

BIENVILLE GLOBAL REVIEW

Argentina: Restoring International Relations

June 2014





SUMMARY

With the Supreme Court's recent denial of Argentina's petition to review the *Pari Passu* case, the saga with the 'holdout' creditors continues. Given both the complexity and urgency of the situation, the prospect of Argentina's default is rising, despite a willingness to pay. The uncertainty likely to ensue over the next few weeks could be setting up an extraordinary buying opportunity for patient investors...

- In *Argentina Part III: A Path To Recovery*, we highlighted four primary areas of adjustment necessary to engineer a normalization and eventual recovery of the Argentine economy. The assumption was that the bulk of the adjustments would occur under a new administration in 2015:
 1. Reduce subsidies in order to resolve the fiscal imbalance;
 2. Implement an inflation-targeting regime by an independent central bank;
 3. Remove capital controls and allow the currency to freely float; and
 4. Settle with external creditors
- On this last front, Argentina has made considerable progress. In February, the administration settled with Repsol, paying them over \$5 billion (in bonds) for the 2012 nationalization of YPF. And in May, they settled with the Paris Club, offering nearly \$10 billion (to be paid over 5 years). Both events demonstrated a newfound willingness to pay in order to normalize relationships with international creditors
- However, the final and most politically-sensitive issue—the 'holdouts,' which includes Elliott Management—has remained unresolved
- On June 16th, the Supreme Court rejected Argentina's appeal in the *Pari Passu* case. The decision surprised the market and the Argentine government, who did not have a 'Plan B' prepared. It was widely believed that the Supreme Court would either accept the case, or request the opinion of the Solicitor General, likely pushing the ultimate outcome to 2015, providing more time for the Argentine government
- With the legal process now largely over, Argentina finds itself in a paradoxical situation ('damned if they do, damned if they don't'). Three options remain. Each is fraught with execution risks:
 1. Pay in full in cash, risking having to pay another \$10-15bn in 'me too' claims, effectively bankrupting the country given the low level of FX reserves;
 2. Negotiate a cash and bond payment that is satisfactory to both the holdouts and the court (in order to preserve FX reserves);
 3. Default on payments owed to holdouts, but continue paying restructured bonds and begin a new exchange offer under Argentine law (preserving FX reserves)
- In a national address following the Supreme Court's decision, President Cristina Kirchner struck a noticeably less aggressive tone, reiterating her desire to negotiate and pay, yet refusing to be subject to "extortion." Settling with all creditors in cash will jeopardize the country's financial stability by reducing its already low level of foreign currency reserves



