

# Opportunities and risks in the Russian debt market

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## MANY ASSET SUB-CLASSES ALREADY AVAILABLE IN THE MARKET

### RUSSIAN DEBT MARKET

#### Instruments:

- ❖ Bonds/notes
- ❖ Loans
- ❖ CDS, CDO
- ❖ Futures
- ❖ other derivatives

#### Seniority:

- ❖ Collateralized
- ❖ Convertible
- ❖ Senior unsecured
- ❖ Subordinated

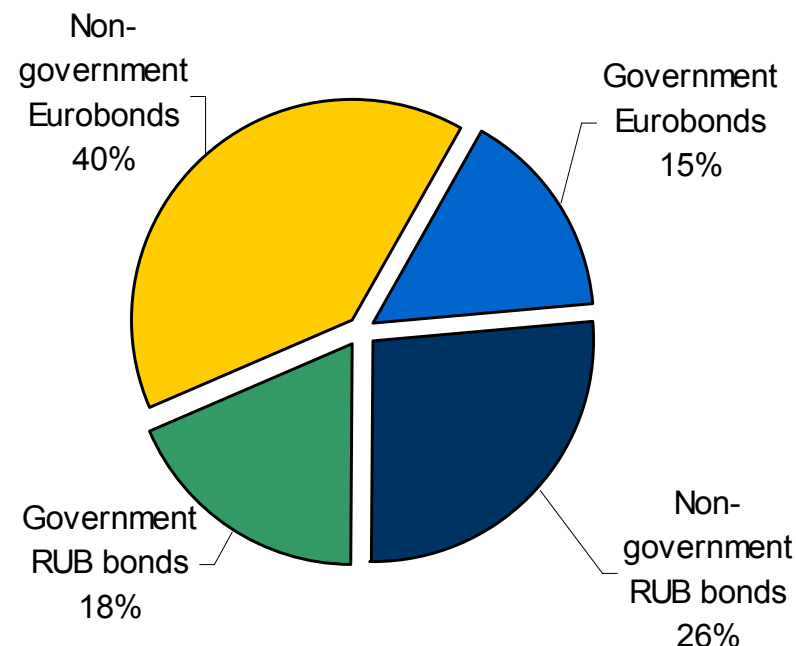
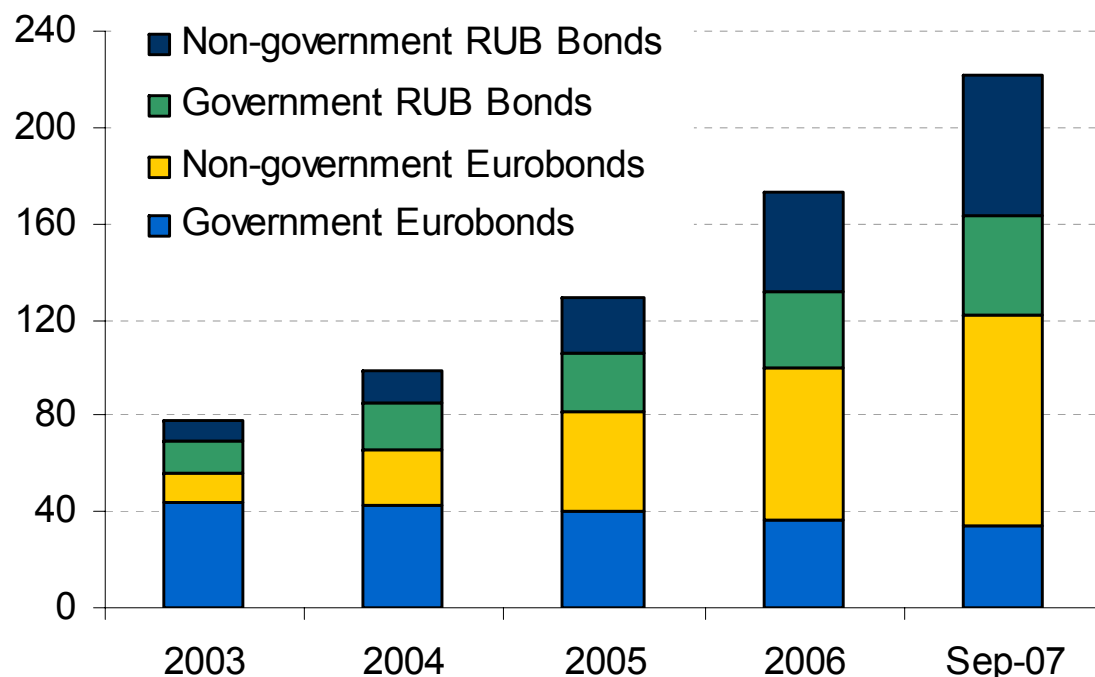
#### Segments:

- ❖ From high-grade to distressed
- ❖ Corps from oil&gas to retail
- ❖ Banks
- ❖ Sub-federals and municipals
- ❖ Households/consumer finance

#### Currencies:

- ❖ RUB
- ❖ USD
- ❖ EUR
- ❖ CHF, GBP, etc.

