After being shut out of the international bond markets for more than three years, Russian issues are finally finding opportunities for issuance, and it has been a steep learning curve for both issuers and lead managers, with some successes — such as City of Moscow's trailblazing three year deal — and some failures — including a poorly timed bond from Rosneft. **Guy Norton** reviews a rollercoaster five months and looks ahead to a corporate pipeline that is already building again.

Finding the right pitch for Russia

At first glance Russian Eurobonds and London buses would seem to be strange bedfellows. But on closer examination a common theme emerges — you wait ages for one of them and then three come along at once. That's the situation that faced investors in the fourth quarter of 2001, when having been starved of any supply for more than three years, they very quickly found themselves faced with an embarrassment of riches. The result? A bad case of indigestion, which threatened to end a run of Russian Eurobond issuance before it had barely begun.

Luckily for ING and UBS Warburg, which were in the box seat for the icebreaking transaction for City of Moscow, there was no shortage of appetite for the first international bond from Russia since the country's financial crisis of August 1998.

Given its fierce determination to service all its external debt obligations on time and in full — Moscow's mayor Yuri Luzhkov made it a point of principle that the city's Eurobonds should be honoured — it was more than appropriate that Moscow was the first Russian issuer to reaccess the international bond markets. What's more, given the prudent investments made with the proceeds of its pre-1998 Eurobond issuance, Sergey Pakhomov, chairman of the Moscow municipal debt committee, was able to justifiably claim at the investor presentations in support of the issue that: "Moscow is the powerhouse spearheading Russia's revival."

The rating agencies agreed, with Fitch upgrading the city to B from B- and Moody's raising it to B2 from B3 in the run-up to launch. As a result, the borrower easily achieved its Eu300m issue size target for the three year deal. As well as benefiting from a favourable ratings backdrop, says Mike Elliff, head of emerging market debt origination at UBS Warburg in London, as the first ever euro denominated offering from Russia, Moscow's bond was "a transaction people felt they had to participate in". Consequently, the lead managers were able to price the deal at the midpoint of its 10.125%-10.375% yield range to give around 75bp over the sovereign curve. Although this was seen as relatively aggressive pricing at the time, there was no shortage of retail investors in particular keen to get hold of a high quality Russian offering with a 10%-plus coupon. As Andrew Dell, head of emerging market debt syndicate at ING in London, notes: "With this issue Moscow established the new parameters for access to the international bond markets by Russian credits."

An emerging markets health check.

Moscow's back with a new issue.

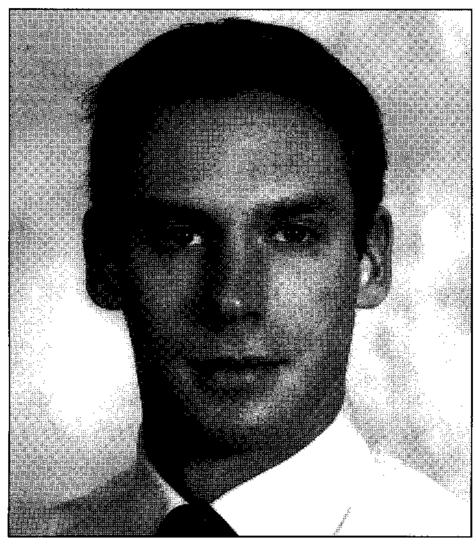
Wrong, wrong, wrong

If the City of Moscow's pioneering transaction marked the high point of the early run of Russian Eurobond issuance then the transaction that followed it — a $150m five year bond for Russian oil company Rosneft via ABN Amro and Dresdner Kleinwort Wasserstein — just as surely marked the low point. If Bruce Willis in the movie blockbuster *Die Hard 2* was 'the wrong man, in the wrong place, at the wrong time', Rosneft's issue was widely regarded by market participants as 'the wrong name, at the wrong price, at the wrong time'.

A relative minnow within the sea of Russian oil companies — Rosneft ranks just number eight — the state owned enterprise was viewed as an old-fashioned Soviet-era outfit, in contrast to its leaner, fitter private sector rivals such as Sibneft.

Certainly, the Rosneft management did themselves no favours with a series of stolid, Russian language presentations to investors, which one London-based fund manager describes acidly as "running a very poor second to watching paint dry in the entertainment stakes." And with the gloss rapidly coming off the oil story as fears of a global economic slowdown began to bite in November, ABN Amro and Dresdner Kleinwort Wasserstein faced an uphill struggle when trying to drum up demand. As a result, they were forced to slash the planned issue to $150m from $300m and even then had to print the deal with a 12.75% coupon to achieve that modest target.

