Venezuela

# The perfect storm

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- The decrease in oil prices is costing Venezuela approximately USD728mn in revenues for every dollar of price decline. This has raised the pressure on Venezuela's hard currency cash flow, increasing the probability of a default; however, we still think it is lower than what the market is pricing.
- Under our commodities team's revised scenario of Brent averaging USD/b104 in 2014 and USD/b96 in 2015, without adjustments, Venezuela would have a deficit in its hard currency cash flow of USD27.8bn in 2015.
- In a scenario of oil prices staying closer to current levels with an average of USD/b80, without adjustments, the deficit in the hard currency cash flow would be USD38.2bn. This would be a situation of high stress for Venezuela.
- This oil shock put Venezuela in a very vulnerable position, with reduced liquidity that limits the capacity to cushion against it, while eroded political capital and a busy electoral agenda add some constraints to the government's ability to adjust.
- Under this new oil price scenario, we think an adjustment is unavoidable. Beyond a decline in revenues, the government would have much more difficulty accessing financial markets to finance its deficit.
- Among the policy alternatives that we think the government has are cutting Petrocaribe, selling CITGO, devaluation through a reduction in FX sales at the strongest exchange rates and allowing oil companies to sell FX in SICAD II, cutting imports, renegotiating the terms of the Chinese loans, liability management, and delaying infrastructure projects.
- We still expect PDVSA to pay the bond maturing this month. With a combination of the previously mentioned measures, we still think the government could pay the bonds maturing in 2015.
- So far, the government has been avoiding the political cost of adjusting, and that it has yet not shown a sense of urgency is a concern. Nonetheless, given the high costs that a default could have, we still believe it has the incentive to try to adjust and avoid a default. The main risk that we still see is an increase in social unrest due to the deterioration in the economic situation.
- Even in a scenario of a (proactive) restructuring of Venezuela's debt, we believe the recovery value for Venezuela/PDVSA bonds could be as high as 45%, limiting the downside potential from current market prices, especially for the long end of the PDVSA curve.

## Strong adjustment unavoidable under new oil scenario

In recent months, Venezuela has faced what could be considered a perfect storm: policy inaction, reports of a possible default, the recent downgrade, court rulings and the recent decline in oil prices. The last has always been the biggest threat to Venezuela's capacity to pay. Our commodities team recently revised down its oil price forecasts, but spot prices have gone even lower. Considering the highly pro-cyclical policies that Venezuela has followed and its inability to make adjustments, this decline puts Venezuela in a very vulnerable position. Reduced liquidity limits its capacity to cushion the shock, while eroded political capital and a busy electoral agenda add some constraints to its ability to adjust. Nonetheless, in our view, Venezuela still has some policy alternatives that would allow the government to adjust and buy time. If oil prices were to remain around current levels (USD/b80-85 for Brent) for the next 12 months, the situation would be extremely difficult to manage and increase the probability of a default; however, we still think it is lower than what the market is pricing.

Our commodities team recently revised down its oil price forecasts, driven by rapid demand contraction, dollar strengthening and unexpected Libyan output return (see *Oil price forecast revised downward*, October 9, 2014). They expect Brent to average $93/bbl in Q4 and $96/bbl in 2015, from $106 and $107/bbl, respectively. This adjustment does not change our scenario for 2014 much, since the average price for the year is declining just $3.0/bbl, but it significantly changes the outlook for 2015. We estimate that Venezuela's cashable exports are about 2.0 b/d (Figure 1). Therefore, for every dollar of decline in the Venezuelan oil basket, which has approximately a 10% discount to Brent, Venezuela will lose approximately USD728mn in revenues. Overall, the revision in price forecast implies a decline in revenues of more than USD7.0bn per year in a situation in which we were already estimating a deficit in the hard currency cash flow of USD16.9bn in 2014 and USD19.6bn in 2015 (see *Higher political than credit risks, EM Quarterly*, September 2014).

FIGURE 1

**Cashable exports (mn b/d)**

| | 2011 | 2012 | 2013 | 2014F | 2015F |
|---|---|---|---|---|---|
| Production | 2.99 | 2.91 | 2.90 | 2.90 | 2.90 |
| Imports | 0.09 | 0.18 | 0.18 | 0.18 | 0.18 |
| Available oil (1) | 3.08 | 3.09 | 3.08 | 3.08 | 3.08 |
| Domestic consumption (2) | 0.65 | 0.68 | 0.70 | 0.70 | 0.70 |
| **Exports (3) (1-2)** | **2.44** | **2.41** | **2.38** | **2.38** | **2.38** |
| Deliveries to China | 0.48 | 0.53 | 0.55 | 0.50 | 0.40 |
| Exports used for loan payment (4) | 0.17 | 0.18 | 0.18 | 0.22 | 0.24 |
| Petrocaribe | 0.46 | 0.39 | 0.38 | 0.34 | 0.20 |
| Financing provided (5) | 0.20 | 0.21 | 0.20 | 0.18 | 0.12 |
| **Cashable exports (3-4-5)** | **2.07** | **2.02** | **2.00** | **1.97** | **2.02** |