SUMMARY

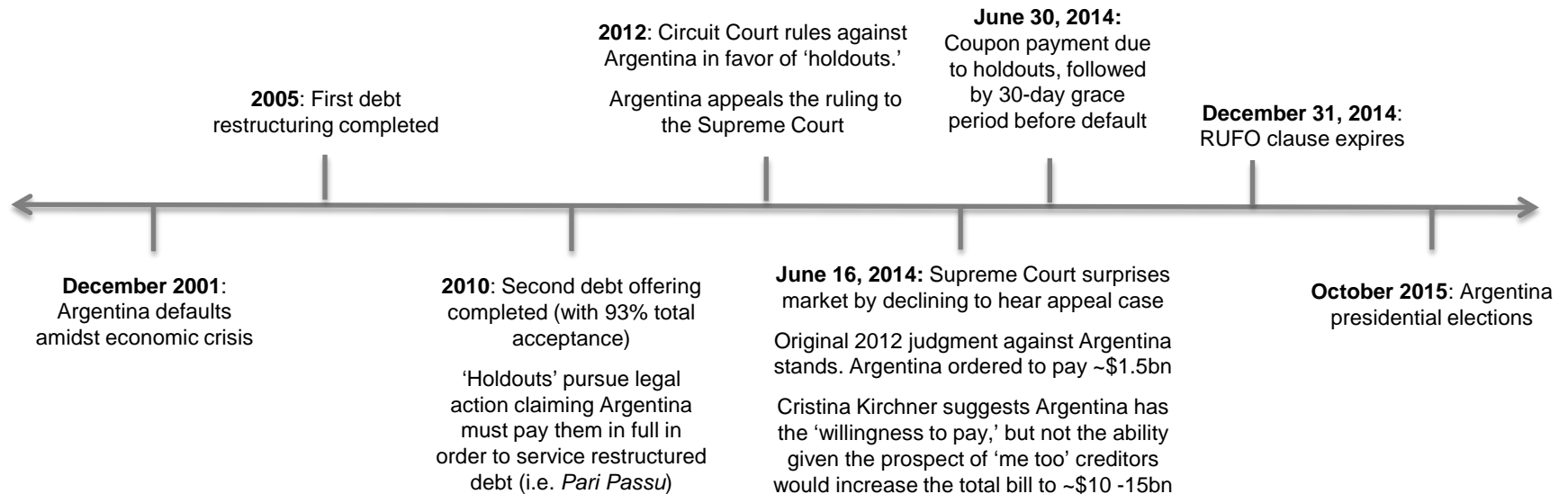
- Since then, Economy Minister Axel Kicillof and Cabinet Chief Jorge Capitanich have given mixed signals. Sources suggest there is considerable in-fighting within Cristina's cabinet with some ministers encouraging payment while others prefer default and restructuring. Regardless, at the moment, it seems that Argentina is likely to miss a June 30th coupon payment. Also, Kicillof has begun the process of converting NY law bonds to Argentina law, which would constitute a violation of a court order. The saga continues...
- The outcome remains both uncertain and binary in nature, leading to volatility across Argentine assets. In the event of a default, Argentine equities and bonds are likely to decline sharply. Conversely, a negotiated settlement would be positive, continuing the process of normalizing relations and lowering Argentina's country risk
- To be clear, the Kirchner administration's newfound desire to negotiate and settle outstanding claims is not the result of an ideological shift to more rational policies. Rather, Cristina's principal motivation is her own political survival
- In 2011, when Cristina was reelected president, total FX reserves were \$50bn. Today, reserves are \$28bn, less than 3 months import coverage
- When contemplating potential outcomes and scenarios, it's important to recognize that the level of FX reserves is crucial. Argentina is dependent on them. The government needs foreign currency in order to import energy, service existing debt and to provide citizens with currency to travel abroad. At the moment, the Kirchner administration also needs reserves to maintain an overvalued exchange rate in order to anchor inflation, which has been rising
- For this reason, Argentina does not have the wherewithal to isolate itself for another 10 years as part of a prolonged default. For the economy to function, and for Cristina to survive politically, Argentina needs capital inflows. The most efficient route to rebuilding reserves is to borrow internationally. And a prerequisite to tapping international creditor markets is settling outstanding claims. Clearly, a prolonged default would severely inhibit Argentina's ability to attract capital over the remainder of Cristina's term
- A prolonged default would also jeopardize Cristina's ability to obtain immunity from prosecution following the end of her presidency
- The Kirchner administration's policies and antics have done unquantifiable harm to Argentina's economy and reputation. Yet it is because of these eccentricities that assets in Argentina are both cheap and highly levered to a moderation of policy under a new administration in 2015
- A default would almost certainly lead to panic selling, likely providing a tremendous buying opportunity to patient investors who recognize the forthcoming political regime change



ARGENTINA: RESTORING INTERNATIONAL RELATIONS

Following the default in 2001, Argentina successfully restructured 93% of their defaulted bonds. However, the 'holdouts' have prevented the country from tapping international creditor markets. In 2012, the 'holdouts' were given a favorable court ruling. Argentina sent this ruling to the Appeals Court before it was pushed up to the Supreme Court, who recently declined to hear the case, upholding the ruling in favor of the holdouts, and effectively ending the legal process...

