Venezuela/PDVSA Monthly Report
December 2018

Venezuelan debt closes 2018 with mostly negative returns and an unprecedented divergence between senior debt (which continues to be repaid) and unsecured bonds (persisting in default). The market echoed the yearly trend in December, with a strong drop in long-term PDVSA bonds, stable prices throughout the Sovereign curve, and positive returns in PDVSA 20 and VENZ 34. This took place in a global risk-off environment, with a sharp fall in prices of risky assets and commodities - especially oil - as well as a major widening of High Yield credit spreads.

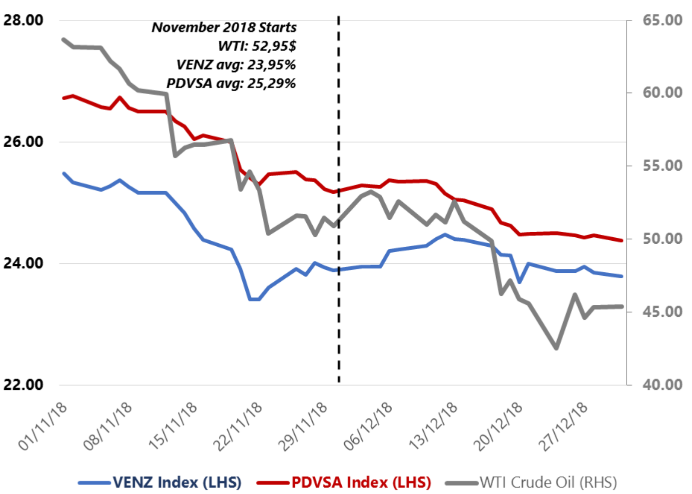

Chart N°1: VENZ/PDVSA bond indexes and oil prices, Nov-Dec 2018.
Source: Bloomberg, Knossos Asset Management.

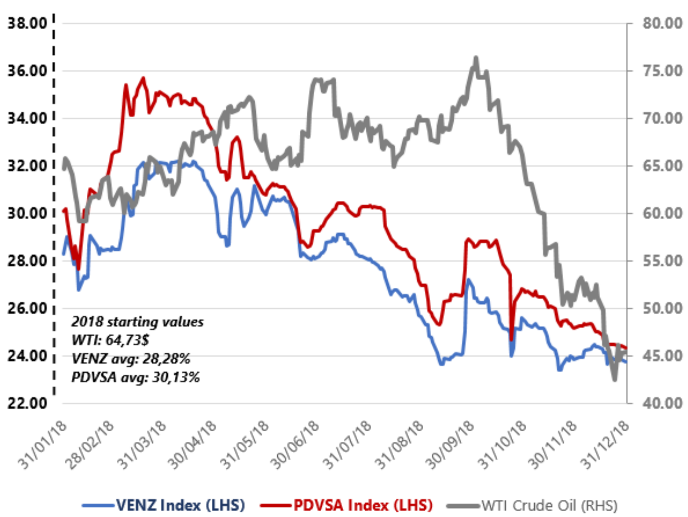

Chart N°2: VENZ/PDVSA bond indexes and oil prices, 2018 year.
Source: Bloomberg, Knossos Asset Management.

Unfavorable external drivers came alongside recent advances by key creditors (such as ConocoPhillips, Crystallex and Gold Reserve, as well as holders of PDVSA 2020), which have threatened to seize Citgo and other external assets of the Republic to demand repayment of their claims at all costs. The threat of losing Citgo Holding - and therefore, access to the US oil market - encouraged the Maduro administration to remain solvent with these commitments, to the detriment of holders of unsecured bonds, who have endured over a year (and more than USD 9Bn) of principal and interest payments in default.

In response to these developments, bondholders have assembled in at least 3 separate groups and hired legal advisors, aiming to lead a future restructuring process for Venezuela and PDVSA debt that provides an equitable treatment to all external creditors. Of these, the most agile is a group of VENZ 34 bondholders, holding an aggregate USD 380m position on the security and which formally engaged in debt acceleration procedures in the second half of December.

Moreover, the dispute between PDVSA and Crystallex persists in 2019, after the state oil company resumed its efforts to appeal the Delaware court order to execute a forced sale of PDV Holding (owner of Citgo Holding Inc.) in favor of the Canadian mining company. Restarting appeal procedures was perceived by Crystallex as a repudiation of last November's deal and suggest that Judge Stark, who is handling the case, could finally give green lights to Citgo's foreclosure, although the deadline initially set (December 20, 2018) went by without news on this case.

