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PDVSA's Peculiar Oct. '22 Bond May Carry Elevated Risks

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Overview

In late May 2017, it was reported that Goldman Sachs (**GS**), on behalf of clients of its asset management unit, had bought US$2.8 billion in face value of a US$3 billion bond issued by Petróleos de Venezuela S.A. (**PDVSA**), the Venezuelan state-owned oil company. The trade occurred on 23 May 2017 and settled over the next two days; the price was reported to be 31 cents per dollar of face value.[1] It was later disclosed that the broker-dealer arm of Japan's Nomura Group (**Nomura**) had bought US$100 million in face value of the same bond as part of the same transaction, paying roughly the same price as GS.[2] We will refer to the bond purchased by GS and Nomura as the "**Oct. '22 Bond**," as its final principal repayment is due in October 2022.[3]

The transaction was controversial for a number of reasons. In the months leading up to the deal, political opponents of the current Venezuelan government sent letters to the heads of 13 major international banks, including the chief executives of GS and Nomura, warning of the risks attendant in financing that country's regime.[4] While GS and Nomura used a third-party broker for their purchases, there was an increase of US$765 million in the Central Bank of Venezuela's foreign exchange reserves between 23 May and 25 May 2017, indicating that the Venezuelan government was the ultimate recipient of the sale proceeds, according to news reports. As such reports began to emerge, some of those opposed to the Venezuelan government accused the buyers of propping up the regime; others, concerned about the effect on Venezuelan citizens, criticized the financial terms as onerous; and some Venezuelan opposition leaders threatened not to honor the Oct. '22 Bond if they take power.[5]

In this brief, we analyze the market prices for this bond and assess what, if anything, these prices may tell us about the bond's future prospects if PDVSA does enter bankruptcy.[6] PDVSA is a Venezuelan company, and its primary insolvency proceedings would likely take place in Venezuela. However, many of its bonds are issued in US dollars under New York state law, and it is the authors' understanding that arrangements for these bonds may need to be approved in bankruptcy court in the US.

Background on the Oct. '22 Bond

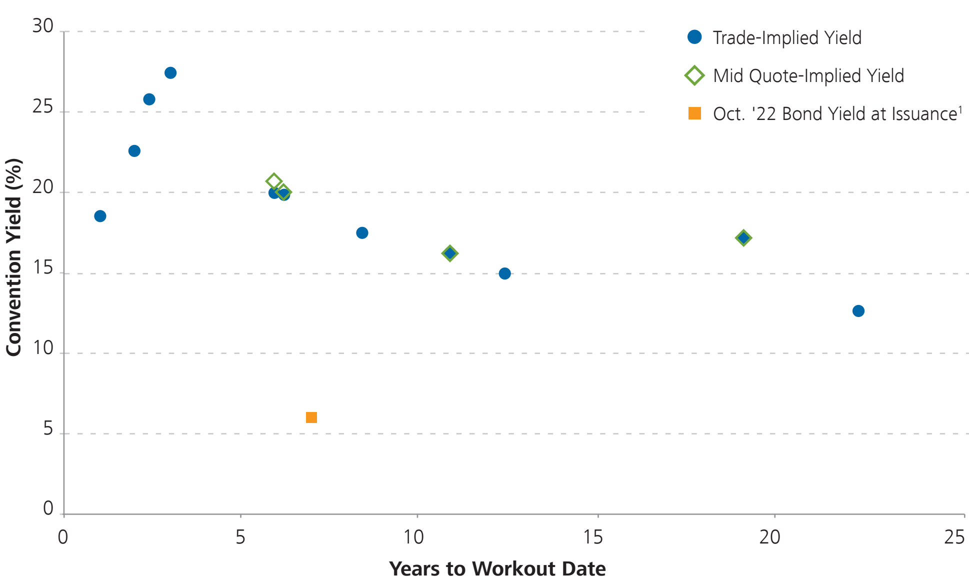
According to the Bloomberg database, the Oct. '22 Bond was issued on 28 October 2014 and has three scheduled principal repayments, with US$1 billion to be repaid on each 28 October of 2020, 2021, and 2022.[7] The bond pays a semi-annual coupon at a 6% annual rate, and it ranks as senior unsecured debt. However, no prospectus or term sheet has yet been made public.

Based on the notes to PDVSA's 2014 financial statements, it appears that the bond was issued as part of a multi-party transaction among three Venezuelan state-controlled entities: (1) PDVSA, (2) the Central Bank of Venezuela, and (3) Banco de Venezuela S.A., a state-owned commercial bank.[8] The exact nature of the transaction is not clear. The existence of the bond was not widely known until March 2016, when Bloomberg began reporting indicative prices for it.[9]

Valuation at Issuance

As of 28 October 2014, PDVSA senior unsecured bonds denominated in US dollars were trading with yields between approximately 13% and 28%. The bonds with the closest maturities shorter and longer than the Oct. '22 Bond had yields of approximately 20% and 18%, respectively.[10] If the Oct. '22 Bond was issued at par on the same date, its yield at issuance was 6%. It is not plausible that this bond was issued in an arm's length transaction at par without some sort of undisclosed consideration being included as part of the transaction.

