AEGON Asset Management

NAVIGATING VENEZUELA'S DEFAULT

By Phil Torres, Director of Sovereign and Emerging Markets Research
Andrew Maslan, Distressed Analyst

"Now we're in a different situation with a country [US], but I would borrow knowing that if the economy crashed you could make a deal. And if the economy was good it was good so therefore you can't lose."

—President (then candidate) Donald Trump

"Venezuela has always fulfilled its international obligations, in times of oil boom and in times of low oil prices (...). Our intention is to continue fulfilling, but to stop the financial persecution of banks and international organizations against Venezuela,"

—President Nicolas Maduro

Latest Developments

At approximately 5:30pm November 1, 2017, the President of Venezuela, Nicolas Maduro, issued a vague speech to his nation declaring the intention to appoint a special commission, headed by Vice President Tareck El Aissami, to refinance, re-profile, or restructure the nation's debt.

The decision to pre-announce a restructuring/refinancing of Venezuela's debt is curious. They made roughly $2 billion in debt payments on PDVSA (the nation's wholly owned oil company) the week ending November 3, including a verbal guarantee that they would make the $1.12 billion principal payment on the Venezuela sovereign debt maturing the same week. Why pre-announce a restructuring after you make these large payments and when, at the PDVSA level, they face roughly $200 million in payments through April 2018 and ~$1 billion through October 2018 (relative to the sovereign that owes close to $3.8 billion during the same period)? Venezuela has confounded analysts for years as their willingness to pay in the face of extreme limits in ability has exceeded expectations.

Perhaps the intent is to restructure only Venezuela's debt and stay current on PDVSA – a tactic analysts have considered. This approach may preserve the operational capacity of PDVSA to generate US dollar reserves and gain relief from the Venezuela debt load. The risk to this strategy is a lengthy legal battle in US courts. Venezuela debt holders must prove, against the interests of Venezuela and PDVSA bondholders, that PDVSA and Venezuela are alter egos (one-and-the same) and a default on one is a default on the other.

Another reason for the approach may be to achieve a full re-profiling of debt in order to improve the PDVSA CAPEX capacity to mitigate the rapidly declining production capacity. Limits to this strategy include US sanctions forbidding transactions with Venezuela and the specific collateral rights of PDVSA 2020 bond holders to seize the equity of PDVSA's single asset in CITGO.

There are a variety of conspiracy theories as well, including speculation that the Venezuelan leadership owned a majority of recently matured bonds, that they are attempting to manipulate bond prices lower to acquire at cheaper prices, and that this is related to an internal and ongoing fraud-related purge at PDVSA.

At the moment, our thinking is the special commission announcement has not necessarily changed things: Yesterday we knew Venezuela was severely strained in its ability to pay. Yesterday we knew Venezuela has an unusual willingness to pay. Yesterday we knew the capital structure and legal constraints are exceptionally complicated and severely limit possible avenues forward. Lastly, the announcement of a desire to restructure is not a default trigger.

Our strategy

First, we have been consistently surprised, if not confused, by the sovereign's choice to pay bondholders instead of citizens given the severe social degradation internally - they have serviced debt for much longer than expected. Venezuela is one of the highest yielding and largest constituents in the emerging markets complex. For benchmarked investors, to have held zero exposure would have meant extreme underperformance for several years. To mitigate this risk and the obvious need for the country to restructure we created a positioning strategy that we think outperforms in a restructuring, performs inline status quo, and underperforms amid an isolated short-maturity tightening.

Second, positions in 2020 PDVSA bonds are collateralized by the equity in CITGO. Our analysis leads us to conclude that the value of the CITGO collateral bondholders can claim is in excess of par.

Further Background

The combination of tight liquidity due to lower oil export revenues and intensifying political factors have increased the likelihood of a balance sheet breaking point. As background, Venezuela is an OPEC member with the largest oil reserves and the 8th largest gas reserves in the world. PDVSA is the state-owned oil and gas company and is the primary source of the Republic's dollar-denominated revenue. With 95% of export revenue from oil and oil -related products, the Republic's political and economic conditions are deeply connected to the price and production of oil.

Magnified by the substantial declines in PDVSA's production from years of underinvestment and mismanagement, the Venezuelan crude oil price drop from $89/bbl in 2014 to today's low prices has significantly eroded the Republic's revenue. Even so, with an expected $28 billion in 2017 export revenue against only $12 billion in debt service, $6 billion in services imports, and an expected import bill of $19 billion, the cash flow deficit appears manageable with the Republic's $10 billion foreign reserve account. In fact, the Republic's overall debt as a share of GDP at 75% is arguably reasonable. However, after many years of extreme import dependency (with imports as high as $59 billion in 2012), this forced "cram down" to today's import level has caused a scarcity of even the most vital goods, and substantial societal and political pressure to stop payment on external debt. Amid intensifying protests and increased political opposition, the current President Nicholas Maduro's creeping authoritarianism has only increased fervor, and consequently, the likelihood of a credit event despite his administration's past unwavering commitment to its external debt.