By pricing the issue with a 13% launch yield the leads provoked immediate controversy, with rival bankers claiming that in giving Rosneft an overly cheap-looking 200bp premium over sovereign levels they had effectively stopped the new issue market for Russian corporates in its tracks. But Reid Payne, head of emerging market debt syndicate at ABN Amro in London, says that a sharp rally in the sovereign curve — the benchmark 2007 dollar Eurobond had tightened in from a yield of 10.95% to 10.06% during the marketing period for Rosneft — had made the issue look artificially cheap.



Mike Elliff, UBS Warburg: Moscow's euro denominated bond was a 'must have'

Nevertheless, the lacklustre reception to the Rosneft issue leads one rival banker to claim: "There's no irrational exuberance towards Russia — so there's no institutional demand for badly marketed issues."

In the wake of the Rosneft issue Sibneft shelved plans for a $250m year five year issue to be lead by ABN Amro and Citigroup/SSB, a decision that many saw as an indictment of the pricing on the Rosneft deal. Meanwhile, the City of Moscow returned to the euro market with a second offering: a Eu400m 4-1/2 year transaction via BNP Paribas, Dresdner Kleinwort Wasserstein, JP Morgan and Merrill Lynch.

Although Moscow's Pakhomov acknowledges that the city's two issues were launched too close together, unlike Sibneft the city did not have the luxury of being able to pick and choose when it could issue. Under legislation introduced after the August 1998 crisis, sub-federal issuers can only refinance external debt obligations in the years in which they mature. With Eu750m of redemptions in 2001, Moscow thus had to issue whenever a suitable opportunity arose. With four lead managers, the bond was viewed as cumbersome. But it was still a qualified success, attracting orders from over a 100 different accounts. "We struck a good balance between retail and institutional demand," says Jonathan Brown, head of emerging market debt syndicate at JP Morgan in London.

On the road

Barely had the initial troika of issues hit the market in November, than the cycle of potential issuance restarted, with roadshows for another trio of issuers: Gazprombank, steelmaker Magnitogorsk Metallurgical Kombinat (via Deutsche Bank) and mobile telephony operator MTS (via DrKW and ING). Thankfully, in a market already showing worrying signs of issuance fatigue only the strongest of the three issuers, Gazprombank and MTS, dared to issue before the Christmas break.

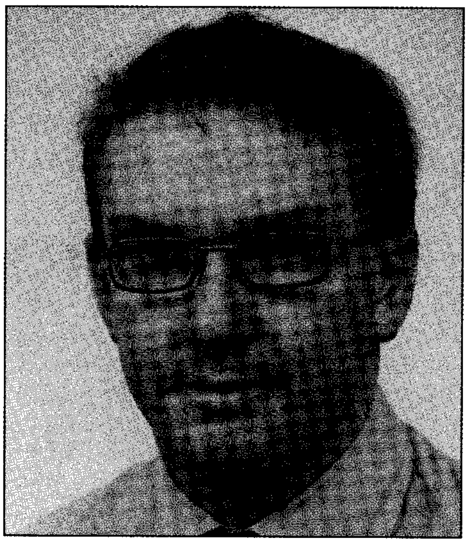
Given expected heavy corporate supply in dollars, Gazprombank wisely chose a Eu150m two year deal via Deutsche Bank and was rewarded with a strong investor reception, which enabled the lead to price the issue at the tight end of the 9.75%-10% indicated pricing range. Although belonging to Russia's maligned banking system, the credit was able to remind investors of its close association with Gazprom (which owns the bank, is its main client and is dependent on it for its cash management operations) and as a result managed to attract both institutional and retail investor accounts in France, Germany, Italy, Switzerland and the UK.

"A lot of Russian corporates have the ambition to be world-class names, which will facilitate global distribution of their bonds"

Also in December, MTS proved under the guidance of Dresdner Kleinwort Wasserstein and ING that the right Russian name with the right marketing can work successfully in the dollar bond markets. Described by ING's Dell as a "kickass credit", market leader MTS was the ideal story to present to any investors displaying signs of ennui towards Russian corporates after the disappointment of Rosneft. Despite being launched just before the Christmas holiday, a simultaneous US and European roadshow for MTS's $250m 10.95% three year issue did much to restore investor confidence in corporate Russia. "The MTS management team performed extremely well — they came across as being extremely professional and totally on top of their brief," says Dell at ING.