Timeline of the *Pari Passu* Case





ARGENTINA: RESTORING INTERNATIONAL RELATIONS

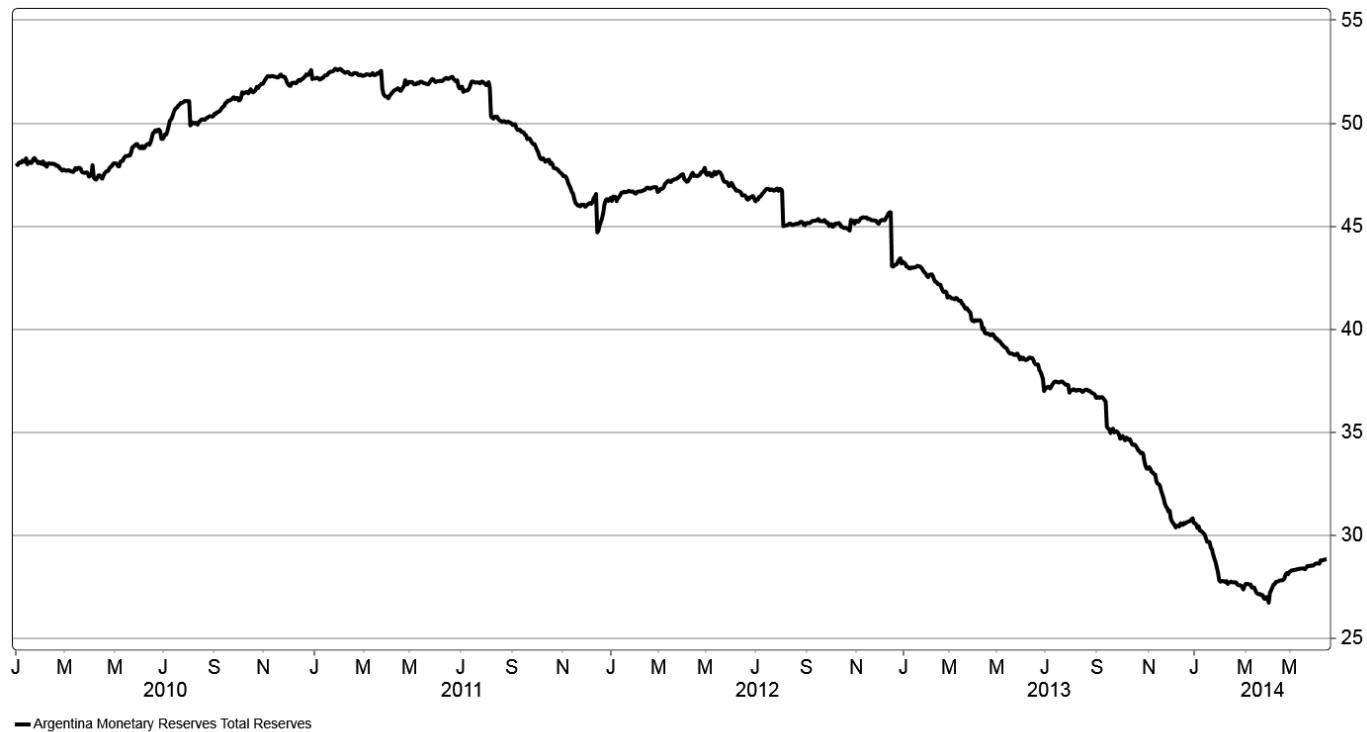
With the Supreme Court's rejection of the appeal, and the 2012 court decision in effect, several payment amounts are relevant over the coming months...

- \$900mm of coupon payments due to all bondholders on June 30th. If Argentina does not make this payment, they have a 30-day grace period to do so before entering default
- However, under the court order, if Argentina pays the \$900mm in coupons, they also have to pay an additional \$1.5bn in principal and accrued interest to the holdouts (i.e., Elliott, etc.)
- If Argentina were to pay Elliott and the other holdouts the \$1.5bn ordered by the court, they may ultimately be forced to pay another \$10-15bn to "me too" holdouts (i.e., holdouts who own the same bonds, but not involved with the Elliot lawsuit)
- These payment scenarios are set against a gross level of central bank reserves totaling \$28bn
- Herein lies the problem: although Argentina wants to pay its restructured debt holders, it cannot pay those claims and all of the holdouts in cash because this would constitute 55% of the country's gross reserves (i.e., all of their liquid reserves), likely leading to an immediate balance of payments crisis
- Thus, Argentina will either need to somehow defer payment over several years, negotiate a deal to pay with a combination of bonds and cash, or default by evading the court order (impeding their progress in restoring relationships with international creditors)
- Furthermore, if the \$15bn of payments are made, then there is the potential for the RUFO (i.e., "rights upon future offers") clause mandating an additional ~\$120bn of payments. The RUFO clause—part of the 2005 restructuring—requires that more favorable terms be made available to all holders of the restructured debt. Therefore, if the holdouts are paid in full, the 2005 and 2010 restructured bondholders would need to be treated equally
- Whichever route Argentina pursues, the complexity of the case leads to high execution risks. A negotiated settlement needs to occur before the end of the 30-day grace period following the coupon payment due June 30th

ARGENTINA: RESTORING INTERNATIONAL RELATIONS

To function, Argentina requires foreign currency reserves, which have persistently declined since Cristina Kirchner's reelection in 2011. The liability to the 'holdouts' (~\$1.5bn) plus the potential 'me too' claims (estimated to be \$10 – 15bn) amount to more than 50% of Argentina's remaining reserves, calling into question the country's capacity to pay...