Figure 1. **Oct. '22 Bond Yield at Issuance Compared to Market Yields on Outstanding PDVSA Senior Unsecured Bonds Denominated in US Dollars (28 October 2014)**



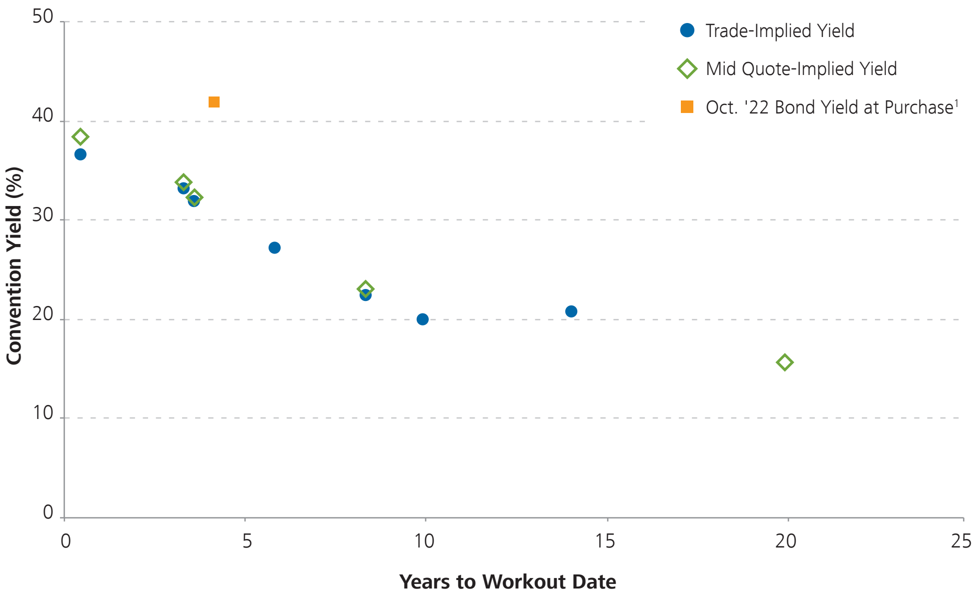
Notes and Sources:
Data are from Bloomberg, L.P. Trade-implied yield is shown for bonds with TRACE data available on 28 October 2014, and refers to the convention yield implied by the closing trade price on that date. For bonds without TRACE data on that date, the yield implied by the closing Bloomberg Generic mid-market quote is shown if available. All bonds shown have either bullet maturities or *pro rata* par sinking fund redemptions. For bonds with bullet maturities, the workout date is the maturity date and the convention yield is the yield to maturity. For bonds with sinking fund redemptions, the workout date is the average life (par) date and the convention yield is the yield to average life (par).

[1] Assuming an issue price of par (100% of face value).

Valuation as of May 2017

GS and Nomura each purchased the Oct. '22 Bond at a discount to par, approximately 31 cents to the dollar, implying a yield of approximately 42%. While other PDVSA senior unsecured bonds also traded at a discount to par, the yield implied by this trade price is higher than that of other PDVSA bonds that traded or were quoted at this time, with even short-term bonds trading at yields under 40%.

Figure 2. **Oct. '22 Bond Yield at Purchase Compared to Market Yields on Other Outstanding PDVSA Senior Unsecured Bonds Denominated in US Dollars (23 May 2017)**



Notes and Sources:
Data are from Bloomberg, L.P. Trade-implied yield is shown for bonds with TRACE data available on 23 May 2017, and refers to the convention yield implied by the closing trade price on that date. For bonds without TRACE data on that date, the yield implied by the closing Bloomberg Generic mid-market quote is shown if available. All bonds shown have either bullet maturities or *pro rata* par sinking fund redemptions. For bonds with bullet maturities, the workout date is the maturity date and the convention yield is the yield to maturity. For bonds with sinking fund redemptions, the workout date is the average life (par) date and the convention yield is the yield to average life (par).

[1] Assuming a purchase price of 31% of face value and a settlement date of 25 May 2017.

