

RUSSIAN BONDS



Foreigners Gain a New Appetite For Russia's Ruble Bond Issues

Local debt market dealers in Moscow say foreign investors, attracted by ruble appreciation, are coming in ever-greater numbers to the ruble bond market. Some, such as Ashmore Investment, are drawn to the sovereign bond market.

Historically high oil prices have been the main cause of the currency's gain. The ruble began last year at 29 against the dollar, and rose to 27.7. "We expect to see a similar story this year, driven by high inflows and more of a bias to containing inflation than tackling appreciation," says Jon Harrison, emerging market currency strategist at Dresdner Kleinwort Wasserstein.

Many analysts in Moscow believe the market is artificially cheap because the Russian state pension fund, managed by state bank Vnesheconombank, invests only in ruble sovereign bonds. Other state banks like Sberbank also invest mainly in ruble sovereign bonds. The market isn't very liquid because these investors tend to buy and hold.

Foreign investors increasingly are drawn to other benchmark issuers such as Gazprom and the City of Moscow, which is seen as the benchmark for the whole market because of the high liquidity of its issues and its complete credit curve.

City of Moscow is the only Russian issuer besides the sovereign with an investment-grade rating by all three international rating companies. It is well known among foreign investors — partly after being the first Russian

issuer to come back to the Eurobond market after the 1998 debt crisis. Because of a Russian law passed in 2000, the city issues the majority of its debt in ruble bonds.

The large presence of such a well-known issuer has attracted many foreign investors into the ruble bond market. "Foreign investor participation has risen to as much as 80 percent in some of our issues, particularly in the short-end of the curve," says Sergey Pakhomov, chairman of the City of Moscow's State Debt Committee, which manages

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the city's bond issuance. The local branches of foreign banks such as Citigroup and Deutsche Bank are the main foreign investors buying its paper in such quantity, he says.

The proprietary desks of Western investment banks, together with some large New York and London hedge funds, are known to be making large emerging market 'carry plays,' where they borrow in western markets at low interest rates and invest in the higher rates of emerging markets.

Some other ruble bond issues also have benefited from
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heavy foreign investor participation. Russian Railways, for example, issued a Ru12 billion (\$420 million) local bond in December, where around 50 percent of the book was made up of foreign investors, according to lead manager JP Morgan.

The issue, the largest ever in the local bond market, was also the first to have a foreign bank as a lead manager. "We mainly marketed the issue to a group of hedge funds playing local currencies in emerging markets globally," says Bob Fernandez, head of Russian fixed income at JP Morgan. "We have a team in London that is in contact with these people, which provides them with local currency opportunities around the world."

JP Morgan and the local lead manager, Web-Invest, structured the deal into three tranches, of one-year, three-year, and five-year maturities. Fernandez says the two shorter maturities were particularly popular with foreign investors.

Other big blue chip issues have also attracted foreign investor participation of around 50 percent, including Gazprom's RU5 billion three-year issue and Lukoil's Ru6 billion issue, both in November. "There will be other big issues," says Fernandez. "But they won't be aimed mainly at foreign investors. The main investors remain local banks. If foreign investors are there too, it helps, but issuers shouldn't rely on it. It depends how the currency does."

Dominant Role for Local Banks

Around 80 percent of outstanding ruble bonds are held by domestic banks, according to Rosbank, last year's top ruble bond lead manager. The dominance of banks in the investor base can be a big risk for the market, as last year's mini-banking crisis proved.

The crisis was caused by the clumsy introduction of a

THE SEARCH FOR YIELD LEADS TO CENTRAL AND EASTERN EUROPE

The low-rate environment for G8 government and investment-grade corporate debt has prompted many western banks, fund managers, and hedge funds to look to emerging markets for yield pick-up. This caused the longest bull run in emerging market debt history.

The week of March 9 was the best ever for emerging market funds, with the largest inflow since 1995, according to EmergingPortfolio.com Fund Research (EPFR), a fund tracking company based in Cambridge, Mass.

Local currency funds attracted the most capital of all the emerging market funds tracked by EPFR. "This suggests an asset allocation shift towards higher yielding local currency debt and away from dollar-denominated sovereign debt by European institutional investors," says Brad Durham, EPFR co-founder and research director.

Two fundamental shifts in investor behavior seem to be at work. First, emerging market debt is increasingly

a normal investment for pension funds and money managers. As a result, traditional emerging market funds and hedge funds are being forced to move a tier down, into local currency debt, to find pick-up.

