

## Russia

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# Russian Regional Eurobonds

## Review of 2001 budget performance

### Sub-sovereign/municipal

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**Most Russian regions saw budget revenues increase substantially in 2002 on the back of improving economic fundamentals in Russia. The sector offers an attractive pick-up in yield over Russian sovereign issues.**

**Nizhniy Novgorod's revenues in 2001 at US\$376.3m were 109% above those of 2000.** The region reduced debt in 2001 for the first time since the 1998 crisis. We are forecasting revenues of US\$450-500m in 2002 and we expect the amortisation payments beginning in 2003 to be less than 10% of revenues.

**The City of Moscow's revenues in 2001 reached US\$7.8bn or 16.3% higher than 2000.** Following its issue of €750m, we estimate that Moscow has total debt of US\$1.9bn or 21% of 2002 budgeted revenues.

**Both the St. Petersburg and Yamalo-Nenets bonds mature this year.** The amounts outstanding are now quite small, and will be redeemed this year. Both bonds offer a reasonable spread above Russian sovereigns though both issues are now quite illiquid.

**We recommend a BUY** on Nizhniy Novgorod with a target price of 92.5, a **BUY** on the Moscow '04 with a target price of 105, and a **BUY** on the Moscow '06 with a target price of 109. We recommend a **SELL** on St. Petersburg and Yamalo-Nenets.

#### Bonds outstanding

Issuer	Coupon (%)	Maturity	Rating	Price	YTM (%)	Spread over sovereigns (%)	Rec
Nizhniy Novgorod (US\$)	8.75	04/05	Caa3	86	16.82	9.00	BUY
City of Moscow (€)	10.25	10/04	Ba3/B+	103.75	8.59	1.06	BUY
City of Moscow (€)	10.95	04/06	Ba3/B+	104.75	9.54	1.76	BUY
Yamal (US\$)	9.50	12/02	Caa1/CCC+	75	9.69	4.13	SELL
City of St.Petersburg (US\$)	9.50	06/02	Ba3/B+	101	6.51	0.95	SELL

#### Financial data (US\$m)

##### City of Moscow

	1999	2000	2001
Tax revs	3,179	4,700	5,148
Total revs	4,312	6,958	7,819
Total exp	4,294	6,154	7,002
Surplus	17	804	816
Total debt	1,826	1,538	1,942
Debt/revenues (%)	42.3	24	22.1

##### Nizhniy Novgorod

	1999	2000	2001
Tax revs	121.2	153.4	185.4
Total revs	167.6	180.1	376.3
Total exp	212.5	187.2	345.2
Surplus/def.	(44.9)	(7)	31.1
Total debt	175.2	188.1	167.5
Debt/revenues (%)	104.5	104	48.5

##### City of St. Petersburg

	1999	2000	2001
Tax revs	738	911	1,011
Total revs	1,038	1,327	1,492
Total exp	1,050	1,272	1,310
Surplus/def.	(12)	55	182
Total debt	537	446.7	394.3
Debt/revenues (%)	51.7	33.7	26.4

##### Yamalo-Nenets AO

	2000	2001
Tax revs	495.7	412.6
Total revs	786.3	660.5
Total exp	659.4	639.7
Surplus	126.9	20.8
Total debt	130	89
Debt/revenues (%)	16.5	13.5

# Investment considerations

***Economic improvement  
leads to higher budget  
revenues in 2001***

Actual budget outcomes in 2001 across Russian regions generally show a considerable improvement over budgetary performance for 2000, with Yamalo-Nenets an exception due to its exposure to the oil and gas sector. This comes as no surprise given Russia's improving economic performance in 2001 and improved tax collection. What does come as a surprise is that revenue collection no longer appears to be seasonally weighted towards the final quarter. Over the past ten years, it has been observed that tax revenues at both the regional and federal level are strongly weighted towards the second half of the year and, in particular, the final quarter when as much of 40% of annual total revenues were collected. During 2001, revenues appear to have been evenly spread over the year, suggesting a more efficient system of tax collection. However, this also led to Moscow and Nizhniy Novgorod undershooting our forecasts for full-year revenues based on 3Q01 budget actuals.

