Venezuela/PDVSA Monthly Report
September 2018

Venezuelan debt recovers its correlation with crude oil prices and posts a strong performance in September. Venezuelan and PDVSA bonds had a volatile month, falling more than 6% in the first half and then climbing strongly in the final week (see Chart N°1). A positive environment in the EM and energy sectors fostered the demand for Venny paper by distressed debt investors, who took advantage of near-record low valuations to buy long-term bonds of both the Republic and the state oil company and led to a slight increase in secondary-market trading activity. The rally at the final week coincided, remarkably, with Maduro showing up and making at speech at the UN General Assembly in New York.

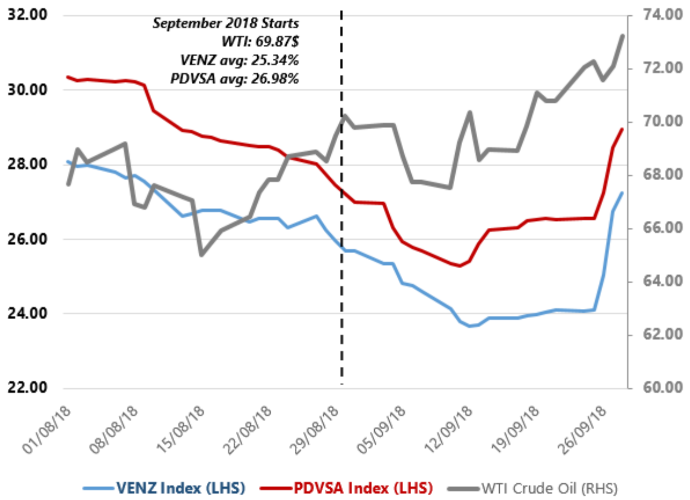


Chart N°1: VENZ and PDVSA avg. bond prices vs prices of WTI Oil (Aug-Sep 2018). *Source: Bloomberg BGN, own calculations.*

There have been no major changes in the oil industry's outlook, characterized by a continuous decline in production. According to OPEC secondary sources, oil product fell 36 thousand b/d in August, to 1.23m b/d; thus, the average production in 2018 represents the lowest annual reading in six decades.

On the economic front, the main development was the China-Venezuela high-level mixed commission, held in mid-month in Beijing. On September 15, Maduro announced the signing of 28 cooperation agreements with Beijing, focusing on the oil sector. In exchange for technical assistance, a 6-month extension of the grace period for principal payments on the Sino-Venezuelan joint fund, and the promise of a credit line of USD 5,000 million (still unconfirmed), Venezuela gave away 9.9% of its equity interest in the joint venture Sinovensa to Chinese state oil company CNPC. This change brings CNPC's stake to 45%, the highest for a foreign partner in all of the oil sector JVs, and the first time in post-nationalization history that the foreign counterparty has more than 40% of the equity in an oil project.

A key detail of the signed agreements is the pledge of the Venezuelan government to enact adjustments in monetary and exchange policy, given that the Chinese government is conditioning a subsequent extension of the grace period on principal payments to the improvement in the macroeconomic indicators of the nation. As a response to the pledge, the Venezuelan Central Bank established an unusual 100% reserve requirement ratio on new deposits (as of September 1), essentially neutralizing the financial sector's ability to expand monetary liquidity by the way of credit. This policy took place alongside a significant increase in the volume of foreign currency offered in the public foreign exchange system -rising to more than USD 5.3 million per week at the end of September-, and a sharp drop in business confidence and economic activity, driven by the unprecedented 5900% increase in the minimum wage, which spells doom for most small- and medium-enterprises. This combination of monetary tightness and the negative shock to activity has led to a sudden and massive appreciation of the real exchange rate, as a result of a stagnant black market rate in the midst of inflation rising at a more than 100% monthly average pace in the last semester.

Headlines were limited in the debt front, despite the volatility in bond prices. Of note, a group of PDVSA 20 holders (led by Blackrock and Contrarian Capital Management and holding about 60% of the amount outstanding) pushed forward a statement in Delaware court, noting that they would be against a sale of PDV Holding in favor of the Canadian mining company Crystallex. Their argument stresses that the forced sale of PDV Holding (and therefore of Citgo) would eliminate any incentive to the state oil company to pay the amortization of USD 950 MM that expires next October 29, forcing the holders to execute the collateral in an uncertain legal environment and thus risking a "*disruptive liquidation*" of their positions in the PDVSA 20. This opinion complements PDVSA's defense argument, which accuses Crystallex of "*seeking majority control of the company through value destruction*", and that it considers inadmissible that satisfying the arbitration award of the mining company goes beyond the operational concerns of Citgo.