Beyond the twin default/hyperinflation crisis, the oil sector collapse was the main economic event of 2018 in Venezuela. Driven by a disastrous management by Manuel Quevedo, PDVSA suffered the largest drop in oil production since the 2003 strike, and closes the year at 1.14m b/d (-37% in 2018). Furthermore, Quevedo was nominated to the General Secretariat of OPEC for 2019. Although the foreign partners of the joint ventures have complained about his management style on several occasions, Quevedo remains in command of the state oil company as of the date of publishing.

Monthly and Yearly Performance

Security	30/11/2018	31/12/2018	Total Return	Total Return (2018 YTD)
VENZ 13 5/8 08/15/18	25.00	**23.65**	**-5.41%**	**-58.19%**
VENZ 7 12/01/18	23.05	**21.40**	**-7.13%**	**-46.71%**
VENZ 7 3/4 10/13/19	23.30	**23.75**	**+1.83%**	**-4.20%**
VENZ 6 12/09/20	22.75	**22.80**	**+0.20%**	**-1.96%**
VENZ 12 3/4 08/23/22	23.90	**23.90**	**-0.11%**	**-14.32%**
VENZ 9 05/07/23	23.25	**23.05**	**-0.80%**	**+1.17%**
VENZ 8 1/4 10/13/24	24.00	**23.55**	**-1.75%**	**+3.48%**
VENZ 7.65 04/21/25	23.15	**22.85**	**-1.31%**	**+1.43%**
VENZ 11 3/4 10/21/26	24.80	**25.05**	**+0.92%**	**-0.07%**
VENZ 9 1/4 09/15/27	23.70	**23.65**	**-0.06%**	**-6.92%**
VENZ 9 1/4 05/07/28	23.45	**23.10**	**-1.61%**	**+2.74%**
VENZ 11.95 08/05/31	23.75	**23.80**	**+0.30%**	**-10.17%**
VENZ 9 3/8 01/13/34	27.60	**28.15**	**+2.03%**	**+10.48%**
VENZ 7 03/31/38	23.00	**23.05**	**+0.29%**	**+1.68%**
PDVSA 8 1/2 10/27/20	93.30	**93.65**	**+0.41%**	**+12.87%**
PDVSA 9 11/17/21	19.15	**18.45**	**-3.58%**	**-39.26%**
PDVSA 12 3/4 02/17/22	20.00	**19.10**	**-4.49%**	**-49.56%**
PDVSA 6 05/16/24	16.15	**15.10**	**-6.32%**	**-37.53%**
PDVSA 6 11/15/26	16.05	**15.15**	**-5.64%**	**-36.43%**
PDVSA 5 3/8 04/12/27	16.05	**15.10**	**-6.02%**	**-42.41%**
PDVSA 9 3/4 05/17/35	20.10	**19.10**	**-4.77%**	**-34.21%**
PDVSA 5 1/2 04/12/37	16.25	**15.15**	**-6.94%**	**-41.29%**

Table N° 1: Venezuela/PDVSA bond performance, December 2018.
Source: Bloomberg CBBT, Knossos Asset Management. ***Note: Returns were adjusted to account for the accrued interest lost, per recent EMTA resolutions.**

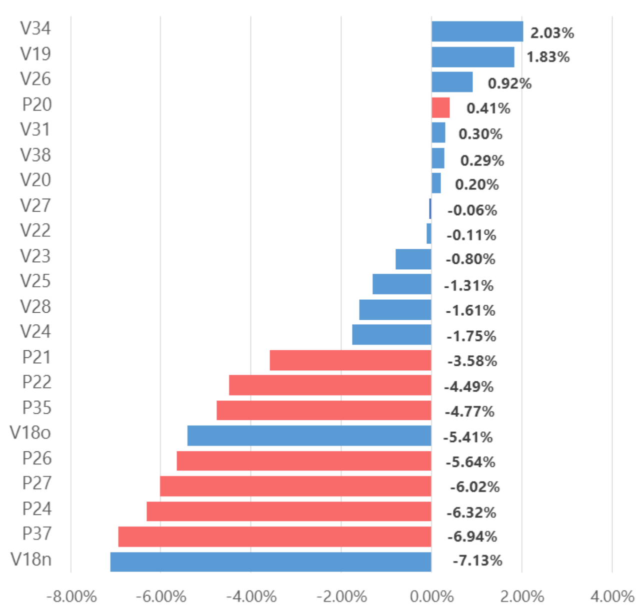

Chart N°3: VENZ/PDVSA bonds by total return, December 2018.
Source: Bloomberg, Knossos Asset Management.

