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INVESTOR UPDATE

NOVEMBER, 2017

VENEZUELA UPDATE - "The Inevitable Debt Restructuring"

SUMMARY

Venezuelan President Maduro has announced on state television that after the payment of the maturing 2017's on November 2nd, the country will enter into negotiations with creditors to restructure its outstanding debts. Sanctions imposed by the US have been blamed for the restructuring with the President noting that it has become increasingly difficult to negotiate the treacherous debt waters given the new paradigm. Recall that on August 24, 2017, US President Donald Trump issued an executive order banning US trade in new bonds issued by the government of Venezuela including its state-run oil company, PDVSA.

No official timeline has been given for the refinancing/restructuring nor have there been any details. However, there are some key discussion points that can give creditors guidance:

(I) **US Sanctions** will make any restructuring difficult as there is a ban on new bonds issued by the government of Venezuela including those issued by its state-run oil company, PDVSA.

(II) The restructuring could be **lengthy and complex** given the size of Venezuela's debt as well as the myriad of creditors owed.

(III) The **credibility of the ruling party** is an issue and hence creditors' confidence in agreeing any terms with the negotiating party will be tested.

(IV) Creditors will likely ask that needed **economic reforms** be a part of any deal. However the Maduro administration has been resistant to structured economic reforms.

(V) The recently instituted all powerful **National Constituent Assembly (ANC)**, which would likely have to sign off on any new debt agreement, has been declared as unconstitutional by international governments. They have been declared unconstitutional because it is alleged that the ANC was put in place to avoid constitutionally due elections for Mayors,

Governors and the President. It also has the "legal authority" to dismiss public officials and even change the constitution

(VI) The government is likely to **attempt to delay the default process** until it is able to divert oil exports from the US to China, India and Russia.

JMMB Research has had a sell recommendation on Venezuela from as early as 2015 and an underweight position from May17, 2013. Hence it should be no surprise therefore that Venezuela has gotten to the point that the President has been forced to announce plans to restructure the sovereign's debt. The main reasons for the announced plans stem from overly burdensome financial needs (interest & principal payments) combined with negative investor sentiments limiting capital market access, weak economic fundamentals, international sanctions and an ongoing economic crisis.

The total burden faced by Venezuela when we combine the debt owed by the sovereign and the state owned oil company, PDVSA is approximately US$114.8 billion. Between 2018 and 2020 overall, the country will need, on average, approximately US$12 billion per year. When we adjust our forecast to the medium term, between 2021 and 2027, total financing needs on average per year comes in at US$8.43 billion. It is only in 2028 and beyond (2037) that total financing needs per year, on average, declines to a more manageable US$2.5 billion. Consequently, given the factors outlined above, some form of restructuring was inevitable.

President Maduro has announced that after paying out US$1.1 billion due on November 2nd (the maturing 2017's), the country will seek to renegotiate ("refinance & restructure") its approximately US$114.8 billion hefty debt load. After years of irresponsible social spending, nationalization of major industries and general economic mismanagement—Venezuela found itself overly dependent on oil. As we have noted in previous research pieces (Venezuela Update-Mar-29-2016 etc.), Venezuela derives about 15% of GDP, 50% of government revenues and 95% of its exports from oil, gas and petroleum related products (the Hydrocarbon sector). Hence with the collapse of global oil prices in 2009 and again in 2015 and the moderate to weak recovery since, the problem has simply escalated out of control.

KEY POINTS TO CONSIDER IN THE RESTRUCTURING/ REFINANCING PROCESS

- **The Impact of US Sanctions.**
  The huge problem that Venezuela faces is that the sanctions imposed by the US makes a traditional market-based restructuring impossible under the Maduro administration. Recall that on August 24, 2017, US President Donald Trump issued an executive order banning US trade in new bonds issued by the government of Venezuela including its state-run oil company, PDVSA. Consequently the exchange of defaulted bonds for new bonds (the normal restructuring approach) with likely longer maturity dates, reduced coupon/interest payments and a principal haircut would not work.

- **The restructuring process could be time consuming and complex.**

While Venezuela has a massive debt burden in terms of money owed to the creditors in the capital markets, the country also has debt, worth billions, owed due to international arbitration rulings. Money is owed to firms due to past nationalizations of industries and even more money is owed to service providers, particularly in the oil sector. If these funds are added to the money owing to bond creditors, Venezuela's total debt to creditors climbs from US$114.8 billion to US$123 billion.

The process of creditor repayment is further complicated by the fact that **PDVSA bonds lack collective action clauses.** This means that even if the majority of bondholders vote to accept certain restructuring terms, this does not bind all creditors/owners of the bonds. Hence, holdout creditors may demand repayment in full from Venezuela, consequently extending the negotiation process considerably.

- **The other issue is the credibility, or lack thereof, of the ruling PSUV Party.**

The negotiating team charged with handling the debt restructuring is being led by Vice President Tareck El Aissami. The Vice President has been accused, by the US, of drug trafficking. This means that bondholders cannot legally engage with him. Hence assurances given by the VP will likely be viewed with some level of scrutiny.

- **Any deal put forward by the Maduro Administration will likely only get approval from creditors if important economic reforms are included.**

These reforms however are likely to be a major sticking point as the socialist/left leaning party has shown limited appetite for orthodox economic policies.

- **The restructuring could be delayed.**

The threat of an oil embargo on Venezuela due to undemocratic practices increases the sovereign's dependence on China, Russia and India. Currently it is estimated that Venezuela exports 700 thousand barrels of heavy sour crude oil (700k-bpd) to the US. Any restructuring would likely be met with legal action by creditors to seize overseas assets including refineries and oil shipments **which would eventually topple the government due to the absence of cash inflows to government coffers**.

It is therefore estimated that Venezuela will empty its coffers and continue to service its debt (with potential delays) until more of its exports to the US (700k-bpd worth approximately US$11 billion at current prices) can be diverted to China, Russia and India. It is estimated that only approximately 250K-bpd has been diverted from the US so far.

This approach could buy the Maduro administration time to shore up its coffers to at least deal with the purchase of food and other essentials. This would put the administration on a stronger footing to win back state power if/when elections are eventually called. **We believe, at this time, that this delayed approach will be the most likely scenario**.

The key dates when the sovereign will face liquidity pressures in the near term include;
(I) maturities of US$1 billion in August-2018 (sovereign),
(II) US$850 million in October (PDVSA), &
(III) US$1billion in December (sovereign).
In addition there are also US$5 billion in coupons coming due in 2018.