## RUSSIA'S BOND MARKET IS ALREADY QUITE BIG

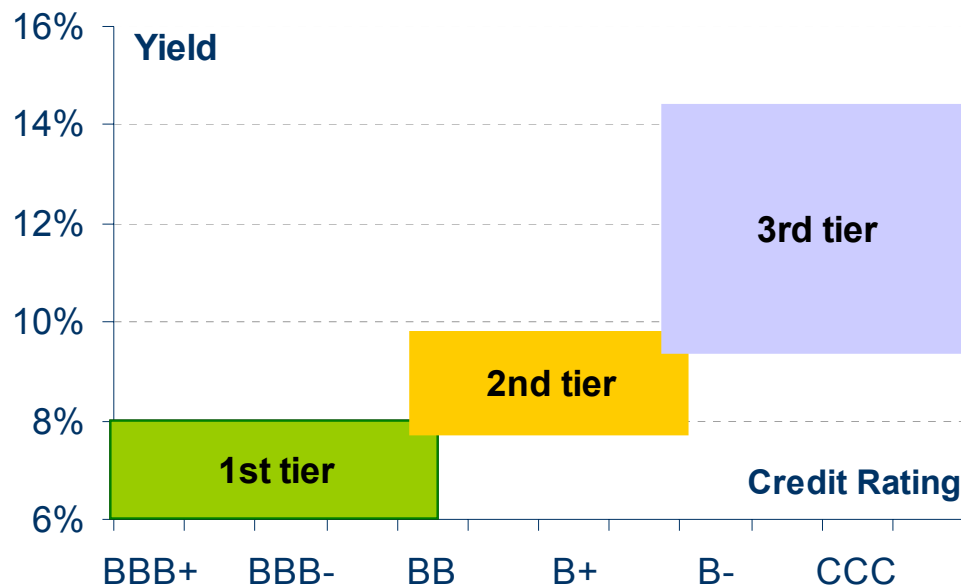


Source: CBonds, MDM estimates.

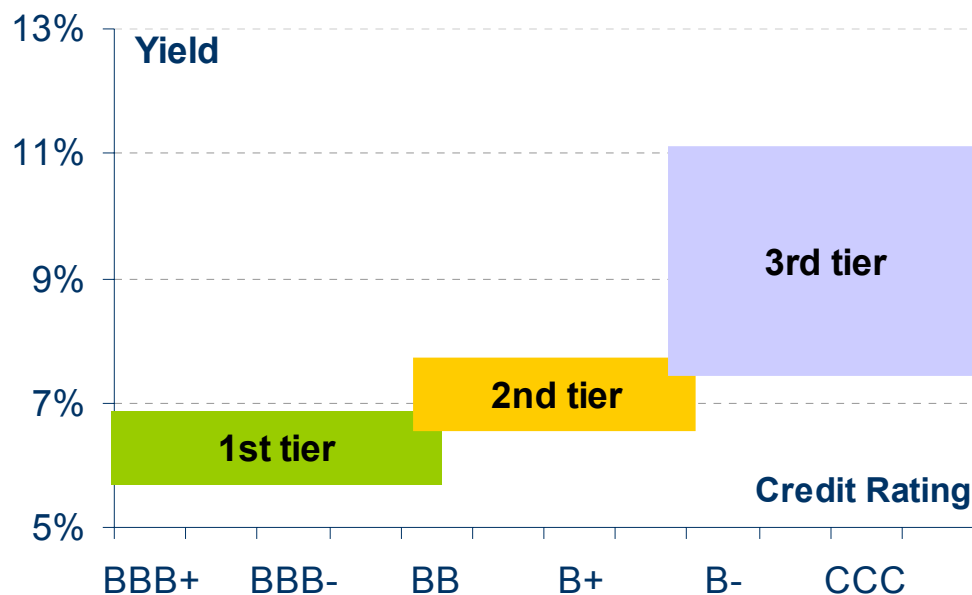
- ❖ A rapidly growing market worth USD220bn as of Aug 2007
- ❖ Approximately 280 Eurobond issues and over 720 RUB issues
- ❖ Over 120 names in Eurobonds and over 500 names in RUB bonds
- ❖ Over 20 Euroclearable RUB bonds
- ❖ Securitizations, CDOs, etc.
- ❖ In terms of depth (volumes, tenor), local bond market is catching up with external market