Venezuela and PDVSA bonds posted average losses of -0.9% and -4.7% in December 2018, respectively. PDVSA low-dollar-value bonds fell by over -6%, leading the losses in the complex. In contrast, VENZ 19 and 34 bonds climbed around 2% and outperformed the PDVSA 2020 senior bonds.

To assess total returns in 2018, we include the impact of accrued interest lost after the EMTA's trading convention - established at the beginning of the year – to quote 'all-in' prices on Venezuelan debt. Two securities posted double-digit gains in 2019 (PDVSA 20 and VENZ 34), while on the other hand, the rest of PDVSA's unsecured curve logged its worst annual decline in history (with bonds losing between -34 and -50% YoY). By far, the worst performer among both curves was the VENZ 13.625% 18. The bond returned -58% in 2018, as the market completely priced out the option premium for a principal repayment in this bond.

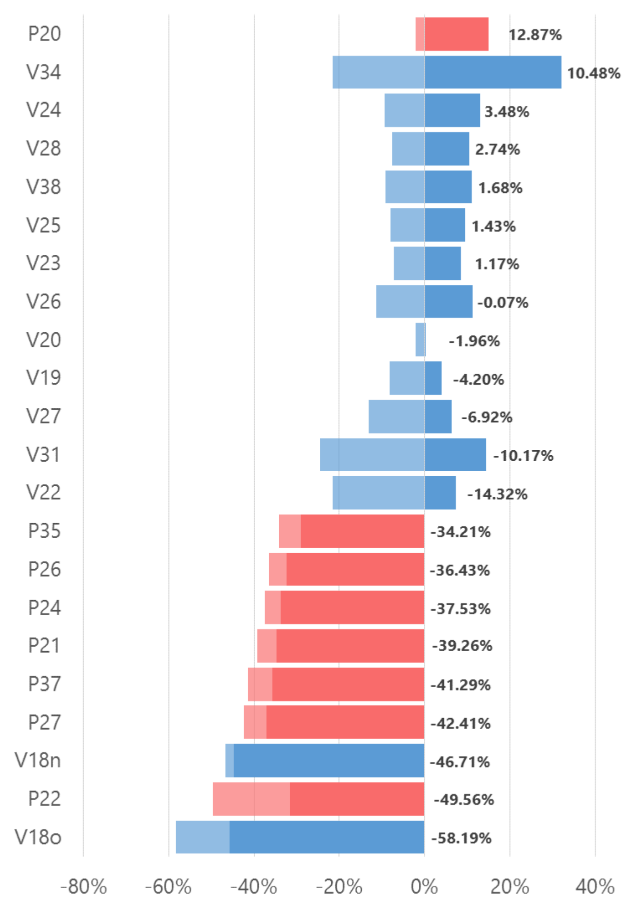

Chart N°4: VENZ/PDVSA bonds by total return, 2018 year.
Source: Bloomberg, Knossos Asset Management. ***Note: Price returns in dark bars and accrued interest (or interest lost, due to EMTA resolutions) in clear bars.**

Evolution of the curves

Yield curve analysis lost relevance for Venezuelan debt after the default announcement, which led us to focus our analysis to the term structure of bond prices. Throughout the year, we saw drops of up to 20 points in VENZ bonds due in 2018 (to levels in line with the rest of the curve), in contrast to up to 7 point increases (VENZ 34) in the long end of the curve. For PDVSA, the entire unsecured curve fell by 7 to 10 points, while the PDVSA 20 went up by 12 points in 2018.

Security	2017 c.	2018 c.	Price change
VENZ 13 5/8 08/15/18	43.50	**23.65**	-19.85
VENZ 7 12/01/18	38.75	**21.40**	-17.35
VENZ 7 3/4 10/13/19	22.85	**23.75**	0.90
VENZ 6 12/09/20	22.75	**22.80**	0.05
VENZ 12 3/4 08/23/22	22.25	**23.90**	1.65
VENZ 9 05/07/23	21.25	**23.05**	1.80
VENZ 8 1/4 10/13/24	20.90	**23.55**	2.65
VENZ 7.65 04/21/25	20.90	**22.85**	1.95
VENZ 11 3/4 10/21/26	22.50	**25.05**	2.55
VENZ 9 1/4 09/15/27	22.30	**23.65**	1.35
VENZ 9 1/4 05/07/28	20.90	**23.10**	2.20
VENZ 11.95 08/05/31	20.80	**23.80**	3.00
VENZ 9 3/8 01/13/34	21.30	**28.15**	6.85
VENZ 7 03/31/38	20.80	**23.05**	2.25
PDVSA 8 1/2 10/27/20	81.30	**93.65**	12.35
PDVSA 9 11/17/21	28.50	**18.45**	-10.05
PDVSA 12 3/4 02/17/22	28.05	**19.10**	-8.95
PDVSA 6 05/16/24	22.85	**15.10**	-7.75
PDVSA 6 11/15/26	22.50	**15.15**	-7.35
PDVSA 5 3/8 04/12/27	23.85	**15.10**	-8.75
PDVSA 9 3/4 05/17/35	26.95	**19.10**	-7.85
PDVSA 5 1/2 04/12/37	23.65	**15.15**	-8.50