Monthly Performance

Security	31/08/2018	28/09/2018	Total Return	Total Return (2018 YTD)
VENZ 13 5/8 08/15/18	26.50	27.70	+4.53%	-48.83%
VENZ 7 12/01/18	26.00	26.30	+1.15%	-34.07%
VENZ 7 3/4 10/13/19	25.40	25.85	+1.77%	+5.10%
VENZ 6 12/09/20	24.70	27.05	+9.51%	+16.65%
VENZ 12 3/4 08/23/22	26.20	27.70	+5.73%	+2.76%
VENZ 9 05/07/23	24.70	27.20	+10.12%	+20.66%
VENZ 8 1/4 10/13/24	25.00	26.60	+6.40%	+17.96%
VENZ 7.65 04/21/25	24.55	26.90	+9.57%	+20.83%
VENZ 11 3/4 10/21/26	26.25	27.80	+5.90%	+12.31%
VENZ 9 1/4 09/15/27	26.25	27.65	+5.33%	+10.84%
VENZ 9 1/4 05/07/28	24.55	26.05	+6.11%	+16.88%
VENZ 11.95 08/05/31	26.20	27.70	+5.73%	+8.40%
VENZ 9 3/8 01/13/34	27.10	29.55	+9.04%	+17.11%
VENZ 7 03/31/38	24.75	26.20	+5.86%	+16.69%
PDVSA 8 1/2 10/27/20	84.80	85.00	+0.24%	+2.49%
PDVSA 9 11/17/21	21.10	23.35	+10.66%	-22.55%
PDVSA 12 3/4 02/17/22	22.95	24.10	+5.01%	-32.07%
PDVSA 6 05/16/24	19.10	22.10	+15.71%	-7.30%
PDVSA 6 11/15/26	19.15	21.95	+14.62%	-6.51%
PDVSA 5 3/8 04/12/27	20.75	22.05	+6.27%	-12.97%
PDVSA 9 3/4 05/17/35	21.35	23.40	+9.60%	-18.47%
PDVSA 5 1/2 04/12/37	20.75	22.10	+6.51%	-12.15%

Table N° 1: Performance of Venezuela/PDVSA bonds, September 2018.
***NOTE: Returns were adjusted to account for the accrued interest lost, per recent EMTA resolutions.**

Measured by the JPMorgan EMBI+ Venezuela index, VENZ government bonds posted a +6% return in September 2018. PDVSA, on the other hand, recorded an average advance of + 8.5%, with double-digit gains in the belly of the curve. Investor demand focused on low dollar value bonds (PDVSA 24/26, VENZ 20), as well as in relatively high coupon securities and low nominal prices (PDVSA 21/35, VENZ 23/25/34). In contrast, short-term bonds substantially underperformed in the up move, especially in the case of PDVSA 20s (up only +0.25% in the month). This movement in debt prices suggests that investors are taking into account current interest to value the instruments, even though both issuers are in default for more than a year. The strategy consists of maximizing Past Due Interest (PDI), and operates under the assumption that a hypothetical future debt restructuring would take into account PDI as part of the liability subject to a recovery payment, either in cash or (more likely) in kind, through the issuance of a new restructured bond curve.

