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# EM Trade Idea

## Venezuela: How Will the Story Unfold?

In this piece we discuss the current situation in Venezuela related to its plan to withdraw from the IMF, and in light of the costs and benefits, analyze the likely outcome.

Without prior negotiation with bond-holders withdrawal from the IMF will trigger a technical default on Venezuela's Eurobonds, giving bond-holders the right to accelerate principal repayment. It is quite likely that there is a sufficient number of bond holders for whom acceleration will result in net financial gain, either because their bonds are trading below par, or because of the implications for their credit derivative exposures. This is likely to be the worst-case scenario for Venezuela.

Alternatively, Venezuela can attempt to negotiate with bond-holders to remove the acceleration clause from the bonds, prior to pursuing its plans to withdraw. As we discuss, this option is also likely to be complicated and extremely costly since given the acceleration clauses, withdrawal is equivalent to giving away put options, struck at par, to all bondholders. Assuming the government has no incentive to actually default, investors will not give up these options without compensation, the aggregate value of which we calculate in excess of USD 500 million.

At the same time the direct financial benefits to withdrawal appear to be minimal. Based on IMF accounts, it appears that the government would gain only USD11 million, far less than the USD 250 million which President Chavez suggested.

The rational decision for Venezuela would clearly be not to follow through the plan to withdraw, although some face-saving gestures will need to be found before the government can pursue this option. We believe that in the end, economic rationality will prevail, although in the short-term there is likely to be more noise before the matter can be quietly forgotten.

In terms of strategy, it is hard to judge whether the probability of Venezuela's withdrawal from the IMF and the subsequent credit event occurring has been sufficiently priced in the market actions seen during the past three days. If investors judge that this is the case, the best risk reward is simply to do the opposite: **sell short tenor protection outright, or buy the 27s against the 20s or the 16s.** However, such a position would suffer a significant loss in the event of an actual default. **A more limited downside option is to buy 10Y protection and buy a premium bond, preferably the 27s, with a notional ratio of 10mm x 5mm.** The trade likely makes money under all scenarios except an actual default with recovery more than 80%.

### Market Strategy

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## Venezuela: What Happens Next?

Venezuela reiterated on Thursday its intention to withdraw from the IMF. According to Economy Minister Cabezas the official decision was already announced by President Chavez. However, in the meantime, Minister Cabezas also reiterated that the government would continue servicing all its debt obligations and hence indicated that investors should be confident about the willingness and the ability of the government to continue servicing its debt and should have no reasons to demand an acceleration of the maturity of the outstanding bonds.

**It is important to point out that the government of Venezuela does not want a default, technical or otherwise.** Even though the government has a large amount of cash at hand, it also has significant need of it to maintain its expansionary fiscal policy and continue moving forward with its domestic and external policies, such as the recently announced nationalization of companies in a number of sectors of the economy. In addition, it is also important for the government to maintain access to external capital markets in order to continue issuing Eurobonds to local investors. This policy helps the government to control inflationary pressures and raise financing at low cost while allowing local investors to purchase the bonds at the official exchange rate in local currency and subsequently sell the bonds abroad for dollars. Given the above, we believe the government of Venezuela has no incentive to carry out any action that will jeopardize its access to external markets. However, despite reiterating that it will continue servicing all of its debt obligations, withdrawal from the IMF result in a default event which will almost certainly lead to the attempted acceleration of its some of its debt obligations, which, if successful will trigger a credit event on all credit derivative contracts which contain Venezuela as a reference entity.

Below we present the potential outcomes, analyzing in detail how the market would react, and the likely costs of each. The options are essentially to abandon the plan to withdraw, to negotiate with creditors to change the terms of the bonds prior to withdrawal, or to withdraw, trigger a technical default and negotiate with bond holders after the fact. We examine the benefits to withdrawal and find that the net financial gain is only USD 11million, far less than the USD 250 million advertised by President Chavez. **We argue that since the costs of negotiating with creditors is likely to vastly exceed the benefits of withdrawal the plan is likely to be abandoned, although not until some face-saving strategy can be found. In the final section we discuss the strategy implications in the light of the analysis.**

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## Costs of Withdrawal and the Government's Options

Under the premise that the government will try to avoid a technical default, the government has the following options:

**Option 1: Do not follow through with the plan to sever ties with the IMF while continuing to endorse alternative regional proposals and allowing the option of withdrawal from the IMF to fade away to avoid a costly credit event.** To do this, the government would need to perform some symbolic but face-saving gestures such as removing presence with IMF and emphasizing the endorsement for the Bank of the South. It is important to note that government has experienced similar situations in the past when they didn't follow through with their announced plans after weighing up the economic costs.

