Venezuela/PDVSA Monthly Report
August 2017

Venezuela and PDVSA bonds behaved erratically throughout the month of August. Despite prices were on average unchanged with respect to July's closing levels (*See Chart N° 1 attached)*, there was an unprecedented disparity in performance between short- and long-term maturities. The month started with a sharp bounce in bond prices, led by the PDVSA 8.50% 2017 – which went up by over 10 points in the first week of August – after investors reassessed the risks of US economic sanctions in the short term. After the initial bounce, the long end of the curve retraced back to the year's lows; meanwhile, the 2017 and 2018 maturities continued to be in strong demand, propelled by rumors that the government was looking to coordinate with China a bond buyback program for the closest-to-maturity bonds.

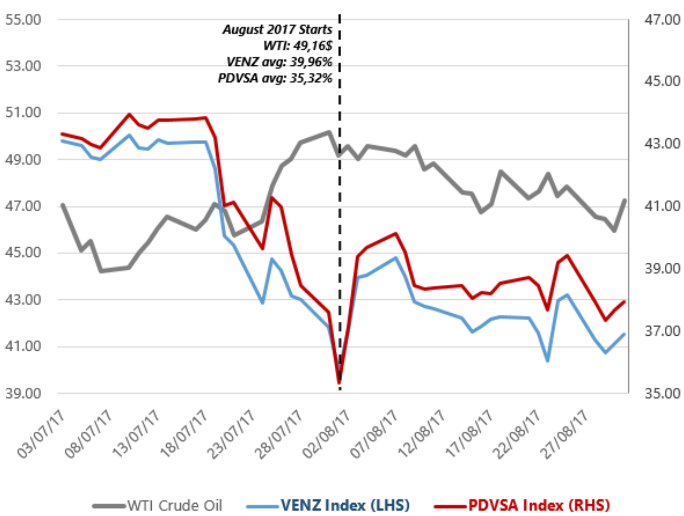

Chart N°1: VENZ and PDVSA avg. bond prices vs prices of WTI Oil (Jun-Jul 2017). ***Source: Bloomberg BGN, own calculations.***

The negative performance throughout most of both curves was attributed to a constant stream of credit-negative headlines. Venezuela's crude oil basket lost -4.3% of its value; on the other hand, International Reserves fell by -2.2% (-220mm USD) and oscillated below the 10Bn mark throughout the month. In addition, Fitch cut the Republic's rating by a notch (to CC, citing a high probability of default in the short term); Crystallex kept on advancing in their litigation against the country (this time, a New York court authorized the Canadian miner to confiscate Venezuela's deposits in BNY Mellon in order to collect on its USD 1.4Bn claim); and the late release of PDVSA's 2016 financial statements, which reflected a -90% collapse in net profit, a fall in output close to 300k bbl/d and the recognition of USD 6.5Bn in private loans with Rosneft (payable with crude oil sales in the future, and thus worsening the liquidity position of the state oil company).

Lastly, the US government imposed sanctions in the Venezuelan credit market. The White House illegalized the issuance of new USD-denominated debt. Specifically, the sanctions outlaw the purchase or sale of all debt securities issued by the Republic or PDVSA issued after the decree (except for short-term commercial debt) and trading on the VENZ 2036 bond, issued at the end of last year. Additionally, strong restrictions were put to financial transactions directly or indirectly involving Venezuelan public entities. On the other hand, CITGO is banned from sending dividends back to its parent, and all secondary-market transactions would be now subject to getting a license from the OFAC.

In response, several counterparties have cut their exposure to Venezuelan debt; specifically, Credit Suisse imposed strong internal controls (as well as forbidding all trading on PDVSA 6% 2022 and VENZ 2036 bonds), and Cantor Fitzgerald (including its subsidiaries GFI and BGC) suspended its brokerage business in VENZ/PDVSA bonds indefinitely.

