Venezuela/PDVSA Monthly Report
April 2018

Venezuela and PDVSA bond prices drifted lower throughout April, save for the PDVSA 20 senior secured notes. Selling flows accelerated in the final week of the month, contrasting with the advance in WTI crude oil futures, which continue to carve fresh multi-year highs (*See Chart N°1*). The growing divergence between oil and bond prices underlines the *distressed* character of Venezuelan debt, no longer responding to traditional macroeconomic drivers.

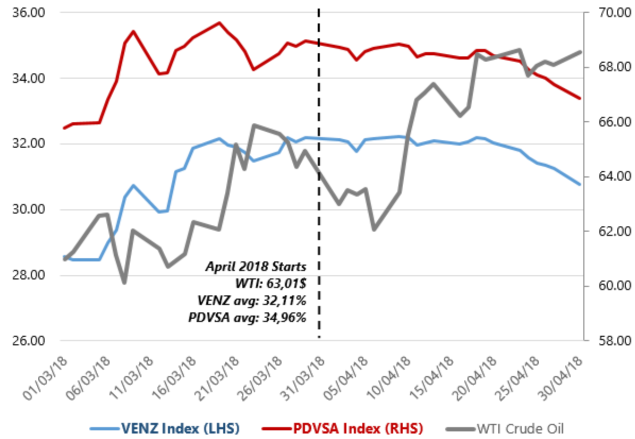


Chart N°1: VENZ and PDVSA avg. bond prices vs prices of WTI Oil (Mar-Apr 2018). ***Source: Bloomberg BGN, own calculations.***

The selective treatment by the Maduro administration on external commitments became evident in April, as the government defaulted on the ELECAR 18 principal payment alongside the growing amount of missed coupon payments on the rest of Venezuela and PDVSA unsecured debt, totaling USD 2.9 Bn as of April 30th. On the other hand, the government made the payment of the PDVSA 20 coupon without using the grace period, possibly in response to reports that the main holders of the security, backed by the equity of Citgo Holding, were organizing ahead for the execution process of the collateral in case the state oil company failed to service the debt commitment.

Meanwhile, the domestic economy deteriorates at an accelerated pace. Oil output accumulates a 23% fall in the last twelve months to a current level of 1.51m bbl/d, according to figures released earlier in the month by the OPEC; in parallel, more than 25,000 PDVSA employees have quit their posts since the beginning of 2017. The situation is further worsened by a climate of hostility against oil multinationals: two employees of a joint venture associated with Chevron were imprisoned by the Venezuelan justice for alleged treason, and the company responded by evacuating its key executive staff from the country. Additionally, hyperinflation and the exponential growth of monetary liquidity caused a collapse in the price of Bolívar in the parallel market (going from VEF 200,000 to almost 800,000 in April alone). Government policies have focused almost exclusively on the promotion of the *Petro*: according to a statement from Maduro at the end of the month, the authorities obtained more than USD 3,000 million in the primary auction of the cryptocurrency and would be depositing a third of the amount collected to the central bank's reserves. However, International Reserves reported by the BCV do not reflect any such inflows and sit at USD 9,924 MM at months'-end.

In parallel, the international community has kept exerting pressure against the Maduro administration, and the diplomatic crisis manifested in two ways during April: first through a temporary closure of diplomatic relations and air transport between Venezuela and Panama; and afterwards by a statement from the US Treasury Department, stressing that coordinated actions (financial sanctions) alongside other countries in the region were being considered, and further emphasizing that a new government that took sensible economic measures would receive the support of the international community.

