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By:
Alejandro Grisanti
Asdrúbal Oliveros

Edited by:
Gabriel Dobson

NATIONALIZATION: THE REVOLUTION SQUEEZES BUT DOESN'T CHOKE

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THE CLIENT

To everyone's amazement, the Government began the nationalization processes of the power companies and CANTV with astonishing speed. The way the announcements were made and the consent of the main shareholders point to a clear political triumph for the Government. The key questions now are: What will be the Government's management strategy now that it controls the companies? Secondly: Will other sectors follow?

Government and EDC reach agreement

The memorandum of understanding between PDVSA and AES Corp. was inked on Thursday, February 8, thus avoiding the potential dangers of an expropriation. The agreement contemplates the purchase of 82.14% of the shareholders' equity of Electricidad de Caracas (EDC) for the sum of US\$ 739.2 million, putting an implicit total value of US\$ 900 million on EDC, or US\$ 0.2735 per share. Shareholders will also receive a dividend of VEB 78 per share, thus raising the total purchase price to US\$ 1.02 billion or US\$ 0.3096 per share. This price puts the price of VEB 665.6 on each share, at the official exchange rate, or VEB 1,238.4 at the parallel exchange rate.

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This is why the shares are currently quoted at VEB 800 apiece, or an implicit exchange rate of VEB 2,660/US\$, meaning that the cheapest way to buy dollars this week is through the purchase of EDC shares.

The State pays itself *and* receives the change

It is difficult to value this case because the Government rules the roost, as they say. EDC's main source of income is the sale of electricity, and its price has in nominal terms been frozen these last 3 years. In a highly inflationary environment this means a significant loss of income in real terms. If we assume that this restriction will continue for the next 5 years, the value of EDC would be about 14% less than what the Government paid for it. If, on the other hand, this power company were in any other Latin American country, or if we assumed that it were able to increase its rates to keep up with inflation, it would be worth 63% more than the Republic is paying for it (i.e., US\$ 1.47 billion rather than the US\$ 900 million paid).

Government chalks up another victory with the CANTV purchase

The Government, through the Telecommunications Ministry, has taken the first steps towards buying CANTV. Upon signing the memorandum of understanding (MOU), the Government has acquired the package of shares owned by Verizon (28.5%) for US\$ 572.2 million. This works out to US\$ 17.85 for each American Depositary Share (ADS) acquired, representing the changing of hands of 224,410,604 shares. This offer is relatively lower than the one made last year by Carlos Slim through the TELMEX - América Móvil consortium.

The MOU states that if a dividend is to be paid, it will be deducted from the agreed price (US\$ 17,85), meaning that the Government's offer is equivalent to 85% of Slim's offer.

Paradoxically, when Slim announced his intention to buy CANTV, the Government considered his offer extremely low, not representing the true value of the company.

A steal for the Government

On the face of it, the Government puts the value of CANTV at something over US\$ 2.0 billion. At *Ecoanalítica* we are convinced that in light of the strategic value of the company and its position in the market, and if the Venezuelan regulations of the telecom sector were similar to the majority of Latin American countries, CANTV's real value would be something in the order of US\$ 4.0 billion. The Government is acquiring the company for about one half of its true worth.