Table Nº2: VENZ/PDVSA price curves, 2018 year.
Source: Bloomberg CBBT, Knossos Asset Management.

2019 Outlook - Venezuela

Our view is that the number one priority of the Venezuelan government for 2019 is the economy. In an increasingly challenging domestic and external environment (which will worsen after January 10, given the international community's repudiation of Maduro's new presidential term), government survival will critically depend on the ability of authorities to contain a growing number of threats on the economic front that compromise its short-term viability. In this sense, the challenges faced by the authorities can be divided into two main groups: the recurring issues of sustaining dollar cash flow in an environment of debt default and financial sanctions, and the new challenges that entail the deepening of the hyperinflationary crisis and chronic fiscal imbalances.

Same old challenges: Liquidity, selective default and sanctions.

Despite the multi-million dollar agreements with Russia and China announced by Maduro throughout 2018, the truth is that funding has not been secured for 2019. Miraflores has not yet fulfilled the multiple political and economic conditions required by foreign partners to disburse the credits. Furthermore, a more than -30% drop in oil prices during the last half of the year (which will be felt in oil revenues in the first quarter of 2019) and oil export forecasts of less than 1m b/d for year, suggest that Venezuela will once again face a balance of payments deficit without readily available sources of liquidity.

A core assumption of our analysis is that the government will maintain its strategy of paying all creditors that pose a risk to its viability in the short term, while bargaining for more flexible payment terms with its strategic partners and remaining in default with respect to unsecured external debt.

We anticipate that the government will undertake a multi-stage strategy consistent with these objectives. The first action front will focus on avoiding the seizure of PDVSA's external assets. As long as Venezuela continues to direct most of its cash-generating exports to the US (our base scenario for 2019, since we see a low probability of an oil embargo against the Maduro government), maintaining control of Citgo Holding will be a priority for PDVSA.

However, given the sharp drop in the value of oil exports - due to the double whammy of lower production and prices - we consider that debt service linked to Citgo and other key external assets (PDVSA 2020, liabilities with Crystallex and ConocoPhillips) could enter into conflict with maintaining debt service to Russia and China during 2019.

In order to resolve this conflict, we assign a high likelihood to Maduro seeking a preemptive negotiation of bilateral debt agreements - as well as loans pending approval - with Russia and China, committing to much lower (or even nil) oil shipments for the amortization of these loans next year, in order to save hard-currency liquidity and be able to meet the most urgent debt payments.

This scenario implies, in our view, that Maduro would be forced to accept strongly unfavorable terms for the Republic, as well as concessions in monetary and oil sector policy that would have been unthinkable in previous years. Actions such as the depreciation in the DICOM rate - at levels similar to the parallel dollar -, suggest that the government is willing to take the measures required by its foreign partners to release the new financing.

Although we expect the unequal treatment between senior and unsecured creditors will remain intact in 2019, we believe that bondholders will have increasing incentives to advance all legal measures to demand repayment of their claims. In addition to the group of VENZ 34 holders (whose strategy seeks to outsmart the rest of the creditors and demand immediate repayment of its sole USD 1.5Bn issue), we see very likely that other groups of unsecured bondholders would execute cross-acceleration clauses in their securities.

While we do not anticipate bondholder efforts to achieve concrete results in 2019 due to the typical slowness of litigation of this nature, the risk of surprise seizures of the Republic's external assets will persist throughout the year, and the authorities must be prepared for events such as the capture of the Curaçao-based Isla refinery by Conoco in June 2018. In addition, the current US sanctions regime prevents any type of debt and equity issuance, which makes an orderly restructuring of the debt impossible, even if Maduro were willing to do so. All of the above suggests an increasingly complicated and unpredictable scenario for the Republic on the external debt front.