***Recommend a BUY on  
Moscow and Nizhniy  
Novgorod***

Despite the undershoot, we remain generally positive about the performance of the Russian regions and expect the improvements seen over the past two years to continue. The bonds of all four regions offer a sizeable pick-up over Russian sovereign yields, though the Yamal and St. Petersburg issues are very short-term as both mature this year, and they are now very illiquid. We therefore recommend a **SELL** on the Yamal and St. Petersburg issues and a **BUY** on the Nizhniy Novgorod and both Moscow issues.

# Oblast of Nizhniy Novgorod

## **Summary of restructuring terms**

Nizhniy Novgorod issued its US\$100m Eurobond in October 1997 with a coupon of 8.75% and an original maturity of October 2001. In December 1999, the bond was restructured on the following terms:

- 50% of the coupon due in October 1999 was paid in cash.
- Coupons due in 2000 and 2001 were paid 35% in cash.
- Coupons due in 2002 will be paid 50% in cash.
- Unpaid portions of the coupons to be capitalised and accrue interest at the coupon rate of 8.75%.
- Starting April 2003, the whole outstanding amount (including interest at the full 8.75%) to be amortised in five equal, bi-annual instalments of US\$23.87m with the final payment due in April 2005.

## **Restructuring forced upon region by 1998 economic crisis**

The restructuring of the Oblast's Eurobond was prompted by the collapse in revenues that followed in the wake of Russia's devaluation and domestic debt default in August 1998. Not only were the Oblast's rouble-denominated revenues worth a great deal less in dollar terms, but the collapse of many of Russia's banks caused severe illiquidity. This led to the return of the non-cash economy, which was in the process of being eradicated prior to the crisis. During 1999, the Oblast's total revenues fell to US\$168m, compared with US\$370m in 1998 and US\$549m in 1997. However, the liquidity crisis meant that around half of the Oblast's revenues were received in the form of barter and offset. The restructuring was designed to save cash by giving the Oblast relief on its coupon payments for three years and to reduce refinancing risk by providing an amortisation structure. Since completing the restructuring, the Oblast has made all due payments on time.

## **Developments during 2001**

### **New governor elected in July**

In July 2001 the electorate of the Oblast elected a new Governor, Gennady Khodyrev. Khodyrev is a former first secretary of the Communist Party regional committee in Nizhniy Novgorod. In 1997 he failed in a bid to become regional governor of Nizhniy Novgorod, losing against Ivan Sklyarov. In 1998 Khodyrev resigned his Communist Party membership and served briefly in Primakov's government, though, when the government collapsed, he was re-elected to the Duma under the Communist ticket. This time, he defeated Sklyarov and has again resigned his membership of the Communist Party for the duration of his term in office. Khodyrev announced that he is not opposed to liberal reform and announced his willingness to work constructively with Sergei Kiriyyenko, the Governor General of the Volga region and President Putin's representative in Nizhniy Novgorod.

### **Reports of a restructuring ...**

On Friday 16 November, a *Tass* report was widely quoted on newswires which claimed that Khodyrev had delivered a speech saying that the Oblast was going to begin talks with investors to restructure the Eurobond. The report quoted Khodyrev saying that the proceeds had not been used entirely for commercial projects (including US\$25m used to pay salaries) and that the Oblast was looking at buying back the debt for a smaller sum. Later the same day, *Tass* reissued its story but this time Khodyrev was quoted saying that Nizhniy Novgorod planned to stick to the schedule of redeeming the

**... shortly followed by a retraction**

Eurobonds and would make all future payments on time. Khodyrev also added that, as some of the Eurobond proceeds had been spent on non-commercial projects such as road construction, a large of the repayment would have to be made from the regional treasury, ie, out of the Oblast's regular taxation revenues.