As a result, he adds, MTS was able to take maximum advantage of the growing sophistication of the corporate investor base for Russia, especially in Europe. "The level of corporate analysis has improved a lot on the back of the development of the high yield market in Europe in the course of the last five years. Five years ago a company like MTS could not have done a deal because of the lack of ability to analyse corporate credit."

Priced to yield 11.25% at launch, within the 10.5%-11.5% range indicated before launch, the Rule 144A, Registered Rights issue attracted a strong institutional following, with geographic distribution split 29% US, 29% UK, 9% France, 7% Germany and 7% elsewhere in Europe. Funds took 55% of the bonds, banks 40%, and the balance was snapped up by retail. "The MTS issue showed that there's strong fundamental demand for Russian corporates," says Dermot Mayes, global head of emerging debt capital markets at DrKW in London.


Dermot Mayes, DrKW: "MTS showed there is strong demand for corporates"

In the glow of the Gazprombank and MTS issues the year ended on a high note, which helped to dispel some of the concerns surrounding the Rosneft issue. Moscow even managed to get a Eu50m tap of its 2004 bond away, thus completing its Eu750m target for 2001.

At the beginning of this year the debt default by Argentina over the Christmas period initially threatened to stymie the Eurobond issuance plans of Russian corporates as investors showed signs of becoming more risk averse. However, economic news out of Russia continued to be positive, with the result that even a potentially tricky credit, steel company Magnitogorsk Metallurgical Kombinat (MMK), was able to access the markets, with a Eu100m three year bond via Deutsche Bank.

Although the company had originally planned to launch a larger and longer dated dollar issue, volatility in the dollar market at the start of the year provoked a switch to the euro market. On the back of its eye-catching 10% coupon, the issue attracted a strong bid from Italian and German retail accounts. It also received a sizeable bid from accounts in Russia, which came in for around 20% of the bonds at the primary market stage.

"We know the company well and are comfortable with its financials," says Sergei Sidorov, head of fixed income at Russian investment bank Nikoil. "We sold bonds to small and medium-sized banks looking for assets to hedge their euro exposure."

The Ba3/B rated company had a strong credit story to tell — it has turned its earnings around in the past two years, thanks to the boom in domestic construction.

Sibneft joins the party

Shortly after MMK hit the markets, oil company Sibneft took the plunge with a revised version of the $250m three year issue it had pulled in enough demand at launch. In the end the company launched a $250m five year issue via Citigroup/SSSB, ABN Amro having being dropped from the bookrunning group.

Featuring a coupon of 11.5%, the deal was priced to yield 721bp over Treasuries, or around 190bp over the Russian sovereign curve — roughly the same pick-up as Rosneft.

Ironically, the Sibneft issue was helped by the preceding Rosneft bond, which was performing well after its difficult launch, helped by the sense of crisis in the Middle East which has buoyed oil prices. From a yield of 13% at launch, the Rosneft deal had rallied in to 12.35% by the time the Sibneft issue hit the market. Citigroup/SSSB reported a total book of $400m, with 30% of the bonds going to US offshore, 25% to the UK, 20% to Russia and the balance to Germany and Austria. Demand by investor type was 70% asset managers, 20% banks and 10% retail.

Sustained interest from the same accounts that brought the original issue meant that Citigroup was able to launch a $150m tap of the Sibneft issue in early March, with the threat of military action against Iraq helping to boost investor appetite for Russian oil plays. Positive investor sentiment towards Russia in general also enabled DrKW and ING to increase their MTS transaction by $50m in March.

Expanding corporate pipeline

By early April, the Russian corporate Eurobond bandwagon had started to roll again, with JP Morgan and UBS Warburg roadshowing a $150m-$200m three to five year deal for mobile telco VimpelCom and Credit Suisse First Boston and Citigroup/SSSB hosting investor presentations for a benchmark $500m five to seven year transaction for Gazprom. As Rafael Biosse duPlain, co-head of emerging market origination at Citigroup/SSSB, tells *EuroWeek*: "Every time we talk to the market about Russian corporates we see new names interested in buying them. As a result we expect to see an increase in the size, maturity and distribution of Russian corporate Eurobonds — a lot of Russian corporates have the ambition to be world-class names, which will facilitate global distribution of their bonds."

At the moment the primary investor base for corporate Russia remains dedicated emerging market players, but over time Biosse duPlain believes the spectrum of accounts will widen to include generalist global bond funds and specialist industrial sector asset managers.

He warns, however, that potential issuers need to be fully prepared if they are to be successful. "Companies need to have the right management and business strategy in place, and they need to be able to deal with the press and investor relations." ☐