KNOSSOS ASSET MANAGEMENT

AN AFFILIATED COMPANY OF MIURA GROUP

Venezuela/PDVSA Monthly Report
February 2017

Venezuela and PDVSA bonds close in February with positive total returns for the third straight month, albeit with increased price volatility. During the month, which was characterized by high debt service (USD 705mm in coupons between VENZ 13,625% 2018/2022/2031 and PDVSA 2022), the market alternated between **ups** – driven by coupon reinvestment flows - and **downs** – triggered, among other factors, by the designation of VP Tareck El Aissami in the US Treasury Department's OFAC list of alleged drug kingpins. A rally in the last days erased most of the losses, and bonds close near last month's closing levels (*See Chart N° 1*).

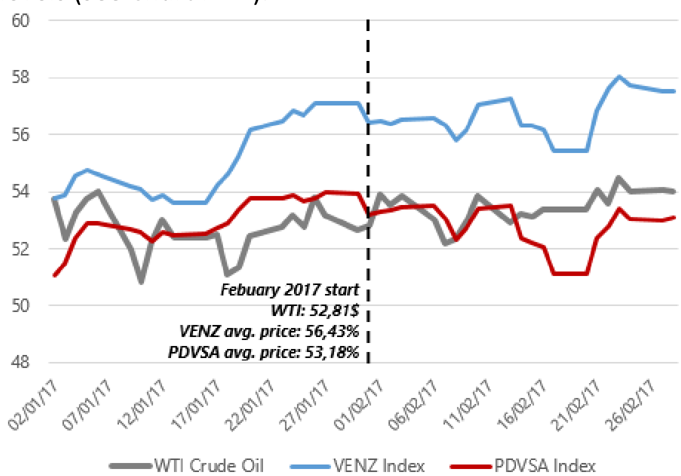


Chart N°1: VENZ and PDVSA avg. bond prices vs prices of WTI Oil (Jan-Feb 2017). *Source: Bloomberg BGN, own calculations.*

Following January's market trend, short and medium-term bonds, especially the 2019 and 2020 tenors, outperformed. In contrast, selling flows concentrated on PDVSA low-dollar-value debt. This is consistent with the analyst consensus of reduced default probability in the near future, but a negative outlook for the credit down the road. The continued slump in Reserves (currently at USD 10.42Bn, -2.2% in February) and the search for all possible external financing options, including a repurchase operation worth over USD 1Bn between the Central Bank and Nomura -according to a Reuters piece released on Feb 9th-, suggest that the economic authorities are keeping on their strategy of willingness to pay "at all costs" from the previous years.

The external backdrop remains positive for Venezuelan debt. Emerging Market bond funds received around USD 6.6Bn of inflows in February (USD 9.96Bn net inflow year-to-date) and oil prices hover near 18-month highs. In addition, the sharp compression in spreads on global High Yield debt seen in the past months has increased the relative attractiveness of Venezuelan debt and despite recent gains, bonds are still trading at 20%+ yields, which remains significantly higher than the rest of the EM HY universe.

Monthly Performance

Security	31/01/2017	28/02/2017	Total Return
VENZ 13 5/8 08/15/18	88.15	**89.95**	+3.07%
VENZ 7 12/01/18	73.75	**72.80**	-0.53%
VENZ 7 3/4 10/13/19	60.90	**65.70**	+8.54%
VENZ 6 12/09/20	52.90	**55.60**	+5.86%
VENZ 12 3/4 08/23/22	65.80	**68.75**	+5.54%
VENZ 9 05/07/23	50.90	**52.85**	+4.99%
VENZ 8 1/4 10/13/24	47.70	**48.50**	+2.95%
VENZ 7.65 04/21/25	46.60	**47.40**	+2.88%
VENZ 11 3/4 10/21/26	58.90	**59.20**	+1.96%
VENZ 9 1/4 09/15/27	53.40	**52.65**	-0.13%
VENZ 9 1/4 05/07/28	48.80	**48.70**	+1.26%
VENZ 11.95 08/05/31	58.65	**59.10**	+2.15%
VENZ 9 3/8 01/13/34	49.25	**49.75**	+2.52%
VENZ 7 03/31/38	44.90	**45.15**	+1.71%
PDVSA 5 1/4 04/12/17	93.65	**95.95**	+2.84%
PDVSA 8 1/2 11/02/17	87.05	**87.20**	+0.87%
PDVSA 8 1/2 10/27/20	77.90	**81.10**	+4.85%
PDVSA 9 11/17/21	57.35	**57.25**	+1.05%
PDVSA 12 3/4 02/17/22	66.05	**67.50**	+3.45%
PDVSA 6 05/16/24	40.30	**39.95**	+0.32%
PDVSA 6 11/15/26	38.25	**37.75**	-0.17%
PDVSA 5 3/8 04/12/27	38.00	**36.80**	-1.97%
PDVSA 9 3/4 05/17/35	50.50	**49.75**	+0.03%
PDVSA 5 1/2 04/12/37	37.90	**36.50**	-2.52%

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

Venezuela and PDVSA bonds appreciated by 1% in February and delivered a total return of +2.15% including interest. The best performers were the 2019-2020 maturities (VENZ 2019 led the month with a +8.5% return). PDVSA bonds underperformed, especially on the low-dollar-value segment of the curve. PDVSA 2037 lost -2.5% for the worst performance in the month among both curves (*See Chart N° 3 for the full rankings*).