"The shift to local currency debt is clear because everyone is hungry for yields," says Giancarlo Perasso, head of emerging market debt research at WestLB. "There isn't much yield left in classic Eurobond debt, as the majority of emerging market debt, at least in sovereigns, is investment grade. The more adventurous investors have made a lot of money in local currency debt."

Matthias Leonard-Lang at KTL, a Luxembourg-based asset manager, is one emerging market investor increasingly investing in local currency debt. "You get three sources of yield from the local currency play," he says. "You get higher return from the coupon. You get improving yields. And you get currency appreciation."

Rising values have been particular-

ly enticing for foreign investors in eastern European convergence currencies. For example, the Polish zloty appreciated by 14 percent against the dollar in 2004. The Romanian leu appreciated even more, and Leonard-Lang says he believes it will appreciate by between 8 percent and 15 percent this year as the Romanian central bank opens up its local debt markets to foreign investment.

The Ukrainian hryvna is also expected to come under strong appreciation pressure this year. That's the main reason foreign investors have flocked to Ukrainian local government bond auctions, with some reportedly 15-times oversubscribed.

"We're increasingly investing in local currency debt in both Ukraine and Russia," says Jerome Booth, chief strategist at Ashmore Investment, one of the largest European emerging market fund managers. "It's mainly because of the appreciation story," he says.



federal banking law that took away the licenses of banks that failed to meet certain Central Bank requirements by May 2004.

The reform led to the high-profile bankruptcies of Sodbiznesbank and Guta Bank, and to a panicked run on deposits at Alfa Bank, which saw withdrawals of \$400 million in two weeks. Banks hesitated to lend to each other because they didn't know who would fall next. The crisis "produced a serious outflow of funds from banks in the ruble bond market, which severely restricted liquidity," says Nikita Gusakov, head of international sales at Alfa Bank.

Construction companies like Inteco, SU155, and Glavmosstroy were also badly hit because they relied very heavily on bank financing and investors thought they might have difficulty refinancing loans. No construction company

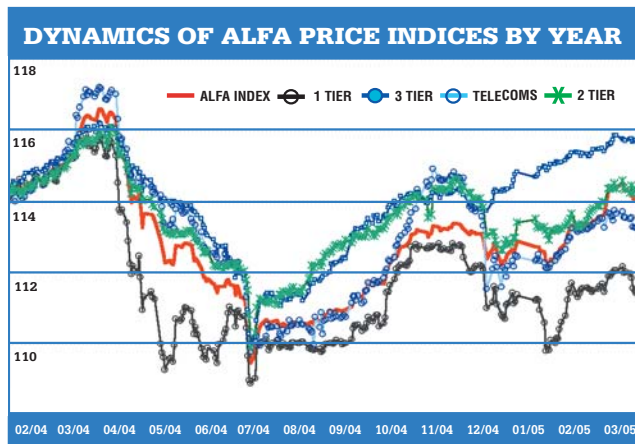
The market slowly began to recover in September. Ruble bond investors have become more serious about credit quality and more selective about which corporate bonds they buy.

debt was maturing at that point, but their financing plans remain hampered by investors' memories of that time. Spreads on first-tier and second-tier debt widened during the crisis because second-tier debt was so illiquid.

The market slowly began to recover in September. Ruble bond investors have become more serious about credit quality and more selective about which corporate bonds they buy. "It was the first time people seriously thought about the possibility of default in the market," Gusakov says.

Other risks remain for the ruble bond market. "There's no liquidity and very bad disclosure," says Fernandez of JP Morgan. "The market is not that well served in terms of research and credit ratings," agrees Alfa Bank's Gusakov. "The big blue chip issuers are rated, but the second-tier stocks generally aren't. They're not required to be."

Because of the increasing presence of foreign investors, the ruble bond market is also becoming more correlated with the Eurobond market and therefore more vulnerable to global swings in market sentiment. The connection was illustrated last month when both Russian Eurobond

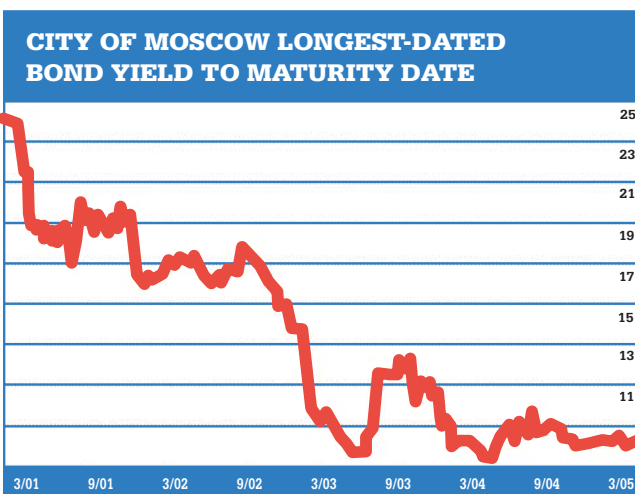


Source: Alfa Bank

benchmarks and ruble bond benchmarks lost around 60 basis points in a week.

