Venezuela/PDVSA Monthly Report
January 2019

The Venezuelan debt market started in 2019 with the highest monthly returns in history, guided by the resurgence of "regime change bets". After months of trading near all-time lows (both in prices and traded volumes), VENZ/PDVSA bonds were in strong demand by institutional investors since the first week of the year, bolstered by multibillion-dollar inflows into Emerging Market bonds. Since a good part of the EM community held significant underweights in Venezuelan credit at the start of the year, and given the absence of meaningful players in the offer side to balance flows, demand from both dedicated funds and opportunistic investors led prices up around 10 points on average along both curves.

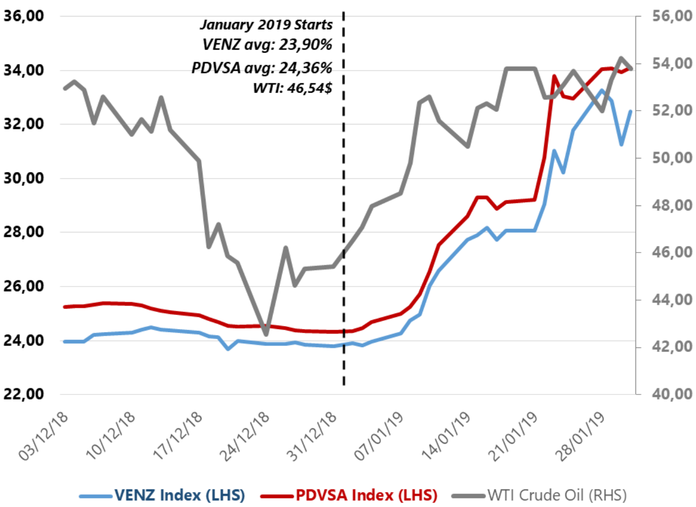

Chart N°1: VENZ/PDVSA bond indexes and oil prices, Dec'18–Jan'19.
Source: Bloomberg, Knossos Asset Management.

According to the market consensus, renewed investor appetite for the bonds of the Republic and - especially - the state oil company was driven by the rapid unfolding of the political crisis in Venezuela since the beginning of the year. The opposition enjoyed first-mover advantage, electing Juan Guaidó (a lawmaker of the *Voluntad Popular* party) as president of the National Assembly (**AN**) on January 5th. During his oath, Guaidó denounced that President Maduro would be "usurping" the country's presidence as of January 10, at which time the incumbent party was set to begin a new 6-year period as a result of the May 2018 presidential elections. The voting was widely disawoved at the time by the international community due to multiple allegations of political discrimination (after most opposition parties were barred from fielding candidates), unfair electoral conditions and fraud.

After the proclamation of Maduro for a new term, governments of the USA, European Union and Lima Group (a coalition of nations of the Americas) ignored the ruling party and offered their support to the National Assembly as the only legitimate power in Venezuela. Brazil went further, being the first government to recognize Juan Guaidó as interim president of the nation. On January 23, the AN head was sworn in as 'President in Charge' of the nation, thus establishing a transitional government with the goal to reestablish constitutional order in Venezuela and organize general elections. This government has been recognized by much of the western world, while countries allied with Maduro (China, Russia, Turkey) have denounced it as an US-backed coup attempt.

The final week of January brought a new round of sanctions by the US Treasury Department. Executive Order 13857 expanded the regime of asset freezes and dealing prohibitions to the entire Venezuelan government, which translates into a de facto ban on oil exports and imports of diluents by PDVSA, as well as the blockade of most assets of the Venezuelan government under US jurisdiction. Furthermore, two attempts by Maduro to move funds (gold reserves at the Bank of England, and deposits from BANDES sitting in Portugal's Novo Banco, amounting to over USD 2.4 Bn) were blocked, in a push by the AN to "protect" the external assets of the Republic while the governance crisis gets resolved.

Lastly, General Licenses established in the latest Executive Order by the Trump administration barred US entities from buying Venezuelan debt in secondary markets. The measure, initially aimed at PDVSA bonds and expanded to VENZ debt days later, has triggered a near-total shutdown in Venezuelan credit trading, leaving investors who entered the rally at the beginning of the month trapped in their positions until further notice.

Monthly Performance

VENZ/PDVSA bonds posted an average return of +35.9% and +57.6% in January 2019, respectively. However, excluding the CITGO-backed PDVSA 20 notes (which rose less than 1% in the month), bonds issued by the state oil company climbed by +65.8%, almost doubling the gains seen in equivalent VENZ securities.