Source: PDVSA, Barclays Research

Under our commodities team's revised scenario, which implies $93.6/bbl and $86.4/bbl for the Venezuelan basket in 2014 and 2015, assuming no adjustments, the hard currency cash flow would reach USD27.8bn in 2015 (column D and E of Figure 2), which would make a strong adjustment unavoidable. The combined effect of lower prices and a decline in the volume of net oil exports due to additional barrels needed for the repayment of the debt to China brings net oil exports down USD10.4bn in the remainder of 2014 and 2015.

Additionally, the government would have more difficulty accessing financial markets to finance its deficit, which could bring the total adjustment needed up to USD15.4bn.

FIGURE 2

**Strong adjustment unavoidable under new oil scenario (USD bn)**

| | | Original | | New Non-Adjustment | | New Adjusted | |
|---|---|---|---|---|---|---|---|
| | 2013E | 2014F | 2015F | 2014F | 2015F | 2014F | 2015F |
| | A | B | C | D | E | F | G |
| **Total Inflow** | **79.6** | **74.2** | **75.6** | **72.0** | **67.4** | **72.1** | **68.3** |
| Net Oil Exports | 74.4 | 69.7 | 70.8 | 67.5 | 62.5 | 67.6 | 63.4 |
| Oil Exports | 88.1 | 83.5 | 83.3 | 81.1 | 74.6 | 81.1 | 74.6 |
| (-) China | 6.4 | 7.4 | 7.4 | 7.4 | 7.4 | 7.4 | 7.4 |
| (-) Oil agreements | 7.2 | 6.4 | 5.1 | 6.2 | 4.7 | 6.1 | 3.8 |
| Non-Oil Exports | 5.2 | 4.5 | 4.8 | 4.5 | 4.8 | 4.5 | 4.8 |
| **Total Outflow** | **95.8** | **91.1** | **95.2** | **91.1** | **95.2** | **88.6** | **86.2** |
| Private Sector* | 31.3 | 31.8 | 33.6 | 31.8 | 33.6 | 30.4 | 30.0 |
| Public Sector | 34.8 | 31.1 | 33.2 | 31.1 | 33.2 | 31.1 | 31.2 |
| Debt Service | 11.2 | 13.2 | 13.4 | 13.2 | 13.4 | 13.1 | 13.0 |
| Others | 18.5 | 15.0 | 15.0 | 15.0 | 15.0 | 14.0 | 12.0 |
| **Net balance** | **(16.3)** | **(16.9)** | **(19.6)** | **(19.1)** | **(27.8)** | **(16.5)** | **(17.9)** |
| **Financing** | **10.5** | **14.5** | **23.0** | **14.5** | **23.0** | **10.5** | **18.5** |
| Chinese Fund | 5.0 | 4.0 | 5.0 | 4.0 | 5.0 | 4.0 | 6.0 |
| Issuances | 4.5 | 8.0 | 7.0 | 8.0 | 7.0 | 5.0 | 5.0 |
| Oil Financing and Russia | 1.0 | 2.5 | 3.0 | 2.5 | 3.0 | 1.5 | 2.0 |
| Asset sales (CITGO) | | | 8.0 | | 8.0 | | 7.0 |
| **Change in RI due to Gold prices** | **(4.5)** | **(0.5)** | **(1.3)** | **(0.5)** | **(1.3)** | **(0.5)** | **(1.3)** |
| **Net Flow** | **(10.3)** | **(2.9)** | **2.1** | **(5.0)** | **(6.2)** | **(6.5)** | **(1.3)** |

* Includes CENCOEX, SICAD I and SICAD II. Source: BCV, PDVSA, Barclays Research

The needed adjustment could be even larger, considering that current prices are approximately USD/b14 below the average forecast for next year. Therefore, as a stress test, we evaluate the scenario of Brent averaging USD/b80 in 2015 (USD/b72 for the Venezuelan basket). Net oil exports would decline USD23.7bn compared with the original scenario in aggregate this and next year. Without adjustments next year, the deficit would reach USD38.2bn (column D and E of Figure 3), which would seem to be extremely complex to manage. In that sense, we consider $80/bbl the critical level for Venezuela. Even if it implements different measures, the government could still make the payments of 2014-15 at a sustained price of $80/bbl. The capacity to pay beyond that, considering the possible asset reductions of this year and next, would depend on structural adjustments (eliminating the distortions in the FX market, creating an incentive to increase production and reduce the dependence on imports, etc), which the current administration seems unlikely to implement.

