J.P.Morgan

Latin America Emerging Markets Research
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Venezuela and PDVSA

Lower oil prices could be a game changer; use rebounds to get to Neutral on PDVSA

Emerging Markets Strategy

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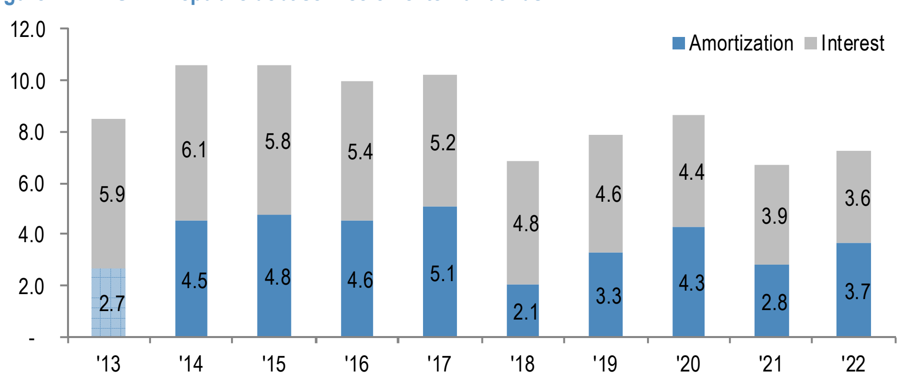
- 2014 was a difficult, muddle through year in which an opportunity to adjust macro policies was missed
- Venezuela should see at least $8bn lower oil revenue versus 2014 if its basket settles at $80/bbl ($77.7/bbl last week)
- Tighter controls and lower USD revenue in 2014 already forced a strong contraction of imports and debilitating stagflation—at the cost of presidential approval ratings
- With legislative elections looming in 2H15, policy choices will only become more difficult next year, especially amid lower oil prices
- We still think the government will prioritize external debt service, and a muddle through is possible, but scenarios for political and social stability seem highly unpredictable
- Market levels are near the extremes since Lehman, but for investors that have ridden out overweight positions so far, we recommend using any rallies to move closer to home
- We move Venezuela down to Market Weight in the EMBIG model portfolio; we also move PDVSA to Neutral versus other corporates
- High dollar price bonds have been punished but still should be avoided outside of the very front end
- We think Venezuela €'15s will pull to par, and we prefer PDVSA'17Ns to PDVSA '15s; we think bonds in the $40s should be close to recovery value.

Figure 1: PDVSA + Republic debt service on external bonds



Source: Finance Ministry, PDVSA, Bloomberg and J.P. Morgan calculations

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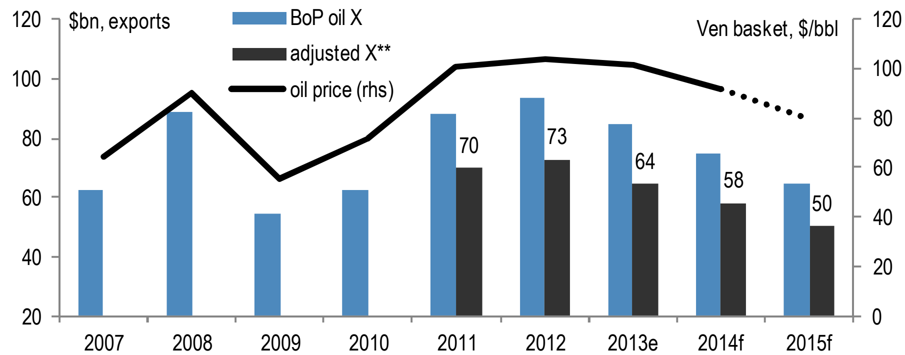
2014 was a difficult year, and 2015 won't get easier

2014 was a missed opportunity, and 2015 will now be even harder with lower oil prices. Venezuela entered 2014 with what appeared to be a golden opportunity to introduce a macroeconomic adjustment to correct imbalances that had grown large amid overspending during two straight election years (2012-13). Although the government has denied the need to implement any comprehensive package of stabilization measures, the economy has been forced to adjust to the realities of balance of payments constraints. A tightening of capital controls and a convoluted partial FX devaluation has knee-capped the supply side of the economy, leading to recession and a rather sharp reduction of imports. However, there has been no effort to cool the demand side, in fact just the opposite. Ongoing large fiscal deficits continue to largely be closed via monetary financing (through central bank lending to PDVSA). This is exacerbating rather than mitigating monetary imbalances, and keeping expectations for inflation (already above 60%) and the parallel FX rate unanchored, in turn fueling capital flight leakage. While partial adjustments are likely to continue on an *ad hoc* basis, at this point, following the September dismissal of the "Ramirez agenda" we do not think the government will deliver any comprehensive structural changes ahead of the 2H15 National Assembly elections.

