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For offshore investors

Emerging market bonds

Venezuela: Much ado about nothing?

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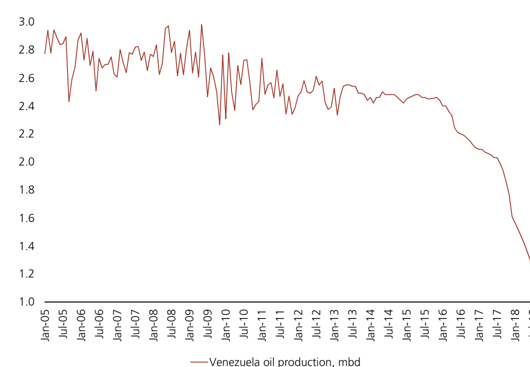
- The recently proposed economic changes by the Maduro administration will fail to stabilize the country's macro dynamics or its oil production decline, in our view. Furthermore, these measures risk destabilizing social dynamics and could lead to more severe tensions within ruling party factions.
- Additional US sanctions are reportedly in the pipeline, this time blocking the sale of oil processing products by US companies to Venezuela, which would further cripple Venezuela's oil sector.
- There has been no communication between Venezuela's government and bondholders for some time. A comprehensive debt restructuring cannot be carried out without the lifting of US sanctions. A necessary condition for such lifting at this point appears to be a political regime change in Venezuela. In this report we provide a review of recent litigation efforts against Venezuela and PDVSA in US courts.
- A sudden regime change in Venezuela under current economic conditions cannot be ruled out. Investors with a longer investment horizon and both a willingness and ability to tolerate losses could maintain a small exposure to the country's bonds in the context of a broadly diversified portfolio. Those with low risk tolerance and no appetite for an uncertain restructuring process should refrain from holding Venezuelan bonds.
- Chavismo is displaying a remarkable ability to hang on to power. The longer the current administration remains in charge, the lower recovery values are likely to be in a debt restructuring, in our view. The opportunity cost of holding Venezuelan bonds is also high. In this note we also provide ideas for investors looking for alternatives to Venezuelan risk.

The Maduro administration has begun implementing numerous economic measures aimed at stabilizing Venezuela's economic outlook. Recent announcements include a sharp FX devaluation and commitment to a more flexible FX regime, a re-denomination of the currency from the bolivar fuerte to the bolivar soberano that drops five zeros and which will be linked to a new cryptocurrency whose value is designed to be backed by oil reserves, a sharp minimum wage hike, a series of tax hikes, and a promised reduction in gasoline subsidies.

Recent CIO coverage of Venezuela

- Venezuela: Rigged elections trigger more external pressure, 22 May 2018
- Venezuela: Waiting game, 25 January 2018
- Venezuela: What have we learned since Maduro's big speech?, 21 November 2017
- Venezuela: Severe market reaction, not a good time to sell, 6 November 2017
- Venezuela: Murkier outlook, better valuations, 25 October 2017
- Venezuela: US administration turns up the heat, 29 August 2017

Fig. 1: No end in sight for oil production decline
Venezuela oil production, in million barrels per day



Source: UBS, IEA, as of August 2018

However, we believe the proposed changes will fail to stabilize the country's macro dynamics or its oil production decline. In isolation and carried to completion, some of the announced measures appear steps in the right direction. But without an accompanying boost to confidence, including a comprehensive macroeconomic plan with a serious commitment to fiscal consolidation, as well as an FX injection into the economy and relief from US sanctions, the effectiveness of the measures will be extremely limited, in our view. Furthermore, these measures risk destabilizing social dynamics and triggering further protests against President Nicolás Maduro's regime, and could lead to more severe tensions within ruling party factions as rent-seeking actions become more challenging to execute.

In sum, the recently announced steps will likely bring little meaningful macro relief. We believe inflation will continue to accelerate and domestic activity will contract still further and carry with them potential political costs to the Maduro administration.

Additional US sanctions in the pipeline?

On 24 August news agency McClatchy reported that a new package of sanctions, this time blocking the sale of oil and oil processing products by US companies to Venezuela, would be released in the next three months. If implemented, we think these sanctions would hurt Venezuela's oil sector further (see Fig. 1). Venezuela currently imports US diluent to allow the extra heavy crude it produces to flow through pipelines to the nation's coast in order to be exported.

