INVESTOR UPDATE

APRIL, 2017

VENEZUELA UPDATE

SUMMARY

We maintain our sell recommendation on Venezuela, as we believe that the underlying fundamentals have not shown significant improvement. The sovereign's ability to service its debt remains under severe strain because of continued hyper-inflation, economic contraction and ongoing political tensions.

THE FUNDAMENTALS

The latest forecasts indicate that economic activity contracted by 10% in 2016 and is projected to contract a further 2% in 2017. Recall that the lifeblood of the Venezuelan economy is oil, natural gas and other hydrocarbon related commodities/by-products. Venezuela derives about 15% of GDP, 50% of government revenues and 95% of its exports from oil, gas and petroleum related products. For most of 2016, oil prices fluctuated between US$30/barrel and approximately US$45/barrel. The forecast for 2017 is for prices to climb above US$50/barrel and remain there. This is likely the major reason for the more moderate contraction in growth as projected for 2017. Venezuela however needs oil prices to return to above US$80/barrel for the sovereign to run a balanced budget based on external estimates.

FINANCING OBLIGATIONS - A SOURCE OF CONCERN

Venezuela's gross external financing obligations which capture short term debt maturities, amortization and interest payments compared to their current account receipts/inflows---are under pressure. This ratio, referred to as the external vulnerability indicator, has deteriorated from 81.5% in 2010 to an estimated 210.3% in 2016. The forecast is for sustained pressure in 2017 with the ratio estimated at 203.6%.

For 2017 Venezuela has total cash flow needs of about US$9.3 billion comprising both the needs of the sovereign as well as PDVSA, the state run oil company. This suggests that 2017 will be an even more difficult year for Venezuela when compared to financing needs of US$4.9 billion in 2016. Remember also that in 2016 there was a swap deal involving the PDVSA 2017's which was used to ease the cash flow pressure on the sovereign overall. The next 3 years (2018 to 2020) will also prove challenging barring any major swap or restructuring. In total, Venezuela has average cash flow needs of approximately US$12 billion per year between 2018 and 2020.

THE POLITICS

The political situation in Venezuela should remain highly polarized. The division in views and political ideology between President Nicholas Maduro and the left leaning Chavismo political movement on the one hand and the Opposition, that won control of the National Assembly,---will continue to be a source of instability, protests and riots. The central government and the Maduro/leftist Supreme Court have been in open conflict with the National Assembly. Political tensions are expected to remain a source of instability leading to ongoing shortages of basic commodities, hyper-inflation and deteriorating living standards.

PDVSA AND DECLINING OIL REVENUE

Venezuela has the second highest proven oil reserves in the world behind Saudi Arabia. Nonetheless, the entity continues to miss its production targets. Production declined by 300 thousand barrels per day between 2015 and 2016. As at 2016 the oil production level is recorded at 2.4 million barrels per day, a far cry from the 3.3 million barrels per day recorded in 2004. Because of Venezuela's history of nationalizing private companies and not compensating owners appropriately, very few international oil companies are willing to invest in Venezuela's oil. Consequently, the heavy sour crude oil, which is sand based and has a high sulfur content, cannot be extracted with ongoing efficiency as new and ever evolving technology is required. This technology is possessed by the international oil companies.

A GOOD TIME TO EXIT

The recent moderate uptick in oil prices and the more robust forecast for price buoyancy has led some investors to have a more favourable outlook for Venezuela. In addition, the slight increase in oil when combined with the government's ongoing commitment to prioritize the payment of external debt is a positive. This has led to an uptick in Venezuela bond prices representing a good time to exit.

CONCLUSION

We maintain our sell recommendation on Venezuela. The economic fundamentals have not improved, and more importantly the financing requirements over the next 4 to 8 years represent a massive burden. Last year (2016) saw financing requirements of approximately US$4.9 billion. The strain led to a swap deal involving the PDVSA 2017's. For the year 2017 the financing requirements increase by approximately 90% to US$9.3 billion. The year 2018 sees financing needs of US$9.5 billion with 2019 and 2020 seeing a jump up to 13.6 billion. For 2021 and 2022, there is an expected moderate decline to a still high US$8.7 billion. Venezuela does not experience a respite until 2028 when financing requirements decline to US$3.6 billion.

In our view, in order to survive Venezuela requires significant restructuring of its debt involving an extension of maturities out to 2028 and beyond as well as a possible principal haircut and reduction in coupons. The rating by the international rating agencies along with the negative outlook indicates that there is a likelihood of default or a distressed debt exchange in the next 12 months.

Theoretically it is possible that PDVSA could default and the sovereign continue to pay its debts. Recall that PDVSA's debt is not guaranteed by the government. Further, the government's debt does not have cross-default clauses connected with the debt of PDVSA. However, given that PDVSA is a wholly owned state enterprise, a default of PDVSA would mean a default of Venezuela itself.