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Amundi ASSET MANAGEMENT

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# VENEZUELA ON THE EDGE OF THE CLIFF: LET'S BE CAUTIOUS

INVESTMENT TALKS

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## What is your analysis of recent events in Venezuela?

President Nicolas Maduro recently announced the Republic of Venezuela's intention to restructure all foreign debt, thus recognising the country's current debt load as unsustainable. The nation missed a coupon for about $200ml and failed to make the payment by the end of a 30-day grace period, triggering the rating agencies downgrade to default. A meeting of the International Swaps & Derivatives Association will follow shortly to discuss whether a week-long delay on bond payments from the state oil company will trigger default-insurance contracts on those securities. We think Maduro's move is part of a political game to increase his chances of re-election in 2018, and it follows an attempt to consolidate power by the regime, including sweeping victory in recent *gobernatorial* elections – despite a 21% approval rating at the time. With this political capital in hand, pushing bond payments further out, *Chavismo*[1] now turns to the debt issue. To further delay and complicate the negotiation process, the Republic invited bond holders to Caracas on 13 November to begin restructuring negotiations. The meeting was chaired by Venezuelan Vice President Tarek El Aissami. Among the attendees was the Economy Minister Simon Zerpa. who also serves as CFO of PDVSA, the state oil company. Both Mr El Aissami and Mr Zerpa have been sanctioned by the US, which inhibits US persons participating in the discussion. No specific proposals seemed to have emerged from the meeting but government officials insisted they plan to continue to service obligations.

## What is the market expecting for the near future?

The restructuring announcement changes the prevalent consensus towards both Venezuela and its related quasi-sovereign bonds. The market was expecting Venezuela to service into 2018 and then seek to restructure the Republic only. Now the market has begun to debate the Republic's specific timetable and the range of potential outcomes. With Maduro in power, the range of outcomes is narrow. The market's assessment of the probability of a transition, and therefore Maduro's future, will be important drivers of bond prices. Maduro's recent comments confirm that the Republic plans to include PDVSA and other Venezuela quasi-sovereign issuers in the restructuring programme. PDVSA and the electricity company Elecar collectively have $750m in coupon arrears on $66bn of outstanding bonds. It appears that the government is proposing to address these arrears collectively or concurrently with the Republic. The Republic may be attempting to protect PDVSA by going for a restructuring. Considering the complexity of the government's position, the decision to restructure may reflect a desire to negotiate a more favourable outcome, which is unlikely, in our view.

***A full Venezuelan sovereign default scenario would be one of the most complex events of its type and would require a large-scale restructuring.***

## What happens if Venezuela should default?

A full Venezuelan sovereign default scenario would be one of the most complex events of its type and would require a large-scale restructuring. Only the Republic knows Venezuela's total debt level, which is estimated to be around $150bn. US investors hold some 70% of Venezuelan hard currency debt. This introduces further complication to an already complex situation, given the prevailing US sanctions. Creditors include recipients of promissory notes, as well as those with material trapped capital – such as airlines. This creates a potential burden on the state through unresolved claims. It also contributes to uncertainty around bond servicing, as the total size of these claims is not widely known.

[1] Chavismo is a left-wing political ideology based on the ideas of the former president of Venezuela Hugo Chavez, in power from 1998-2013, which combines elements of socialism, nationalism and populism. The economic consequences of *Chavismo* – and of Maduro's brand of Chavismo – have been devastating for the country, which is struggling with recession and hyperinflation.

