KNOSSOS ASSET MANAGEMENT
AN AFFILIATED COMPANY OF MIURA

Venezuela/PDVSA Monthly Report September 2017

The Venezuelan credit market had a mostly positive performance during the month of September, characterized by low bond price volatility and a significant recovery in the global energy markets.

Of note, the disparity of returns between short-end and long-end bonds observed in previous months persists. While several VENZ and PDVSA bonds changed hands around multi-year lows in September, the state oil company's notes amortizing this year are trading up to all-time-highs.

On aggregate, we observe that the average bond return lagged the performance in crude oil futures. In the other hand, PDVSA bonds outperformed the Sovereign, and the gap between the two names went up throughout the month (*See Chart Nº1 attached*). This behavior was mostly explained by a delay in the coupon payment of the VENZ 2027, plus a series of credit-negative headlines that hit the tape at the middle of the month and which affected medium- and long-term bonds (main component of the VENZ price index) disproportionately.

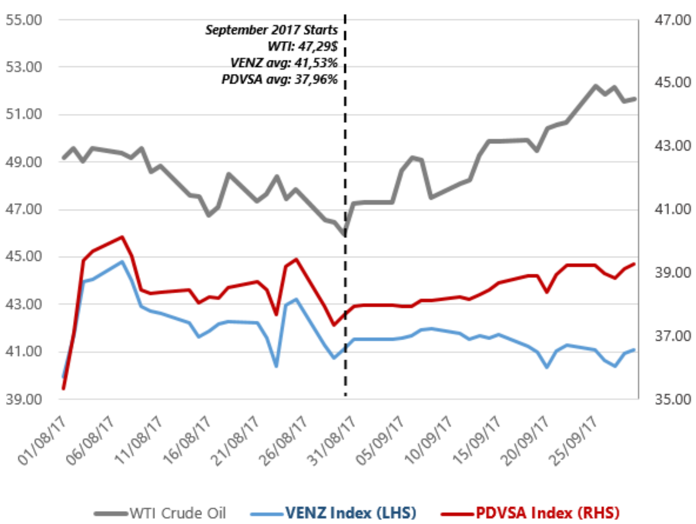


Chart N°1: VENZ and PDVSA avg. bond prices vs prices of WTI Oil (Ago-Sep 2017). ***Source: Bloomberg BGN, own calculations.***

Despite not being the first time that the Republic or PDVSA undergoes a grace period on interest payments, the delay on the VENZ 2027 was a special event. Since this maturity was the first to come after the Trump administration imposed financial sanctions to Venezuela, market participants went through a tense, uncertain-filled week with no information coming from the authorities. It was only on September 21st, six days after the scheduled date, that the National Public Credit Office (ONCP) tweeted that the payment was on its way, alleging "operational difficulties" behind the delays.

Besides the grace period, several news served as a remainder to investors about the precarious liquidity position faced by the Republic. First of all, local press reported that officials from the Venezuelan Central Bank (BCV) were negotiating a term extension on an USD 800mm gold-backed loan with Citigroup, which matures in October and under risk of collateral execution if the government doesn't pay back on time. Moreover, PetroChina Americas reviewed current loans backed by future oil sales signed with Venezuela and recommended not to extend new credit nor reprofile existing loans, citing the prohibition imposed by Trump's sanctions. In parallel, the authorities of Venezuela and Russia are currently negotiating the terms of a bilateral debt restructuring of over USD 4Bn of loans which the Republic didn't pay on the scheduled dates or the grace period granted by the Russian authorities.

Lastly, the uncertainties surrounding payment agents persists: Citibank was finally replaced at the end of the month on the payment agent roles it had renounced months ago, but one of the substitutes (Delaware Trust Company, in charge of PDVSA 2026 bonds) quit a few days after taking the positon, in unknown circumstances. Worse of all, rumors point out that US correspondent banks are closing all lines with Venezuelan government entities. All signs suggest that the limitations imposed by Trump have severely impaired the capacity of the Maduro government to deal in US Dollars. This situation explains the constant calls by Venezuelan officials to migrate all financial and commercial transactions to Euro, Yuan and other currencies, as a way to avoid the situation they describe as a "financial blockade" against the Venezuelan government.