Advances in recovery efforts by some creditors

There has been no communication between Venezuela's government and bondholders for months regarding a potential path to debt restructuring. According to Bloomberg reports, some bondholders have started to form groups and seek legal advice. One of these groups reportedly warned Venezuela on 25 June that it needs to treat all investors fairly and that it won't support any debt restructuring that doesn't treat them in such way. No concrete legal action has been initiated yet by bondholders in US courts.

Interestingly, companies which used to perform business activities in Venezuela and have been seeking compensation through arbitration proceedings for expropriations and other damages have been moving closer to their goals in recent months (c.f. Financial Times; Bloomberg).

Canadian mining company Crystallex, which has been trying to enforce a USD 1.2bn arbitration award against Venezuela, has asked a US federal court to seize the shares of a PDVSA subsidiary which is the US parent company of CITGO. Crystallex argued that it should be allowed to seize the shares as PDVSA is ultimately the "cover" or "alter ego" of Venezuela. In the context of the case, the court accepted Crystallex's interpretation earlier this month and on 24 August it cleared the way for Crystallex to sell the shares, unless Venezuela posts a bond in court or reaches a settlement. Other interested parties will also be allowed to comment on the issue, such as holders of PDVSA 2020 bonds, which are secured by 50.1% of CITGO shares, and Rosneft, which lent money to PDVSA secured by the remaining CITGO shares. This case will have potentially broader implications than the issue at hand. Other creditors of Venezuela

might now be able to look at PDVSA to satisfy Venezuela's debts, although this might not be as straightforward as it seems (see Box 1 for more information).

ConocoPhillips, which had obtained court orders freezing PDVSA assets in the Caribbean further disrupting Venezuela's ability to export oil, last week forced PDVSA to agree to pay the full amount of USD 2bn awarded by an International Chamber of Commerce tribunal in April.

And some companies holding unpaid PDVSA promissory notes pushed ahead with efforts to obtain payment and sued the oil company in May.

For a detailed review of such developments recently, please refer to Box 1.

Although continued litigation against Venezuela and PDVSA is likely to follow, in our view, it is important to remember that a comprehensive debt restructuring cannot be carried out without the lifting of US sanctions. A necessary condition for such lifting at this point appears to be a political regime change in Venezuela, in our view.

What to do with Venezuelan bonds?

A sudden regime change in Venezuela under current economic conditions remains a clear possibility, in out view. Historically, hyperinflation in emerging markets has often led to regime change. Venezuela's declining oil production is making it increasingly difficult for the Maduro regime to keep appeasing its supporters. We believe the latest round of economic measures will add fuel to the fire.

With "dirty" prices in the USD 25–27 range, Venezuelan sovereign bonds offer investors an affordable exposure to regime change, in our view. The payoff structure continues to look asymmetric. The total upside return for select Venezuelan bonds in more benign scenarios exceeds the downside in the negative scenario, in our view. We believe investors with a longer investment horizon and both a willingness and ability to tolerate losses should maintain a small exposure to the country's bonds in the context of a broadly diversified portfolio. Those with low risk tolerance and no appetite for an uncertain debt-restructuring process should refrain from holding Venezuelan bonds.

Alternatives to Venezuela

Maduro, as well as Chavismo, continues to show a remarkable ability to hang on to power and we believe the status quo may drag on for some time to come. The longer the current administration remains in charge, the lower recovery values are likely to be in any potential debt restructuring, in our view. The opportunity cost of holding Venezuelan bonds is high given the lack of coupon payments and no certainty that the unpaid carry will be recognized in a potential restructuring.

Investors looking for very high yield alternatives could explore positions in some troubled Latin American corporate names. Our regional corporate credit analyst Donald McLauchlan believes Ocyan (formerly Odebrecht Oil & Gas), which completed its debt restructuring in late 2017, and Odebrecht Engineering & Construction, which has made progress in reaching leniency agreements in several jurisdictions, could be interesting alternatives to Venezuela risk.