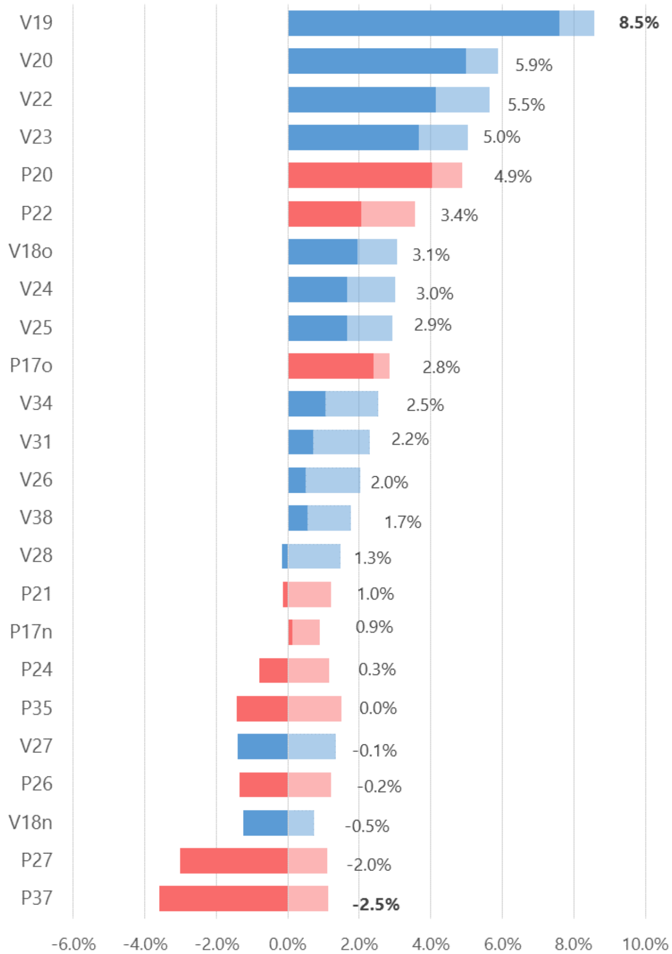
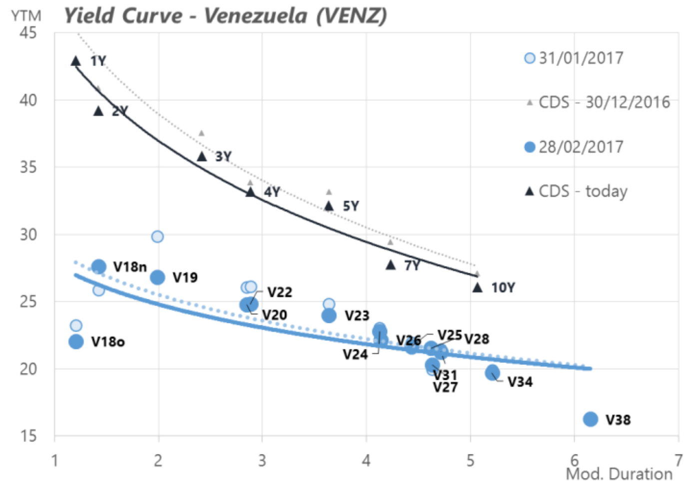


Chart N°3: VENZ/PDVSA bonds by Total Return, February 2017.
NOTE: total return separated by changes in market value (dark) and accrued interest (light section); return figures do not assume coupon reinvestment
Source: Bloomberg, Knossos Asset Management.

Evolution of the curves

The following charts (*N° 4 and 5*) show the evolution of Venezuela and PDVSA yield curves in February 2017, both for cash bonds and CDS. The Venezuela curve continues to bull-steepen and VENZ 2019 showed the greatest yield compression in the complex (-301bps). Not all short-end bonds outperformed, though: the yield on VENZ 7% 2018 rose by +175bps, affected by its relative richness at the start of the month. All-in-all, yields fell -47bps on average.



Graph N°4: Venezuela Yield curve changes, February 2017.
Source: Bloomberg CBBT.