# USUALLY INVESTORS REFER TO 3 TIERS OF ISSUERS

## RUB Bonds



## Eurobonds



## INTEREST RATES ARE NOT EXTREMELY APPEALING

- ❖ High grade bonds are trading at negative real interest rates
- ❖ Only high-risk bonds offer yields above inflation
- ❖ Government-protected bank deposits look far more attractive

Example. Russian Standard Bank: 1-year ruble bond:  $\leq 9\%^*$  vs 1-year deposit for individuals  $\geq 12.0\%$

Advantages of the deposit:

- largely guaranteed by the government (i.e. sovereign risk)
- deposits are senior to bonds in bankruptcy proceedings
- tax on deposit interest would be lower

*\* Yield before the most recent events of a massive sell-off*

## IS THERE ANY VALUE IN BONDS? YES

### “AREAS” OF OPPORTUNITIES:

1. Leverage
2. Credit approach/distressed debt opportunities
3. Relative value trades
4. Watching important “technical” signals

## LEVERAGE

Leverage helps magnify buying power, i.e. increase upside and downside

### **RISK IN LEVERAGED TRADES DEPENDS ON:**

- ❖ The gap between the asset yield and cost of repo
- ❖ The level of leverage (ratio of own funds vs borrowed funds)
- ❖ Volatility of repo costs
- ❖ Volatility of underlying asset price and yield
- ❖ Liquidity of the asset

## EXAMPLES OF LEVERAGED TRADES

### Example 1. Pure price risk. Long-dated OFZs

Yield: 6.65%

Max cost of repo: 6.0% (Central Bank overnight)

Haircut: 1.25%, i.e. available leverage 1:79

Yield on a leveraged trade assuming simple yield unchanged:  $6.65\% + (6.65\% - 6.0\%) * 79 = \mathbf{58\%}$

### Example 2. Price and liquidity risk. AlZhK ruble bonds

Yield: 7.65%

Max cost of repo: 6.0% (Central Bank overnight)

Haircut: 17.5%, i.e. available leverage 1:4.7

Yield on a leveraged trade assuming simple yield unchanged:  $7.65\% + (7.65\% - 6.0\%) * 4.7x = \mathbf{15.4\%}$

### Example 3. Price, liquidity and credit risk. Russian Standard Bank ruble bonds

Yield: 12.0% (after the recent sell-off)

Max cost of repo: 6.0% (Central Bank overnight)

Haircut: 9%, i.e. available leverage 1:10

Yield on a leveraged trade assuming simple yield unchanged:  $12.0\% + (12.0\% - 6.0\%) * 10x = \mathbf{72\%}$



## CREDIT APPROACH

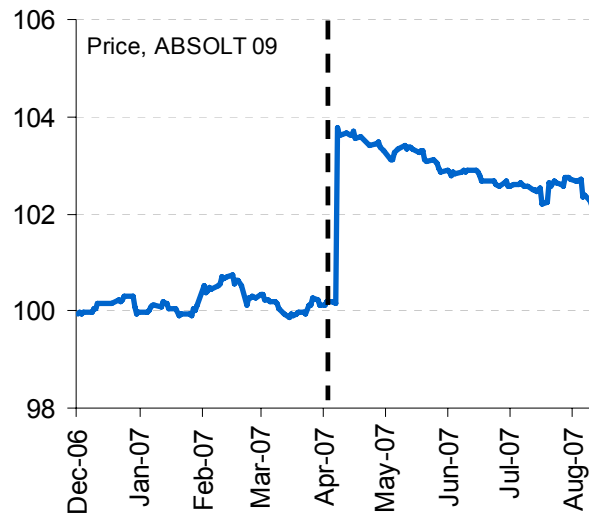
Defined as a search for underpriced risk or issuers with credit upside...