**Governor critical of previous administration**

Most observers agree that Khodyrev was scoring political points against his predecessor, Sklyarov, during whose administration the bond was issued. Khodyrev was telling his electorate that he did not feel the proceeds from the Eurobond were all used wisely and that he is not responsible for the financial burden placed on the Oblast. In our opinion, it is highly likely that pressure was applied on Khodyrev to remedy any damage from his first announcement by making an unequivocal statement that he would abide by the terms of the restructured bond. Shortly after coming to power, President Putin sharply curtailed the powers of regional governments to borrow externally as a direct response to several defaults and restructurings of external debt by Russian regions. Putin's government realised that regional defaults would reflect badly on the credit standing of the Federation and could hamper its efforts at effective external liability management. We therefore believe that the Federal government is not prepared to tolerate a regional government attempting to restructure its Eurobonds for a second time.

Since making the above statements, Governor Khodyrev has not made any further references to the Eurobond, either positive or negative. Taking the above events in a more positive light, the Governor's comments are the first unequivocal statement by the Oblast since the bond restructuring that it intends to stick to the agreed terms. Taken in the wider context of Federal disapproval for a restructuring and the Oblast's improved financial condition (see below) we believe the outlook for the bonds has actually improved.

## Financial analysis

**Revenues no longer weighted to fourth quarter**

Total revenues for 2001 were US\$376.3m, somewhat less than the US\$400-425m we had forecast based on 3Q01 revenues of US\$296.9m. Revenues were below our original expectation because, unlike in previous years, taxation revenues were spread quite evenly over the course of the year rather than being heavily weighted towards the fourth quarter. Also, non-tax revenues as of 3Q01 included two large items (grant from the federal budget and the repayment of a large budget loan) that were not repeated in 4Q01.

**Higher direct taxes but sales taxes down 32%**

Total revenues in 2001 were 109% higher than in 2000. Overall tax revenues increased a respectable 28% though sales taxes actually decreased 32% due to the elimination of VAT revenues from regional budgets. From the beginning of 2001, 100% of VAT revenues are transferred to the Federal budget. Direct taxes on corporates and individuals increased 48% to US\$128m – we believe this to be the result of a stronger economy and tax reforms improving the level of tax collection. The largest revenue increases were in the form of transfers from other budgets (up to US\$55m from US\$14.2m in 2000) and the consolidation of US\$93.2m of special purpose funds onto the Oblast budget. We expect 2002 revenues to continue the last two years' run of growth and we are now forecasting total revenues of US\$450-500m for the year.

**2001 sees Oblast's first budget surplus and net debt repayment**

During 1999 and 2000, the Oblast was obliged to run a budget deficit to maintain levels of services, which it financed by borrowing domestically. As a result, debt levels rose from US\$147m to an estimated US\$188m at end-2000. During 2001, the Oblast ran a budget surplus of US\$31.1m of which US\$24m was used to reduce debt. The largest debt repayment during 2001 was the settlement of its DM50m (US\$22m) loan from

WestLB. This loan was lent to the Oblast in mid-1998 and the proceeds were deposited in the Nizhniy Novgorod branch of Inkombank. This deposit became frozen when Inkombank became insolvent and the Oblast spent several years negotiating a mutually acceptable settlement with WestLB. Now that this claim is fully settled, the Eurobond represents the Oblast's only external debt. As of end-2001, we estimate the Oblast's total debt outstanding to be US\$167.5m, of which US\$116.8m is the Eurobond (including US\$16.8m unpaid interest capitalised as principal). The Oblast's accounts show a year-end cash balance of US\$33m equivalent.

## Conclusion and recommendation

*Nizhniy Novgorod offers  
the best value among  
Russian bonds*

Nizhniy Novgorod bonds currently trade at an offered price of 86, which equates to a YTM of 16.82% or a spread of 9.0% over the Russia '05. We price the Nizhniy Novgorod issue against the Russia '05 although, due to its amortising structure, the Nizhniy Novgorod bond has an average life of slightly over two years. In our view, the credit spread over Russia is too wide and a spread of 5% would be more appropriate, implying a YTM of 12.8% and a price of 92.5. We recommend a **BUY** on Nizhniy Novgorod with a target price of 92.5 in the next six months.