We have been and remain of the opinion that despite these imbalances, Venezuela has strong incentives to continue to service its external debt. Given that the government controls the FX revenue stream from PDVSA and that the external debt profile remains relatively smooth (PDVSA and Republic amortizations around $5bn per year through 2017, and lower thereafter), up until now we have also been confident about ability to pay in the context of a Venezuelan oil price basket around $90/bbl, so long as Venezuela continues to prioritize bonded debt over other claims. This prioritization has indeed been the government's revealed preference, largely because we think the authorities fear that there is too much at risk in a default scenario in terms of: a) risk to assets abroad (namely Citgo and its refineries); and perhaps more importantly b) risk to Venezuela's ongoing ability to export barrels of crude to foreign jurisdictions (particularly to the US); and to some degree c) PDVSA's need to maintain some minimal level of credibility with the IOC and NOC joint-venture partners that Venezuela is depending on to help recover oil production.

Oil prices still quite high in 2014, but not high enough to avoid external adjustments. Venezuela's oil basket has averaged over $94/bbl so far this year, down from $101/bbl in 2013, and should finish 2014 at an average of around $92/bbl. Calculations of total oil revenue are clouded by doubts over PDVSA's official export figures, as well as by barrels that do not deliver 100% cash flow due mainly to the Chinese and Petrocaribe/Cuba arrangements. Nonetheless, former PDVSA President Rafael Ramirez has signaled in recent local press interviews that Venezuela loses $700 million annually from every $1 decline in the price of its basket. Setting aside any other calculations for the moment, Ramirez's own figure suggests a Venezuelan basket at $80/bbl (ie WTI around $85/bbl) would result in at least $8bn of lower export revenue in 2015, this coming on top of the $18-20bn cumulative annualized oil revenue decline that we estimate already occurred between 2012 and 2014 due to lower prices ($12/bbl) and declining exports volumes over the last two years.

Figure 2: Venezuela oil at $80 could trim roughly $8bn from export proceeds



Source: BCV and J.P. Morgan calculations **estimate of cash-generating oil exports.

Venezuela does adjust to lower oil prices, but 2014-15 is not 2009

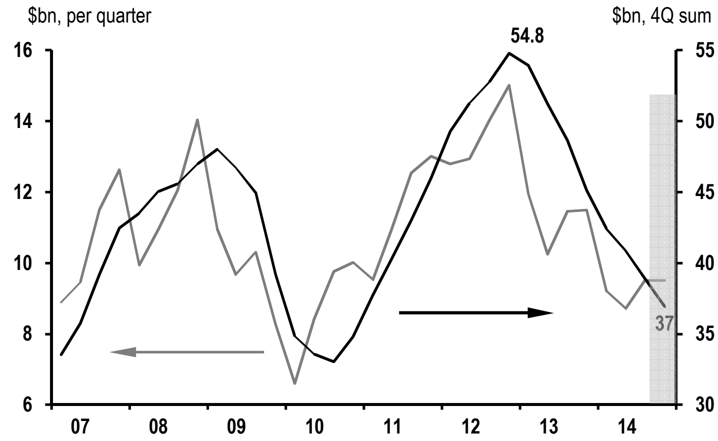
Despite the incoherent policy adjustment, Venezuela has indeed already adjusted to these lower oil revenues. Measurement is complicated by the lack of timely data (ie, no GDP figures in 2014, and no external accounts data since 3Q14). However, monthly goods imports data from INE, which historically are quite correlated with BoP figures, suggest a contraction from the record $55bn level of 2012 down to an annualized pace below $40bn in 2014. This contraction, necessary to balance external accounts in the face of lower export revenues, is comparable in magnitude to the 2009 correction that occurred following the sharp correction of oil prices post-Lehman. However, the 2009 correction came in a sharply different context, facilitated by a more popular Chavez administration that had the political capital and good sense to lean against domestic demand via a VAT increase and lower spending. The 2009 correction also came with Venezuela enjoying significantly stronger buffers. Central Bank reserves were at an historical high over $40bn at end-2008, of which close to $30bn were cash (though about half of that was transferred to Fonden in 1H09). The private sector was also in a much stronger position in 2009 following half a decade of strong growth and access to external trade credit, though they were beginning to deal with a substantially less friendly business climate. Venezuela didn’t explicitly devalue the official FX rate until 2010 (from USD/VEF 2.15 to a dual 2.6/4.3 platform), but anecdotal evidence at the time suggested PDVSA had informal access to sell excess cash on the parallel market, which averaged over USD/VEF 6 during 2009.