***The IMF participation would encounter a number of challenges, including the lack of updated information.***

## Who could come to the rescue?

We see quite limited options. Venezuela does have some assets, even though foreign currency reserves have declined in the past years. The country has an equivalent of $1.2bn in SDR[2] reserves with the IMF, and around $7.7bn in gold. Further external support from Russia is also a possibility. The government could also negotiate an extension to several Chinese loans due at the end of this year. Venezuela getting further loans from Russia or China remains a low probability event, in our view. China is unlikely to bail out the government, having previously declined to revise the terms of a loan. The IMF enters the process facing a number of challenges. It is said to regret its role in the recent Greek bailout. At that time, the Fund was pressured to take a 30% participation, a transaction it says it now regrets. This may influence the Fund's path of engagement with the Republic. The Fund enters the discussion with incomplete and outdated information. Venezuela had reduced contact with the IMF in recent years. The fund's first challenge will be to develop a precise understanding of the situation – a goal that may take time to be achieved. Holdouts present a real challenge to any attempted restructuring or re-profiling of maturities. Another wildcard: in the US, a creditor with a court judgement is entitled to attach receivables, which means creditors could seize oil payments. As a result, the Fund might alter its traditional approach and attempt a more direct resolution. For example, the Fund might move to engage the market earlier by going for an early debt haircut; should it go down this route, we expect considerable scepticism. Lastly, IMF's decision to support the restructuring and commit any funds to the country has a complex political dimension given antagonistic relationship between Venezuelian government and the US. Overall, we believe that the Venezuela story will persist for several years.

***A slowdown in Venezuelan output could impact US refineries.***

## Where does the state oil company PDVSA stand in all of this?

PDVSA enters restructuring talks with c. $42bn in outstanding bonds, of which $29bn are USD-denominated. 2016 EBITDA has been estimated at $15bn compared with $66bn in 2011. The company currently operates 44 rigs, down from 70 a few years ago. PDVSA's oil production is likely to have fallen below 2.0 mm bpd (barrel per day), (-11% YoY), as sanctions complicate oilfield equipment purchasing. PDVSA ships around 1mm bpd to service borrowings from China and Russia, as well as to service other political commitments made by the regime. This limits the amount of production available for debt servicing. PDVSA is a different legal entity than the Republic, hence an event that impacts the Republic doesn't automatically impact the company (so called cross-default). The Republic's intention may be to protect PDVSA and oil flows ensuring access to petrodollars. Sovereign bondholders, however, will immediately seek to attach those flows through legal remedies based on the legal argument of '*alter ego'*. Furthermore, it is unlikely that the IMF would allow the Republic to default while PDVSA continued to service.

## Would you expect any spillover from the Venezuela crisis?

Contagion among EM is mitigated by a number of factors. Firstly, the possible default of Venezuela has been well flagged. In fact many investors believed Venezuela should have defaulted long time ago. Secondly, fundamentals in EM are currently generally strong and the spreads reflect a healthy macro background. Most countries are not overleveraged, and we see current account surpluses in many EM economies. Where there is a potential contagion is around US refineries. Venezuela supplies crude to many US refineries, particularly those around the Gulf. These refineries produce gasoline and are configured to take Venezuela's sour crude. A slowdown in Venezuelan output could reduce US gasoline production, which might alter inflation or growth characteristics. While that is theoretically possible, at this juncture it does not look likely.

In Russia, some petroleum companies are invested in PDVSA (mainly Rosneft, but also Gazpromneft and Bashneft). There is also a reported miss on a payment to ONGC, the Indian state oil company. Were Venezuela would service its debt or restructure, the result

[2] SDR, Special Drawing Right is an international reserve asset defined and maintained by the IMF.

would be immaterial given the relative size of the exposure for those companies. In an unlikely scenario of a blockage of the Venezuelan oil exports, US majors and oil servicing companies will have a negative but limited impact.

***We don't see any rapid solution to the restructuring process.***

### Do you see opportunities emerging from the crisis?

The timing and tone of the government's proposals may have a material impact on discussions, successful or otherwise. PDVSA, as the country's main source of hard currency export earnings, could give exposure to Venezuelan yields from a possibly advantaged position if an event occurred. Given the overall uncertainty, the complexity of both PDVSA and the Republic's capital structure, and the unknown size of overall liabilities, it is too early to make a meaningful assessment of potential recovery value. An additional consideration is about alternative investment opportunities – if Venezuela's interest rate spread continues to widen, it might pull investment from other, higher-risk debt issuers: the composition of return from EM could shift in character. Overall, we remain very cautious on Venezuela, we don't see any rapid solution to the restructuring process, and we continue to look for tactical opportunities as they emerge with risk control as a priority for our investors.



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