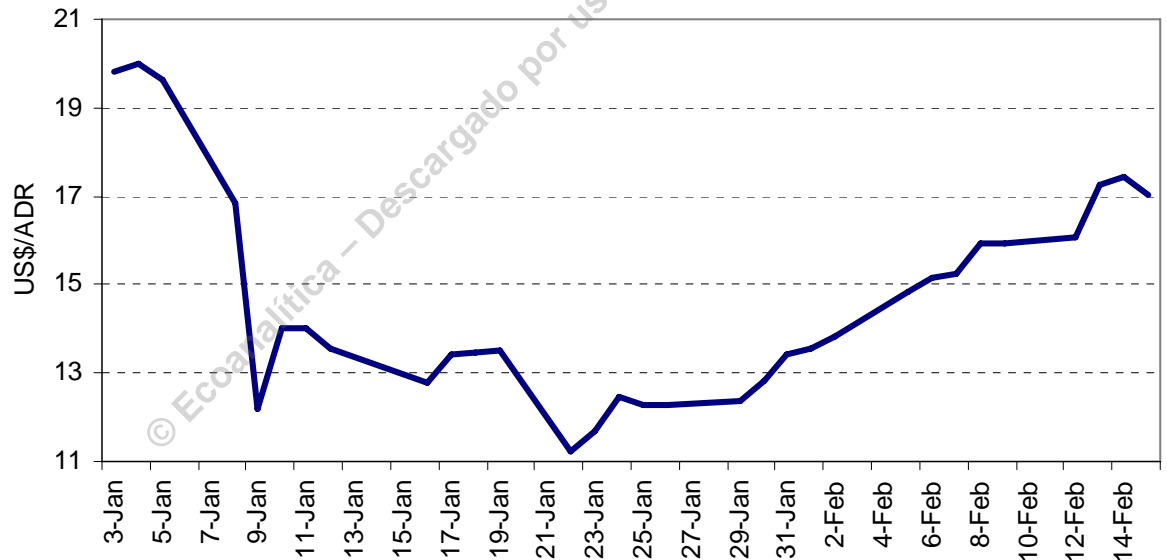
Weekly Report

Share price fluctuates sharply

The State is also going to make two Public Purchase Offers (PPOs) (in Spanish *Ofertas Públicas de Adquisición*, or OPAs). One is to be registered before the National Securities Commission (*Comisión Nacional de Valores - CNV*), aimed at Class D CANTV shareholders who wish to sell their shares. The second PPO will be registered with the US Securities & Exchange Commission (SEC), for the purpose of acquiring the company's ADSs that are registered in the USA.

It must be noted that since President Chávez announced the nationalization, the share price has fluctuated wildly, with a low of US\$ 9.46 right after the announcement, to US\$ 17.85 this week. Therefore any keen speculator with access to privileged information has been able to make huge winnings from this situation.

ADR-CANTV (VNT)



Sources: Reuters and Ecoanalítica

The CANTV case: Will the cycle be repeated?

In regard to the State's purchase of CANTV, it is important to bear in mind what was recently said by the now ex-President of CANTV, Gustavo Roosen¹. The first thing that Roosen mentioned was that in 2001 (only 6 years back), the current Telecommunications Minister (then Director of CONATEL) had pointed out that "*I don't think it was a mistake to privatize CANTV. Quite the contrary, it was a wise move*

¹ "CANTV", an article published in *El Nacional* on January 17, 2007

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because in 1991 the State unburdened itself of an inefficient operation, and we can unquestionably see that the quality of service now provided by CANTV is far removed from that of the nationalized CANTV.”

Investment is all-important

This clearly reflects the difference between the administration of a publicly-owned company and a private company. Suffice it to say that CANTV was until now the biggest private investor in the country. According to Roosen, between 1992 and halfway through 2006, CANTV invested more than US\$ 6.7 billion, an average of US\$ 447 million per year.

Therefore, at **Ecoanalítica** we ask ourselves: Will the State be able to continue with this level of investment in the future, in a sector as changing and dynamic as telecommunications? This may, of course, occur while oil prices are high, but what will happen when the prices drop and the fiscal scenario is less rosy than it is now?

Why did the President have to lambaste the private sector when he announced the nationalizations?

At **Ecoanalítica** we fail to understand why the President was so aggressive when he announced the purchase of certain companies. If the Government's purpose is to control companies that provide “strategic” services, why didn't the President simply announce a PPO instead of nationalization - it would have worked out far less costly.

Over the long term, the measure will translate into less investment, less growth, more inflation, more unemployment, and salaries still further removed from reality

It is clear that in countries where there is no respect for private property, investment will be markedly lower than in those countries, socialist or otherwise, where there is a stable legal framework that respects private property rights. Private investment is a source of growth, creation of jobs, and of greater productivity generated by those same jobs. Real salaries are simply a reflection of a country's levels of productivity.