**Option 2: Venezuela tries to negotiate with bondholders to remove the IMF condition so that the withdrawal would not trigger a credit event. However, the cost for doing this is very high.**

First, let's take a look what the government could do from technical stand point to remove the IMF condition from the bond indentures. According to the bond prospectus documents<sup>1</sup>, in order to remove the condition (which is a non-payment-related modification), the government would need to call a meeting of bond holders (with no less than 30 days and no more than 60 days notice), and then in the meeting, **the government would need to obtain 2/3 of the votes (in terms of outstanding obligations represented at the meeting) to remove the IMF membership condition.** The quorum for the meeting would be a simple majority (in terms of outstanding obligations). If a quorum is not reached a new meeting would be called within ten days at which the required quorum would fall to 35%. **Note that there would need to be a separate vote for each individual bond obligation.**

It is important to note that the IMF membership clause will need to be removed from the covenants of all bonds in order for the government to completely remove concerns of acceleration. Certainly, for the bonds trading below par, it is likely that many bondholders will be in favor of acceleration. Indeed, this possibility is precisely what has been behind the recent price action. However, even for the premium bonds, since there is always a chance that those bonds could fall below par in the future, the government would need to change the terms of all the bonds to be free of the risk of acceleration. Whether the negotiation takes place through a debt exchange (in which bondholders exchange their existing bonds for new bonds with financial incentives and without the IMF membership clause), or through an outright payment (compensation), the government would need to put up a significant amount of financial concession to creditors.

**Note also that the incentive determining whether an individual bond holder would wish to accelerate (or not) their obligation is likely to be more complex than simply whether or not their bond is trading below (or above) par.** It will also depend upon their other holdings of Venezuelan debt and derivative exposure. For instance, a real-money investor holding a range of bonds across the curve may not wish to accelerate their holding of (low priced) 2020s because of the negative consequences such an action would likely have for their holding of (high priced) 2027s. Conversely, an investor with a large long position in default protection, paying a high spread, may even be willing to accelerate a bond trading a little above par (say the 2025s) given that if acceleration occurs they would be able to deliver the 2025s and extinguish the future premium payments on their CDS. The complex incentives of different market participants could make the process of acceleration unpredictable.

**How much would the government have to pay in order to achieve the goal of removing the possibility of acceleration? We can reason that by withdrawing from the IMF the government has essentially given away a put option to all bondholders struck at par given the acceleration clause.** At a minimum, investors will need to receive the value of these options before agreeing to change the terms of the bonds. For some bonds with sub-par prices, such as the 2020s (current price about 92), the intrinsic value for the put option is significant, while for bonds trading far above par, the intrinsic value is 0 but the value for the option would still be a positive number, and for the bonds trading around par, the value is also quite substantial. Without going into details, simply the intrinsic value related to the sub-par bonds is in the region of USD 300 million, and the aggregate cost of negotiating with all bond holders, given over USD20bln outstanding of Venezuela Eurobonds, could plausibly exceed USD 500 million.

How much creditors would demand in order to have the IMF withdrawal clause removed would depend on their own individual incentives to have the bonds accelerated or not. As discussed above, such incentives are complex and likely go beyond the simple intrinsic and time value of the put option. However, it is important to note again that the clause must be

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<sup>1</sup> There are some procedural differences between the various bonds. The following text describes the processes set forth in the prospectuses for the 2016s and 2020s. These two bonds are currently the lowest priced bonds and hence the most likely to face an acceleration attempt in the event of a default event.

removed from each and every obligation in order to entirely remove the risk of acceleration. Hence we believe that the cost to Venezuela of removing the clause would be substantial.