In line with our investment thesis for 2019 (introduced in last month's report), PDVSA bonds outperformed as expectations of a regime change (closely linked to the possibility of an orderly restructuring of the nation's external debt) were the main driver of investor demand during the month. Also in line with our view, the unsecured bond with the worst relative performance was VENZ 34, which traded at a premium of almost 5 points on average with respect to the curve at the beginning of the year. This premium, however, remains at 3 points at the end of January.

Security	31/12/2018	31/01/2019	Total Return	Total Return (2019 YTD)
VENZ 13 5/8 08/15/18	23,65	31,25	+32,26%	+32,26%
VENZ 7 12/01/18	21,40	30,25	+41,43%	+41,43%
VENZ 7 3/4 10/13/19	23,75	30,95	+30,45%	+30,45%
VENZ 6 12/09/20	22,80	31,25	+37,03%	+37,03%
VENZ 12 3/4 08/23/22	23,90	33,45	+40,06%	+40,06%
VENZ 9 05/07/23	23,05	31,95	+38,61%	+38,61%
VENZ 8 1/4 10/13/24	23,55	32,35	+37,23%	+37,23%
VENZ 7.65 04/21/25	22,85	31,35	+37,19%	+37,19%
VENZ 11 3/4 10/21/26	25,05	33,55	+34,00%	+34,00%
VENZ 9 1/4 09/15/27	23,65	33,05	+39,72%	+39,72%
VENZ 9 1/4 05/07/28	23,10	31,45	+36,13%	+36,13%
VENZ 11.95 08/05/31	23,80	33,55	+40,86%	+40,86%
VENZ 9 3/8 01/13/34	28,15	34,95	+24,11%	+24,11%
VENZ 7 03/31/38	23,05	30,85	+33,75%	+33,75%
PDVSA 8 1/2 10/27/20	93,65	94,20	+0,62%	+0,62%
PDVSA 9 11/17/21	18,40	30,45	+65,27%	+65,27%
PDVSA 12 3/4 02/17/22	19,15	30,60	+59,46%	+59,46%
PDVSA 6 05/16/24	15,05	25,65	+70,44%	+70,44%
PDVSA 6 11/15/26	15,05	25,60	+70,53%	+70,53%
PDVSA 5 3/8 04/12/27	15,10	25,30	+67,94%	+67,94%
PDVSA 9 3/4 05/17/35	19,15	29,50	+54,32%	+54,32%
PDVSA 5 1/2 04/12/37	15,10	26,00	+72,43%	+72,43%

Table N° 1: Venezuela/PDVSA bond performance, January 2019
Source: Bloomberg CBBT, Knossos Asset Management. ***Note: Returns were adjusted to account for the accrued interest lost, per recent EMTA resolutions.**

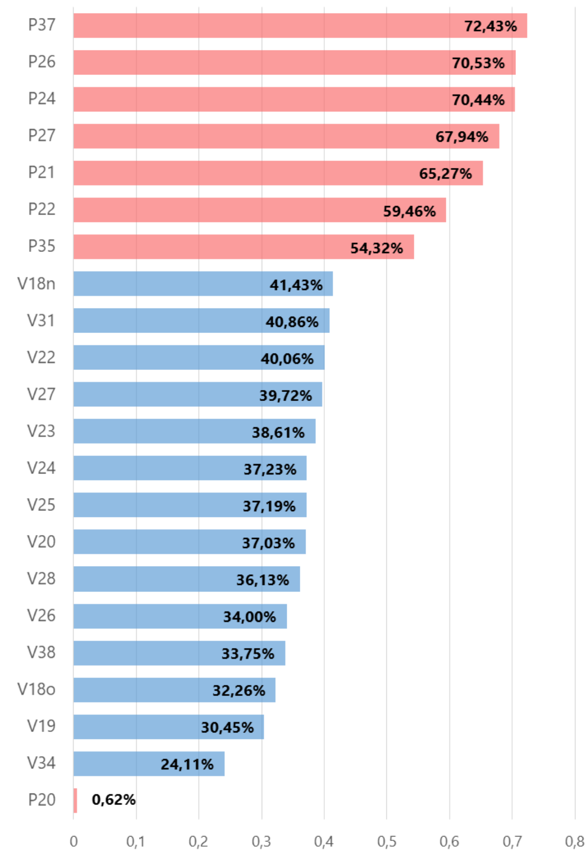

Chart N°3: VENZ/PDVSA bonds by total return, January 2019
Source: Bloomberg, Knossos Asset Management.