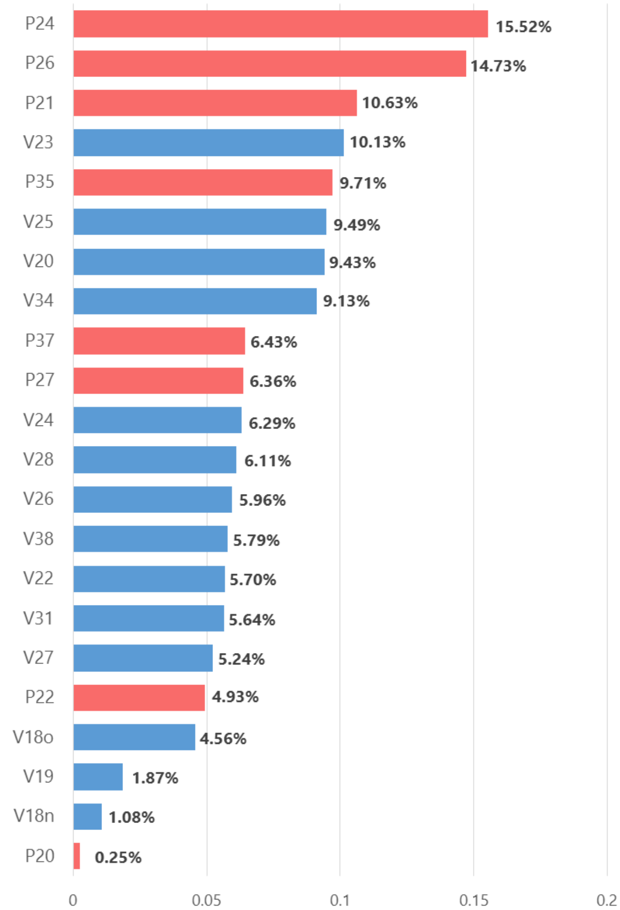
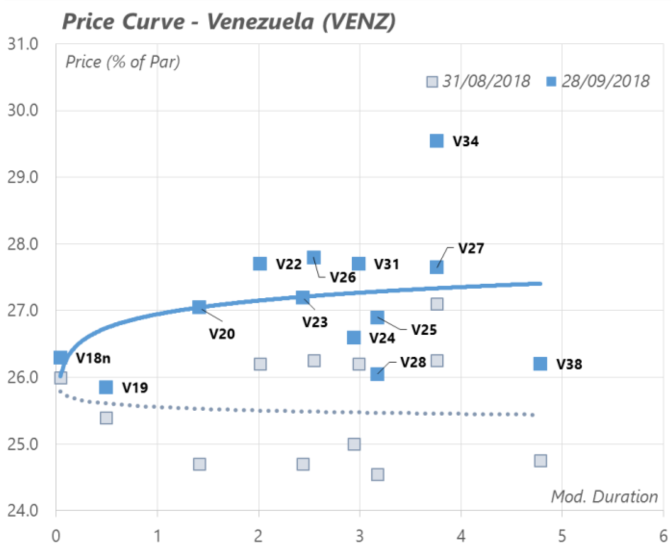


Chart N°2: VENZ/PDVSA bonds by Total Return, September 2018.
Source: Bloomberg, Knossos Asset Management.

Evolution of the curves

Graphs 3 and 4 show the evolution of the price curves of VENZ/PDVSA bonds at the end of September 2018. In the case of Venezuela, VENZ 34s are quoted with a premium of almost 3 points on average with respect to the rest of the curve. In addition to its attractive relationship between PDI and cash price, demand for this security is also explained by its high CAC threshold (85% of the vote of issuers is required to modify material terms, in contrast to 75% in the rest of the curve). It is possible that there is a group of investors that is accumulating a portfolio with more than 15% of the issue, in order to act as holdouts in future negotiations with the Republic. Beyond this outlier, the rest of the curve shows little variation in cash prices and follows a slightly positive slope. This could be driven by the fact that a longer tenor ensures a flow of PDIs at a known coupon rate. In contrast, the rate at which bonds with defaulted principal payments would accrue is uncertain, and is subject to a future court ruling on the settlement rate, which would not necessarily be the current coupon rate.



Graph N°3: Venezuela Price Curve evolution, September 2018.
Source: Bloomberg CBBT.

In the case of PDVSA, the curve remains strongly inverted as the PDVSA 20 continues to trade in the range of 80-90% versus average prices of 23% in the unsecured bonds. However, the recent legal controversy surrounding Citgo Holding has led to selling pressure on the PDVSA 20s, especially after the Delaware court ruling that set the stage for an eventual order to liquidate PDV Holding. As we mentioned earlier, a forced sale of the parent company of Citgo Holding could invalidate the collateral of the PDVSA 20s. However, the current prices seem to discount a low probability of occurrence of this event in practice.