Making ends meet in 2014, but painfully

Turn the page forward to end-2014, and Venezuela is undergoing an import contraction with tighter FX controls, and fewer USD being disbursed to the private sector relative to the public sector. Unlike 2009, the government is working against itself having accelerated spending, supported by monetary financing from PDVSA. This is flooding the country with liquidity, in turn fueling USD demand in the context of de-anchored inflation expectations that are teetering upon a vicious circle with a parallel FX rate that has more than doubled to USD/VEF 100 during the year. Despite the effort to keep domestic demand stimulated, the supply side of the economy has hit a wall, crippled by price controls, broken supply chains, and access to imported inputs that is inconsistent at best. Negotiations with the government over past FX-related claims are agonizingly slow. Meanwhile, the buffers that existed in 2009 are severely compromised. Central Bank reserves moved below $20bn for the first time in over a decade with the October 8 maturity payment of Republic '14s ($1.5bn), taking the cash portion of reserves down to a bare minimum. President Maduro and other officials have on numerous occasions announced they would make their off budget cash in Fonden and Chinese funds more transparent, but this has not yet occurred, leading market participants to discount the existence or availability of these funds altogether.

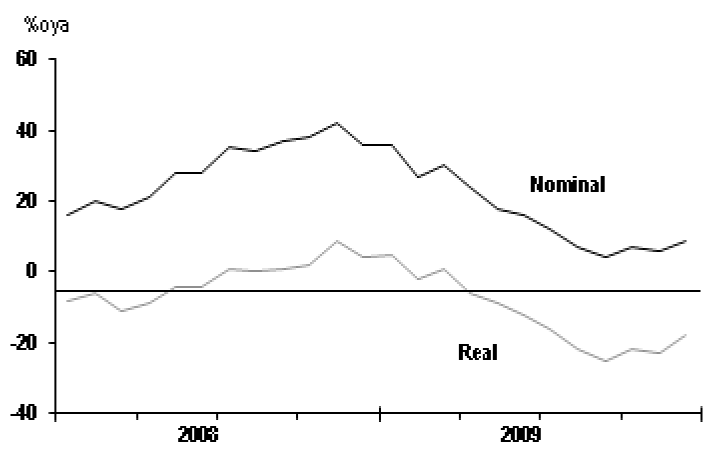
The result of this mix is a sharp recession, much higher inflation, more pervasive scarcity—and plummeting presidential approval ratings. Against this troubling backdrop, external accounts have managed to close so-far in 2014, but the process has been painful, even with oil prices having averaged over US$10/bbl above the current level.

Figure 3: Imports reflect the adjustment, but how much lower can they go?



Source: INE and J.P. Morgan.