While it is conceivable that bid-offer spread could explain this large difference in yields, the daily high-low range of trade prices in TRACE for other PDVSA bonds suggests that bid-offer would not normally account for such a large difference.[11] In June 2017, GS reportedly sold approximately US$300 million in face value of its asset management clients' holdings of the Oct. '22 Bond at a price of about 32.5 cents per dollar—only slightly higher than the purchase price—also suggesting that bid-offer did not solely account for such a large difference.[12]

Recovery Expectations

Doubts about the recovery value of the Oct. ’22 Bond if PDVSA were to declare bankruptcy may play a role in its relatively high yield. In fact, Venezuelan opposition leaders have openly called for repudiating this bond as an illegitimate debt, which understandably could make investors wary. Another possibility is that the claim value of the Oct. ’22 Bond in bankruptcy may be disputed by other senior creditors of PDVSA. In general, claims for “unmatured interest” are disallowable under Section 502(b)(2) of the US Bankruptcy Code, and courts have interpreted unmatured interest as including the portion of a bond’s original issue discount (**OID**)[13] not yet accrued as of the petition date. The currently available (albeit limited) information regarding the origin and characteristics of the Oct. ’22 Bond suggests that it may not have been issued at par in an arm’s length transaction. Some of PDVSA’s creditors may argue that a bankruptcy court should treat the Oct. ’22 Bond as having OID and should disallow claims for the unaccrued portion thereof. The recovery value of the bond relative to par value may thus be lower than that of other senior unsecured obligations of PDVSA.

Notes

[1] The Central Bank of Venezuela's foreign exchange reserves increased by US$308 million on 24 May 2017 and by an additional US$457 million on 25 May 2017, the day the deal was reportedly completed. According to Bloomberg data, a trade in this bond is generally expected to take two business days to settle, suggesting that the trade in question occurred on 23 May 2017. A subsequent letter from the president of Venezuela's National Assembly to the chairman of the US Securities and Exchange Commission also states that the trade occurred on 23 May 2017. See Kejal Vyas and Anatoly Kurmanaev, "Goldman Sachs Bought Venezuela's State Oil Company's Bonds Last Week," *The Wall Street Journal*, 28 May 2017; Central Bank of Venezuela, "Reservas Internacionales," 7 July 2017, available at https://web.archive.org/web/20170707213511/http://www.bcv.org.ve/excel/2_1_1.xls?id=28; and Julio Borges to Walter J. Clayton, 22 June 2017, p. 2, in Twitter post by Angel Alvarado, 22 June 2017, available at https://twitter.com/AngelAlvaradoR/status/877908021464236033.

[2] Anatoly Kurmanaev and Liz Hoffman, "Nomura Bought Controversial Venezuelan Bonds at Steep Discount," *The Wall Street Journal*, 31 May 2017.

[3] The ISIN code for the Oct. '22 Bond is XS1126891685.

[4] See Joshua Goodman, "Venezuela opposition boss asks Wall Street to cut off Maduro," *Associated Press*, 22 April 2017, and Corina Pons, Marianna Parraga, and Olivia Oran, "Goldman, Nomura heeded warnings before Venezuela bond deal," *Reuters*, 5 June 2017.

[5] See, for example, Ben Bartenstein, "Goldman Sachs Defends Venezuela Bond Deal Vilified by Opposition," *Bloomberg News*, 30 May 2017, and Katia Porzecanski, Christine Jenkins, and Noris Soto, "Wall Street Is Starting to Get Nervous About Venezuela's 'Hunger Bonds,'" *Bloomberg News*, 9 June 2017.

[6] The views expressed are those of the authors and do not necessarily represent those of NERA Economic Consulting. The authors are not lawyers and the views expressed here do not constitute legal advice.

[7] The bond is redeemed at par on a *pro rata* basis through a mandatory sinking fund.

[8] PDVSA, "Balance de la Deuda Financiera Consolidada, 31 de diciembre de 2014," p. 10, available at http://www.pdvsa.com/images/pdf/RELACION%20CON%20INVERSIONISTAS/Deuda/Balance%20de%20la%20Deuda/2014/Informe%20de%20la%20Deuda%20al%2031-12-2014.pdf. Also see Pedro Rosas Rivero, "Pdv22: The Phantom Menace," *Caracas Chronicles*, 30 March 2016, available at https://www.caracaschronicles.com/2016/03/30/pdv22-phantom-menace.

[9] Sebastian Boyd, "A Mystery Bond in Venezuela Has Traders Scratching Their Heads," *Bloomberg News*, 29 March 2016.

[10] In this paper, we use time to maturity to refer to the time to workout based on a bond's yield calculation convention. For bonds with a sinking fund structure, the time to workout is the time to the weighted average of the principal repayment dates (weighted by present value). For bonds without a sink feature, the time to workout is the time to maturity.

[11] The Financial Industry Regulatory Authority's Trade Reporting and Compliance Engine (TRACE) is the vehicle that facilitates mandatory reporting of over-the-counter secondary market transactions in eligible fixed-income securities. See FINRA, "Trade Reporting and Compliance Engine (TRACE)," available at https://www.finra.org/industry/trace.

[12] Matt Wirz and Liz Hoffman, "Goldman Begins Selling Some of Its Controversial Venezuelan Bonds," *The Wall Street Journal*, 30 June 2017.

[13] OID, a form of interest, is the excess of a debt instrument's stated redemption price at maturity over its issue price. See Internal Revenue Service, *Publication 1212: Guide to Original Issue Discount (OID) Instruments*, Cat No. 61273T, 29 December 2016, p. 2, available at https://www.irs.gov/pub/irs-pdf/p1212.pdf.

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