## Low liquidity limits the capacity to cushion the shock

Referencing what the government did back 2009, when oil prices declined to levels even lower than the current ones, it adjusted, increased indebtedness but also used part of its accumulated stock of assets. However, since then, its liquidity position has deteriorated. While there has always been much controversy about the actual size of the stock of assets, we have said that the best proof that the government had accumulated a significant amount of assets is that according BCV figures, between 2012 and 2013 it used USD21.6bn from this stock to finance its deficit. Therefore, independent of the current level, the stock is clearly lower, and the proportion that is liquid is even lower.

FIGURE 3

**High stress under a scenario of Brent at USD/b80, but still with some capacity to adjust**

| | | New Adjusted | | Stress Non-Adjustment | | Stress Adjusted | |
|---|---|---|---|---|---|---|---|
| | 2013E | 2014F | 2015F | 2014F | 2015F | 2014F | 2015F |
| | A | B | C | D | E | F | G |
| **Total Inflow** | **79.6** | **72.1** | **68.3** | **69.1** | **57.0** | **69.4** | **58.5** |
| Net Oil Exports | 74.4 | 67.6 | 63.4 | 64.6 | 52.2 | 64.9 | 53.6 |
| Oil Exports | 88.1 | 81.1 | 74.6 | 78.0 | 63.5 | 78.0 | 63.5 |
| (-) China | 6.4 | 7.4 | 7.4 | 7.4 | 7.4 | 7.4 | 7.4 |
| (-) Oil agreements | 7.2 | 6.1 | 3.8 | 6.0 | 3.9 | 5.8 | 2.5 |
| Non-Oil Exports | 5.2 | 4.5 | 4.8 | 4.5 | 4.8 | 4.5 | 4.8 |
| **Total Outflow** | **95.8** | **89.5** | **86.2** | **91.1** | **95.2** | **86.9** | **78.6** |
| Private Sector* | 31.3 | 31.3 | 30.0 | 31.8 | 33.6 | 29.9 | 25.7 |
| Public Sector | 34.8 | 31.1 | 31.2 | 31.1 | 33.2 | 30.9 | 28.3 |
| Debt Service | 11.2 | 13.1 | 13.0 | 13.2 | 13.4 | 13.1 | 13.0 |
| Others | 18.5 | 14.0 | 12.0 | 15.0 | 15.0 | 13.0 | 11.5 |
| **Net balance** | **(16.3)** | **(17.4)** | **(18.0)** | **(21.9)** | **(38.2)** | **(17.5)** | **(20.1)** |
| **Financing** | **10.5** | **12.5** | **18.0** | **14.5** | **23.0** | **10.5** | **18.5** |
| Chinese Fund | 5.0 | 4.0 | 6.0 | 4.0 | 5.0 | 4.0 | 5.0 |
| Issuances | 4.5 | 7.0 | 3.0 | 8.0 | 7.0 | 5.0 | 5.0 |
| Oil Financing and Russia | 1.0 | 1.5 | 2.0 | 2.5 | 3.0 | 1.5 | 1.5 |
| Asset sales (CITGO) | | | 7.0 | | 8.0 | | 7.0 |
| **Change in RI due to Gold prices** | **(4.5)** | **(0.5)** | **(1.3)** | **(0.5)** | **(1.3)** | **(0.5)** | **(1.3)** |
| **Net Flow** | **(10.3)** | **(5.3)** | **(1.3)** | **(7.4)** | **(15.2)** | **(7.5)** | **(2.9)** |

* Includes CENCOEX, SICAD I and SICAD II. Source: BCV, PDVSA, Barclays Research

BCV has not published figures for the external position of the government since Q3 13. At that point, although the reported external assets were about USD53bn, we estimated that about 70% of that could have some restrictions. Therefore, after discounting restricted assets such as gold reserves, the IMF position, bonds, etc., the available assets were about USD15bn (see *Venezuela: The leopard doesn't change his spots*, April 22, 2014). Our estimate is that liquid assets currently are USD10-12bn (Figure 4). The local consultant Ecoanalitica estimates the non-committed external assets at USD8.4bn as of the end of September. In any case, this represents about three months of imports, which does not leave significant space for the government to reduce the necessary adjustment.

Nonetheless, it could still make liquid some of its non-liquid assets. For example, the gold reserves, which account for approximately USD15bn, could be exchanged for cash. However, as long as they are in Venezuela, nothing can be done. We do see the government trying to bring them back to international markets; if it did, we believe there could be internal and external implications. It could be seen as a sign of desperation, which could increase internal frictions, and the perception of government weakness could raise the discount rate of the rent-seeking group and deepen the extraction of resources. On the external side, while it could reinforce the short-term capacity to pay and reduce the exposure to another volatile commodity (gold), it could be seen as a sign of low willingness to adjust.