In parallel, the Maduro government installed the National Constituent Assembly (ANC by its Spanish acronym), against the will of millions of Venezuelans. In its first session, the ANC granted itself all-encompassing powers over all public entities and a two-year ruling period; additionally, it ruled that regional elections (which had to be undertaken in 2016) will take place in October. The opposition, unable to neutralize the imposition of the ANC, agreed on participating in the elections, demoralizing civic society and as a consequence, the capacity of convening mass protests against the government was lost.

Monthly Performance

Venezuela and PDVSA bonds closed around unchanged on average in August, and returned +1.6% including interest. However the performance disparity was extreme, up to 3500 basis points between the month's leader (VENZ 13.625% 2018, which shot up +26%) and the laggard (VENZ 2038, -8.8%). In general terms, medium- and long-term bonds kept on plumbing new 52-week lows, while the short end of the curve bounced sharply throughout the month, erasing most of the losses experienced in July.

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Security	31/07/2017	31/08/2017	Total Return	Total Return (2017 YTD)
VENZ 13 5/8 08/15/18	59.00	74.75	+25.89%	+1.30%
VENZ 7 12/01/18	51.40	59.15	+15.93%	-0.67%
VENZ 7 3/4 10/13/19	42.75	44.25	+4.85%	-10.38%
VENZ 6 12/09/20	39.50	39.25	+0.66%	-9.82%
VENZ 12 3/4 08/23/22	44.40	45.50	+4.44%	-11.53%
VENZ 9 05/07/23	38.65	36.90	-2.40%	-9.89%
VENZ 8 1/4 10/13/24	38.25	36.10	-3.55%	-9.63%
VENZ 7.65 04/21/25	38.90	35.80	-5.90%	-9.03%
VENZ 11 3/4 10/21/26	42.20	40.50	-1.52%	-13.35%
VENZ 9 1/4 09/15/27	41.90	39.95	-2.47%	-9.89%
VENZ 9 1/4 05/07/28	38.35	36.00	-3.78%	-10.27%
VENZ 11.95 08/05/31	41.25	41.15	+2.00%	-11.39%
VENZ 9 3/8 01/13/34	40.00	38.20	-2.39%	-5.69%
VENZ 7 03/31/38	38.85	34.65	-8.83%	-9.09%
PDVSA 8 1/2 11/02/17	75.05	90.45	+20.94%	+20.25%
PDVSA 8 1/2 10/27/20	65.25	73.90	+13.86%	+7.87%
PDVSA 9 11/17/21	39.55	38.90	+0.38%	-14.72%
PDVSA 12 3/4 02/17/22	44.90	45.50	+3.31%	-11.09%
PDVSA 6 05/16/24	32.85	30.50	-5.40%	-11.48%
PDVSA 6 11/15/26	32.50	30.35	-4.81%	-10.14%
PDVSA 5 3/8 04/12/27	32.55	30.35	-5.10%	-10.25%
PDVSA 9 3/4 05/17/35	38.45	35.85	-4.31%	-12.25%
PDVSA 5 1/2 04/12/37	32.55	30.20	-5.43%	-9.22%