One key instance to ensure the medium-term viability of the Maduro government is recovering the oil industry. In the last days of the year, announcements of new service contracts - between PDVSA and new companies from the US and France - represent a radical change in the industry's legal and operational background. Among other novel measures, we highlight the figure of long-term oil production contracts with first-time foreign partners (instead of Joint Ventures managed at PDVSA's discretion), 49.9% stakes for the foreign partner, unregulated exports and preferential royalties. Although a change in the terms of oil investments does not guarantee a successful recovery in output - nor that it will take place in the short term -, we consider that this new investment model is consistent with a renewed interest of the authorities to exploit all the possible opportunities to boost hard-currency income.

A last front would focus on circumventing the US/EU sanctions regime. We anticipate more sanctions against individuals, as well as an increasingly restrictive monitoring of the Venezuelan government's financial transactions. However, we rule out the possibility of a total financial blockade, which could support Maduro by offering him an external enemy consistent with his political discourse. For now, the government's challenge lies in maintaining access to the global payments system through a network of counterparties based outside the US, including Novo Banco (Portugal), Evrofinance Mosnarbank (Russia) and other institutions based in the Middle East and Hong Kong. Maduro will face a 'stress test' to its network of counterparties in early 2019, once the most recent US Executive Order (which seeks to prohibit gold trafficking from Venezuela) would lead related parties to strengthen their AML regimes. This could lead the Republic to lose correspondent banking lines if its counterparts determine that increased reputational risks would not compensate maintaining the Venezuelan government as a client.

New challenges in 2019: Hyperinflation, Dollarization and Fiscal Adjustment

Economic instability in 2019 suggests inevitable, never-before-seen changes in the Venezuelan State. Without capacity nor willingness to carry out preventive reforms, accelerating inflation and an increasingly reduced size of government will lead to the widespread use of the dollar and other currencies in private transactions, similar to what happened in Zimbabwe in 2009. Therefore, we believe that the Maduro government will allow de facto dollarization of the economy, mainly due to inertia.

In this scenario, the government would forfeit its ability to issue local currency at the moment it ceases to make economic sense for it to do so, a factor that has occurred in all hyperinflation episodes throughout history. We believe that, if current trends continue, the Maduro administration would finance fiscal spending with inflation tax (that is, by accelerating money-printing) until the end of 2019. By then we forecast that the acceleration of inflation will reduce seignorage revenues to drastically lower levels, insufficient to cover the growing fiscal deficit. Authorities then would have to look for an alternative to close the fiscal deficit when reaching this breaking point, so we deem likely a stealth privatization of state enterprises alongside a drastic reduction of public payrolls as inevitable fiscal adjustments in 2019.

Clearly, Maduro would also have to face the latent risk of social unrest in response to the adjustment measures he's forced to take during 2019. In our opinion, the government has so far been successful in maintaining a minimum of stability by disrupting the connection between popular discontent and political mobilization, mainly through the repression and persecution of leaders of parties, unions, students and even communal councils. Another key strategy is the use of the crisis to deepen the dependence of individuals on state subsidies. Faced with an increasingly narrow budget, we anticipate a sharp contraction in social spending for next year, which is why we believe that the government will make an increasingly greater use of repression by the security forces to avoid a social outbreak that could put the Maduro government at risk.

2019 Strategy – VENZ/PDVSA

Our base scenario for 2019 calls for a continuation of the status quo in the Venezuelan debt market. However, considering the current price levels, this implies that the potential returns in certain segments of the curve, especially in the PDVSA low dollar value, could be positive and significant in an alternative scenario of political transition and greater odds of a debt restructuring in the medium term.

The decision to take a position in the bonds, and the timing of the investment, is necessarily data-dependent and subject to the evolution of future events. We believe that it would only make sense to take a position in the debt if concrete signs of a government transition are given, a necessary (but not sufficient) condition for the positive scenario for bondholders to materialize.

We forecast near-zero returns for VENZ in 2019. We believe that the market is pricing in similar expectations to ours regarding what would happen next year in Sovereign bond prices, so we see a low probability of sudden ups or downs in the VENZ curve for the coming year.

On the other hand, we forecast strongly positive returns (conditional on signals pointing to regime change) in the PDVSA unsecured curve. Our more optimistic outlook regarding the state oil company's debt stems from our view that current levels already priced in the negative scenario; therefore, we do not expect a greater drop in relative terms in PDVSA bonds. Meanwhile, we see the potential for a much higher appreciation in the positive scenario, since the main bondholder groups are betting on a *pari passu* deal between VENZ and PDVSA on the face of a hypothetical restructuring, which in our view would lead to PDVSA/VENZ bond price ratio to increase strongly, from the current value (0.65x) at a ratio closer to historical averages (0.95x-1.05x).

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