## What can the government do?

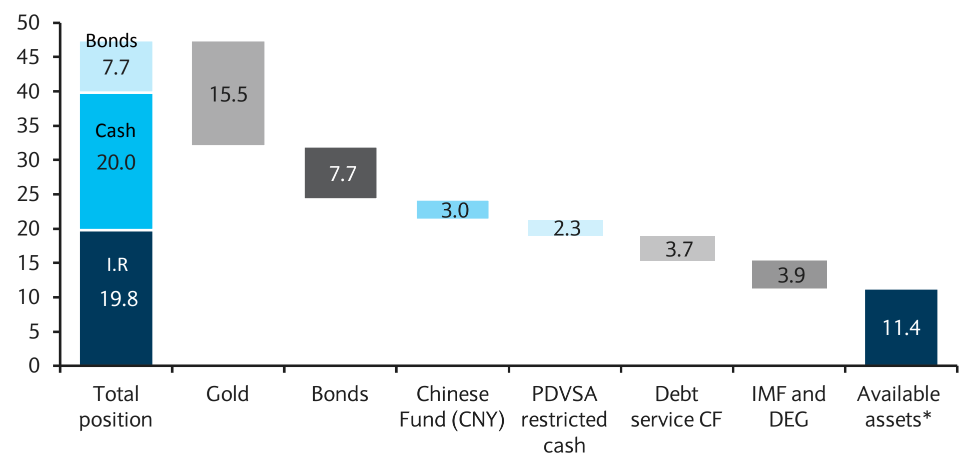
Given the limited liquidity and the tougher financing conditions, most of the external shock would have to be transferred to the domestic economy through an adjustment. Even if the margins of maneuver for the government have been reduced, we still think it could take some measures that combined could compensate for the decline in exports. These include:

1. **Cutting Petrocaribe:** According to PDVSA financial statements, Venezuela was sending 463 k b/d to the Central American and Caribbean countries in 2011, but since then this has been cut. According to the different conditions of the agreement, Venezuela was providing financing for approximately half of the deliveries. These declined to 377 kb/d in 2013, but we see further government cuts as highly likely. It will likely try to minimize the political cost of the adjustment; the main effect of cutting Petrocaribe would be a reduction of Venezuela's influence in the region, which at this point is unlikely to be seen as the top priority. A reduction to a level that just keeps the deliveries to Cuba (around 95 b/d) is more likely; the government would get additional cash from this of USD1.5-2.0bn.

2. **Selling CITGO:** A measure with a relatively low political cost could be the sale of the government's refining and fuel distribution chain in the US, CITGO. Although government statements on this matter have given mixed messages, there are press reports (eg, Bloomberg, Reuters) about a government advisor evaluating bids for the company. According to an evaluation by our equities team (see *U.S. Independent Refiners: CITGO Valuation Analysis*: September 15, 2014), CITGO could be valued at USD7.0-9.0bn. On conservative assumptions, even with a closing price at the lowest point of the range, it would be more than enough to cover bonds maturing in 2015 (USD4.9bn). Considering that if Venezuela/PDVSA were to default, this would likely be one of the first assets subject to be seized by investors, and the state would lose them, we believe the government has significant incentive to sell it at least to buy time.

3. **Devaluation:** We have been expecting the government to devalue the average exchange rate at which it sells FX through a reduction of the amount sold at the strongest exchange rates and the continued gradual depreciation of the SICAD I rate. Under the new scenario, we would expect the elimination of dollar allocations at VEB 6.30/USD by next year and the progressive transference of the sector receiving dollars at this exchange rate to the SICAD I rate. Nonetheless, the main

FIGURE 4
**Low liquidity (USD bn)**




Source: BCV, PDVSA, Barclays Research

immediate effect of this measure would be on the fiscal, not the external accounts, since the government would be able to sell the dollars that it receives from oil exports at a weaker rate. In principle, it would not bring any additional dollars into the economy, and as the government would still keep offering dollars at a relatively strong exchange rate in at least one of the mechanisms, there would still be excess demand. This would require the government to pass on import restrictions to reduce FX demand.

A devaluation could increase the FX supply, so could lead the government to allow oil companies to sell FX in SICAD II. Up to now, they have been allowed to sell dollars through this mechanism only from oil exports to cover their opex, for which they still have to sell dollars at VEB 6.30/USD. This seems to be a key impediment to the pursuit of investment projects. The implication is that if oil companies could sell dollars at a more competitive exchange rate, they could accelerate the execution of their projects. International oil firms (Chevron, Repsol, Rosneft, etc) have signed agreements with Venezuela to invest more than USD11bn in the country within the next three to four years. About 40% of that could be expenditures in local currency. These projects have the capacity to increase production approximately 300 k b/d. Therefore, this measure could not only increase the short-term supply of dollars from foreign investment but also from exports in the medium term. As a reference, in periods of low oil prices, oil exporting countries have been in a weaker position to negotiate and have tended to give better conditions to oil companies.