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

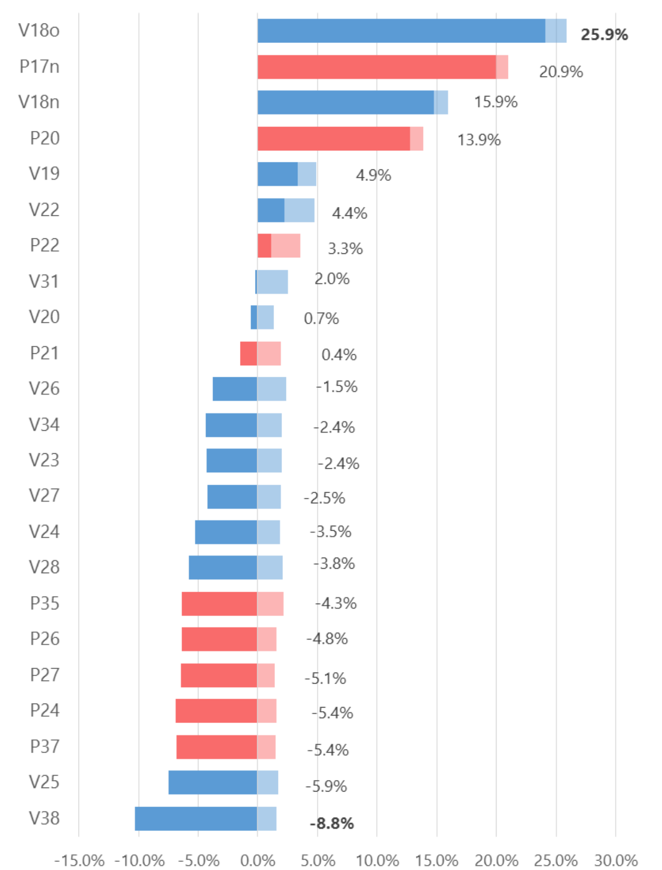
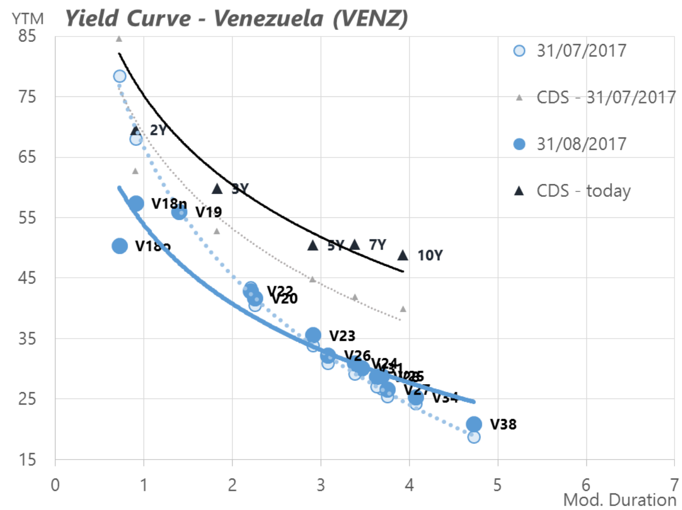


Chart N°2: VENZ/PDVSA bonds by Total Return, August 2017.
NOTE: total return separated by changes in market value (dark) and accrued interest (light section); return figures do not assume coupon reinvestment

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 July of 2017, respectively, for both cash bonds and CDS. The Venezuela sovereign curve reversed most of the upward shift in the short-end experienced in July, while the long-end shifted slightly upwards. Yields fell by -180bps on average, but the figure is misleading: excluding the 2018 maturities (where yields collapsed over -2000bps), the rest of the curve shifted upwards by +120bps during August.



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

The PDVSA curve performed in-line with the sovereign: unprecedented compressions in short-end yields (YTM on the PDVSA 8.50% 2017 fell by 6700 basis points) combined with a parallel shift up in the long end. On average yields went down by -733bps throughout the cash bond curve, but went up by +150bps excluding the PDVSA 8.50% 2017 and PDVSA 2020 bonds.

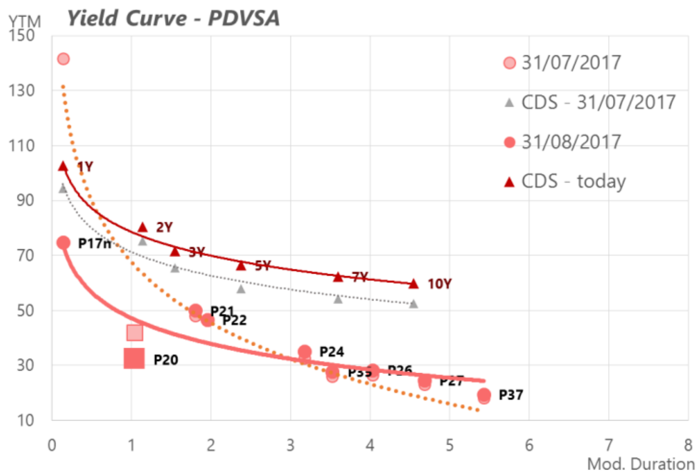


Chart N°4: PDVSA Yield Curve changes, August 2017.
***Source: Bloomberg* CBBT.**

October on the horizon: can they keep on paying?