Monthly Performance

Security	30/03/2018	30/04/2018	Total Return	Total Return (2018 YTD)
VENZ 13 5/8 08/15/18	39.20	37.35	-4.73%	-26.71%
VENZ 7 12/01/18	37.75	37.25	-1.30%	-5.80%
VENZ 7 3/4 10/13/19	29.90	29.25	-2.16%	+20.00%
VENZ 6 12/09/20	29.40	28.45	-3.22%	+22.76%
VENZ 12 3/4 08/23/22	33.65	31.60	-6.01%	+20.39%
VENZ 9 05/07/23	29.60	28.85	-2.60%	+28.38%
VENZ 8 1/4 10/13/24	29.60	28.75	-2.97%	+28.16%
VENZ 7.65 04/21/25	29.90	28.50	-4.58%	+28.69%
VENZ 11 3/4 10/21/26	33.50	31.30	-6.52%	+27.85%
VENZ 9 1/4 09/15/27	32.35	31.40	-2.93%	+27.75%
VENZ 9 1/4 05/07/28	29.85	28.65	-3.95%	+29.46%
VENZ 11.95 08/05/31	33.75	31.10	-7.84%	+24.72%
VENZ 9 3/8 01/13/34	34.35	33.40	-2.68%	+35.22%
VENZ 7 03/31/38	30.70	29.80	-2.85%	+34.09%
PDVSA 8 1/2 10/27/20	85.70	86.75	+1.21%	+4.62%
PDVSA 9 11/17/21	33.80	30.45	-9.86%	+2.34%
PDVSA 12 3/4 02/17/22	33.70	30.95	-8.16%	-7.69%
PDVSA 6 05/16/24	27.25	25.55	-6.28%	+7.87%
PDVSA 6 11/15/26	27.00	25.50	-5.63%	+9.14%
PDVSA 5 3/8 04/12/27	28.05	26.45	-5.71%	+5.38%
PDVSA 9 3/4 05/17/35	31.10	28.50	-8.38%	+0.49%
PDVSA 5 1/2 04/12/37	27.85	26.45	-5.00%	+6.15%

Table N° 1: Performance of Venezuela and PDVSA bonds, April 2018.
***NOTE: VENZ bond returns were adjusted to account for the accrued interest lost, per the EMTA resolution of January 5th 2018.**

Venezuelan debt posted a negative return of -5.54% in April 2018, measured by the JPMorgan EMBI+ Venezuela index. On average, PDVSA bonds (-6%) underperformed VENZ (-3.9%). In contrast, PDVSA 20 bonds closed the month in positive territory, advancing + 1.2% and settling at a price of 86.75%, more than double that of VENZ bonds due in 2018. Generally speaking, high coupon bonds presented the biggest price drops, while a sample of VENZ securities (18n, 19, 23 and 34) outperformed. Market watchers have pointed out that these select issues caught a bid from investors seeking to position in bonds with more days of past-due interest, which presumably would have a higher recovery value in the context of a hypothetical negotiation where accrued interest is taken as part of the liability to be restructured.

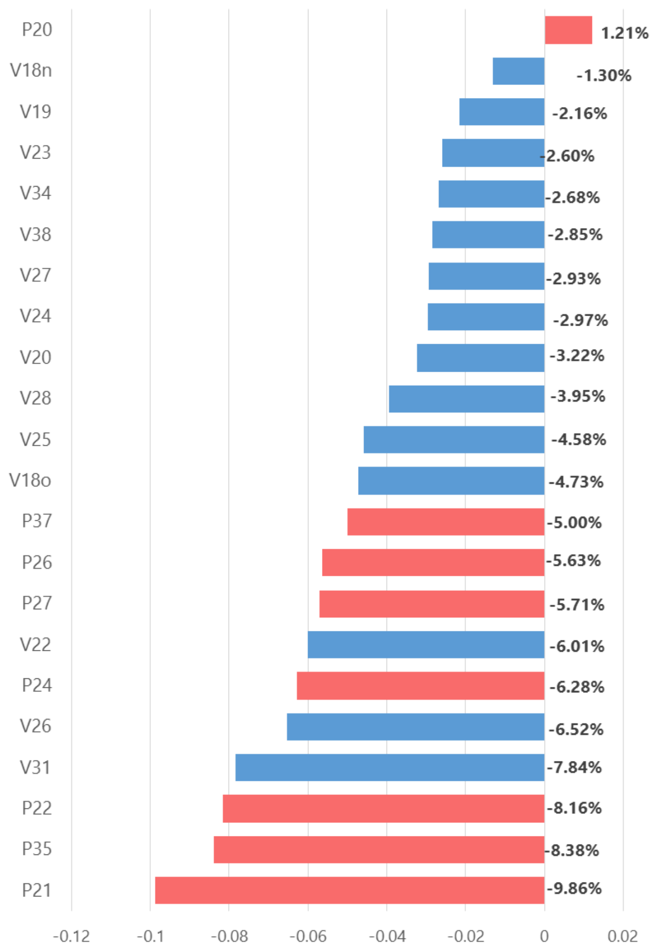
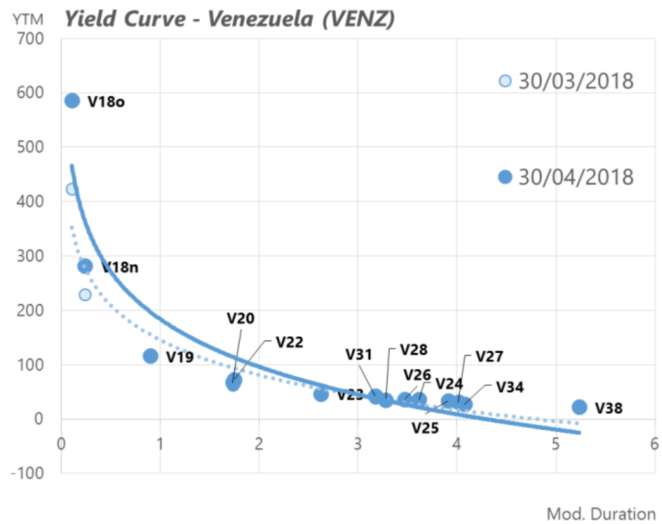