4. **Cutting imports:** Compared with the goods imports peak, reached in 2012, of nearly USD60bn, we estimate that this year, imports could be about USD45bn (BCV has not published imports figures since Q3 13, but INE reported a 17.6% decline in 2013 and 21.8% in H1 14; even if not exactly comparable, the trend could be used as a proxy). Despite the decline, this is still higher than the level reached in 2009-10 (USD38bn), when oil prices declined. We were originally expecting an increase of the FX allocation in the coming months due to the elections next year. However, under the new conditions, we do not see that as possible. Therefore, we expect a reduction in FX allocations to the private sector through the different exchange mechanisms of up to USD8bn in 2015 versus our original scenario and USD5.5bn compared with our estimate for this year. Though it is smaller, we also expect a reduction in public imports, which could be cut by about USD2.0bn, considering that a significant portion of that is oil imports and would be correlated with the oil price.

5. **Renegotiating the terms of the Chinese loans**: China is clearly the biggest creditor for Venezuela, and it has given Venezuela better financing conditions than the market has. There have been recent changes to some of the clauses of the bilateral funding agreement, according to which China has basically removed the restriction on sending barrels beyond the minimum amount required to ensure the debt payment. Venezuela was sending more than half a million barrels to China, from which 200-280 kb/d, depending on the oil price, were used to pay the debt. After this modification, PDVSA could at least reduce its delivery costs, sending more barrels to other markets, such as the US. A further possibility would be to look for an extension of the lengths of the credit lines from three to four or five years. This could cut the debt service to China USD1.0-1.5bn. One of the revolving credit lines is also expected to mature and be renewed by China next year. This would imply a disbursement to the fund of USD4.0bn by China and USD2.0bn by

Venezuela. Those proportions could be changed, as is the case of the third credit line created last year, in which China contributed USD5.0bn and Venezuela USD1.0bn. In that way, China could provide some additional financing that could compensate for the more difficult access to financial markets. In normal conditions, the total amount outstanding of the Chinese Fund debt would decline approximately USD1.0bn per year, given the amortizations to the large volume loan. Therefore, even if China increases its contribution to the short-term credit lines by USD1bn, it would not increase its exposure to Venezuela.

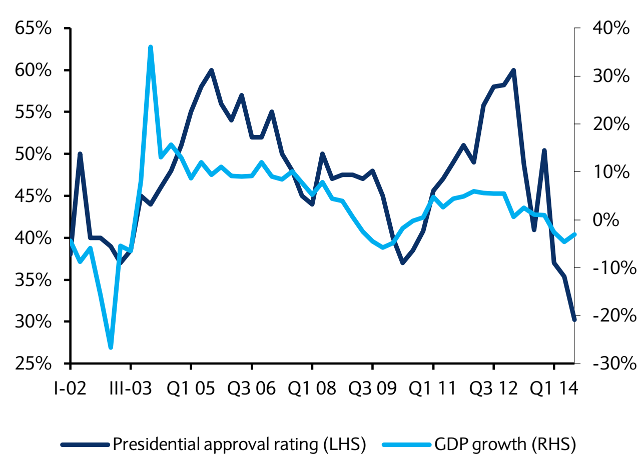
6. **Liability management:** Among the treasury and PDVSA, the total debt service for the next three years is USD13.5bn, reaching a peak of USD14.7bn in 2015. There have been press reports (eg, Bloomberg, Reuters) commenting about the possibility of making a debt swap to extend maturity. Under current market conditions, the only way to do this would be to place bonds with very high coupons or apply an exchange ratio that would significantly increase the debt outstanding. Therefore, we view this as unlikely. Nonetheless, PDVSA could use its pension fund to buy short maturity bonds and exchange them for long maturity ones, as is happening with the PDVSA 14.

7. **Delaying infrastructure projects:** Beyond public imports, the government has been paying infrastructure projects to foreign companies such as Odebrecht in FX. It could stop these projects or delay payments to contractors.

Other possible measures are an increase in gasoline prices and a reduction in public expenditures. Although these could contribute to the sustainability of the adjustment in the medium term, we would not include them in the primary set of policy alternatives, given that in the short term they do not bring any additional dollars to the economy. Therefore, they would make only a small contribution to reducing the hard currency deficit, which should be the government's priority in the next 12 months. A potential increase in gasoline prices is unlikely to bring the price even close to market prices. Therefore, it would be unlikely to reduce smuggling. The effect on domestic fuel demand is also limited, considering an inelastic demand in the absence of substitutes for oil or a means to provide a more efficient use. In the case of expenditures, they could be the only tool to reduce the effect of the adjustment. Therefore, we believe an increase in expenditures targeting the political base of Chavismo is