Box 1: Relevant readings on recent creditor recovery efforts

- https://www.law360.com/bankruptcy/articles/1049150/the-state-of-creditor-recovery-efforts-in-venezuela-part-1
- https://www.law360.com/articles/1049170/the-state-of-creditor-recovery-efforts-in-venezuela-part-2
- http://www.creditslips.org/creditslips/2018/08/court-approves-crystallexs-attachment-of-citgo-parent.html
- http://www.creditslips.org/creditslips/2018/08/some-thoughts-on-the-alter-ego-ruling-in-crystallex-html?utm_source=feedburner&utm_medium=email&utm_campaign=Feed%3A+creditslips%2Ffeed+%28Credit+Slips%29

Please see our 7 June report "OEC: Better half takes narrow lead," and our 13 July report "Odebrecht: Base case up, risk case down" for more information.

Sovereign and corporate high yield bonds from countries we are overweight in our emerging market credit model portfolio – Argentina, Bahrain, Côte d'Ivoire – might also interest investors, though these bonds trade at much higher prices than Venezuelan ones currently do.

UBS CIO risk views

Credit risk flags

CIO attaches a credit risk flag to the instruments under its coverage. Credit risk is assessed based on the remaining tenor and / or instrument type. The flag indicates the likelihood that a holder of the instrument will not receive a coupon or principal payment when it comes due. For subordinated and hybrid instruments, which are usually callable and have a remote or no fixed maturity date, we apply one uniform credit risk flag per issuer and instrument type. The idea is to reflect the possibility of contractual trigger events or regulatory intervention occurring. Either can impose losses on bondholders regardless of the remaining term of the instrument or a specific issuer default event. Credit risk flags only indicate our view of the riskiness of a particular instrument. Credit risk flags should not be seen as recommendations to buy, hold or sell. In fact, any combination of risk flags and relative value recommendations is possible.

Very low credit risk

We believe that the probability of debt payments not being made when they come due is very low (cumulative probability of less than 2%).

Medium credit risk

We believe that the probability of debt payments not being made when they come due is low to medium (cumulative probability of non-payment between 2% and less than 20%).

High credit risk

We believe that the probability of debt payments not being made when they come due is at least one in five cumulatively.

Issuer credit outlook

We complement the instrument-specific risk information of the credit risk flags by indicating our outlook for the credit quality of an issuer over the next 12 months. Depending on instrument pricing, all combinations of an issuer credit outlook and relative valuation recommendations are possible.
Improving: We expect the credit profile of the issuer to improve, to an extent that may result in upgrades by rating agencies.
Stable: We do not expect the credit profile of the issuer to change meaningfully.
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UBS CIO valuation views

Relative value bond recommendations

Our relative value bond recommendations are based on an average investment horizon of six to 12 months. They reflect our assessment of a bond's attractiveness relative to comparable instruments under CIO coverage. Comparable instruments typically exhibit similar credit quality, are denominated in the same currency, belong to the same segment of the bond market, and have a similar remaining tenor until redemption.
Views on a particular instrument can change within the six- to 12-month time frame, and those that apply to one instrument do not necessarily apply to others of the same issuer. Views on a particular instrument may be withdrawn if it does not have a sizeable basket of comparable instruments under CIO coverage.

Bonds seen as “attractive” are expected to generate a total return exceeding the average return of comparable instruments. Our recommendation can stem from a positive view on the issuer’s credit profile not fully reflected in the price, unduly high risk premiums, our take on an instrument's call probability, the risk of coupon deferrals, and external factors including regulatory intervention.

Bonds seen as "fair" are expected to produce a total return broadly in line with the average return of comparable instruments.

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Sell recommendations

A Sell recommendation is assigned when the risk of an adverse outcome for an instrument exceeds what is reflected in its current valuation. Such situations can include those in which the instrument appears likely to post negative total returns until redemption, either due to a highly negative yield to maturity or an imminent call at a price below market valuations.

For details please see "Understanding bonds: A guide to CIO's credit offering", published 08 March 2017.

Appendix

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For more background on emerging markets generally, see the CIO GWM Education Notes, *Emerging Market Bonds: Understanding Emerging Market Bonds*, 12 August 2009 and *Emerging Markets Bonds: Understanding Sovereign Risk*, 17 December 2009.

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Appendix

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