Chart N°2: VENZ/PDVSA bonds by Total Return, April 2018. Returns were adjusted to account for the accrued interest lost, per recent EMTA resolutions.
Source: Bloomberg, Knossos Asset Management.

Evolution of the curves

Graphs 3 and 4 show the evolution of the yield curves of Venezuela and PDVSA bonds in April 2018. In the case of VENZ, the curve shifted strongly upwards, as the VENZ 18 approaches its expiration date (the securities presented a rise of +16500 bps to yield 586%). Excluding the 2018 maturities, the VENZ curve moved upwards by +167bps during April, without significant differences between the short and long end.



Graph N°3: Venezuela Yield curve changes, April 2018.
Source: Bloomberg CBBT.

The PDVSA curve shifted higher, especially in the short end (PDVSA 21 led the move higher at +1365bps, to yield 89.50%). In contrast to unsecured debt, the PDVSA 20 showed a drop of -370bps, to close the month with a yield of 19.7%.

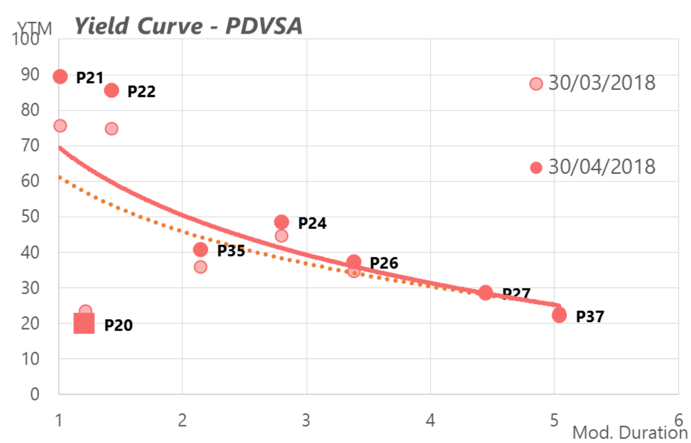


Chart N°4: PDVSA Yield Curve changes, April 2018.
Source: Bloomberg CBBT.

Acceleration: avoid at all costs

The timely payment of the PDVSA 20 coupon made it clear that the government's strategy consists on avoiding an imminent process of external debt acceleration at all costs. Although the strategy seems clearly unsustainable, especially because it doesn't preclude unsecured creditors from accelerating, the government nevertheless preferred to avoid (or at least postpone) the risk of an expensive liquidation process of Citgo Holding at a critical moment for the Maduro government, in which it faces an unprecedented crisis in the oil industry and a latent risk of losing power through the ballot box. The strategy in terms of debt service in the coming months should maintain the trend observed throughout 2018: total default on unsecured bonds, and timely payment on securities likely to trigger an acceleration process by creditors. This implies a high level of improvisation in the external debt management and the possibility of an accidental default, in case the capacity and willingness to pay demonstrated in this payment could not be sustained for the USD 950 MM maturity (capital plus the second principal amortization of PDVSA 20) due next October 28.