Monthly Performance

Venezuela and PDVSA bonds finished the month with an average +0.3% rise and a total return of +2% including interest. The main driver was the persistent price divergence between short end bonds (such as the PDVSA 2020, which returned +12.6% in September) and Sovereign long-term debt (ie. VENZ 2034 bonds, which lost -4% in the month). Dealer commentary reinforces this view; they report heavy client selling on most of both curves, except for the shortest tenors which remain with a strong bid by institutional investors and local players.

Looking at year-to-date performances, the reason (or a consequence) of the reported market flow becomes evident: only bonds due in 2017 and 2018 have positive returns throughout the year; meanwhile, every other strategy in Venezuelan debt has posted two-digit losses.

Security	31/08/2017	29/09/2017	Total Return	Total Return (2017 YTD)
VENZ 13 5/8 08/15/18	74.75	**74.65**	+1.29%	+2.52%
VENZ 7 12/01/18	59.15	**65.70**	+11.65%	+10.28%
VENZ 7 3/4 10/13/19	44.25	**45.10**	+3.11%	-7.75%
VENZ 6 12/09/20	39.25	**38.90**	+0.27%	-9.55%
VENZ 12 3/4 08/23/22	45.50	**46.65**	+4.68%	-8.17%
VENZ 9 05/07/23	36.90	**35.45**	-1.79%	-11.23%
VENZ 8 1/4 10/13/24	36.10	**34.25**	-3.05%	-12.03%
VENZ 7.65 04/21/25	35.80	**34.00**	-3.09%	-11.50%
VENZ 11 3/4 10/21/26	40.50	**38.85**	-1.52%	-14.36%
VENZ 9 1/4 09/15/27	39.95	**39.90**	+1.50%	-8.58%
VENZ 9 1/4 05/07/28	36.00	**34.85**	-1.02%	-10.98%
VENZ 11.95 08/05/31	41.15	**40.50**	+0.72%	-10.76%
VENZ 9 3/8 01/13/34	38.20	**35.85**	-4.07%	-8.67%
VENZ 7 03/31/38	34.65	**33.50**	-1.48%	-10.26%
PDVSA 8 1/2 11/02/17	90.45	**94.45**	+4.99%	+26.04%
PDVSA 8 1/2 10/27/20	73.90	**82.95**	+12.63%	+20.80%
PDVSA 9 11/17/21	38.90	**41.35**	+7.61%	-8.81%
PDVSA 12 3/4 02/17/22	45.50	**46.65**	+4.73%	-7.68%
PDVSA 6 05/16/24	30.50	**30.75**	+2.24%	-9.62%
PDVSA 6 11/15/26	30.35	**30.50**	+1.98%	-8.46%
PDVSA 5 3/8 04/12/27	30.35	**30.55**	+1.95%	-8.60%
PDVSA 9 3/4 05/17/35	35.85	**34.25**	-2.22%	-13.86%
PDVSA 5 1/2 04/12/37	30.20	**30.40**	+1.94%	-7.56%