Figure 4: Chavez delivered a real contraction in budgetary spending in 2009



Source: National Treasury, BCV and J.P. Morgan calculations

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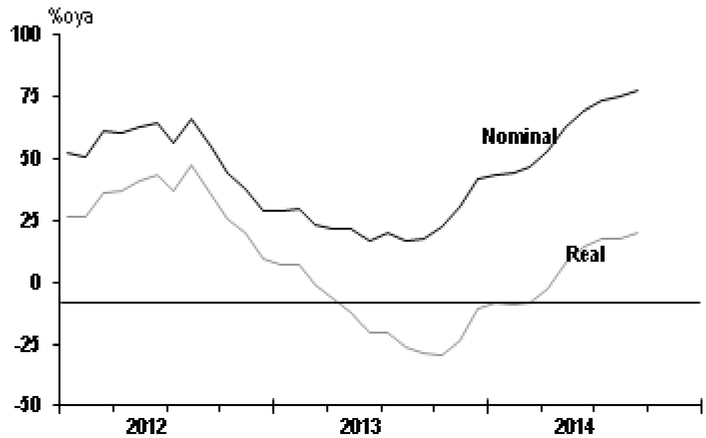
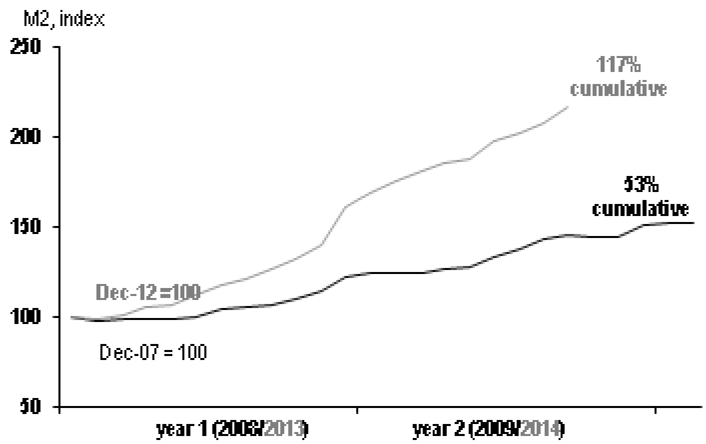
Figure 5: Maduro has looked to reaccelerate spending to counter falling popularity



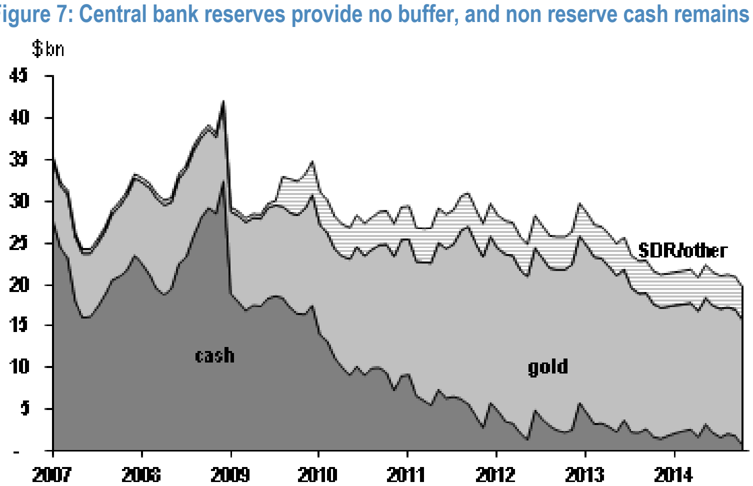
Source: National Treasury, BCV and J.P. Morgan calculations

Figure 6: Much more liquidity sloshing around



Source: BCV and J.P. Morgan calculations

Figure 7: Central bank reserves provide no buffer, and non reserve cash remains opaque



Source: BCV and J.P. Morgan.

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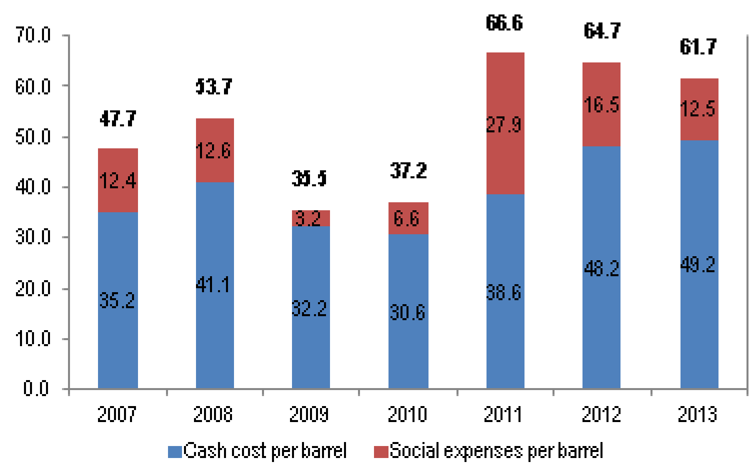
Strain on PDVSA yet to be relieved