**Fig 1 Oblast of Nizhniy Novgorod – actual budget performance (US\$m)**

Yr to Dec	1997	1998	1999	2000	2001
Taxation revenues	400.8	273.1	121.2	153.4	185.4
Non-tax revenues	61.8	42.6	23.1	9.8	9.1
Other income	86.2	53.8	23.4	16.9	181.8
<b>Total income</b>	<b>548.8</b>	<b>369.5</b>	<b>167.6</b>	<b>180.1</b>	<b>376.3</b>
Oblast expenditures	270.8	153.6	83.8	108.3	135.6
Transfers to other budgets	275.3	145.9	127.3	61.9	96.8
Other expenditure	34.5	48.2	1.4	17.1	112.8
<b>Total expenditure</b>	<b>641.2</b>	<b>368.9</b>	<b>212.5</b>	<b>187.2</b>	<b>345.2</b>
(Deficit)/surplus	(89.0)	0.6	(44.9)	(7.0)	31.1
<b>Total debt (est.)</b>	<b>185.0</b>	<b>147.2</b>	<b>175.2</b>	<b>188.1</b>	<b>167.5</b>

Source: Company data, Federal Russian Ministry of Finance, ING Barings estimates

# City of Moscow

## ***Moscow issued €750m in Eurobonds at the end of 2001***

The City of Moscow returned to the Euromarkets with two new bond issues in late 2001. Under rules introduced by President Vladimir Putin in 2000, Russian regions may no longer borrow on international markets, except to refinance maturing obligations. The rule is applied to each calendar year, ie, regions must refinance maturing obligations within the same calendar year. During 2001, Moscow was authorised to issue up to US\$735m in new debt and the outcome was that it succeeded in placing €750m in Eurobonds.

- 16 October – €300m 10.25% three-year issue launched.
- 15 November – €400m 10.95% five-year issue launched.
- 14 December – €50m tap on the 10.25% '04 issue completed.

## ***Moscow maintains sovereign ceiling rating***

Both bonds have traded up sharply since issue, assisted by Moody's two-notch upgrade of Russia from B2 to Ba3 at the end of November, followed a few days later by a similar two-notch upgrade for the City of Moscow. On 19 December, S&P also raised Moscow's ratings to B+. The City of Moscow continues to be rated by both rating agencies at the sovereign ceiling.

## **Financial analysis**

### ***2001 revenues 16% above plan***

Moscow's total revenues in 2001 amounted to US\$7.8bn or 16.3% above the budget plan for 2001. Actual total revenues fell short of our forecast of US\$8.1bn made on the basis of 3Q01 budget performance. This was due to the fact that in 2001 budget revenues have been spread fairly smoothly throughout the year, rather than being heavily back-ended into the fourth quarter as in the past. We believe that this reflects a more efficient system of tax collection under the Putin administration compared to the past and certainly does not detract from a very creditable performance by Moscow. Total expenditure was only 9.5% above plan, resulting in a budget surplus for 2001 of US\$816m.

### ***Moscow's debt/revenue ratio still low at 21%***

As of July 2001 Moscow had total direct debt of US\$1.078bn, or US\$1.274bn if guarantees issued are included. Direct debt has now increased to approximately US\$1.73bn, if the two Eurobond issues are included (or US\$1.9bn including guarantees). This gives a debt/forecast total revenues ratio of 21%. We believe this is a conservative ratio for City of Moscow's size and economic potential. Comparative figures are Prague (35% – A-), Lisbon (62% – Aa2), Barcelona (91% – Aa3) and Copenhagen (98% – Aa1).

