# Venezuela Economics and Strategy

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## Our views on 9 critical issues for bondholders

- **Extinguishing statute of limitations and the dilemma of taking legal action**
- **The PDVSA 2020 bond would be deemed as valid and CITGO would be protected**
- **Trading ban relief for US agents is possible but needs a catalyst**
- **Next important date for bonds is 22 October**

① **The expiring statute of limitations periods could create legal costs for some investors.** These are statutory provisions that establish the period during which a claim must be brought to a judge for enforcement, or else the creditor loses the right to enforce it in court. Venezuelan bonds were issued under NY law, which establishes a statute of limitations period of 6 years for this type of contracts. Since October 2017 marked the start of the Venezuelan default, the rights to demand payment through the judicial system will start to phase out in October 2023, as the interest and capital payments were missed by the government, unless the bonds were accelerated. In this last case, the period starts to run from the day of acceleration. It is possible for national authorities and bondholders to extend the deadline to initiate legal action and offer some space to negotiations on a restructuring, implementing a so-called "tolling agreement", and the Maduro administration has already unsuccessfully attempted to do so. The proposal failed due to the lack of a recognition by the US government. The likelihood of such a deal going forward is mostly linked to US foreign policy goals. Without further concessions from Chavismo, it does not seem likely that Venezuela's current authorities could gain a minimum degree of recognition that would enable implementation of a standstill. Hence, to avoid waiving their rights we think investors will need to, at least initially, incur in legal costs.

② However, **even if investors fail to initiate legal action before the statute of limitation ends, that does not mean their claim is lost**. It would basically depend on the defaulting government's incentives to negotiate some kind of deal. History offers two important precedents on this regard: (1) Saddam Hussein included all creditors in the restructuring that occurred 15 years after the default in 1990, regardless of them having enforced the claim or not in court; (2) in the late 2000s, Liberia did the same with defaulted claims in the acclaimed restructuring of liabilities dating back 30 years. In the case of Venezuela, we are of the view that the government that emerges from the 2024 election would show willingness to include all bondholders and organise a friendly restructuring process, as it would probably help to secure the much-needed financial assistance (and aid) of international financial institutions. A team of advisors of Juan Guaidó cast doubts on the validity of the 2020 PDVSA bond at the outset of the interim government but even if the opposition wins, we think that the new authorities will drop any legal challenge to avoid reputation costs.

③ **The validity of the PDVSA 2020 bond.** Our opinion on this issue is that the bondholders' claim will be upheld by US courts. Arguments presented by the opposition (National Assembly 2015) regarding the validity of the bonds are rather weak. Essentially, opposition lawyers insist that Maduro failed to submit for approval the indenture of the bond to the 2015 opposition-controlled Assembly. However, they disregard the fact that the local legal framework allows for "exceptions" that could create the space for justifications by the government.

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Also, in the context of the literature on "odious debts", the 2020 bonds did not raise new funds for Maduro to use in activities that allegedly did not benefit the country, as the issuance consisted of a bond swap offered to gain short-term financial relief. If US courts confirm this line of thinking and reaffirm the validity of the bonds, then the question turns to what would happen to CITGO. Here our view is even clearer: the US government will continue to protect the company from legal action by bondholders until a broad debt restructuring process can start. We consider that the political costs for the US-Venezuela relationship of abandoning CITGO to the action of US courts would be simply too high to bear (see Moderation of trade sanctions could stimulate PDVSA bonds convergence, Venezuela Economics and Strategy, 25 October 2022).

④ **Increased probability of extreme political scenarios # 1.** The rise of María Corina Machado as the main opposition figure going into the October primaries adds important risks to the outlook for the 2023-2024 period (see Moderation, the essential ingredient for a feasible transition, Venezuela Economics and Strategy, 14 February). Machado's radical stance in several issues incorporate potential scenarios in which previous failed boycotting strategies could re-emerge if electoral conditions demanded by her (if she eventually wins the primaries as most polls suggest) are not met. However, it is important to note that she also embodies the largest possibility of transitioning to a more democratic government (and a better set of public policies) as soon as 2025. She certainly has the potential not only to win the primaries, but to generate a level of enthusiasm among opposition voters that increases the odds of a high turnout in the election. Polls suggest that with Machado leading a united opposition ticket instead of the more moderate alternatives of Henrique Capriles or Benjamín Rausseo, there are higher chances of a Chavista defeat in a reasonably clean election. In this vein, an eventual opposition victory would have to be obtained by a sufficiently large margin that could be difficult to revert or change by last minute strategies by the incumbent administration, and that could rule out any military non-democratic exit.