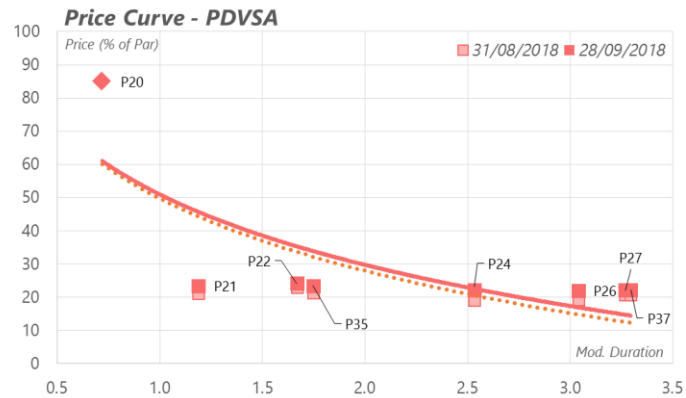


Chart N°4: PDVSA Price Curve evolution, September 2018.
***Source: Bloomberg* CBBT.**

Crystallex v. PDVSA 20 holders: who will win?

The main story of 2018 in the Venezuelan debt market is near its final chapter. *"Will they pay or not pay the amortization of the PDVSA 20s?"* is the biggest mystery that has surrounded the market in a year where VENZ/PDVSA bonds have lost their prominence in the EM credit sector. It has been an extremely complicated year for the Venezuelan economy and its bond market, after the beginning of the worst twin default/hyperinflation crisis in the history of Latin America. However, even though it has defaulted on all the other external creditors, the Maduro government has remained solvent in the PDVSA 20, the only liability in the almost USD 150bn pile of external debts and commitments with a collateral enshrined by international law.

In this context, the amortization of USD 950 MM of the PDVSA 20 next October 29 is subject to still-unsolved problems of capacity and viability of payment. PDVSA's incentives to maintain debt service in this security are evident, given that a non-payment would lead to the forced sale of Citgo Holding. However, beyond the willingness to pay, the key problems of capacity and operational viability to service the upcoming maturity are still present. PDVSA has seen its cash flow in hard currency severely affected by the accelerated fall in production and a growing tendency in recent years to request loans payable with future oil deliveries, under agreements with China (in 2007) and then with Russia (since the beginning of 2017). Because of this, it remains unclear whether PDVSA's own hard currency liquidity position would be sufficient for the amortization, even after having cut all other spending items to a minimum. However, the main risk factor in the market's view is that no Venezuelan public entity has correspondent lines with US banks. The Maduro government would thus have to bet on a successful execution with the chain of intermediaries for the last coupon payment on the PDVSA 20 (which, it should be noted, was made without delays on April 29).

Amidst the conflict between the creditors on the look for Citgo Holding, the holders of the PDVSA 20 defined their position. The statement by holders of PDVSA 20 can be understood as an argument against the liquidation in favor of Crystallex and also as an implicit alliance with Venezuela, since the bondholders expressed that their incentive is to continue receiving debt payments (and for therefore, that Citgo remains in the hands of PDVSA). In our opinion, the intervention of this group could result in a postponement of the resolution of the dispute between Crystallex and the Republic, at least until the end of the month (so they can have one lesser obstacle to receive their amortization payment). On the other hand, we also believe it is possible for Crystallex to continue advancing in a parallel lawsuit, also submitted in Delaware state courts, alleging a "fraudulent transfer" of collateral, which began in November 2016 in response to the use of Citgo holding shares as lien for the issuance of PDVSA 20.

Notwithstanding the outcome of the PDVSA 20 payment, the rupture of the "corporate veil" between the Republic and PDVSA implies that Venezuela has already lost possession of Citgo. In line with the conclusions of our previous report, we consider that it is not a matter of if, but when the US refiner will be liquidated (as it represents the only valuable external asset still in the hands of the nation), and who among the long line of external creditors of Venezuela would benefit from this liquidation. Therefore, the underlying problem for the Maduro government is to determine whether it is worth paying USD 950 MM to avoid a credit event in the PDVSA 20 for another semester, subject to the evolution of the multiple lawsuits against it that could also lead to a forced sale of Citgo Holding. Among the disputes, the case against ConocoPhillips stands out, where PDVSA promised to pay USD 500 MM over a period of 3 months (which expires at the end of November) to avoid asset seizures by Conoco. This is just one of the multiple obstacles faced by PDVSA in the period until the next payment date on the 20s. In any case, we believe that the Maduro government will attempt to resolve the liabilities due "*as they come*", and try to continue paying to extend their ownership of Citgo as long as possible.

