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VENEZUELA UPDATE

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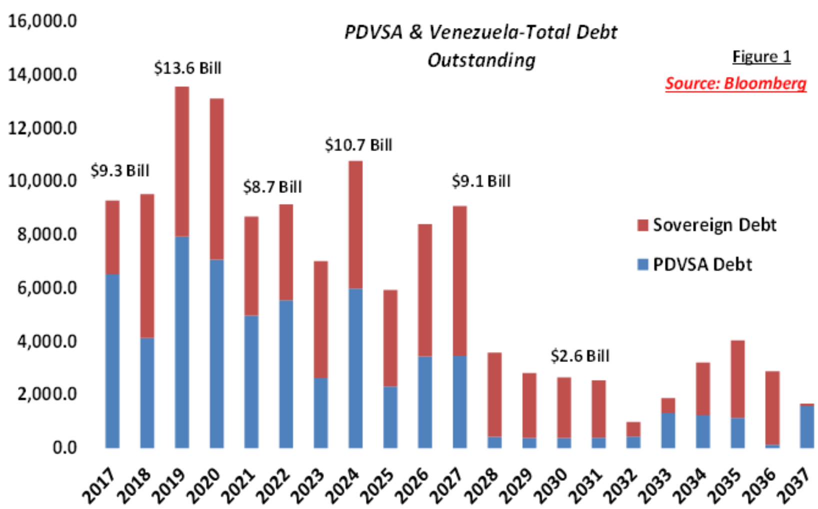
Aid from China & Russia

Venezuela (the sovereign & PDVSA) has accumulated arrears of approximately US$7.0 billion since it defaulted on its debt obligations in November-2017. The country has outstanding debt of approximately US$67 billion going out to 2038 with US$23.7 billion set to mature over the next five years (***Figure 1***). The amount owed is in addition to debt outstanding due to various international court rulings because of Venezuela's nationalization of private assets and industries in the past. Currently the only optimistic scenario that we see, which could provide a silver lining for investors, is the possibility of aid from China and/or Russia.