**Option 3: Venezuela government carries out the plan to withdraw from the IMF resulting in the acceleration of one or more of its bond obligations.** This would trigger a credit event for CDS even if they continue servicing their debt (which they have said they would). This would be the most costly scenario for Venezuela, both economically and politically, and would have very complicated implications. Venezuela would surely see its access to external financing cut, or its cost dramatically increased (a rating downgrade would be quite certain), which could derail many of their nationalization and social plans. In addition, it is common knowledge that the local banks in Venezuela hold Credit Linked Notes linked to Venezuela (among other issuers). These banks could face significant losses, and if the government decides to compensate the losses, the loss will be transferred to the government.

Although we believe the possibility of this occurring is very small, it is still important for investors to be fully aware of the consequences. Assuming Venezuela has officially withdrawn from the IMF, but the condition that requires the country to be a member of the IMF remains in all (or some) of the bond indentures. Then a bond will likely be accelerated quite soon (the most likely bond would be the 20s). The amount of outstanding obligations required for triggering the acceleration of any series of bonds is only 25%. Consequently, a credit event is triggered and all the credit derivatives contracts will trigger. To trigger CDS, it would only need USD10mm notional amount of the bonds to be accelerated. Even if there is no bond accelerated immediately, the liquidity in the CDS market would likely still evaporate, simply because the threat of a credit event would loom over it.

The situation would be very complicated even if the government continues all the debt service obligations. After the credit event, not only CDS contracts would be triggered, but the large amount of FTD baskets and CLNs the local banks hold would also be triggered. We expect a huge demand in the market for the sub-par bonds due to the cheapest to deliver option in the CDS contracts (including the ones embedded in the FTD baskets), which could push the prices of these bonds up toward par, although ultimately the value of the bonds will depend on whether the government of Venezuela recognizes the right of the bond-holders to receive par. **If the government respects the acceleration then the recovery value on the bonds is 100, and hence triggering the CDS contracts actually has no financial implication for the protection buyer or seller.** In this case the government has implicitly assumed all the financial costs of the credit event and the winners would be the sub-par bond holders. Assuming the government continued to service its obligations, the premium bonds might suffer in the turbulence but not necessarily much and CDS protection would be worthless.

On the other hand, if the government refuses to recognize fully the acceleration rights of bondholders the situation will become significantly more complicated. This would be an event of actual, not just technical, default, triggering an extremely costly chain of events. The value of all bonds would fall. Despite the demand from protection-holders to deliver the sub-par bonds, the value of the bonds will depend ultimately on the recovery value recognized by the government. The government would certainly lose all access to external financing and would again be put in a situation of having to negotiate with bondholders. Failure to reach agreement could end up in circumstance such as Argentina currently finds itself in, whereby a group of disgruntled hold-out investors refused to participate in the restructuring and continue to prevent access to external financial markets for fear that payments can be attached. To the extent that Venezuelan banks were the protection sellers, the government would likely end up paying some form of compensation for the losses in any case. In this case the winners would likely be the protection holders, with all bond-holders losing out as the value of the acceleration clause is undermined, and bonds began trading on recovery values, with the exception of bondholders who bought the bond at a below par price that is even lower than the recovery value.

**Furthermore, in the wider market, the unwinding of first-to-default baskets of EM credits would likely have implications for the other credits in the baskets – mostly Argentina and**

Ecuador, and to a lesser extent, Brazil, because the dealers involved would need to buy a significant amount of protection in these credits to offset the previous hedges.

All in all, this would be an extremely messy situation in which many would lose and few would gain.

## Benefits of Withdrawal

Further to the above analysis of the significant costs to withdrawal, it appears that the financial benefit is rather minimal and not nearly as much as recently quoted in the press (USD250mm). Actually, we believe the actual payment to which Venezuela is entitled is significantly less. Based on IMF data, we estimate it to be a mere USD11mm, as shown in the table below. The majority of the country's quota is held in bolivars at the central bank, while in addition Venezuela would need to repay its SDR allocation.