Argentina Foreign Currency Reserves



Importantly, both Argentina's economy and Cristina's political survival are dependent on FX reserves

Because the country needs capital inflows, the Kirchner administration cannot afford a prolonged default. Isolating Argentina for another 10 years is simply not an option

Source: Macrobond

ARGENTINA: RESTORING INTERNATIONAL RELATIONS

Reserves are necessary to import energy, provide foreign currency to Argentines traveling abroad, and to service debt...

Sources of Variation of Central Bank Reserves (in USD, billions)

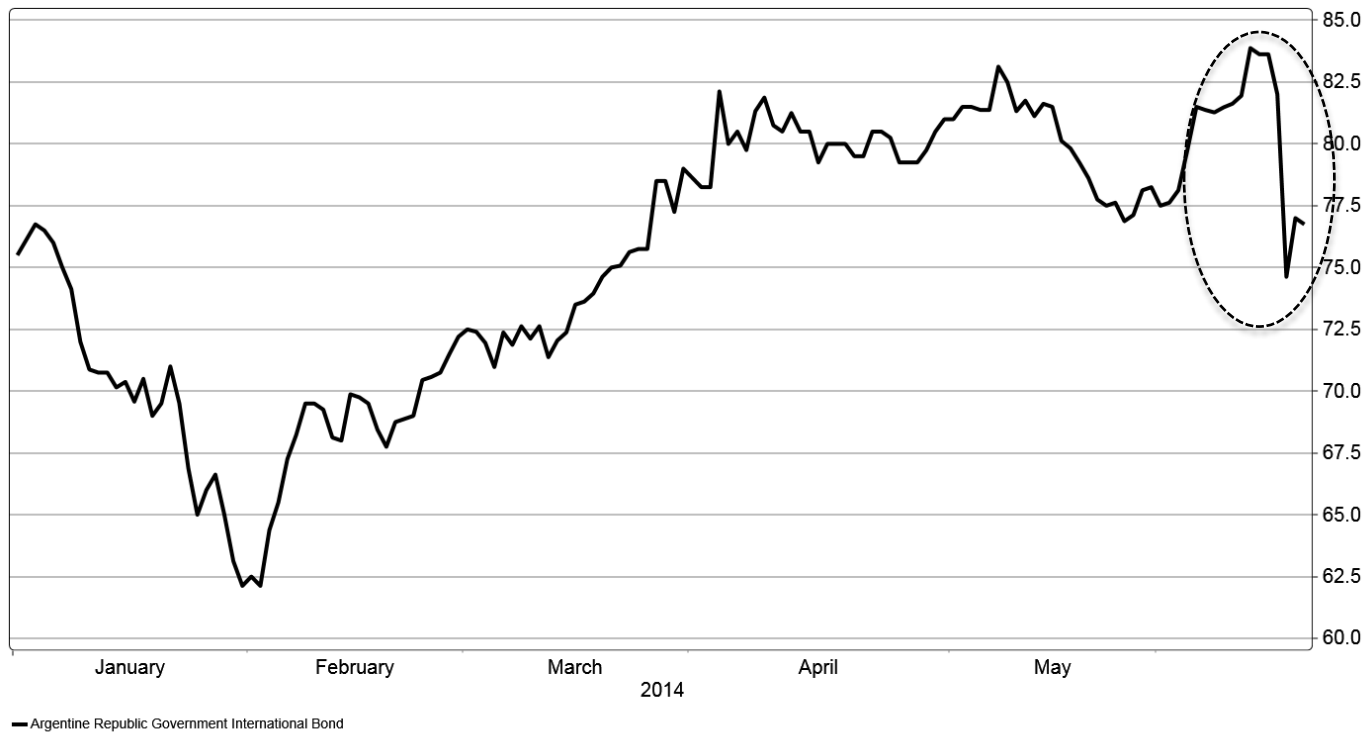
	2011	2012	2013
Balance of Goods	15.2	14.7	1.7
Energy	-2.2	-3.5	-6.5
Balance of Services	-1.1	-3.8	-9.4
Tourism	0.3	-2.9	-7.0
Financial Loans, Dividends Other	10.9	1.7	1.9
Foreign Currency Private Purchases	-21.6	-3.4	0.4
Debt Payments (net)	-4.4	-11.2	-7.0
Fall in USD profits	-4.8	-1.0	-0.4
Total Variation of Reserves	-5.8	-3.0	-12.7