... which requires intensive credit work, but pays off nicely

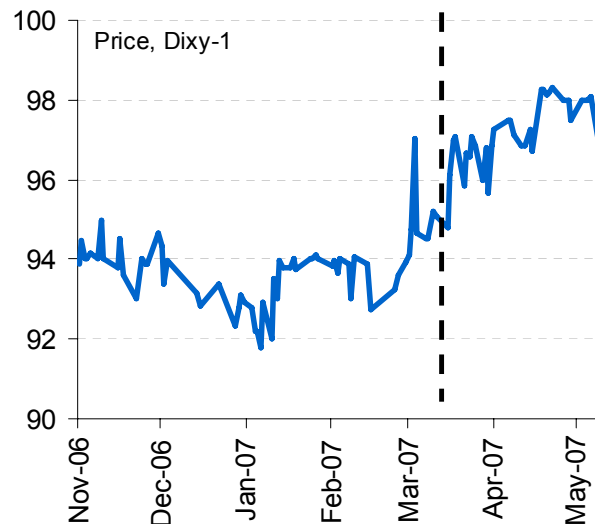
### Approach 1. Look for credit-positive trends and names that are likely to be affected:

- ❖ Acquisitions by a stronger entity, equity injections (banking sector, retail, development, utilities)
- ❖ Government-sponsored consolidation and increased case for state support (defense, machinery)
- ❖ Sector-positive changes (prices, demand, regulatory environment)

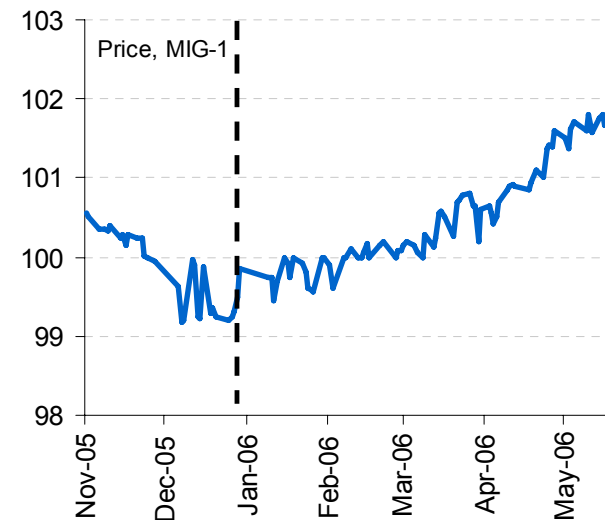
#### Absolut – acquisition by KBC



#### Dixy - IPO



#### MIG – integration into UAC



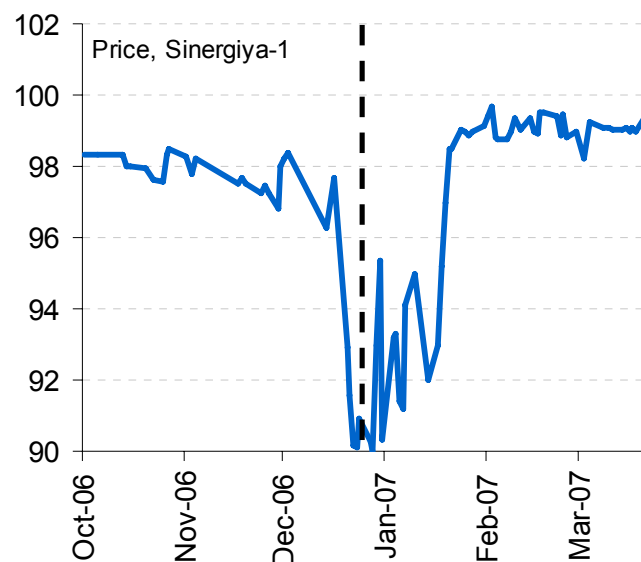
Source: MICEX, Bloomberg, MDM estimates.

## CREDIT APPROACH

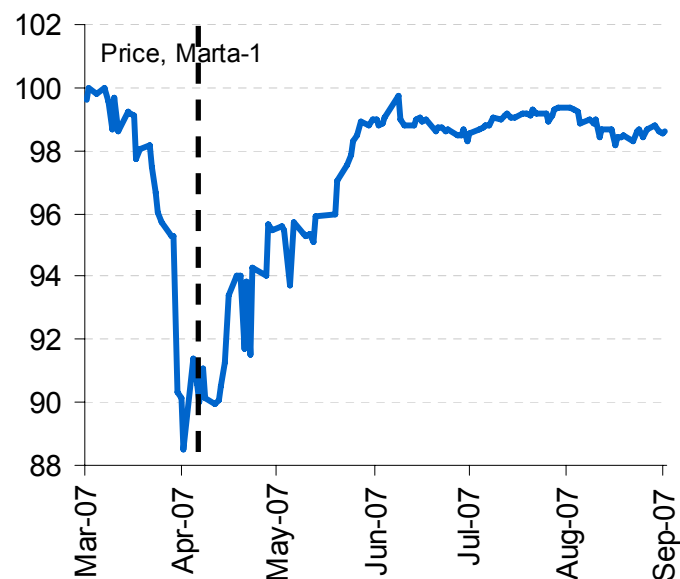
### Approach 2. Look at the highest yielding bonds in the segment, including “distressed”:

- ❖ Understand what is behind the high yield: poor technicals or credit-negative news
- ❖ Meet the company to get a better understanding of their willingness and ability to pay
- ❖ Russian market offers unique opportunities due to inefficient bond risk management at banks and lack of analytical capacity

#### Sinergia (vodka maker)



#### Marta (leveraged holding with assets in retail and development)

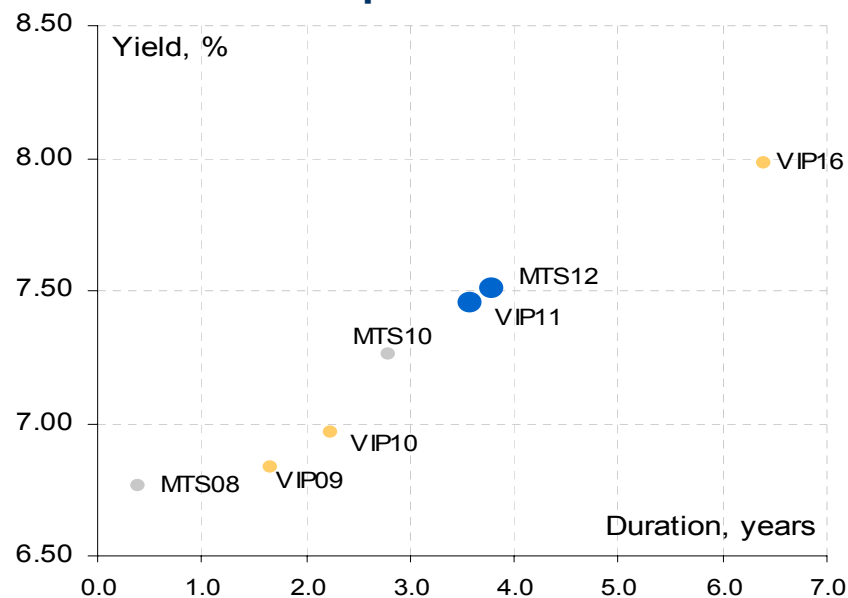


Source: MICEX, Bloomberg, MDM estimates.

## RELATIVE VALUE OPPORTUNITIES: ARBITRAGE BETWEEN SIMILAR CREDITS

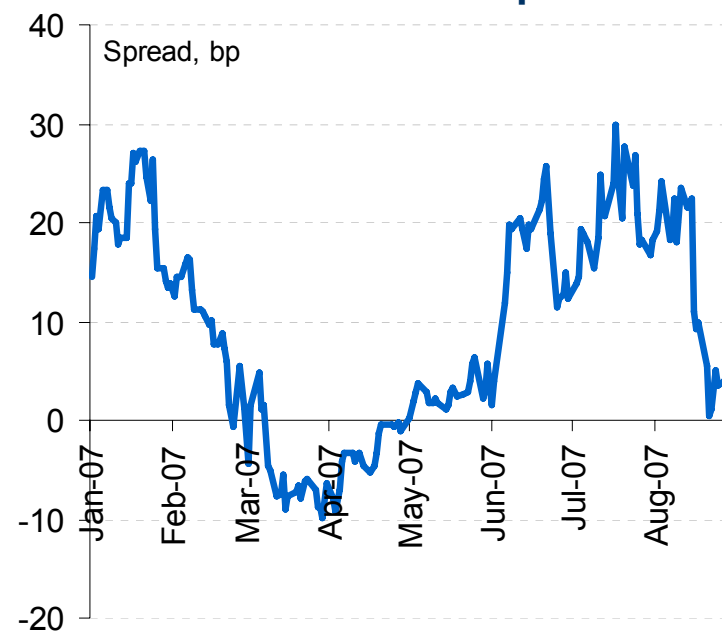
- ❖ Similar credits in theory should trade at similar spreads
- ❖ If historical spreads fluctuate around target levels, this adds comfort in the trade
- ❖ In order to do arbitrage, you should buy cheaper bond against a short position in a more expensive one; costs of repo and bid/offer spreads should be taken into consideration
- ❖ In a “soft arbitrage” trade you can simply switch from one bond into another
- ❖ Key risk: similar credits may suddenly become different

### MTS and VimpelCom Eurobonds



Source: MICEX, Bloomberg, MDM estimates.