**Figure 1:**

**Venezuela's position in the IMF (as of March 31, 2007)**

a	1. Quota	4,044,039,053	
b	-of which in Bolivar	3,554,482,355	<-- held in account at central bank
c	-of which in FX ("reserve tranche")	489,556,698	<--left to be withdrawn
d	2. SDR Allocation	481,935,819	<--needs to be entirely repaid
e	-of which actually held	3,984,575	
f	3. Other contributions (SCA accounts, burden sharing)	n.a.	<--not published

**Memorandum Items:**

Net Financial Benefit from Withdrawal:  $c - (d - e) + f = 11,605,454 + "f"$

Note 1: the reserve tranche forms part of an IMF member's central bank FX reserves and can be withdrawn at any time

Note 2: Venezuela pays interest to the IMF on the balance between the SDR allocation and their actual holdings

Source: IMF

## Strategy Recommendations

Given the above, we still believe the most likely outcome of this saga is that Venezuela will technically remain a member of IMF after some symbolic gestures aimed at further severing its ties with the institution. However, no outcomes can be ruled-out and in the short-term there is likely to be a significant amount of noise as the rhetoric continues, and hence we advise market participants to be prepared for alternative outcomes. We believe the market will likely normalize in the end, but the current market looks extremely uncertain. After three days price actions, it is likely that the probability of a credit event or uncertainty related to it has sufficiently been priced in the market, though no one can say for sure. 1Y CDS has widened by 90bps, and the 27s have sold off by 5pts relative to the 20s. Even though under such a technical default scenario default protection really does not offer much value, many traders still need to have some protection against some outside chance that a more serious default occurs involving a significant haircut. That is why there has been high demand of short dated Venezuela protection in the market during the past 3 days.

Investors that are confident that the technical/actual default scenarios will not take place should simply put on the reverse positions to those that have recently been implemented, i.e. sell short tenor protection outright, or buy the 27s against the 20s or the 16s. Given that under the scenario of a technical default, a short protection position will not lose money, it is tempting to put on such an outright position if you are very strongly convinced that a technical default will be the worst possible outcome. However, given the uncertain nature of the event we should not completely rule out the even worse scenario of a actual default in

which there is a significant haircut involved. Under that scenario, an outright selling protection position will incur huge losses.

A more limited downside option is to **buy 10Y protection and buy a premium bond, preferably the 27s, with a notional ratio of 10mm x 5mm**. A major motivation here is obviously that the 2027s have been sold off much more than 10Y CDS, which barely moved as investors have been focusing on the short tenors. This trade will break even at about 80% recovery rate under the unlikely worst case scenario of an actual default. The risk and return profile for the trade can be described as follows

- i) If it becomes apparent that Venezuela will not withdraw from the IMF then you make more money on the bond than you lose on the protection. Assuming both CDS and bonds traded back to previous levels, the trade will lose about 0.7% of 10mm notional on the CDS spread compressing and gain about 3% of 5mm notional due to the tightening of bond spread, yielding a net return of 0.8% of 10mm notional. As we have discussed this is the most likely outcome.
- ii) If Venezuela withdraws, a bond is accelerated, and the accelerated payment is met by Venezuela then the protection would expire worthless provided that no bond traded below par, i.e. that Venezuela honored the acceleration in full. There is a risk that at the same time as the acceleration, the rest of the curve sells off due to concerns about deterioration in the view for the credit and the possibility that other bonds, even above par, get accelerated. However, we would argue that the 27s are likely to be among the last bonds to be accelerated in this scenario, and in that case it is likely that the situation will have developed by then towards an actual default scenario, where the CDS protection will have value. We analyze this situation next.
- iii) If payment default occurs (this happens if the government refused to service the accelerated principal payment – an very unlikely event), the premium bonds will sell off the most since all bonds will be trading at recovery value and with the 10x5 notional ratio and current price of 2027s at 120 you should make more on CDS than you lose on the bonds if the recovery value is  $\leq 80\%$ . You would lose money if recovery value turns out to be above 80%. However, under the scenario of an actual default the recovery value will certainly be much lower than 80%.
- iv) If negotiation with bond-holders turns out to be successful, the situation is similar to the first scenario above but the net gain will likely be even more because even the premium bonds holders may get paid some money at negotiation..

# Appendix 1

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