Even though the most recent sanctions imposed by the US do not represent the existential threat feared by the market, the rules of the game have changed. As covered earlier in this report, several key Wall Street players have imposed increasingly stricter controls on Venezuelan bond trading, and compliance checks among the still-active participants have become more rigorous. This setting has affected dedicated investors disproportionately, which have seen increasing obstacles to trade the credit during the past months. In this context, it was evident to expect a mass liquidation on benchmark bonds; during the past weeks, the securities have drifted towards new lows for the year even though oil prices have stabilized above the 45$/bbl mark

The dependence of Maduro's political project to Russian financing is becoming increasingly more evident, and more worrisome for the Republic's financial position. A Reuters report, published at the beginning of the month and partially confirmed afterwards in the notes of PDVSA's financials, pointed out that Russian oil company Rosneft had been extending credit to its Venezuelan counterpart under the figure of 'prepaid oil shipments' since 2014. Since then, PDVSA had allegedly used this source of financing to cover debt maturities in two separate occasions, and after failing to repay USD 4Bn of the loans in due time, it has become forced to deliver more than 200k bbl/d of oil to Rosneft to cover its debts. Short-term liquidity has become painfully expensive for the Republic, as reflected by an increasingly stretched cash flow in hard currency, as well as in the need to deliver JV stakes to the Russians in projects all across the country, not only in the Orinoco Belt but also in the Maracaibo Lake and even on the Paria Gulf.

China's appearance as 'bond buyer of last resort' reignites short-end bullish bets. Rumors of the still-incipient buyback deal have encouraged a strong *rally* in bonds maturing this year and next, but there are still no concrete details about the nature of the operation that deal that's allegedly under being negotiated between Venezuela and China. According to the brief statements provided by public officials interviewed on the matter, the Republic is looking to finance a buyback at discounted prices for the bonds amortizing next October (PDVSA 8.50% 207 and PDVSA 2020), in order to transform the financial commitments into a bilateral loan between Miraflores and Beijing and thus avoid a credit event later in the year. The negotiations have been hermetic, in classic Chinese fashion, so we only can speculate that the authorities are taking into consideration the impact of the restrictions on financial transactions imposed on Venezuelan debt by the Trump administration, as well as the possibility of an escalation of the targeted sanctions regime in the short term. Increasing authoritarianism by Maduro & Co., cemented in the installation of the National Constituent Assembly and the incessant hostile rhetoric against the Venezuelan opposition, suggests that the White House will continue to deepen its policy of sanctions, complicating any refinancing operation involving bonds issued under US law.

The fate of the Q4 2017 maturities rests upon three major unknowns: Capacity, Willingness and Viability to pay. With regards to capacity, the stock of liquid reserves held by the Republic sits between USD 1.5 and 2Bn according to the analysts, an amount that's insufficient to cover the October/November maturities (of around USD 3.7Bn). Willingness to pay is another wild card; recent comments by Maduro – inviting bondholders to convene to a meeting in Venezuela to discuss the current situation – suggest that the government might be willing to explore with its creditors the range of options available in the context of the newly-established *'financial blockade'* his regime is now facing. Lastly, investors are facing the increasingly higher risk of a total standstill in the Venezuelan debt market, brough either by more counterparties suspending their trading activity, or by the US government imposing a direct prohibition on capital and/or interest payments on bonds, a situation that might trigger a credit event even in a scenario where Venezuela has both capacity and willingness to serve the upcoming debt maturities.

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