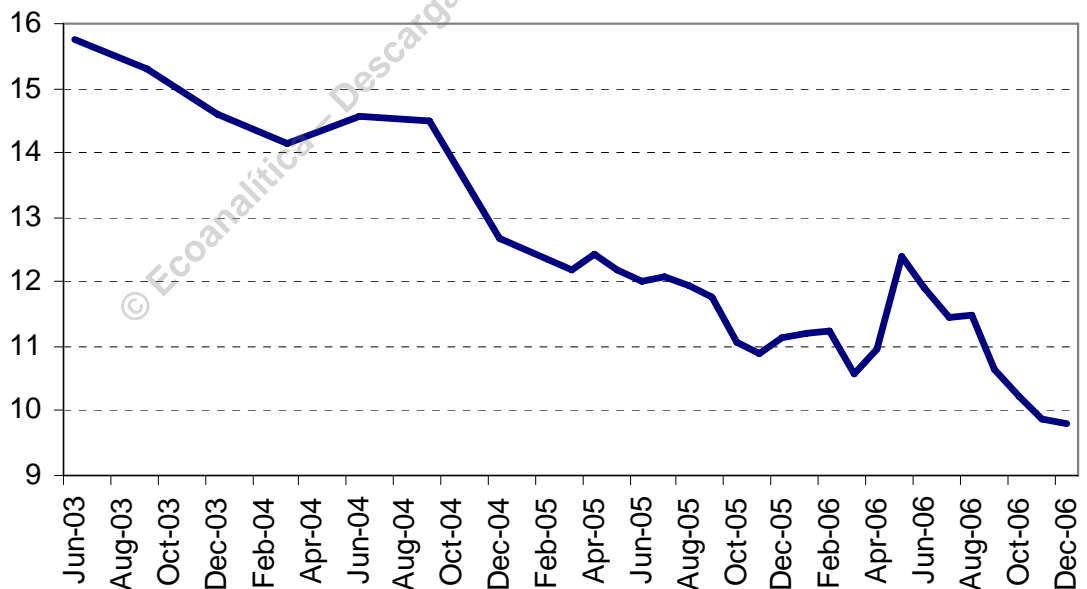
Ideology takes over

This leap taken by the Government makes no sense - political or economic. The only possible explanation is that ideology is imposing itself over the economic and political costs of such measures. If this is the correct conclusion, and it is indeed the ideology factor that is behind the Government's announcement, then the nationalization of other companies deemed “strategic” will continue.

Perverse incentives for the private sector ... especially for the financial sector

If this is true, then the private sector will have already started calculating their position on the “list of possible nationalizations” and seek to protect themselves by wringing all they can out of their companies ahead of an eventual announcement by the President. While this is perhaps true of all sectors, it is particularly dire news for the financial sector. In the midst of exchange controls and the massive expansion of liquidity, the assets of this sector have been growing at a far faster rate than their increases of capital have. In 2006, for example, total assets of the financial sector grew by 74.2%, almost double the rate of equity growth which was only 40.3%. This has meant that the system’s capitalization index, when measured as equity plus operating earnings as a percentage of total assets, has fallen from 15,7% in June 2003 to 9,8% at the close of 2006. This is obviously not a positive trend and could in fact be the seed of a medium-term crisis for the financial system.

Financial Sector
Pat+Operating Management/ Total Assets
(VAR %)



Sources: SUDEBAN and Ecoanalítica

The revolution squeezes but doesn't choke

In our first report this year we commented that the intensity and deepening of the so-called “radicalization of the process,” would be seen in the price the Government is ready to pay for CANTV and EDC. **Ecoanalítica** thinks that, although they are below Latin American standards and their stock market quotations, the prices offered were not that far from the latest stock market valuations. Therefore, even though the revolution stepped one pace closer to radicalization, the so-called Twenty-First Century Socialism is not so far removed from the State capitalism applied by Chávez during his first 8 years of power.