Security	31/12/2018	31/01/2019	Price change
VENZ 13 5/8 08/15/18	23,65	31,25	7,60
VENZ 7 12/01/18	21,40	30,25	8,85
VENZ 7 3/4 10/13/19	23,75	30,95	7,20
VENZ 6 12/09/20	22,80	31,25	8,45
VENZ 12 3/4 08/23/22	23,90	33,45	9,55
VENZ 9 05/07/23	23,05	31,95	8,90
VENZ 8 1/4 10/13/24	23,55	32,35	8,80
VENZ 7.65 04/21/25	22,85	31,35	8,50
VENZ 11 3/4 10/21/26	25,05	33,55	8,50
VENZ 9 1/4 09/15/27	23,65	33,05	9,40
VENZ 9 1/4 05/07/28	23,10	31,45	8,35
VENZ 11.95 08/05/31	23,80	33,55	9,75
VENZ 9 3/8 01/13/34	28,15	34,95	6,80
VENZ 7 03/31/38	23,05	30,85	7,80
PDVSA 8 1/2 10/27/20	93,65	94,20	0,55
PDVSA 9 11/17/21	18,40	30,45	12,05
PDVSA 12 3/4 02/17/22	19,15	30,60	11,45
PDVSA 6 05/16/24	15,05	25,65	10,60
PDVSA 6 11/15/26	15,05	25,60	10,55
PDVSA 5 3/8 04/12/27	15,10	25,30	10,20

Table N°2: VENZ/PDVSA price curves, January 2019.
Source: Bloomberg CBBT, Knossos Asset Management.

A Roadmap for Transition

The strengthening of the opposition in 2019 has exceeded even the most optimistic expectations, and represents the biggest challenge faced by the Maduro government to date. The establishment of an interim government, led by Juan Guaidó, contrasts with the victory in the parliamentary elections of 2015 and the wave of protests in 2017, two events that were unable to materialize in actions leading to a government transition. The main difference lies in the reaction of the international community, evolving from tacit support to the opposition, to concrete measures to undermine the economic viability of the Maduro regime.

US sanctions imply a *de facto* oil embargo to Venezuela, and these measures could be replicated by the European Union soon. By expanding the scope of sanctions – from individuals in Maduro's inner circle to all entities directly or indirectly managed by the Venezuelan government - the US has managed to close the main source of dollar liquidity for Venezuela. Far from representing a long-lasting disruption in the nation's affairs, the new actions indicate the intentions of the White House to force a government transition as soon as possible. This is due to the fact that Venezuela can continue to export oil to North America (and CITGO is also authorized to continue operating without limitations), but all proceeds from oil sales must land in US-based accounts controlled by the Guaidó government; the underlying logic is to disrupt Maduro's government only. Furthermore, we believe that it's only a matter of time until the European Union doubles down on the sanctions regime, given that the political stance of the bloc is aligned ever closely with the White House's view.

By losing their main cash-paying customer, the hard-currency cash flow of the Maduro government has critically deteriorated. The new round of US sanctions are forcing PDVSA to redirect some 500,000 barrels per day of crude exports to new destinations, at a time when commercial relations with Venezuela are more toxic than ever. As expected, the state oil company is currently paralyzed, with multiple reports of freighters stationed in the Caribbean Gulf without a clear destination, as well as a major disruption in the supply of gasoline and other derivatives from the US. Maduro has tried for months - without success - to expand oil supply agreements with Indian companies, as well as replacing its suppliers of diluents and intermediaries for the crude trade; given all of the above, we anticipate a sharp fall in oil exports from February onwards. Additionally, we expect a severe hard-currency liquidity deficit in the next quarter, since the accounts receivable from PDVSA to US clients (which could reach USD 1,800 million, according to our estimates) are susceptible of being subject to US sanctions, so Maduro would likely not receive this deferred income.