### ***Plan deficit for 2002 covered by year-end cash reserves***

The 2002 budget forecasts total revenues of US\$8.8bn, a 12.2% increase over the 2001 figure. Most of the increase is expected to come from tax revenues (a 15% increase to US\$5.9bn) reflecting the improving economic climate in Russia. The 2002 budget forecasts expenditure of US\$9.1bn resulting in a deficit of US\$314m. It is unusual for the City of Moscow to have a budget deficit, and the 2002 budget is the first budget in at least seven years to do so. However, it should be recalled that the City recorded a surplus of US\$816m in 2001 and, according to the City's accounts, it had a year-end cash balance of US\$797m. The planned deficit for 2002 is therefore capable of being met from the City's cash reserves.

## Conclusion and recommendation

*We expect Moscow bonds to tighten against the sovereign ...*

The City of Moscow is rated at the Russian sovereign ceiling. In terms of debt levels, quality of revenues, debt management and past performance, it is an excellent credit and in our view should trade very close to Russian sovereign Eurobonds. Russia does not have enough outstanding euro-denominated issues to establish an accurate yield curve in euro, though the March '04 and March '05 issues are useful proxies. The City of Moscow 10/04 is currently offered at 103.75, which equates to a YTM of 8.59% or a spread of 1.06% over the Russia '04. The City of Moscow 4/06 is currently offered at 104.75, which equates to a YTM of 9.54% or 1.76% over the Russia '05. We believe that, based on Moscow's strong credit quality, its bonds should trade at a spread of only 50bp behind Russian sovereigns, implying a price of 105 for the Moscow '04 and 109 for the Moscow '06.

*... and recommend a BUY*

We recommend a **BUY** on the Moscow '04 with a target price of 105 and a **BUY** on the Moscow '06 with a target price of 109, both within the next six months.

**Fig 2 City of Moscow – budget performance (US\$m)**

	1998 Actual	1999 Actual	2000 Actual	2001 Plan	2001 Actual	2002 Plan
<b>Tax revenues</b>	<b>4,550.5</b>	<b>3,179.0</b>	<b>4,700.2</b>	<b>5,059.6</b>	<b>5,148.1</b>	<b>5,922.4</b>
Direct taxes	2,560.5	1,810.4	2,617.7	3,830.0	3,793.8	4,415.3
Indirect taxes	834.4	580.1	1,043.1	715.2	659.3	905.9
Property taxes	458.9	266.8	392.9	456.7	538.4	535.2
Natural resources utilisation taxes	17.7	7.6			14.5	13.4
Other taxes	679.0	514.1	646.5	57.6	142.1	52.6
<b>Non-tax revenues</b>	<b>386.1</b>	<b>335.3</b>	<b>958.1</b>	<b>483.6</b>	<b>917.7</b>	<b>951.9</b>
Revs. from city property	202.5	111.1	212.9	280.6	675.4	314.1
Revenues from property sales	51.6	69.5			0.2	439.4
Admin fee	3.7				12.4	15.1
Penalties	5.3				19.9	24.0
Other non-tax revenues	122.9	74.6	206.1	202.9	209.9	159.2
Other incl. income from DPFs	66.2	797.5	1,299.9	1,128.7	1,753.1	1,901.4
<b>Total revenues</b>	<b>5,002.8</b>	<b>4,311.8</b>	<b>6,958.2</b>	<b>6,671.9</b>	<b>7,819.0</b>	<b>8,775.7</b>
<b>City expenditures</b>	<b>4,764.5</b>	<b>2,804.7</b>	<b>3,846.3</b>	<b>4,449.2</b>	<b>4,338.8</b>	<b>5,931.2</b>
Administration	132.2	69.3	98.7	146.6	120.1	216.5
Police & security	130.0	65.6	65.5	74.0	77.7	147.5
Industry, utility (energy) & construct.	129.1	120.1	111.3	214.0	218.4	140.1
Agriculture	24.1	86.8	56.6	88.6	39.2	64.1
Environment	42.5	40.4	76.1	66.6	140.8	85.0
Transport	372.9	199.5	329.1	281.1	346.7	451.4
Housing & communal costs	1,611.1	793.1	1,284.0	1,340.1	1,529.4	1,780.7
Education & science	695.5	380.0	504.2	627.0	582.9	864.3
Culture & art	98.5	55.8	81.0	96.5	123.7	153.3
Mass media	46.5	37.6	67.6	63.4	72.0	85.2
Health & sport	778.2	436.8	527.9	583.9	564.6	766.5
Social welfare	435.6	261.5	364.8	493.1	489.8	627.7
Other	268.3	258.1	279.5	374.4	33.4	548.8
Settlements with other budgets					582.2	1,053.8
Expenditure of DPFs		796.2	2,009.2	1,339.9	1,691.3	1,901.4
Debt service	227.5	693.5	298.7	560.7	390.3	202.8
<b>Total expenditure</b>	<b>4,991.9</b>	<b>4,294.4</b>	<b>6,154.1</b>	<b>6,349.7</b>	<b>7,002.6</b>	<b>9,089.2</b>
Surplus (Deficit)	10.9	17.4	804.1	322.1	816.4	(313.5)
Average RBL/US\$ for period	10.041	24.952	28.147	29.194	29.194	31.500