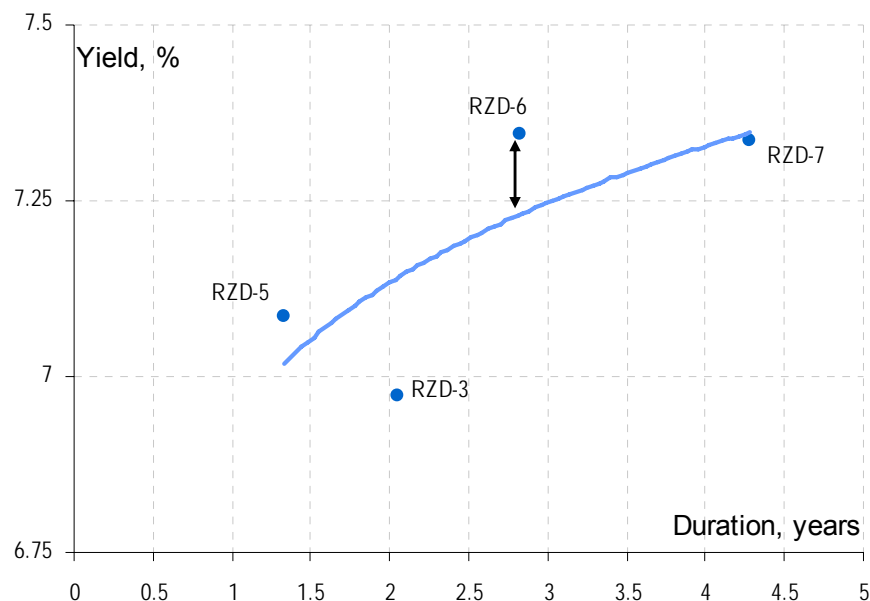
### MTS12 - VIP11 spread



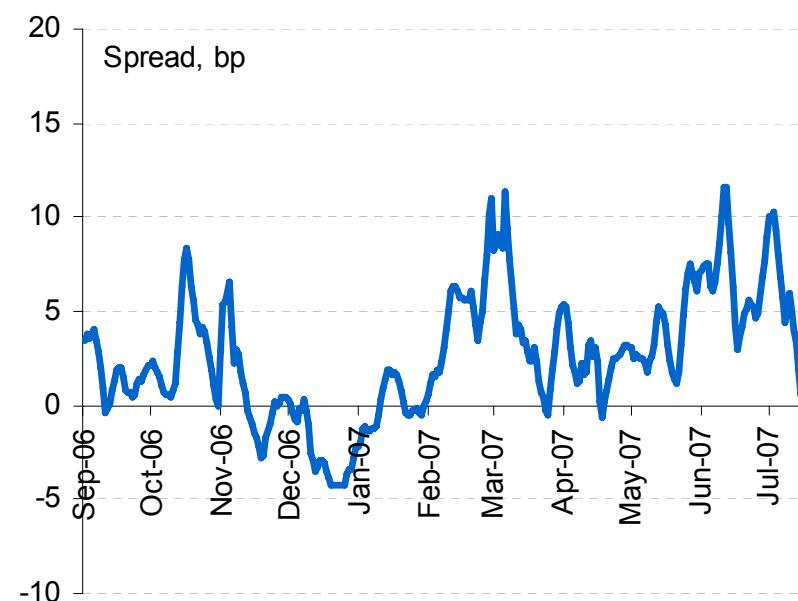
## RELATIVE VALUE OPPORTUNITIES: ARBITRAGE ALONG THE CURVE

- ❖ Senior bond issues of a given issuer should shape a relatively smooth yield curve
- ❖ If one bond trades too far away from the curve, this could be an arbitrage opportunity
- ❖ Key risk: the curve may become more steep or flat in certain circumstances