FIGURE 5

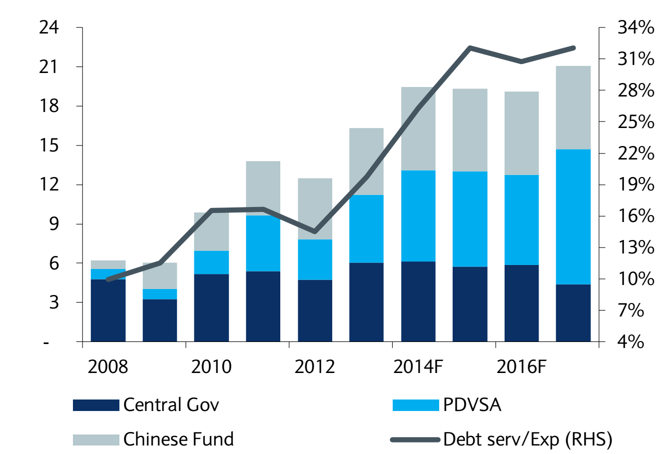
**Deterioration of economic situation puts pressure on government support**




Source: Datanalisis, BCV

FIGURE 6

**Debt service consuming a larger portion of oil exports (based on Brent at USD/b80)**




Source: Ministry of Finance, BCB, Barclays Research likely to continue ahead of the elections. In that sense, we would expect the government to continue to use more monetization to finance expenditures.

## Does the government have the capacity to make the adjustment?

At this point, President Maduro seems to be between a rock and a hard place. Support for Chavismo is at its lowest ever point, according to Datanalisis poll (Figure 5). His popularity has declined 5pp in the past quarter and has dropped 25pp since he was elected in April 2013, to now stand at 30%. He has so far avoided making any significant adjustments, in fear of the political cost; however, after the oil price decline, he is forced to adjust, independently of how painful it could be. It could lead to a drop in government support, with the danger of a heavy defeat at next year's parliamentary elections and the possibility of social unrest growing, which we see as still the biggest risk. Not adjusting and potentially defaulting could have even higher costs and limited benefits.

In our view, the government is conscious of the high risks that a default implies in terms of a possible seizure of oil exports that could cut off practically the only source of FX in a country that is highly dependent on imports of basic goods. Given the government's direct involvement in international trade transactions, even shipments of basic imported goods could be seized. In a country that is already suffering from problems in its supply chain, additional disruptions, even if temporary, could lead to an increase in socio-political conflicts that undermine the stability of the government. Even in a scenario of Brent at $80/bbl, the debt service would consume close to one third of the country's exports (Figure 6). However, half of that is made up of amortizations of Venezuela and PDVSA bonds (USD4.9bn) and interest payments (USD5.6bn). The rest is multilateral, bilateral and commercial debt. Therefore, the short-term benefit of defaulting seems limited. Even on the political front, it appears that defaulting would not be profitable, given that the national debt has so far not been raised as a political issue by the electorate. This leads us to believe that incentives are biased toward adjustment, rather than default.

## Restructuring – "the what if?"

As we highlighted above, we believe Venezuela has the capacity and the incentives to avoid a restructuring, including the lack of "Collective Action Clause"(CAC) in some of the bonds,[1] and the probability of a restructuring being much lower than is priced in by the market.

But even in a scenario in which a (proactive) restructuring of Venezuela's debt becomes unavoidable, we believe that market price downside could be limited. In our scenario analysis, we make an important assumption: any restructuring proposal will include both PDVSA and Venezuela external law bonds. Indeed, offshore PDVSA assets are easily attachable even under a bond restructuring of the Republic, since it will likely be easy to prove the legal link between the sovereign and PDVSA. In addition, while a large part of the cash flow burden is coming from the PDVSA bond structure over the next three to four years, a 'selective' default on PDVSA only would limit the ability of Venezuela to source dollars for imports. We think a restructuring involving both will increase the negotiating power of the Republic.

### *PDVSA off-shore assets: A 'back-of-the-envelope' calculation*

Before describing our restructuring exercise, we attempt to estimate the external assets that PDVSA owns offshore. The goal is to determine a range for the minimum recovery value.

[1] All Venezuela bonds, except the 2018, 2018N and 2027, contain a CAC. The quorum is 66 2/3% to make minor changes, but 75% to make changes to principal/interest rate/currency/calls etc. PDVSA bonds do not contain a CAC.

CITGO, which is fully owned by PDVSA, is the most valuable offshore asset available for attachment. Therefore, the company valuation is pivotal to the analysis. Our equity research team estimates that this is USD7-9bn (see, *CITGO Valuation analysis*, 15 September 2014).