PDVSA's fundamentals have deteriorated due to lower barrels being sold for cash, higher crude purchases from third parties and higher social contributions. We estimate that the company only receives full prices for ~60% of its production, but has to incur the production costs for nearly all the barrels. We estimate that PDVSA sells 700mbpd in the domestic market at prices of ¢6/gallon and sells another 750mbpd at below market prices, including long-term financing or to pay loans provided to the Republic. On the cost side, purchases of crude oil and by-products have increased from $26 billion in 2009 to close to $40 billion/year in the last three years (the bulk of these are from Citgo, though imports to Venezuela are also up). In addition, operational costs have increased due to inflation that has not been fully compensated by PDVSA's ability to sell USD at the highest of the three exchange rates (Cencoex: USD/VEF 6.3; Sicad-1: 12; Sicad-2: 50). Finally, contributions to the FONDEN and social expenses have been over $10 billion in the last three years. If we look at them on a per barrel basis, we estimate that PDVSA pays $12/bl to social initiatives. We believe that the company can make some adjustments but are limited without any major policy shifts (renegotiation of supply agreements, increase to gasoline prices and ability to sell USD at the highest FX rates). In 2009 the company reduced its social contributions to $3.5 billion vs. an average of $14.5 billion in the previous two years. Nowadays, Fonden transfers are a function of the oil windfall tax, and could go down below $2bn again on the lower oil price (recall below $80/bbl, the windfall tax only delivers to Fonden 20% of the difference above the budgeted level of $60/bbl).

Figure 8: PDVSA cash costs are up in USD terms, but social expenses can go down



Source: PDVSA and J.P. Morgan calculations

Lower oil prices in 2015 make muddling through even less comfortable

Looking ahead to 2015, the government is facing increasingly difficult choices. Again, if Venezuelan oil remains in the low $80s, the government will face roughly $8-10bn lower export revenue than 2014 (assuming exports volumes stabilize). Mid-$70s oil takes away an additional $4-5bn annually. So how would Venezuela deal with this scenario, given how challenging 2014 already has been with Venezuelan oil in the low $90s? First, we could see an additional attempt to contract imports further by tightening capital controls and limiting disbursements, but in the wake of the $18bn import correction that has already occurred since 2012, we wonder how much more room is left. A more coherent devaluation and liberalization would help, making imports more efficient and choking off some of the capital flight incentives being fueled by the current multiple rates and misaligned prices. Devaluation would also deliver fiscal revenues above the line, limiting the need for monetary financing, and mitigating the monetary overhang. However, with Maduro's popularity at the lows, spending is not likely to slow in an election year and outright monetary tightening seems unlikely. Following the dismissal of the Ramirez agenda, the best that can be hoped for is probably piecemeal FX moves that maintain some form of multiple rates, thereby keeping arbitrage and rent-seeking incentives alive. Other much discussed moves are hiking gasoline prices, which would also deliver more bolivares to PDVSA above the line, but it in an election year unpopular gasoline hikes are unlikely to be of a magnitude sufficient to choke off smuggling and mitigate domestic demand for fuel

In terms of moves that would directly impact external accounts, there's not much new on the menu. The government or PDVSA could print more USD bonds to deliver to the private sector, and therefore free up more cashflow, but given the depressed levels of the secondary market, this strategy seems limited. Lower subsidized export flows to Petrocaribe are possible, though the Cubans seem to have their own quota more or less assured. It is also important to note that the Chinese will apparently allow more flexible terms for the repayment of the bilateral loans, freeing up some cashflow for PDVSA. We think partial roll-backs of Petrocaribe and the Chinese flexibility might free up some 100-150kbd as a best case scenario, equivalent to $3-4bn annually at $80/bbl. Chinese flexibility on payments may well come at the expense of any new lending for the time-being. Finally, the government could offer significant concessions to oil sector partners that might lead to new FDI, but significant investments and meaningful production increases will probably remain slow moving. Tying everything together, we still think muddle through is possible, even with $80/bbl for Venezuelan oil, but if it has been tight in 2014 with oil averaging $94 (ytd), then 2015 would be even tighter, with more painful adjustments coming on top of an already difficult 2014, and 2015 is an election year.