The decline was sparked by fears that the U.S. Federal Reserve would hike interest rates, thereby reducing the attractiveness of emerging market debt. "The sell off in the ruble bond market was led by foreign banks," says Nikolai Podguzov, vice-president of fixed income research at Trust Investment Bank. "It mainly affected the larger, more liquid issues such as Gazprom and City of Moscow, where foreign investors are more present." The second tier of issuers, by contrast, was less volatile, and even tightened towards the first tier.

Whether the presence of foreign investors in the ruble bond market continues to grow depends on whether the ruble continues its appreciation. It is increasingly popular among emerging market investors and — with oil prices breaking records every month — the ruble bond market remains one of the most attractive local currency plays. ■



Source: Rosbank

City of Moscow: A Capital Investment

Moscow is booming. Its economy is growing far quicker than Russia's, and GDP per capita is \$10,000 — double that of the rest of the country. Unemployment is very low, the city rings with the noise of construction projects, and the streets are increasingly lined with glossy-windowed shops, the best restaurants in Eastern Europe, and even the occasional luxury fashion boutique, including Louis Vuitton and Jimmy Choo.



State Debt
Committee of the
City of Moscow

Its financial position makes the city of Moscow one of the most attractive issuers in the Russian debt market. Moscow in 2001 issued two Eurobonds in a month, making it the first issuer to come back to the market after the 1998 Russian debt crisis. "That's a sign of the respect in which we're held among foreign investors," says Sergey Pakhomov, Chairman of the State Debt Committee of the City of Moscow.

It is the only issuer besides the sovereign with an investment-grade debt rating — meaning it is rated better than state companies like Gazprom or Sberbank. Unlike many other Russian issuers, the city continued servicing its Eurobonds during the debt crisis and then decided to subject its debt management system to radical reform.

Sensible Debt Management

The city used to operate with a balance sheet separate from its debt management department. The debt department was also over-staffed and poorly regulated, and salaries were not linked to performance. Following the crisis, the city integrated its debt management system, reduced staff, and linked the salaries of the remaining employees to performance. It also tried to attract top people from the private sector.

Moscow Mayor Yuri Luzhkov made sure the city would not find itself in financial difficulties again. In a televised meeting, he demanded that the city hold debt to 33 percent of its

revenue. The city collects around \$14 billion in revenues every year, mainly from taxation, but also from the city's sizeable real estate holdings. It runs a deficit of around \$1 billion a year, financed mainly by borrowing.

Strong Credit and Appreciation

Under a federal law established in 2000 to prevent excessive borrowing, Russian regions are not allowed to increase their borrowing in Eurobond debt. That means that Moscow can refinance its Eurobond debt with new Eurobonds, but the lion's share of its debt is in ruble bonds, accounting for about 55 percent of the market's municipal section. "We feel limited by the federal law," says Pakhomov, arguing that Moscow's bonds crowd out other potential issuers. "We're clearly too big for the ruble bond market."

Yet for foreign investors, the city of Moscow's ruble issuance provides interesting exposure to a strong credit and ruble appreciation. "International investors have been buying quite actively, especially after we were given an investment grade rating by S&P this year." Foreign investors have been particularly active in the shorter end of the curve, Pakhomov says.

While the city might feel limited by being confined mainly to the ruble bond market, the market itself receives some benefits from the city's presence. The city, as opposed to the sovereign,

is taken as the benchmark for the whole market, and provides a lot of liquidity. It also pioneers techniques such as buy-back auctions, which it recently undertook for the first time.

It arguably offers an even better investment than the sovereign GKO market, because the GKO market is less liquid, and yields are artificially tightened because it is the only market in which the state pension fund invests.

The city's financial outlook looks rosy even though some uncertainty exists for all regions in Russia because of changes to the constitution's provisions for regional governors. Yet Pakhomov says Mayor Luzhkov will definitely serve until the end of his final term in 2007.

Regardless, the city now operates under firm debt guidelines that would survive any changes in personnel, Pakhomov says. ■



Sergey Pakhomov

Chairman for State
Debt Committee of
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