FIGURE 7

**PDVSA offshore assets: Valuation range**

| | Best case scenario | Worst-case scenario |
|---|---|---|
| CITGO | 9.0bn | 7.0bn |
| Refineries (including St. Croix /Chalmette/Minor) | 2.3bn | 1.4bn |
| Oil tanker** | 1.3bn | 0.8bn |
| Account Receivables (i.e. US Export on balance sheet) | 2.1bn | 1.7bn |
| Total | 14.7bn | 10.9bn |
| as % total outstanding debt | 22% | 16% |

Source: Barclays Research

In addition, as highlighted in Figure 5, PDVSA owns several refineries, of which St. Croix and Chalmette (50% owned by Exxon) are the largest, and approximately 23 oil tankers. Lastly, we think it is fair to include the oil exports that PDVSA makes to the US that are in the form of account receivables. These balance sheet items tend to be stable at USD5-6bn. Since exports to the US are approximately 34% of the total, we think it is safe to assume that the account receivables would be USD1.7-2.1bn. Lastly, for the oil tankers and refineries, we use a combination of book value and comparison with other similar refineries.

Thus, the valuation of offshore assets could be USD11-15bn. The total debt outstanding for PDVSA and Venezuela is about USD66bn, while the minimum recovery value is 16-22%. Therefore, we believe it is fair to assume that on NPV, Venezuela/PDVSA has to offer investors a deal that exceeds these levels to obtain a high participation rate.

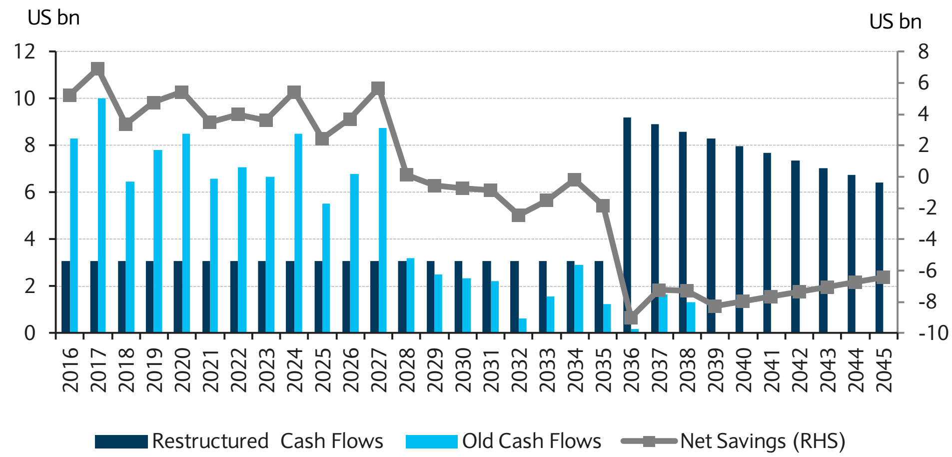
### *Potential recovery values versus prices*

In our analysis, we assume that the restructuring will not occur before 2016. As we discussed above, we believe this is a realistic assumption because even if Brent prices trade in the mid-80s, Venezuela has several weapons at its disposal over the next 12 months to avoid a restructuring (and the incentives to do so).

The external bond amount outstanding by PDVSA and Venezuela is approximately USD61.3bn (excluding 2014 and 2015 maturities), with approximately USD50bn of interest. While this is distributed over the life of bonds that extend to 2038, the cash flows are front loaded. For instance, in 2016-20, the interest and amortization is about USD40bn, coming mostly from PDVSA bonds (Figure 8). It is, hence, evident that a restructuring could reduce the short-term financial burden and balance the negative net flow of USD, as calculated in Figure 8.

FIGURE 8

**Venezuela/PDVSA: Potential cash flows in a debt re-profiling scenario**




Note: We assume Venezuela/PDVSA will issue a 30yr bond with a 5% coupon on a USD61.5bn notional.
Source: Barclays Research

For the discount factors, we assume that the yields on Venezuela/PDVSA bonds will be in line with the average spreads since 2010, plus the current USD 10y US Treasuries. As highlighted in Figure 10, the Venezuela 2017 z-spread has been trading on average at about 920bp; based on the current level of 10y US Treasuries, this translates to a yield of approximately 11%. This is an admittedly benign assumption, which relies on Venezuela's ability to make economic adjustments and investors' realization that if short-term cash flow pressures are relieved by such a restructuring exercise, Venezuela's debt servicing capacity can return to a comfortable path.

Regarding the coupon of the new bond, we make a few further assumptions. First, the outstanding bonds' weighted average coupon rate is 7.18% and 9.50% for PDVSA and Venezuela, respectively. This suggests that any restructuring should be at 7% at most. Second, to make the cash flows relatively small and sustainable, the size has to be at the most 40-50% of the current cash flows, especially for 2016-20. Yet a coupon that is too low would likely lead to a low participation rate. We feel comfortable in assuming that the new