Maintaining an overvalued exchange rate in 2013 — similar to today — encouraged Argentines to convert pesos to dollars, draining FX reserves at the central bank

ARGENTINA: RESTORING INTERNATIONAL RELATIONS

Prior to the Supreme Court's decision, Argentine Sovereign Bonds were trading at the top end of their recent range. The decision surprised the market, which was expecting the Supreme Court to either review the case, or request the opinion of the Solicitor General. After the decision was announced, bonds traded down sharply...

Argentine NY Law Discount Bond (2033)



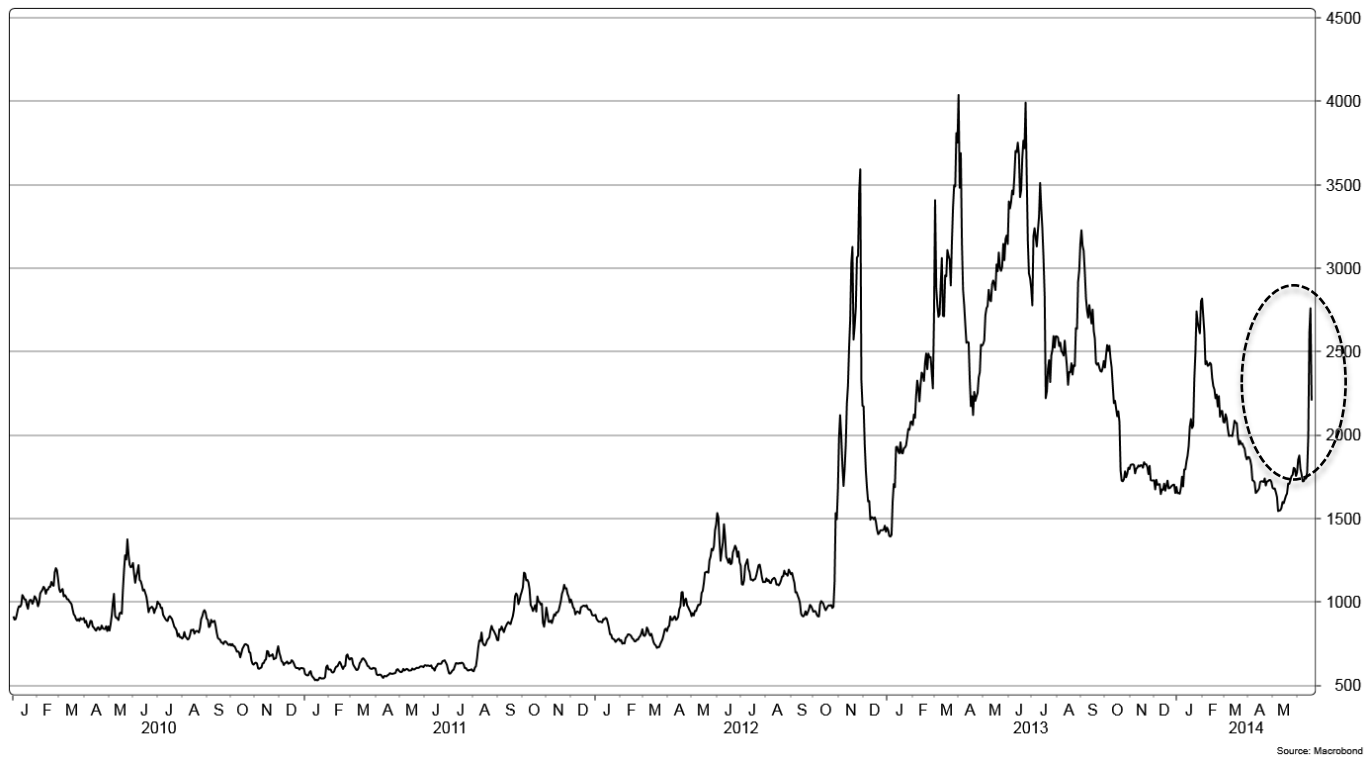
Source: Macrobond



ARGENTINA: RESTORING INTERNATIONAL RELATIONS

After declining from last summer's high levels—when it became clear that Cristina would not be able to seek a 3rd term—Argentina CDS has widened again, reflecting the more likely prospect of default...