Economic Tips

Half-measures. This last weekend the Government announced a series of measures contained within the framework of a so-called “anti-inflation pact,” supposedly aimed at reining in inflation, as follows:

1. Elimination of VAT on certain foods, in particular meat, and the transportation of food items listed as staple commodities.
2. In an effort to restrict liquidity, the method for calculating oil income (Income Tax, royalties and dividends) will be reformulated in US Dollars, not bolivars. This measure merits special comment, since in our opinion it will have no significant impact, apart from reducing the volume of public funds in the financial system. However, it in no way signifies a reduction of public spending - one of the measures needed to curtail inflation.
3. The importance of this measure is that PDVSA will no longer hand Dollars over to the Central Bank (BCV), but rather to the Treasury, which will then exchange them through the BCV, as required for the implementation of specific projects. Thus the role of the BCV in the handling of funds and foreign currency is further diminished, making it even harder for it to apply monetary policy. This will also have a significant impact on the levels of international reserves.
4. There are to be farming subsidies, in order to maintain present prices and avoid cost increases.
5. Increase in foreign currency quotas for credit card users. The allowance will be upped from US\$ 4,000 to US\$ 5,000 for travelers; Internet purchases from US\$ 2,500 to US\$ 3,000; and the cash limit will be raised from US\$ 400 to US\$ 600 per person. However, since the amount of transactions authorized by CADIVI for these concepts is quite low, this will have little impact on the parallel currency exchange market.

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Inflation will remain high. As we have said before, the dousing of inflation fires can only be achieved through the redesign of fiscal, monetary and foreign exchange policies. The Government has to reduce public spending levels (especially the off-budget spending) and loosen up currency control by legalizing the parallel market..

Government authorizes price rises. María Cristina Iglesias, Minister of Light Industries & Commerce, announced an average increase of 38% in the controlled price of beef, adding that from now on the prices will be regulated throughout the chain, including the farming sector and processing plants. The prices of whole chicken, thighs and breasts were also adjusted, along with eggs and powdered milk.

More debt. The National Assembly's Finance Commission authorized the financial conditions needed for the Executive to place public debt. As is usual, these conditions are quite flexible and allow for the issuing of an amount equivalent to VEB 5.3 trillion (US\$ 2.465 billion). The purpose of the issue is to finance the servicing of internal and foreign debt. In this way, the Government can use part of the resources for the joint issue of the so-called "*Bono del Sur II*."

More Argentine debt bonds. According to an article that appeared recently in the Argentine press, the Venezuelan Government is to acquire a further US\$ 2 billion in Argentine debt papers. It is common knowledge that part of this acquisition will be used for the "*Bono del Sur II*" combo.

Price controls ineffective ... According to an internal BCV report, the "absence indicator," which lists the quantity of items not to be found either over the counter or in stock, is now equivalent to 26.1% of the basket of specific products measured monthly by the Institution's surveys. This represents an increase of 2.6 percentage points in respect of last December. Similarly, the "shortage indicator" (when the consumer cannot count on substitute items) stood at 13.4% of the specific products, considerably higher than the 9.2% of last December.

... and ignored. On the other hand, the report indicates that, on average, Venezuelans pay 66% on top of authorized prices for controlled products. In the case of food, this percentage rises to 67.8%.

Good start for the SENIAT. Non-oil collections in January were VEB 4.7 trillion (US\$ 2.182 billion), a real increase of 24% over January 2006. VAT has the lion's share with VEB 1.8 trillion, followed by customs duties at VEB 1.4 trillion.

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NATIONAL TAX COLLECTION (VEB Billions)		JANUARY		
	2007	2006	Var %	Var % Real
TOTAL	4.691	3.195	46,8%	24,0%
Income TAX	1.397	786	77,7%	50,1%
Tax	1.781	1.294	37,6%	16,2%
Customs	1.404	758	85,2%	56,4%
Others Incomes	108	112	-2,8%	-17,9%
Debit Tax	0	245	-100,0%	-100,0%

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Sources: SENIAT and Ecoanalitica

A negligible increase. Gastón Parra Luzardo, President of the BCV, stated that the level deemed optimum for international reserves has been raised from US\$ 29 billion to a little under US\$ 30 billion, i.e., an increase of less than US\$ 1 billion. According to Parra Luzardo, the study conducted to arrive at this amount had already been completed and would shortly be presented to the BCV Board of Directors. It ought also to be shown to the general public. With an optimum level of reserves close to US\$ 30 billion, the BCV will have to transfer about US\$ 5.77 billion to the FONDEN.

