BANCTRUST & CO.

Venezuela weekly report

Nº 125 - December 5 2014

See it to believe it

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- Maduro announced an FX reform to come in the next days
- Securitization of Petrocaribe debt shows a deep need of cash
- We expect an average FX rate between all official schemes at VEF/USD50 in 2015

In the last speech given by the President, Nicolas Maduro, it was stated that SICAD II will be reformed in the forthcoming days. The president announced that the new methodology to be introduced will bring more flexibility, aligned to the need of meeting the productive sector essentials. But, as expected, further details were not provided. And so far there is no news on the characteristics of the reform. Bearing in mind past expectations generated before any FX reform, we remain skeptical on the allegations that the government will lift to some extent the exchange control regime. In other words, we are of a “see it to believe it” opinion in this regard. After Maduro´s declaration it seems like the government acknowledges the urgency in cleaning up the current FX market and making it more commensurate to the country´s reality – from the rates to the structure -, but the structure of the system itself added to current oil prices and lack of confidence, make difficult and costly any attempt of reform.

In terms of greenbacks allocation, according private estimations, the current USD supply through SICAD II covers less than 30% of total demand in such system. During the first three months, April – June, a total amount of USD900million were delivered by SICAD II, in contrast to USD700million allocated in August. Latest official figures (November 2014) revealed a drastic supply reduction of almost 48% since it was launched. According to our estimates, it allocates less than USD17m on a daily basis now, from almost USD50m it averaged in the beginning.

This problem is logically caused by the fall on oil prices, high social spending and the limitations of the system itself: PDVSA cannot sell through SICAD II the revenues coming from exports activities. It can only sell dollars coming from financial revenues, which represents a 15% of total revenues (2013 official figures). This rule, suggestively limits the efficiency in the supply side of the scheme, since the 96% of foreign currency inflows of the country derives from oil exports directly. This gradual shrinkage has not only negatively affected the demand side (private sector), but has also pushed up the unofficial rate because if one of the few means available to obtain foreign currency. This rate is more than thrice the SICAD II rate of VEF/USD50, and will likely keep climbing due to seasonal effects that catalyze the effects of an unsufficient supply and an unsatisfied demand.

Another fundamental aspect is related to the bureaucracy that underpinned the discretional use of the apparatus. According to surveys performed to current SICAD II operators, the main point to stand out is the arbitrariness in dollar allocation. Users cannot logically explain the outcome disparity among consumers that requested the same amount, at the same price, on the same day. There is not transparency in how the consumer´s requirements are going to be adjudicated, either confidence or guarantee that the amount requested will be allocated or at least, partially approved. This automatically misleads the

Issuer of Venezuela Weekly Report:BancTrust Servicios Financieros Sucursal Venezuela, C.A.(Venezuela)

access to the system, making it even more restricted.

To sum up, SICAD II ended up being a rigid and inefficient system with a sort of fix rate (when it was supposed to be a floating one in the beginning). If the president, Nicolas Maduro, has the intention of easing dollars allocation, a comprehensive reform of the mechanism is a must. We do not completely discard the possibility of heading to a more flexible exchange rate market which could be an option to lessen the structural imbalances, however we repeat our stand: “see it to believe it”, given the inconsistency of the government in implementing well-timed measures. In our view, devaluation is necessary but insufficient for instance, if the dollars allocation does not increase or if there is no fiscal discipline.

Securitization of Petrocaribe debt

Nuevo Herald newspaper reported the securitization and sale of cUSD4.0bn in Dominican Republic debt with Venezuela, produced under the agreement of Petrocaribe. According to the media, Goldman Sachs would have purchased the bilateral debt at a deep discount of 59% (41 cents on the dollar), meaning an USD1.7bn disbursement from the original USD4bn. Under Petrocaribe schemes, the Dominican Republic has received an equivalent of USD8.2mbn in crude since 2005, and the scheme of the agreement stablishes that 50% of the oil exported by PDVSA will be financed at 1%-2% at 15-20 years, while the other half is paid in cash.

It is clear that the lack of hard currency liquidity – due to large social spending programs since 2011 -, and therefore the increasing need funds to cover dollar obligations, have gradually deteriorated PDVSA´s finances. Such position ended in an unfavorable deal for Venezuela (even though they received cash) that only covers for 5% of estimated revenue loss in a 12-month period due to the recent oil price decrease, not to mention the lack of consistency with respect to current DR debt yield levels.

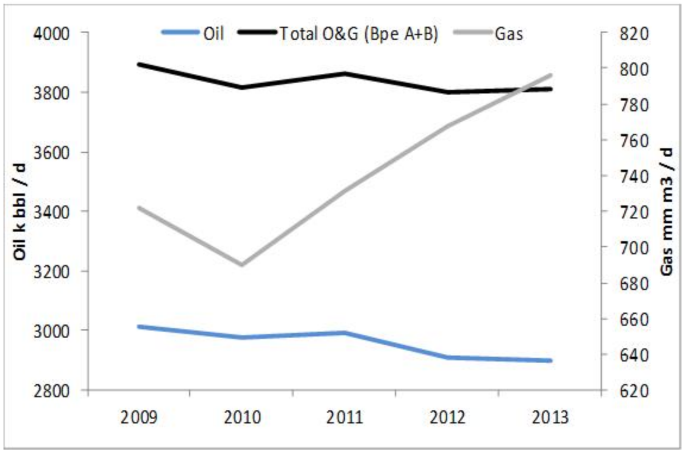
In this respect, we do not see a meaningful impact in Venezuela’s finances, as the market expressed with a sluggish performance on sovereign and quasi-sovereign bonds this week. Even accounting for the full IOU’s outstanding (including Jamaica and other countries under the same agreement) that could duplicate the USD1.75bn the impact would still be mild, as it is a one-time deal and not a constant greenbacks inflow.