Playing the scenario forward, and considering the debt service schedule, we think concern over the medium-term outlook will linger. We think the authorities should have little trouble with the EUR1bn amortization of March 2015 just by properly managing its cashflow. The other bond maturities come in 4Q: $3.4bn of bonds mature between October 28 and November 2. There are also $1.7bn in October-November coupons of the $5.8bn annual total. If we also consider the political scenario, the second half of 2015 could be quite murky. It is hard to see government approval ratings improving meaningfully as the status quo on the economy is stagflation, and any move to credibly address structural imbalances will involve measures the government perceives to be politically costly (devaluation, gasoline price hikes, lower spending). Moreover, government officials are signaling that they cannot afford to lose National Assembly elections next year, given the high stakes for control of institutions like the electoral council and the judiciary just one year ahead of a possible presidential recall election in 2016. (We note that former VP and current Social Movements Minister Jaua this week stated that National Assembly elections are "life and death" and a scenario of the government alternating power with the opposition is unthinkable.) Nor do we think the opposition, though still suffering important internal divisions, would be inclined to "turn the other cheek" if it perceives election results that do not reflect reality. In our view, this backdrop is not consistent with a stable social and political equilibrium in 2015, which in turn could lead to unpredictable outcomes.

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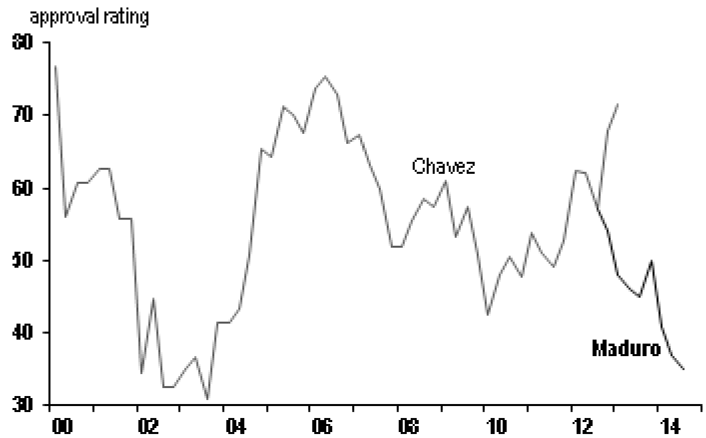
Figure 9: Maduro's approval already at very low historical levels



Source: Datanalisis and J.P. Morgan calculations

Levels seem extreme, but use market rebounds to get closer to home: move to Market Weight

We rode our overweight call down through the August-September sell-off, convinced that Venezuela had ability and willingness to muddle through and continue to honor its bonded debt service, despite the worsening of the fundamental outlook brought about by Economy VP Ramirez's removal from the economic team in early September. We were reluctant to react to the additional market pressure stemming from highly publicized views from academic circles regarding a possible bond default strategy, since in our view the Maduro administration still views of the costs of default looming large over the benefits.

However, the significantly lower oil price of the last weeks, and the increasingly uncertain outlook going forward, does materially change the balance of risks ahead in our view. Muddle through is still possible, and honoring external debt is a priority, but already tough policy choices will become even tougher in 2015, with political noise and possible associated social tension poised to intensify. While we do expect some modest adjustment measures like additional devaluation in the coming months, and we concede that current levels are near the extremes for Venezuela over the last years, for investors that remain overweight, we recommend using market rebounds to get closer to neutral. We move our recommendation of Venezuela to Market Weight and PDVSA in the EMBIG model portfolio to Neutral. On the curve, we like Venezuela €'15s, which should pull to par, and prefer PDVSA '17Ns at a nearly $10 lower price versus PDVSA'15s in the short end (the former starts sinking next year just days after the latter amortizes). In the belly, higher dollar priced bonds have already been punished, but should remain under pressure. We prefer the low USD-price PDVSA '24s and '26s as they offer some downside protection, especially if we take into account that at least one coupon is very likely to be paid. Bonds priced in the $40s should be close to recovery value in our view.

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