OIL TIPS

Oil basket rises to over US\$ 50 per barrel. Last week, the Venezuelan oil basket rose by US\$ 2.19 to stand at US\$ 50.15 per barrel.

Heavy drop in Venezuela's production. According to the International Energy Agency (EIA), Venezuela's January production was at an average of 2.34 million barrels per day (bpd). This is the result of the OPEC-mandated cut-back for Venezuela, although the country was the only OPEC member to apply (late) a production cut-back agreed upon back in October, and which was supposed to enter into force between November and December. Venezuela's average production for the whole of 2006 was 2.55 million bpd.

WTI price declines. The EIA is forecasting that West Texas Intermediate (WTI) crude will average US\$ 59.50 this year, as opposed to the US\$ 66.00 achieved in 2006. If this projection is correct, the average 2007 price of the Venezuelan oil basket will be approximately US\$ 50 per barrel. The EIA also calculates that consumption of by-products will grow by 1.4% over the coming months.

Faja operations at risk. The 195,000 bpd cut-back to be made by Venezuela as part of OPEC's curtailment of its overall offer, could spell trouble for the Orinoco Oil Belt (Faja) strategic associations, putting at risk the operation capability of their up-graders, which cannot work safely at less than 80% of their maximum capacity. The cut-backs also threaten investment and the partners' 2007 well-drilling program could be put on hold - on top of the problems they are already having to contend with involved in the migration to joint ventures.

Moody's adjusts profiles. Moody's upheld the B1 qualification it had assigned to the Faja associations (Sincor, Petrozuata, Ameriven and Cerro Negro), but modified the qualification's prognosis from stable to negative. Moody's noted the lack of clarity surrounding the Government's negotiations and the potential effects this could have on the partners.

BUSINESS SECTOR TIPS

Parmalat invests in Venezuela. As part of its Technical-Industrial Investment Program for Venezuela, Parmalat has announced that it plans to invest US\$ 9.5 million over the 2007 - 2009 period in the 5 industrial plants currently operating in the country, as well as in raw milk reception centers and in support for milk and fruit producers, in response to the growth in the markets.

High level of Internet use among kids. According to its *Ómnibus Kids* market survey (of 500 children in 8 cities around the country), Datanálisis found that 39% of the children now use web services. The most interested users are older boys of higher socio-economic strata. 71% of the children log on through cyber cafés (particularly those of strata D and E). Not knowing how to connect is the main reason for not using the Internet, but strata D and E kids also find it costly.

Franchise boom. According to recent studies, the Government could become the main franchisor in the country, with 14,000 Mercals, 850 PDVSA service stations, and the planned opening up of more than 300 Infocentros. This number will likely grow

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significantly, since the nationalization of the CANTV will account for an additional 500 communication centers. The franchise sector invoices over VEB 400 million per month and the figure rises to more than VEB 1.0 trillion if car dealers and service station operations are included. The sector includes 10,000 micro businesses, is the source of 40,000 direct jobs, invests an average of VEB 600 million, and records an annual growth of up to 20%. 64% of the franchises operating in the country are Venezuelan.