China continues to be Venezuela's last resort ally, coming to the rescue again in September. There has been much speculation and few concrete announcements regarding the results of the China-Venezuela joint summit, in which Maduro met with Xi Jinping for the first time since 2016. In recent years, the trend for China has been not to extend new loans, but to give as much flexibility as possible for the repayment of current loans; while Venezuela has been increasingly insistent on the need for financing and direct investments in the oil sector, to the point that it has yielded record participation quotas for its Chinese partners of joint ventures. This position suggests an upper bound for China's financial support to Venezuela: a release of all oil exports that are sent for repayment, which is equivalent to a grace period on all payments - both principal and interest - in the Chinese Fund loans. This limit suggests that between 250 and 300 thousand barrels per day of output could be released and sold at market prices, leading to an incremental free cash flow of about USD 600 million per month for PDVSA. The counterpart of this position, also taking the Venezuelan stance to the extreme, would be a debt swap for equity participation for CNPC and other Chinese companies in the local industry, and not exclusively in the oil sector, considering the growing influence of Chinese capital in sectors such as Construction and Telecommunications.

On the other hand, Venezuela has not progressed in the macroeconomic stabilization required by the Chinese government to extend financial assistance. The result of the combination of financial repression and exchange intervention has been a mysterious stability in the parallel dollar, while the rest of the economy continues in a worsening hyperinflationary spiral. Although inflation continues to accelerate - at a rate of 223% month-on-month rise in August, which implies a rise of 200,000% in prices compared to August 2017 – the parallel market rate has been more than one month stagnant around VES 100-120 per dollar. The result is a massive appreciation of the real exchange rate, which greatly increases the cost of living and production costs in all industries in dollar terms. This situation, in our opinion, is unsustainable, and we believe the Chinese think the same. All-in-all, we assign a low probability to the execution of the USD 5,000 million loan that Venezuela is requesting since July without obtaining a confirmation from Beijing.

The rally of the last two weeks indicates that there is still optimism among investors about an imminent change of government in Venezuela. The rise in bond prices at the end of September coincided with a new round of US sanctions, this time targeting first lady Cilia Flores, defense minister Vladimir Padrino Lopez, and brothers Delcy and Jorge Rodríguez; all key pieces of Maduro's inner circle. In particular, comments by the US Treasury Department suggesting that sanctions are aimed at "changing the attitudes" of certain key actors, and that therefore could be reversed if concrete steps are taken to reestablish democracy and political freedoms in the country, represent a thinly-veiled incentive for the main players in Miraflores to take this opportunity to find a diplomatic solution to the crisis. Forfeiting this opportunity could mean an escalation in hostilities by the US, so we remain attentive to developments in political matters and specifically to diplomatic relations between Venezuela and Colombia, considering the recent deterioration in bilateral relations between both countries after comments from the ambassador of Colombia in the US, Francisco Santos, that *"all options should be on the table"* to deal with the crisis in Venezuela.

In this environment, and given that risk premiums in the rest of emerging markets continue to be attractive, we consider that the risk of exposure to Venezuelan debt in October may not be compensated. The only bond set to deliver cash flows for the bondholders is PDVSA 20, but its current market price reflects a minimum potential upside in the face of a successful repayment scenario, and a significant potential downside in a non-payment scenario, due to its price differential of more than 60 points with respect to PDVSA bonds without collateral. In the rest of the curve, save for a continued wave of optimism for regime change in Venezuela (an event that we do not see feasible, at least until the end of the year) we consider there are not strong enough factors that could lead to higher bond prices in the current context.

Credit Research and Strategy
Daniel A. Urdaneta Z.
+56 9 7990 8342
daniel.urdaneta@knossosfunds.com
Knossos Asset Management

Disclosure concerning 'Debt Research Reports'

This debt research report and the debt research analyst responsible for the content is not independent of the firm's propietary trading activity and is not subject to all of the independence and disclosure standards applicable to debt research provided to retail investors. While the author believes its sources are reliable neither the author nor Knossos Asset Management represent the information to be complete or accurate. Any views expressed in this message are those of the individual sender at the time of publication and do not represent the views and strategy of Knossos Asset Management, except where the message states otherwise and the sender is authorized to state the views of such entity. This is not an offer to buy or sell, or solicitation of an offer to buy or sell the securities mentioned. The Firm may have positions in the securities mentioned and may make purchases or sales of such securities from time to time in the open market or otherwise and may sell to or buy from its authorized counterparties such securities on a principal basis; such transactions may be contrary to recommendations in this material. This material is intended for Institutional Use only and should not be distributed, forwarded or otherwise disseminated. Under no circumstances is this material intended for use by any retail investor. Additional information is available upon request.