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

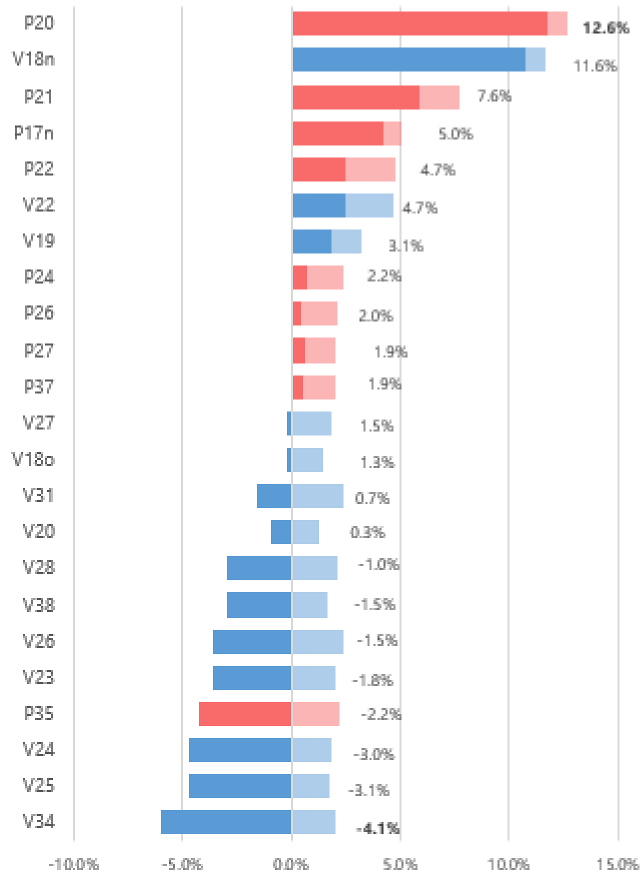
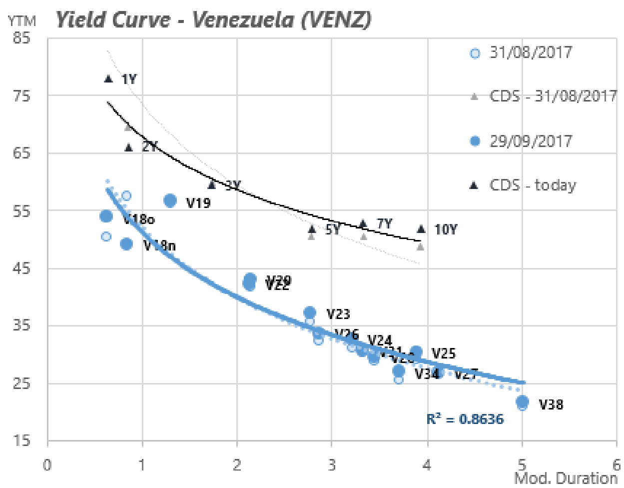


Chart N°2: VENZ/PDVSA bonds by Total Return, August 2017.
NOTE: total return separated by changes in market value (dark) and accrued interest (light section); return figures do not assume coupon reinvestment
Source: Bloomberg, Knossos Asset Management.

Evolution of the curves

The following charts N° 3 and 4 plot the yield curves for Venezuela and PDVSA bonds in September 2017, respectively, for both cash bonds and CDS. The Venezuela sovereign curve was little changed in the month; the only noteworthy movement was the sharp -830bps compression on the VENZ 7% 2018, the Sovereign bond with the best performance in September. On average, yields went up by +40bps, and the inverted shape of the curve remains, pointing out that the riskiest bond (or the one with greatest upside potential, depending on views) is the VENZ 2019.



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

The PDVSA curve shows a slight -70bps fall in the average YTM. In contrast, the PDVSA 2020 bonds outperformed massively (yields -900bps). Looking at the reasons behind the bond's revaluation – note that the intrinsic value on PDVSA 2020 is partially driven by the residual value of Citgo Holding Inc. – one can argue that the Trump sanctions explicitly prohibiting dividend transfers out of Citgo to their headquarters (PDVSA Holding), positive for the US refiner's valuation. Moreover, the sanctions also increase the probability of a credit event in the short term. Both factors are supporting the bond value and underscore the importance of the payment rank in the capital structure of a speculative-grade issuer, especially in cases of distressed companies, such as PDVSA in current form.

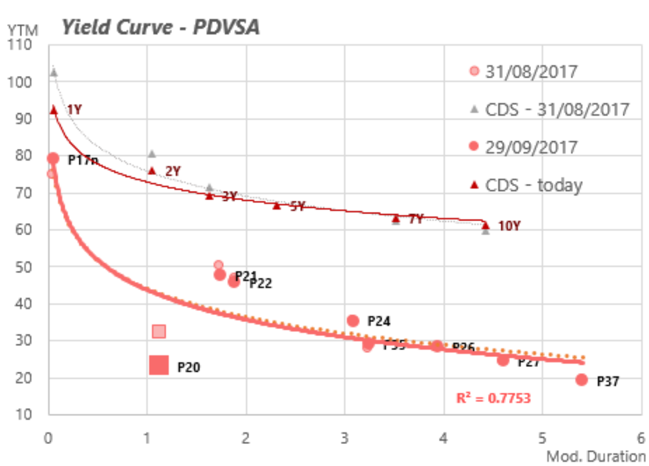


Chart N°4: PDVSA Yield Curve changes, September 2017.