Guaidó's political strategy focuses on increasing incentives for cooperation by dissident military, and increasing the costs of permanence for the leaders of the armed forces. Through a draft Amnesty Law, the approach seeks to couple guarantees to members of the military willing to recognize the transitional government with ever-stronger and more comprehensive individual sanctions for army loyalists. This strategy is based on the growing influence of the army's high command in the Venezuelan economy - especially in the food, oil and gold sectors. We anticipate that Venezuelan gold trade bans - in effect since November 2018 - in conjunction with the new sanctions, will succeed in reducing the army's ability to generate and distribute patronage rents, thus fostering the formation of a critical mass of rebel soldiers. However, their ability to drive a restoration of the country's constitutional order is limited by severe coordination failures, aggravated by military counterintelligence groups that, for the time being, have kept any internal uprising at bay.

Considering the current scenario, we assign a high likelihood of regime change in the next quarter. Our assessment is chiefly based on the sharp drop in hard-currency income that we anticipate in coming months. Without Dollars to distribute, Maduro will find it impossible to maintain the precarious power balance holding his government together; meanwhile, an increasing amount of individuals within his administration would be encouraged to undermine his mandate. That said, a full transition (that is, without power quotas for Chavistas and/or the armed forces) is not guaranteed, and we deem highly likely that Guaidó's transitional government will enter into alliances with elements of the ruling party, as a way to ensure a minimum of governability over the country in the context of a State with severe operational disabilities.

Venezuelan Debt Restructuring: a risk-return assessment

Subject to a successful government transition, the Guaidó team is developing a proposal for a comprehensive debt restructuring, within the framework of an IMF stabilization program and alongside humanitarian aid. In an initial stage, the Guaidó government is requesting multi-million-dollar food and medicine shipments to its allied countries, in order to alleviate the effects of the economic collapse of the Maduro era. Subsequently, it seeks to reactivate the national productive apparatus through foreign investment – both private and multilateral - in the oil and manufacturing sector. Ultimately, once the economy finds its footing, Guaidó's advisers are proposing to begin an orderly and equitable process of restructuring the nation's external debt, consistent with the limited payment capacity envisioned for the first years of economic recovery. While we believe that this process would occur almost certainly in the short term in a scenario of regime change, two important sources of uncertainty lie in the effective Recovery Rate and the time it will take to close the negotiations.

A central feature of the Venezuelan restructuring that we anticipate is the presence of the US government in all stages of the process. The most recent OFAC sanctions seek to protect the Republic's external assets from asset seizures - both from the Maduro government and external creditors - while reaching an equitable agreement for all and consistent with a sustainable recovery of the domestic economy. In this regard, we consider highly likely that the PDVSA 20 bond's collateral would not be executed if the state oil company fails to pay the USD 75 MM coupon maturing on April 27. A viable solution to maintain the current payment rank would be to restructure the security, while keeping the collateral on the shares of CITGO Holding in the remaining liability.

In general terms, we see a more favorable bargaining position for the Republic than for external creditors. We only see the possibility of holdout creditors in VENZ securities without Collective-action Clauses (CACs) or with low CAC thresholds (18o, 18n, 27, 34 bonds). However, we consider that the holdouts' capacity to exert pressure and demand preferential repayment terms will be strongly limited, since it would imply the notoriously bad press of going against a US-backed democratic government that seeks to resolve a humanitarian crisis. Despite the lack of CACs, we see strong incentives from PDVSA holders to restructure amicably, since the legal validity of their liabilities could be challenged in the future if they were left out of the negotiation.

Another pressure point for bondholders is the preemptive shutdown of the secondary market. Given that a reopening is not expected until the end of the country's political crisis, the window of opportunity for opportunistic funds to jump in the credit has been closed, and incentives of current investors are aimed at collaborating for a quick resolution to the crisis. There is concern about whether VENZ/PDVSA bonds would be excluded from EM fixed-income benchmarks, which could trigger a wave of forced selling. Although the bonds are not currently eligible for inclusion to the index due to lack of liquidity, the situation is temporary in nature, so we anticipate that the index providers will take a position in the same spirit of the secondary market sanctions (in order words, we expect them to consider a temporary suspension, subject to an evolution of the political crisis in the country and that does not imply forced sales for EM mutual funds).