FIGURE 9

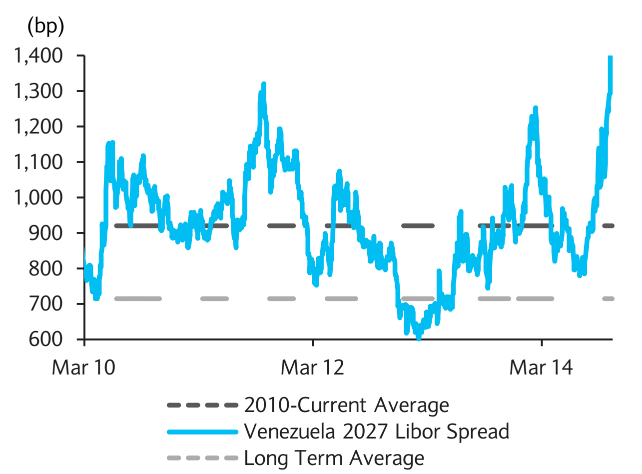
**Recovery value scenarios**

| Exit Yield | 12% | 11% | 10% | 9% |
|---|---|---|---|---|
| **Assumed Coupon** | | **Recovery Values** | | |
| 6% | 47 | 52 | 58 | 65 |
| 5% | 40 | 45 | 50 | 56 |
| 4% | 33 | 37 | 41 | 47 |

Source: Barclays Research

FIGURE 10

**Venezuela 2027 z-spread (2010-current average = 920bp)**




Source: Barclays Research

coupon could be about 5%; combined with the maturity extension, this would imply a very manageable debt service of approximately USD3.7bn per year over the next 20 years, compared with the current structure of USD8.20bn (on average) over the next 5 years.

In our base case scenario (5% coupon, 11% exit yield), the value of the package would be about 45%, which may seem relatively high. However, given the offshore assets (ie, USD11bn in the worst-case scenario), we think it is realistic.

Using our 'base case' recovery value estimate at 45% and assuming that at least the 1y coupon payment will be made, most of the long-end PDVSA bonds are already trading well below the recovery value. Naturally, more severe and disorderly default scenarios may be on investors' mind, but, as outlined above, we assign a very low probability to them and think that our recovery value analysis supports our continued overweight recommendation on Venezuela credit.

FIGURE 11

**PDVSA long-end bonds have limited downside risk, in our view**

| Bond | Dirty Price* | Coupon (%) *(A)* | Assumed Recovery Value *(B)* | Recovery Value + Coupon *(C) = (A)+(B)* | Price Downside *(Dirty Price – C)* |
|---|---|---|---|---|---|
| PD37 | 42.9 | 5.50 | 45.0 | **50.5** | -8 |
| PD27 | 43.4 | 5.38 | 45.0 | **50.4** | -7 |
| PD26 | 47.1 | 6.00 | 45.0 | **51.0** | -4 |
| PD24 | 48.3 | 6.00 | 45.0 | **51.0** | -3 |
| PD35 | 59.3 | 9.75 | 45.0 | **54.8** | 5 |
| PD21 | 60.8 | 9.00 | 45.0 | **54.0** | 7 |
| PD17 | 60.3 | 5.25 | 45.0 | **50.3** | 10 |
| PD22 | 71.5 | 12.75 | 45.0 | **57.8** | 14 |
| PD17N | 73.4 | 8.50 | 45.0 | **53.5** | 20 |
| PD16 | 71.0 | 5.13 | 45.0 | **50.1** | 21 |

Note: *As of 21 October 2014. Source: Barclays Research

FIGURE 12

**Venezuela bonds still seem to have downside risk**

| Bond | Dirty Price* | Coupon (%) *(A)* | Assumed Recovery Value *(B)* | Recovery Value + Coupon *(C) = (A)+(B)* | Price Downside *(Dirty Price – C)* |
|---|---|---|---|---|---|
| VE25 | 53.9 | 7.65 | 45.0 | 52.7 | 1.3 |
| VE38 | 53.2 | 7.00 | 45.0 | 52.0 | 1.2 |
| VE24 | 55.2 | 8.25 | 45.0 | 53.3 | 1.9 |
| VE34 | 59.5 | 9.38 | 45.0 | 54.4 | 5.1 |
| VE20 | 56.2 | 6.00 | 45.0 | 51.0 | 5.2 |
| VE27 | 59.8 | 9.25 | 45.0 | 54.3 | 5.5 |
| VE 19 | 59.3 | 7.75 | 45.0 | 52.8 | 6.5 |
| VE28 | 61.0 | 9.25 | 45.0 | 54.3 | 6.7 |
| VE23 | 62.2 | 9.00 | 45.0 | 54.0 | 8.2 |
| VE26 | 65.6 | 11.75 | 45.0 | 56.8 | 8.8 |
| VE31 | 67.0 | 11.95 | 45.0 | 57.0 | 10.1 |
| VE18N | 63.3 | 7.00 | 45.0 | 52.0 | 11.3 |
| VE22 | 71.9 | 12.75 | 45.0 | 57.8 | 14.1 |
| VE16 | 78.5 | 5.75 | 45.0 | 50.8 | 27.7 |
| VE18 | 94.7 | 13.63 | 45.0 | 58.6 | 36.1 |

Note: *As of 21 October 2014. Source: Barclays Research

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