Source: City of Moscow Municipal Debt Committee, Russian Ministry of Finance

# City of St. Petersburg

***Budget surpluses allow  
St. Pete's to buy back  
most of its bond***

In June 1997, St. Petersburg issued its debut US\$300m Eurobond with a coupon of 9.5%. Following the devaluation of the rouble in August 1998 and the subsequent economic crisis in Russia, St. Petersburg saw its budget shrink sharply in dollar terms. Nevertheless, the city continued to make all coupon payments in full and on time. In 2000, the city's economy returned to growth as local industries were benefiting from a low rouble and no longer faced competition from low imports. Revenues began to rise once more, and in 2000 the city posted a budget surplus of US\$54.8m followed by a budget surplus of US\$181.7m in 2001. These surpluses allowed the city to reduce its overall debt levels, and in 2000 it bought back US\$80m of the Eurobond and in 2001 it bought back a further US\$110m. As of 1 January 2001, there was only US\$108m of the St. Petersburg Eurobond outstanding (US\$2m having been bought back in 1997).

The Eurobond expires on 18 June 2002. According to the city's accounts, as of 31 December 2001 it had a cash balance of US\$140.9m, and the plan budget for 2002 forecasts a surplus of US\$33.9m on total revenues of US\$1.82bn – a 22% increase over 2001 revenues. The city has ample financial resources to redeem the Eurobond at maturity, though we assume that it is continuing to buy back the bond in the market.

## Conclusion and recommendation

***We see better  
opportunities in Russia  
so we recommend a  
SELL***

The St. Petersburg Eurobond is currently offered at a price of 101, which equates to a YTM of 6.51% or a spread of 0.95% above the Russia 11.75% of 10/03. This represents a reasonably attractive spread for St. Petersburg, which should really trade 50-70bp behind the sovereign. However, the maturity of the bond is extremely short and, given the city's activities in buying back the bonds, investors may find it very difficult to acquire bonds. We also believe that Moscow and Nizhniy Novgorod offer much better long-term yields for investors so we recommend a **SELL** on the St. Petersburg 6/02.