Cutting off public expenditure

The president Nicolas Maduro announced a 20% reduction in sumptuary Public Expenditure for 2015. However we do not see a weighty adjustment in social spending planning due to the political costs it would carry, especially in an electoral year. Aligned to what we have reiterated in our previous reports, Maduro emphasized that investments in social projects will not be affected, regardless the international oil prices dynamic (which has decreased by 30% since June). What this suggests is a possible reform execution on areas such as: public administration recruitment, public sector employee’s remunerations, public infrastructure remolding, among others. At the current oil prices, the populist rhetoric has the government between a rock and a hard place (politically and economically speaking) if it wants to win the elections through their usual campaign format, while ensuring cheap imports and debt service. In our view, the government knows that ensuring the latter is paramount and all the moves to increase cash flows are somewhat pointing to demonstrating debt payment capacity. We maintain our view that no default will come in 2015.

Into a context where the oil market is becoming even more challenging, if the social investment is not considered to be touched (being this the largest proportion of the total public expenditure) we truly think that a higher devaluation of the local currency is a must. Knowing that the “fiscal party” has not ended and that the government will not easily let its arm be twisted in terms of social spending reduction, then it would have to devalue the currency to near VEF/USD95 to restore the current fiscal balance, according to our figures. However we believe this scenario is not feasible for the government whatsoever. The costs are simply huge.

Chart 1: Oil and Gas production.



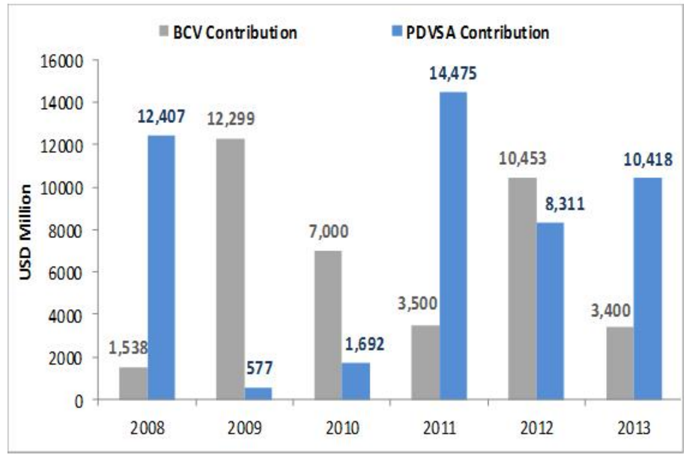
Source: PDVSA.

Referring not to the best scenario for Venezuelan economy but to the most probable option evaluating how the government operates, we foresee for 2015 a possible average devaluation of the currency to VEF/USD50 (considering all the FX mechanisms) and a fiscal deficit of 21% of the GDP. This devaluation most likely will not come in one shot. We think the government will first finish to reallocate all the sectors operating at VEF/USD6.3 to SICAD I rate (VEF/USD12), and then progressively devaluate SICAD I up to VEF/USD17-20, while progressively devaluating SICAD II rate as well (VEF/USD50) to VEF/USD70-80.

Opposition leader Maria Corina Machado charged with conspiracy

Machado was accused of participating in a death plot aimed on President Nicolas Maduro, and charged with conspiracy (penalty from 8 to 16 years of prison if she is found guilty). The accusation came from the same surrogate judge that indicted high treason and conspiracy to several opposition leaders before – among them, Diego Arria and Henrique Salas Römer -, in addition to lawyers in charge of defending students who were imprisoned during the protests wave on 1H14. We believe this process will not favor Machado in the end, legally speaking; although it could boost her popularity as it happened after Leopoldo Lopez's imprisonment. However, it may take months from now before the formal trial is arranged.

Chart 2: FONDEN contributions.



Source: BCV, PDVSA, BancTrust.

One of the differences of President Maduro and late President Hugo Chavez is the harsh measures applied by the former on opposition leaders. Machado was not the first and most likely will not be the last opposition leader to be charged with conspiracy. Already two majors (Daniel Ceballos and Enzo Scarano), apart from Leopoldo Lopez were imprisoned and currently are waiting for a verdict.

Machado was also removed from his office in the National Assembly earlier this year, accused of terrorism (without formal charges), beaten during a formal session of the Assembly, accused of public disorder instigation, and accused of plotting Maduro's assassination. These leaders all have the same characteristic: a frontal and more radical confrontation against the government, requesting Maduro's resignation and/or a reform of the constitution. In stark contrast, leaders identified with Henrique Capriles (and Capriles himself) have been out of the spotlight of these sort of accusations since months. In our view, Capriles' faction leans towards negotiating a transitional government without necessarily rallying people to protest on the streets, as Lopez and Machado did this year with "La Salida".

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