In addition, the timely payment of PDVSA 20s refuted the hypothesis that unpaid coupon payments were withheld by the fiscal agent. This theory was based on the narrative of the "financial blockade" wielded by the Maduro government as the main argument behind the external debt default. On the contrary, recent developments indicate that the government responded to a cost-benefit analysis and determined that defaulting on unsecured bonds would not trigger an imminent acceleration process, since Citgo Holding represents the only PDVSA asset with significant liquidation value, and the first lien entitled to holders of the PDVSA 20 bond would imply that holders of this security would have absolute priority over the rest of the curve when monetizing this asset of the state oil company.

The strategy of unsecured debt holders suggests a medium-term horizon and seems to be oriented towards the accumulation of past-due interest. From the point of view of these creditors, incentives are aimed at waiting for a transition and an improvement in the financial condition of the Republic, with the aim of being able to maximize its recovery value in the context of recovering oil output and renewed access to the capital markets. A key variable during the hypothetical restructuring lies in the treatment that creditors would receive from different segments of the curve, especially the creditors of high coupon bonds versus the holders of low-dollar value bonds. The principle of *pari passu* states that all debts of the same payment rank must be subject to the same conditions in the case of a restructuring; however, price differentials between different bonds of the curve persist, of up to 10 points in some cases. It is clear that the decision on which bond offers the best risk/return ratio is not obvious at the current juncture.

In this sense, the historical precedents are mixed with respect to the accumulation of interests in default. In cases such as Argentina (2001) all the bonds in default that were not restructured in 2005 accrued at a common interest rate, until the Macri administration reached a final agreement with the holdout creditors in 2016. In the case of Dominican Republic (2005) the issuer offered creditors a distressed exchange, consisting of a five-year extension and the payment 'in kind' (ie, additional bonds) corresponding to the interest accrued in the year and a half elapsed between the default and fulfillment of the debt restructuring; evidently, past due coupons were different for each security in this case. Finally, in the case of Russia (1998), the government defaulted on local-currency liabilities before doing so with foreign currency bonds; additionally, the fall in long-term bonds was much greater than those in the short end in the days immediately following the declaration of default, but ultimately the recovery value was the same for all creditors in each currency.

Although unsecured creditors have little incentive for debt acceleration, there are two issues (in addition to the PDVSA 20) that could be problematic for the Maduro government in the remainder of 2018. First, there is the PDVSA 6% 22 (the "hunger bonds" in which Goldman Sachs reports a majority position of USD 1,330 million, or 44% of the issue). There are no coordination problems to accelerate the indebtedness, as Goldman exceeds the threshold of 25% of holders established in the prospectus as a condition to initiate processes of this nature. The other issue that could cause problems is VENZ 18 13.625%, of approximately USD 1,000 MM face value and maturing next August 15. This bond has no collective action clauses and was issued prior to Chávez's ascent to power, which makes it particularly attractive for holdout funds concerned about the legal characteristics of their investments. There's no publicly available register of holders of the VENZ 18s, so it could be the case that a critical mass of creditors is stealthily positioned in this instrument and preparing to litigate against the Republic if the principal payment due in August does not materialize.

The May 20 will take place in the context of a demotivated electorate without guarantees of fair conditions for the opposition candidate. April saw the official start of the electoral campaign (although both candidates have been campaigning unofficially since the end of February). The polls favor the opponent Henri Falcón by a slight margin against Maduro, but the current president has the key advantage of having full discretion over state resources to finance the campaign, which is why most analysts expect him to be re-elected.

The market consensus is that a win by Maduro is all but priced into current bond prices, but that there is also a greater potential for a sizeable rally if Falcón surprised with an electoral victory. **In contrast, we consider that the election results could be the trigger for a new phase of the country's political-economic crisis, as we assign a high likelihood to the US expanding the sanctions regime against the Maduro government if he were to be declared the winner.** In this context, the downward trend in bond prices could aggravate in May if Maduro gets reelected in the contest.

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