**Fig 3 St. Petersburg city budget (US\$m)**

Yr to Dec	1998 Actual	1999 Actual	2000 Actual	2001 Plan	2001 Actual	2002 Plan
Opening cash balance					38.6	
Tax revenues	1,444.0	738.0	910.8	1,051.0	1,011.4	1,355.2
Non-tax revenues	223.2	122.3	174.8	154.6	213.0	171.8
Other	30.4	177.7	241.2	279.6	267.6	293.0
<b>Total revenues</b>	<b>1,697.5</b>	<b>1,037.9</b>	<b>1,326.8</b>	<b>1,485.2</b>	<b>1,492.0</b>	<b>1,820.1</b>
<b>City expenditures</b>	<b>1,356.9</b>	<b>807.7</b>	<b>1,025.8</b>	<b>1,198.5</b>	<b>1,079.5</b>	<b>1,531.0</b>
Administration	44.2	29.5	39.4	60.4	60.1	85.1
Police & security	60.3	33.2	43.7	47.3	38.4	46.2
Environment	1.2	0.7	1.4	1.5	1.4	2.5
Transport	174.2	132.6	103.7	114.0	152.3	102.9
Housing & communal costs	354.6	179.0	262.9	245.6	253.0	329.6
Emergencies	1.5	0.8	1.2	1.0	1.4	1.2
Education & science	317.6	177.5	202.7	231.7	214.2	358.3
Culture & art	36.9	24.4	30.1	37.6	39.0	50.7
Mass media	3.6	0.5	2.6	2.5	1.3	2.2
Health & Sport	187.3	125.7	159.6	157.8	135.9	207.4
Social welfare	132.6	87.2	104.5	179.8	155.7	233.4
Other	42.9	16.6	74.1	119.4	20.6	96.0
Settlements with other budgets					6.2	15.5
Expenditure of designated funds	201.7	159.5	175.7	164.0	172.2	193.3
Debt service	131.9	82.5	70.6	86.4	58.6	61.9
<b>Total expenditure</b>	<b>1,690.5</b>	<b>1,049.6</b>	<b>1,272.0</b>	<b>1,448.9</b>	<b>1,310.4</b>	<b>1,786.3</b>
Surplus (deficit)	7.1	(11.7)	54.8	36.3	181.7	33.9
Average RBL/US\$ for period	10.041	24.952	28.147	29.194	29.194	31.500

Source: City of St Petersburg, Russian Ministry of Finance

# Yamalo-Nenets AO

## ***Yamal rich in oil, gas and minerals***

Yamal (or 'The Yamalo Nenets Autonomous Okrug' to give it its full name) is one of the 89 regions of Russia. Yamal is a huge region (769,000km<sup>2</sup>) in the northern part of western Siberia consisting mainly of marshland and tundra. It was a relatively obscure backwater until oil and gas were discovered in the 1950s, when the region's economy was transformed. With only 497,000 inhabitants (0.3% of Russia's population) it is still sparsely populated due to the inhospitable climate. Yamal contains 90% of Russia's natural gas reserves (and one-third of the entire world's reserves) as well as 10% of Russia's oil reserves. Yamal also has abundant gold, copper, phosphorites, and rare metals but, as more than one-half of the region's territory lies above the Arctic Circle, extraction of these resources is difficult and expensive. The two largest taxpayers are Gazprom, which produces 99% of the region's gas, and Noyabrskneftegaz (a subsidiary of Sibneft). All of the ten largest taxpayers are in the oil and gas sector. Yamal's gas is transported directly into Russia's international pipeline system, and 90% of the gas produced is exported. Yamal is therefore highly exposed to both international gas prices and to Gazprom payment risk. One of the reasons that it was forced to default in early 1999 was that Gazprom and other major taxpayers were experiencing illiquidity and were either not paying all of their taxes or paying a high proportion in offsets.

## ***Yamal defaults on yen-denominated loan***

In April 1998, Lehman Brothers lent ¥13.375bn maturing in April 1999 to Yamalo Nenets AO ('Yamal'), one of Russia's 89 regions. Lehman then swapped the loan into approximately US\$100m and issued participation notes in the loan yielding 12.25% to around ten institutional investors and 100 small investors. Yamal made its first interest payment in October 1998 – just two months after the onset of Russia's economic crisis and devaluation in August 1999 – but by the time the loan matured in April 1999 Yamal was unable to repay and was forced to seek a restructuring. Yamal was doubly hit because the dollar value of its yen loan increased above the original US\$100m equivalent.