⑤ **Increased probability of extreme political scenarios # 2.** Mounting risks of a Chavista defeat in the presidential election would likely be confronted by a radicalisation of the government. This would potentially translate into an end of political concessions, a strengthening of Chavismo's grip on the National Electoral Council, prosecution of opposition leaders and their inner circles, intensifying the campaigns and strategies that discourage participation in the ballot, and abandoning (again) the negotiation table. **Extreme political scenarios are negative for bonds**, in our view, as they reduce the chances of regime change and financial normalisation.

⑥ **Trading ban relief for US agents is possible but needs a catalyst.** The restrictions on US agents to negotiate Venezuelan bonds in the secondary market have been, in our view, one of the most ineffective measures to pressure Maduro. Biden could lift these constraints for the sole benefit of American bondholders without this implying that the US recognises Maduro. After all, trading in secondary market should have no direct impact on the government's ability to obtain financing and anecdotal evidence suggests that several American lawmakers have started to share this view. Certain additional transparency requirements could be demanded to trade the bonds from US agents, or trading might be restricted to a specific type of institution under strict supervision, so as to avoid the participation of untrusted individuals potentially linked to the dark side of Venezuelan finances. On the other hand, for this not to be seen as a token of permissiveness on behalf of the US, it would probably require some kind of gesture from the government that is conditioning the continuity of negotiations to a yet-to-be-implemented USD3.0bn humanitarian aid package from the UN.

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⑦ **Next important date for bonds is 22 October.** Our current estimate of the recovery value that bondholders could eventually pursue is 35 cents on the dollar (see Plenty, yet distant upside, 20 Jun 2022). This estimate rests on two critical assumptions: (1) a 1.7% of GDP primary fiscal surplus; and, (2) a gradual recovery of oil output to a level of 2.2mn bpd in the long term. As argued before, the timing of a relaxation of trading sanctions is hard to predict and will hinge on a catalyst. So far, we had been expecting 2H24 to become the optimal entry point to gain exposure, but this is conditional on political extremism not materialising. On a positive note, Zulia Governor Manuel Rosales's party has recently signalled that it could endorse another candidate, in line with our assumption that Rosales would not be part of the race (see Moderation, the essential ingredient for a feasible transition). Rosales, who is an advocate of moderation, is currently positioned in second or third place in most polls and could play the role of kingmaker if he is able to transfer his support to a more balanced presidential hopeful. Therefore, if a moderate wins the united opposition's nomination next 22 October, we could see positive pricing momentum for bonds, reflecting not only a lower likelihood of extreme political outcomes but also the emergence of a trigger for an easing of trading sanctions.

⑧ **Limited upside for oil production.** After the issuance of the licence for Chevron last November we projected a short-term recovery of approximately 100k in domestic oil output from the current level of 600k-700k bpd. We acknowledged that risks were tilted to the upside, but production will barely reach the 1.0mn-bpd goal set by the government. Looking further into the future, and assuming that sanctions are lifted after the 2024 elections, we foresee a gradual expansion towards a level of 2.2mn bpd in the long term. This constitutes a relatively conservative view on Venezuelan production capacity. It would put domestic production at a level that would be two thirds from the peak of 3.3bn attained during the industry's post-nationalisation period (1975-2023). Considerations related to the prolonged period of disinvestment, damaged infrastructure, structural bottlenecks, human capital flight, and corporate governance deterioration are just the main factors behind our cautious outlook. In this regard, Venezuela is not expected to show a recovery pattern as the one observed in Iran after the lifting of oil trade restrictions in 2016 (1.0mn bpd in one year).

⑨ **Debt-for-equity swaps and VRMs could facilitate the restructuring.** The best course of action for Venezuela would be treating all creditors equally, although this is close to being utopic from a practical point of view. For starters, bilateral creditors (i.e. China in the Venezuelan case) are typically considered to be more senior. Participation in domestic real investment projects (particularly in the oil sector) might be an important alternative to improve the terms of the negotiation, despite the potential increase in the duration of their assets. The possibility of entering a sort of debt-for-equity swap would have to be pondered by creditors, as well as value recovery mechanisms (VRMs) that could be linked to oil output to capture any upside from a more conservative path. While the perception on the effectiveness of VRMs to add value in a restructuring process has been damaged by the negative precedent of Argentina's manipulation of national accounts data, in the case of Venezuela and oil there are secondary data sources that would make data tampering much more complicated.

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