***Source: Bloomberg* CBBT.**

Payment on time, Default or Restructuring?

The Venezuelan government's capacity to pay is a political variable, not an economic one. The country's debt dynamics is completely unsustainable, as a consequence of over a decade of fiscal deficits funded with hard-currency debt issued at the highest interest rate ever paid by a Sovereign worldwide. In retrospective, the high returns achieved by investing on short-end Venezuelan bonds in the past three years correspond to an "informational arbitrage" where investors have taken advantage of the fact that the Maduro government keeps on paying its debts at any costs; much beyond what do rational forecasts consider possible. The current proximate cause is the presence of Russia and China as lenders of last resort, which have already prevented the occurrence of an accidental credit event in several occasions. It's no coincidence, given the context, that opposition politicians have aggressively lobbied financial institutions worldwide to prevent them from extending new loans to the Venezuelan government. All relevant parties operate under the assumption that the current government's political survival is tied to its capacity to serve its external commitments.

Nevertheless, the hypothesis linking a credit event to a regime change is losing support. "If it [the Maduro government] doesn't need to listen to voters, because it's the military who support them, there's no reason to believe that a default would imply a change in government", said Carmen Reinhart, Economics professor at Harvard University, adding that less than 15% of sovereign defaults occurring since 1992 have led to a change in administration. The implications of this new hypothesis are crucial for the 'Willingness to Pay' variable. What would happen if the Government's reaction function changed suddenly, no longer caring about maintaining debt service? It's not a feasible scenario, considering the lack of legal and operational preparations as to avoid the seizure of the Republic's external assets. In addition, all the eyes of the international community are onto Venezuela nowadays, which makes any attempt at debt repudiation (and thus definitely turning into a Rogue State) would lead to almost-immediate retaliation in the form of new sanctions against the regime's officials, making the status quo unsustainable.

Amidst the climate of total uncertainty, 'Event Risk' sits at all-time highs. In this scenario where all control variables are subject to sudden breaks, the only certainty is that the principal debt due on October 28th (PDVSA 2020 amortization) has no grace period. The risk of an 'accident' in this context is astronomical and goes beyond simply having the cash on hand to make the payment. If the USD 840mm due doesn't show up in the payment agent's escrow account at the end of that day, it could lead to the International Swaps and Derivatives Association (ISDA) to deliberate on the occurrence of a credit event by PDVSA. This could lead into CDS being triggered and toss the market to an unchartered and extremely complex legal ground.

The word 'Restructuring' has been heard in the realm of the Venezuelan debt market; in any case, it doesn't seem likely or viable in the current context. Not surprisingly, the Venezuelan case is known in international financial law circles as "potentially the most complex debt restructuring in history." In addition to the more than USD 170 billion in financial, commercial and arbitration liabilities, the government would be facing a forced liquidation of Citgo Holding Inc., which would jeopardize the entire Venezuelan oil refining operation in the USA. Even more serious, sanctions imposed by the Trump government prohibit the issuance of new debt securities or agreements to extend the term of loans currently outstanding. All of this implies that the debt restructuring process could not legally be made under US jurisdiction, which conflicts with the fact that virtually all bonds are issued under US law.

The risk of being exposed to the short end of PDVSA at current levels appears not to be compensated by its profit potential. Considering all factors, the pull-to-par of the PDVSA 2017N of 6.3% at current prices is too low compared to falls greater than -60% (in the hypothetical case of a credit event that sends the bond down to 30 cents). The strategy of investing in the short end of the curve has always had an asymmetric risk profile; however, at the current juncture this profile is virtually unknown, and therefore much more dangerous. However, the Republic was eventually able to pay the September coupons. Does this imply that the viability of payment for capital maturities at the end of October is guaranteed? Assuming that lenders of last resort will continue to support the Venezuelan government for debt payments, everything would depend on the evolution of political developments internally in Venezuela, and hence on the response of the US government. **In this sense, the regional elections set for October 15 represent the key event of the month on the political front**. The Government is facing its last chance to choose between a minimum of respect for institutions or the inevitable decline to authoritarianism and isolation from the rest of the world. To further complicate the situation, the exploratory process of dialogue reinstated between the government and the opposition in September did not produce concrete results, and the position of both sides is unclear right before the elections.

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