### Russian Railways RUB issues



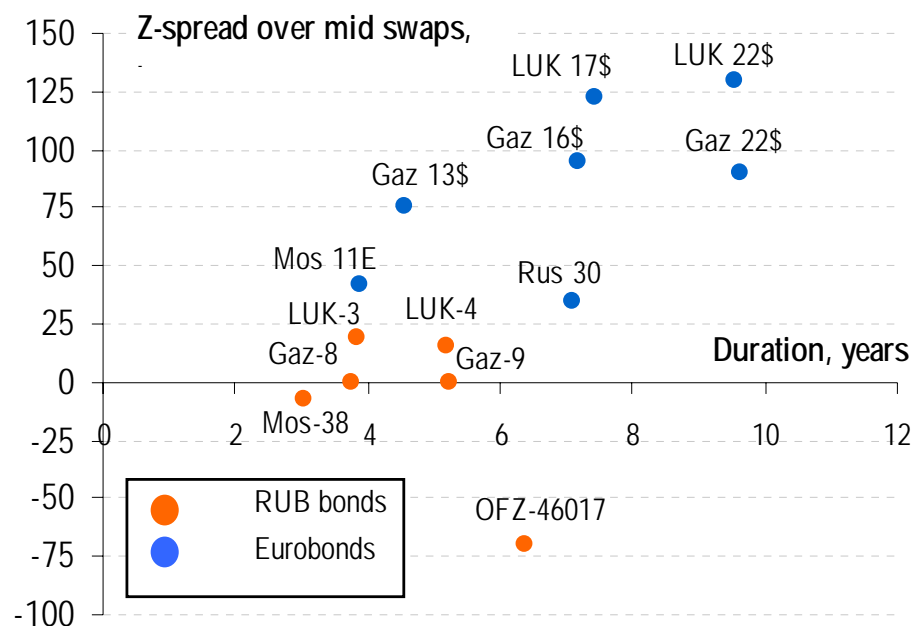
### RZD-6 vs RZD Yield Curve Spread



Source: MICEX, Bloomberg, MDM estimates.

## RELATIVE VALUE: ARBITRAGE BTW BONDS IN DIFFERENT CURRENCIES

- ❖ Interest rate swaps allow to measure spreads of all bonds against one base (e.g. USD LIBOR)
- ❖ In theory, issuer's senior bonds of similar duration should trade at the same spreads over swaps, regardless of the currency
- ❖ Long-dated ruble bonds look overpriced from that perspective
- ❖ However, this "inefficiency" may well be there for a while due to a number of factors, including low access of bondholders to arbitrage instruments



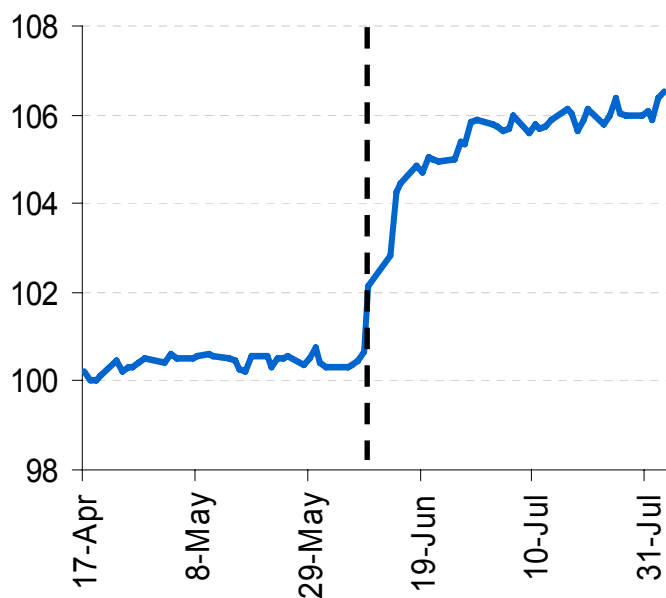
Source: MICEX, Bloomberg, MDM estimates. Chart was built as of mid-July

## TRANSPARENCY IMPROVEMENTS AND A1 LISTING

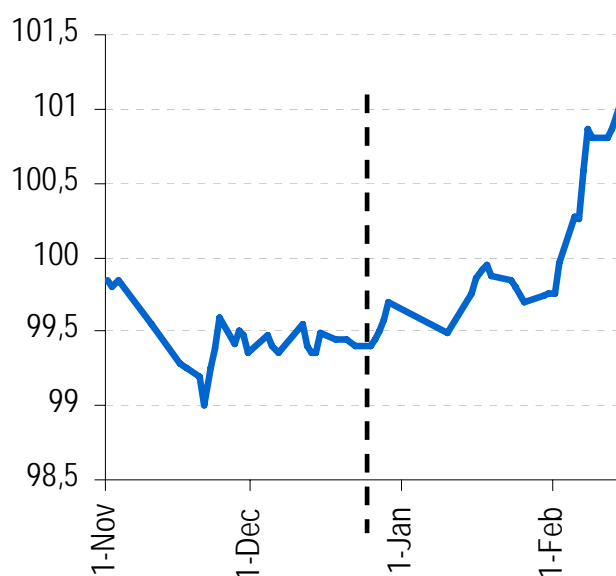
### A RALLY CAN BE TRIGGERED BY:

1. First-time consolidated IFRS report of a complex group
2. Assignment of first-time credit ratings (certain rating level makes bonds eligible for repo at the CBR)
3. A1 listing on MICEX. Such bonds are eligible for investment of pension assets

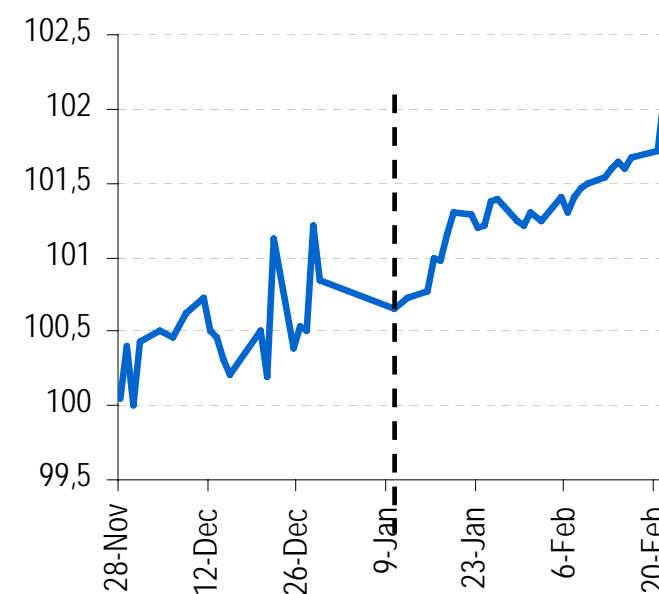
**M-Industria – A1 listing**



**AHML – First IFRS**



**Mirax – First ratings (B2/B)**



Source: MICEX, Bloomberg, MDM estimates.

# RISKS FACED IN THE RUSSIAN BOND MARKET

## 1. Weak credit culture

- ❖ Overpricing of risk due to lack of defaults, aggressiveness of underwriters and excess liquidity
- ❖ Poor disclosure by issuers
- ❖ No covenants in ruble bonds. Relatively frequent violation of covenants in CLNs
- ❖ Little attention to debt subordination

## 2. Liquidity in secondary trading gradually drying up

- ❖ Growth comes from a larger number of issuers, while average issue size is still small (R2bn)
- ❖ Investors cannot follow many names, pick a few and take big chunks
- ❖ A lot of paper is repackaged into derivatives
- ❖ Some bonds (mainly 3<sup>rd</sup> tier) are placed badly from a technical perspective

## 3. Infrastructure restrictions

- ❖ No (t+n) trading in ruble bonds, only t+0, hence no short trading
- ❖ You cannot trade local corporate & bank bonds 4-6 weeks from the issuance date and a few days before coupon payments
- ❖ Reporting requirements are awkward and violation doesn't trigger acceleration

## THOUGHTS ON THE CURRENT TURMOIL IN THE MARKETS

- ❖ We may yet hear more bad news from the US and perhaps Europe
- ❖ New issuance opportunities will be minimal, i.e. refinancing risks will stay high
- ❖ Investors should avoid leveraged issuers during this period
- ❖ As hot money leaves Russia, local market should outperform Eurobonds
- ❖ Ruble strength is difficult to challenge. Support comes from FX reserves, growth and high inflation
- ❖ Guaranteed repo at the Central Bank against a large list of bonds supports sustainability



# MDM BANK HAS SOLID POSITIONS IN THE RUSSIAN FIXED INCOME MARKET

MDM is a regular arranger and bookrunner of many bond deals. Benchmark transactions of 2007:




**ОАО «АИЖК»**  
Выпуск Credit Linked Notes  
**2 600 000 000 рублей**  
Организатор  
Июль 2007




**ОАО «Синергия»**  
Выпуск облигаций  
**2 000 000 000 рублей**  
Организатор, Андеррайтер,  
Платежный агент  
Июль 2007



**ОАО «Седьмой Континент»**  
Второй выпуск облигаций  
**7 000 000 000 рублей**  
Организатор, Андеррайтер, Платежный  
агент  
Июнь 2007



**ОАО «ИжАвто»**  
Второй выпуск облигаций  
**2 000 000 000 рублей**  
Организатор, Андеррайтер, Платежный  
агент  
Июнь 2007



**ФГУП «Почта России»**  
Выпуск Credit Linked Notes  
**3 500 000 000 рублей**  
Организатор  
Июнь 2007

MDM is a source of research covering Russia/CIS debt markets (daily/new issue/ad hoc analytics)