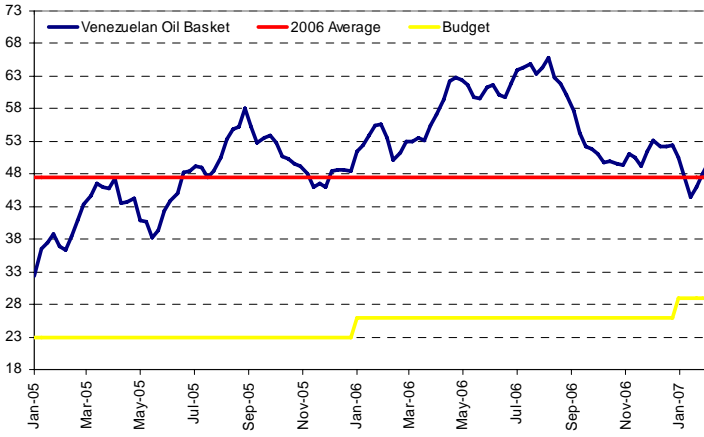
Political Tips

Armando León stays on at the BCV. The National Assembly has authorized Armando León to stay on as member of the Board of Directors of the Central Bank of Venezuela for a further 7-year period. It should be emphasized that León's term was to expire in October this year, but his job will now be to substitute departing Director Domingo Maza Zavala. At **Ecoanalítica**, we believe that the departure of Maza Zavala is regrettable, since although ideologically aligned with the Executive, he always maintained an independent attitude - as well as being a Director who provided the public with much-needed information.

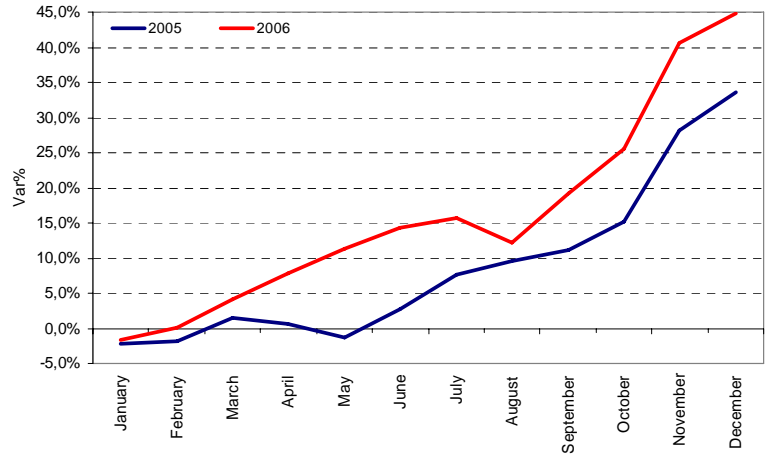
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ECONOMIC OVERVIEW

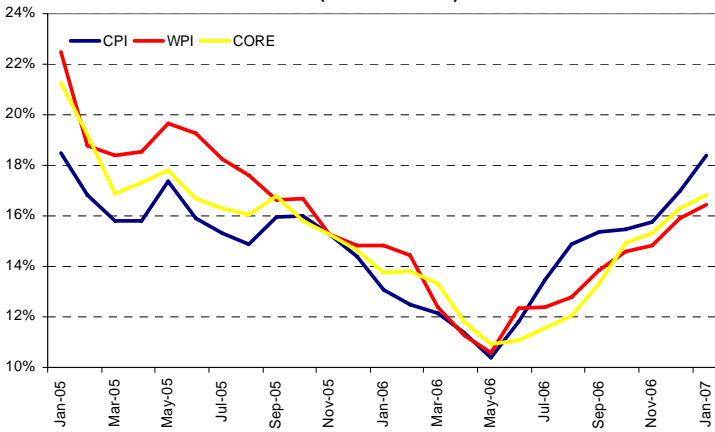
Oil Price
(Venezuelan Basket US\$/pb)