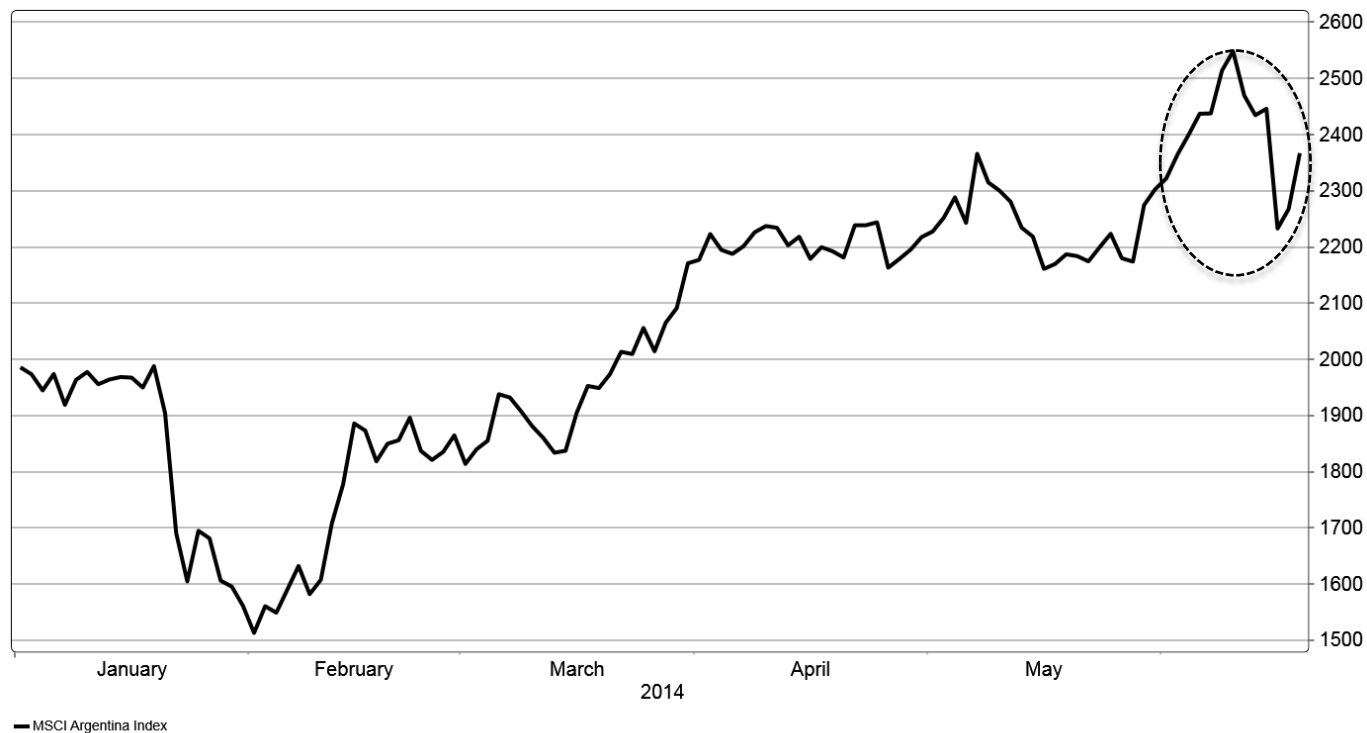
Argentina CDS Spread



ARGENTINA: RESTORING INTERNATIONAL RELATIONS

Following settlements with Repsol and the Paris Club, Argentina's country risk had been declining, resulting in a re-rating of the equity market. But the Supreme Court decision led to a sharp selloff. The situation today remains binary: a default could cause equities to decline by 20 - 40%, whereas a negotiated settlement could cause them to rally back to last week's levels...

MSCI Argentina Index



Source: Macrobond

ARGENTINA: RESTORING INTERNATIONAL RELATIONS

Irrespective of how the near-term events play out, political change is coming to Argentina. A material decline in equities could setup an extraordinary buying opportunity. Today, many equities remain below the levels of 10 years ago and ~50% below their 2008 and 2010 highs. A normalization of policy under a new administration in 2015 could cause equities to re-rate aggressively...

MSCI Argentina Index



Source: Macrobond



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