In contrast, the PDVSA curve shifted upwards during February. Yields on PDVSA 2017 bonds rose by +250bps, around five times the average move in the curve (+54bps). There was an important exception: yields on PDVSA 2020 fell by -190bps, suggesting that investors are pricing in an increasingly higher value to the CITGO Holding collateral (or are reducing their assessment of the associated legal risks).

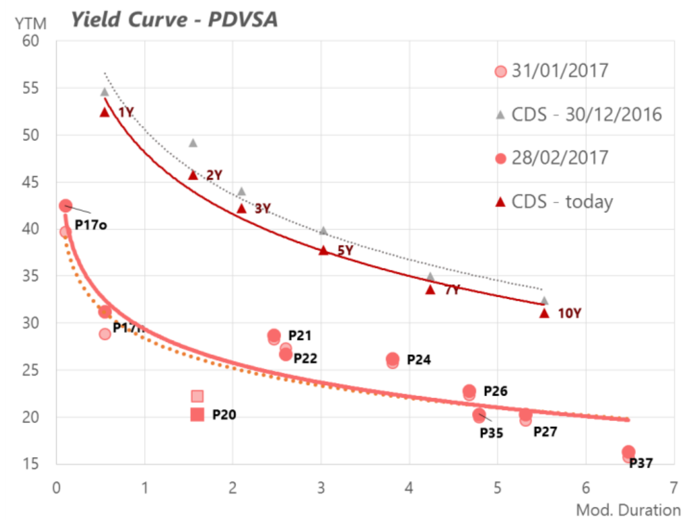


Chart N°5: PDVSA Yield Curve changes, February 2017.
***Source: Bloomberg* CBBT.**

US sanctions, cash flow dynamics and FX financing

The US Treasury Department sanctions imposed on El Aissami led to a sharp selloff in the market, despite not representing a direct threat against the Republic or PDVSA's capacity to remain operational and current on their obligations. However, the change in stance of the Trump administration is evident. The US Senate passed a resolution with bipartisan support on February 28th calling for a constructive dialogue process between the government and the opposition, while also supporting the OAS's call for applying the Inter-American Democratic Charter on Venezuela if dialogue fails. These actions could escalate in the near future, especially if the Maduro administration persists in its systematic repudiation of the demands of the international community (hosting much-delayed regional elections, freeing up political prisoners, opening up a humanitarian aid channel, etc.).

There has been no confirmation yet on whether the Repo operation between BCV and Nomura was executed; likewise, there has been no follow-through on the proposed extension of USD 5 Bn in capex financing from China (announced by state media on February 13th). The recent fall in PDVSA's oil output to 2mm b/d (according to secondary sources at the end of February) emphasizes the operational distress of the national industry and the urgent need for multi-billion capex investments in the Orinoco Belt to barely match last years' output levels. This situation should lead to renewed pressure by multinationals currently operating in the country for the government to effect reforms in the sector and encourage private FDI, the only viable alternative in the current context of the nation's external finances. In this sense, a partial reform of the country's FX legislation was approved at the end of February, rising the share of hard currency earnings that private exporters are allowed to retain from 60% to 80%.

The Republic's cash flow dynamics will have a breather in March, before the critical month of April and the maturity of the PDVSA 2017 "olds". Debt service will decrease significantly next month to USD 229mm (coupons on VENZ 2027/2038). Given that these payments are due by the Republic, they will likely be paid by depleting BCV Reserves, risking a potential drawdown below USD 10Bn before April's heavy debt schedule (USD 2.9Bn due, including 2.1Bn in capital plus interest of the PDVSA 5.25% 2017). It's important to keep in mind that indenture for this bond does not allow for grace periods on the principal repayment, which means PDVSA will not have room to buy time as it did last November (when the state oil company took almost three weeks of grace period on the PDVSA 2035 coupon payment, alleging "operational setbacks").

Given the current environment, is it possible to see a further yield compression in the short end of the curve? We still consider that the answer to this depends critically on a positive oil market environment. A positive surprise in crude oil prices combined with the Executive's policy of 'willingness to pay at all costs' would allow the Republic to sustain the political-economic *status quo* until the end of the Maduro administration (which should be supportive for the VENZ 2018/2019 and PDVSA 2020 maturities). On the other hand, if oil prices surprised to the downside, we expect the market to take a more conservative positioning than the current stance, which would in our view imply a sharp selloff in short- and medium-term bonds versus a better support in long-term debt, especially on low-dollar-price bonds. Consistent with this, we remain concerned about a further increase in US crude output and exports as potential negative catalysts for the oil market. If this trend were to persist (threatening to cut into the market share of Middle East producers) the OPEC consensus of output cuts could unravel, triggering another wave of oversupply and a collapse in crude prices. This would affect Venezuelan debt disproportionately since the equilibrium in the external accounts of the Republic, more than at any other time in recent history, crucially depends on oil revenues.