## ***Restructured in 2000***

A restructuring package was finally agreed in February 2000. Yamal made an initial payment of US\$20m, and the remaining US\$100m was restructured into registered Euroclearable notes bearing interest of 9.5% and an amortising repayment structure out to December 2002. The notes have an unusual feature in that the final US\$7m of principal will be forgiven provided Yamal makes all contractual payments of interest and principal in full and on time. So far, all contractual payments have been paid when due and we assume this will continue. Our yield calculations take the forgiveness of the final US\$7m into account. Investors should note that yield calculations on Bloomberg do not take the forgiveness of US\$7m of principal into account and are therefore incorrect.

## ***Revenues fall slightly in 2001 but remain strong***

Yamal's tax revenues actually fell 16% in 2001 to US\$660.5m. This may seem surprising in a year when improved economic conditions throughout the rest of Russia produced larger budgetary revenues. Two factors contributed to the fall in Yamal's budget in 2001: the region's economy is heavily dependent on the oil and gas sector and lower energy prices translated to lower profits; and the loss of 15% of VAT receipts removed US\$36.1m from the regional budget. The fall was offset slightly by a 46% increase in royalty payments from oil and gas companies to US\$155.4m. Overall

expenditure was cut slightly by 3% to US\$639.7m resulting in a budgetary surplus for the year of US\$20.8m.

## Conclusion and recommendation

*Only US\$26m bonds  
outstanding ...*

*... and US\$7m will be  
forgiven*

*We recommend a SELL*

On 15 December 2001 Yamal made a principal repayment of US\$20m, reducing the balance outstanding under the notes to US\$26m. Two further principal repayments are due: US\$11m on 15 June 2002 and the final US\$15m due on 15 December 2002 but only US\$8m of this will actually be paid. The bonds are currently offered at 75, a price that takes into account the fact that only 73% of the outstanding principal will be repaid, though interest will be paid on 100% of the principal up to the maturity date. At the current price, the YTM on the notes is 9.69%. On 15 June, after the next amortisation payment, the bonds will fall to a price of 55.4 if the yield remains at 9.69%.

At the current price, Yamal bonds trade 4.13% above Russia '03s. Although this represents an attractive spread for Yamal, the bonds have a very short average life and only US\$26m face (US\$19m of actual principal) is outstanding. Furthermore, we believe that Yamal may have bought up some of the bonds in the secondary market during the past one to two years, further adding to the illiquidity of the issue. We believe that the Nizhny Novgorod and Moscow bond issues offer better long-term yields, so we recommend a **SELL** on the Yamal restructured notes.

**Fig 4 Yamalo Nenets AO budget (US\$m)**

	2000 Actual	2001 Actual
<b>Tax income</b>	<b>495.7</b>	<b>412.6</b>
Direct taxes	202.8	205.4
Sales tax	37.4	0.5
Property taxes	20.2	44.2
Natural resources utilisation taxes	106.3	155.4
Other taxes	129.0	7.2
Non-tax revenues	38.2	8.0
Other incl. designated purpose funds	252.5	239.8
<b>Total revenues</b>	<b>786.3</b>	<b>660.5</b>
<b>Oblast expenditures</b>	<b>245.1</b>	<b>374.6</b>
Administration	13.3	13.4
Police & security	9.9	10.8
Research & technical assistance	3.1	2.6
Industry, utility (energy) & construct.	24.1	101.5
Agriculture	12.7	9.3
Environment	0.2	2.6
Transport	29.5	88.8
Housing & communal costs	73.1	77.0
Natural disaster	0.3	0.3
Education & science	27.1	24.3
Culture & art	1.4	1.3
Mass media	9.5	8.4
Health	25.2	22.4
Social welfare	15.7	11.8
Settlements with other budgets	170.7	160.0
Other expenditure	243.6	105.1
<b>Total expenditure</b>	<b>659.4</b>	<b>639.7</b>
Surplus (Deficit)	126.9	20.8
Average RBL/US\$ for period	28.147	29.194

Source: Russian Ministry of Finance

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