Lastly, a key aspect of a successful restructuring lies in aligning the incentives of creditors with the government. A common method is the issuance of instruments whose payments are contingent on the future readings of economic activity. However, we do not foresee the inclusion of GDP-linked Warrants as part of the restructuring proposal. These instruments are illiquid, difficult to value, and susceptible to manipulation, due to the payoffs' dependence on official statistics. On the other hand, the inclusion of warrants linked to oil prices - with a similar structure to that used in the 1990s *Brady Bonds* - would be more suitable to the particularities of the Venezuelan economy, and could serve as a fair mechanism to share risks (and rewards) of the future evolution of the economy between creditors and the national government. Additionally, we believe that the holders could align their incentives with the Republic through an investment or debt-to-equity swap scheme related to the oil sector – in effect, increasing their credit exposure in the country -, demanding in return that the payments of the restructured debt be collateralized with part of the flow of income from these investments.

Even though the restructuring may take multiple forms, the final result from the point of view of dedicated investors is unique: the post-restructuring market value of the debt, or Effective Recovery Rate. This would include the value of both newly-issued bonds (with principal haircuts and/or term extensions) and any instruments with contingent payoffs (such as the oil warrants discussed earlier). In this sense, and starting from a consolidated external debt stock of approximately USD 150Bn, we anticipate a feasible range of Recovery Rates between 15 and 40%:

• The upper bound of 40% is consistent with a GDP of USD 100Bn in the year of the restructuring, and an external debt/GDP ratio of 60%, the maximum tolerated by the IMF as a condition for extending loans to the country.

• On the other hand, we assume that a Recovery Rate of less than 15% will never be accepted, since no creditor would receive a positive capital gain in this scenario.

In order to illustrate our analysis, we calculate the potential returns (in annual terms) for two representative bonds: VENZ 18o and PDVSA 26. We use hypothetical restructuring tenors (from 1 to 5 years) and Recovery Rates (from 15% to 40% of the total value of the passive, that is, capital plus accrued interest), and we assume that past-due interest (current and future) will be honored. Tables 3 and 4 show the results. Note that the potential returns for both securities are relatively equal (a bit higher for PDVSA 26 due to lower pre-restructuring prices, but at the same time subject to higher execution risks). Another key finding: an aggressive restructuring - with Recovery Rates of 20% or less - would result in losses from current market prices in most tenors, even including PDI.

Consistent with our criteria and historical experience, we conclude that the most likely scenario is a debt restructuring with a 30% Effective Recovery Rate (ie, a 70% haircut). This result represents a balance between generating positive returns for investors that currently hold positions in the securities – an adequate compensation for bearing the risks of maintaining their positions throughout the process, even if the Venezuelan debt secondary market were to be reopened - and a sustainable debt burden, allowing for the recovery of the national economy in the medium term. The resolution period should be relatively short (one year or less), once the change of government in Venezuela is completed. However, because the transition continues to be unknown, we do not rule out the possibility that the restructuring could be extended up to 5 years in the future.

VENZ 18o - Yield To Restructuring Heatmap

	RECOVERY RATES						
TIME	15%	20%	25%	30%	35%	40%	**AVG**
1y	-35.6%	-14.2%	7.3%	28.8%	50.2%	71.7%	18.0%
2y	-15.8%	-14.2%	8.7%	19.1%	28.6%	37.5%	10.7%
3y	-8.2%	-2.8%	8.9%	15.7%	21.8%	37.5%	12.2%
4y	-4.3%	1.1%	8.8%	13.9%	18.3%	27.4%	10.9%
5y	-2.0%	2.9%	8.6%	12.6%	16.1%	22.3%	10.1%
AVG	-13.2%	-5.4%	8.5%	18.0%	27.0%	39.3%	12.4%

PDVSA 26 - Yield To Restructuring Heatmap

	RECOVERY RATES						
TIME	15%	20%	25%	30%	35%	40%	**AVG**
1y	-31.70%	-8.93%	13.83%	36.60%	59.37%	82.14%	25.2%
2y	-15.26%	-8.93%	9.40%	19.85%	29.45%	38.39%	12.2%
3y	-9.01%	-2.15%	7.88%	14.64%	20.68%	38.39%	11.7%
4y	-5.77%	0.15%	7.07%	12.06%	16.46%	26.18%	9.4%
5y	-3.81%	1.26%	6.54%	10.50%	13.96%	20.42%	8.1%
AVG	-13.1%	-3.7%	8.9%	18.7%	28.0%	41.1%	13.3%

Tables Nº3,4: *Heatmap* of bond returns under debt-restructuring scenarios, VENZ 18o & PDVSA 26 (Jan 2019)
Fuente: Knossos Asset Management.

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Disclosure concerning 'Debt Research Reports'