period recognized in the Credit Default Swap (CDS) contracts on PDVSA. This unexpected change of speech by Maduro underscores the obvious fact that nation's hard currency cash flow has been taken to the extreme and that the authorities are in a day-to-day struggle to balance the external accounts; a struggle that, it seems, they finally recognize to have lost. The slightest miscalculation in their future plans could result in an accidental credit event, even with the full willingness to continue with debt payments. And it seems that this miscalculation has just arisen, since at the close of November 7, 2017, the payment was not made effective, opening the possibility of CDS on PDVSA getting triggered.

During the last years the focus of the investors had remained in the eternal dilemma: can they continue to avoid default? In contrast, very little interest had been put into trying to predict what could happen if PDVSA or the Republic were to default. From a normative standpoint, several experts in international financial law have published a series of articles outlining a 'realistic' legal framework in which a restructuring of the nation's external debt could take place. All start from the assumption that the country's economic situation and debt dynamics are unsustainable and therefore, a feasible restructuring must take place under the assumption that PDVSA and the Republic do not have the capacity to cover all their commitments at face value. Maduro's recent statements suggest that this assumption has been understood by the current government and that they will act accordingly now.

Broadly speaking, the experts conclude that the ideal strategy should discourage the presence of holdout creditors through a consolidated restructuring of the debt of both issuers (both VENZ and PDVSA), together with activating a provision (established in the bond indentures) that allows the transfer of ownership of all PDVSA assets to the Republic, in exchange for the Republic taking over all the securitized debt (bonds and promissory notes) of PDVSA. If all assets subject to foreclosure were directly owned by a sovereign entity, holdouts would find it much more difficult to determine that they have priority over such assets, and the risk of a forced liquidation of Citgo and other strategic assets of the nation would decrease substantially. From the positive point of view, however, the current political and legal environment suggests that a restructuring scenario is very unlikely.

One possible scenario is an "orderly" default, in which the Venezuelan government is positioned to minimize the negative impacts of a credit event on its operational management. In this sense, it would seek to migrate all its financial transactions to currencies other than the dollar; it would coordinate a transfer of its oil exports to allied countries, which could then act as intermediaries to sell this production to typical buyers of Venezuelan crude in the refineries of the US Gulf Coast; Finally, it would seek to build consensus on diplomatic matters, as well as first-line legal advice, seeking a solution that would allow a minimum of economic and political viability to the current government without the credit event translating into a regime change. The possibility of carrying out a formal restructuring of the external debt is subject to the will of the US Treasury Department, since the current sanctions prohibit new debt issues by PDVSA or the Republic under US jurisdiction.

Alternatively, a default "*a la* Ecuador" is another possible scenario. Based on the experience of President Correa (who announced in 2009 the repudiation of a bond of USD 3.2Bn -claiming it was illegal-, and then bought back the entire issue it in the secondary market at just over 30% of par value), supporters of this view argue that holders of debt located in the US are currently trapped: they can't legally negotiate with the Venezuelan government because of the sanctions, and even if they were able to do so they have zero incentives, since a legal process having OFAC-sanctioned officials as counterparties would be most likely deemed as an 'odious debt' in the future. The logical conclusion? Maduro announces a cessation on payments and offers an implausible plan of restructuring; the holders in the US panic-sell their positions (presumably to entities linked to the governments of Russia and China) and Miraflores negotiates a restructuring plan privately with politically aligned creditors. The feasibility of the hypothesis lies in the nature of the creditor: it has to be someone who is not only willing to negotiate with officials under sanctions in the US, but who has the interest that Maduro keeps governing, and has the ability to influence the world geopolitics to sustain its regime. Due to the large number of assumptions that must be met for the plan to be successful and given that the credit event has occurred accidentally, this scenario seems unlikely at present.

A "disorderly" default is the other feasible scenario, with unpredictable consequences for the country's political and economic situation. The main difference would be the lack of legal and operational preparations for the new reality of being totally expelled from the world financial markets. Once the holders of the debt get organized and trigger acceleration clauses in their bonds, the government would be exposed to countless litigation procedures and the forced seizure of its external assets by the litigating creditors. By definition, a disorderly default implies that there will be no room for friendly negotiation with bondholders, so a forced liquidation of Citgo Holding seems a certainty in this scenario. Additionally, it would not be possible to completely migrate financial operations outside the dollar-based system, which exposes the Venezuelan financial system to a near-total operational blockade. This situation would inevitably result in an economic and political crisis that would jeopardize the viability of the Maduro government, and therefore could represent the end of the status quo.

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