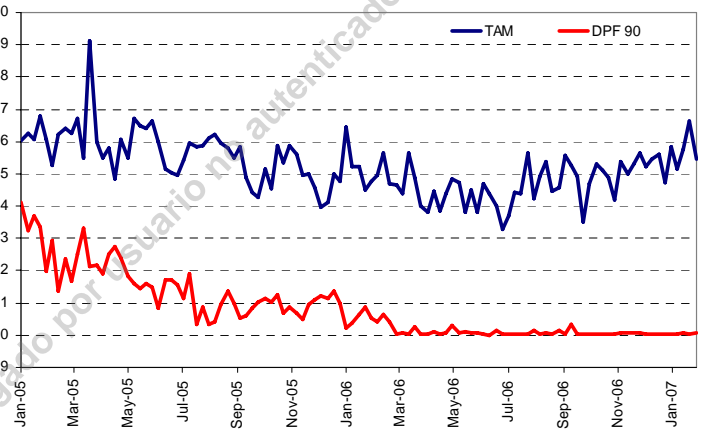
Real Expansion (M2)



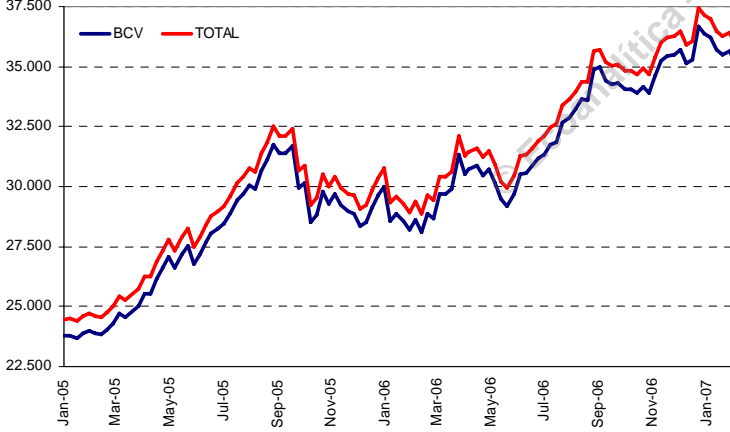
Inflation
(Last 12 Months)



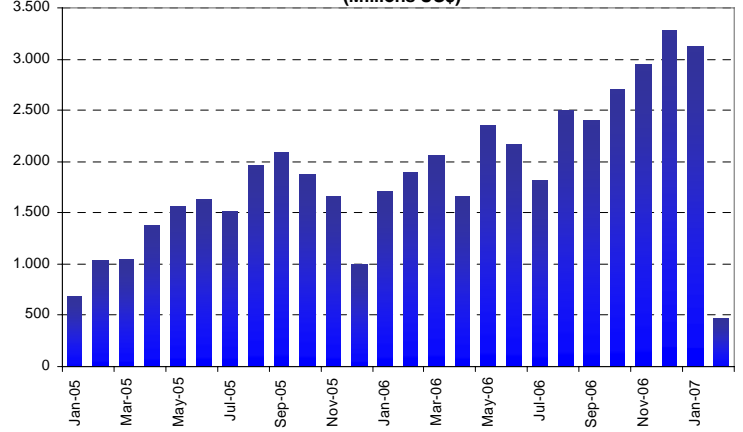
Interest Rate
(Six Principal Banks)



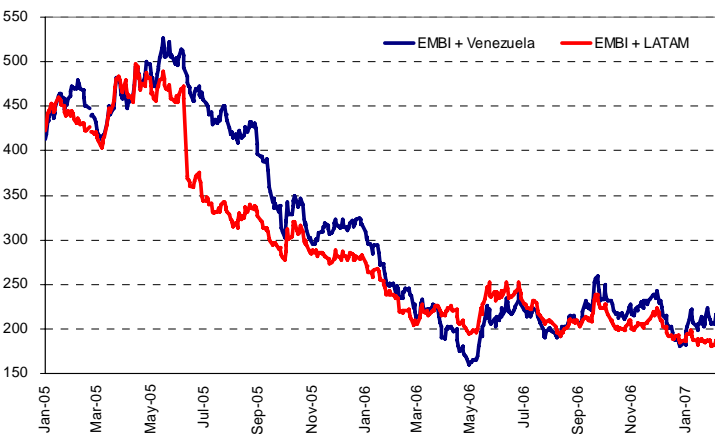
Fx Reserves
(Millions US\$)



Disbursement
(Millions US\$)



EMBI



Central Government
(VEB Billions)