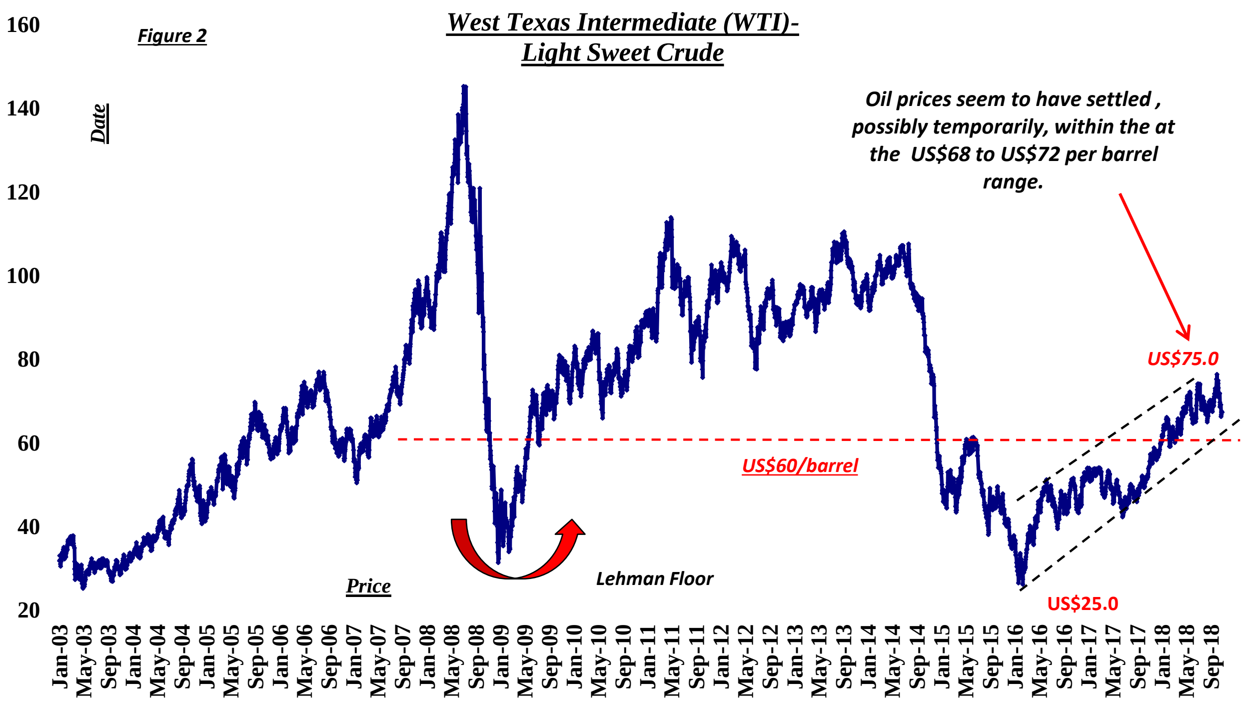


Aid to Venezuela could come in the form of direct liquidity to the government or in the form of support to the oil sector. Support in either form would be a positive for the country. Liquidity reserves, according to domestic media reports, have fallen as low as US$1.0 billion with the NIR coming from US$29 billion in 2012 and US$10 billion in 2016. However, any direct injection would face competition from varying needs (healthcare, basic food items etc.) with debt repayments to bondholders possibly coming down the rung.

Aid to the oil sector in the form of technical support, could represent a better long term outcome for bondholders. Production output from Venezuela's oil sector has fallen to a 33 year low.

Output as at August 2018 has fallen to 1.24 million barrels per day (b/d) from a high of 3.5 million b/d in 1997. Years of underinvestment, nationalization and misallocation of resources are the root causes of the fall in output. Directing aid towards repairing exploration and production (E&P/upstream) fixed assets would help more in our view. ***Essentially giving a man food as opposed to teaching him how to hunt/catch/produce his own food***. Recall that oil represents 96% of export earnings, 50% of government revenues and roughly 15% of GDP directly.

Providing aid to the ailing Venezuelan oil sector is even more attractive when viewed in conjunction with the ongoing rise in global oil prices (***Figure 2***). Oil has climbed from a low of about US$25/barrel in January-2016 to US$75/barrel in early October-2018. To date prices have pulled back to the high US$60's however the fact that prices were able to test the US$75/barrel mark would suggest that technical and geopolitical factors could push it that high again or even to a new recent high closer to US$80/barrel.



Both Russia and China have long standing oil-related relationships with Venezuela. **China** has provided loans to the tune of approximately US$62.0 billion since 2008. Recently (Sep-14), the ***Chinese Development Bank*** announced a US$5.0 billion line of credit to Venezuela aimed at boosting oil production. The money will be used to increase production at three joint venture oil production fields owned by PDVSA and the ***Chinese National Petroleum Corporation*** (CNPC).

Russia has understandably come in a bit later to the party than the Chinese due to their abundant supply of crude. Russian state-run oil company ***Rosneft*** has issued oil backed loans to the tune of US$6.5 billion to PDVSA. US sanctions against Venezuela, rising US protectionism (Trump driven trade disputes) and reduced Iranian supplies to China are among the major reasons for the renewed extension of support to Venezuela by both China and Russia.

Despite the aid, China is concerned about the management and technical expertise at the disposal of the Venezuelans. The Chinese government announced that it would ***deploy its own officials, including technical experts***, to ensure that its US$5.0 billion line of credit (Sep-2018) was utilized properly. This approach is in stark contrast to previous deployment of funds to the Venezuelan government.

Despite the aid however, it is widely viewed that the investments from China may not be enough to boost production given significant damage across the Venezuelan supply chain. The absence of field maintenance over the years, repeated power outages, the ongoing loss of skilled workers, limited domestic gas supplies and the absence of gas compression, which helps to liquefy and transport natural gas, are major hindrances to the production and supply processes. These constraints and a lack of confidence in PDVSA's leadership are the reason that China halted the pace of its support in 2014. The aforementioned factors are also the reasons cited for China not increasing its investments to pre-2014 levels.

CONCLUSION

The situation in Venezuela remains challenging. Economic instability, migration of members of the populous, hyper-inflation, continued political victimization and US sanctions are only some of challenges. The current support from both China and Russia is a silver lining as any aid which improves the oil production process is welcomed especially with oil prices climbing. That said, the aid is not projected to increase oil output to more attractive levels due to the myriad of factors outlined above.

Investors/remaining bondholders face the choice of either going to court in New York to seize PDVSA assets (including refineries in the Caribbean and oil tankers) or waiting to see how the situation plays-out. Whether foreign aid will allow President Maduro to weather the storm and return Venezuela to stability is the million dollar question.

Based on the above, we have no choice but to maintain our SELL on Venezuela at this time.

Source: Businessmonitor.com, Bloomberg, Capitaliq.com, Moodys.com

APPENDIX

IMPORTANT DISCLOSURES

ABSTRACT—As a part of our new Portfolio Strategy we are recommending strict adherence to the following Portfolio Allocation **DEFINITIONS/RECOMMENDATIONS**.

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