Eastern Europe Fixed Income: Weekly Overview

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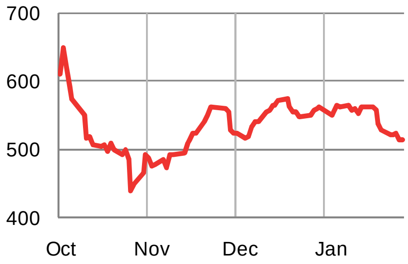
- **The region's Eurobond market[*] grew 1.5% during the week. Russia's and Kazakhstan's Eurobond markets advanced by 1.1% and 1.5%, respectively, while Ukraine continued to outperform delivering 2.3% growth (Trust indices)**
- **Russia's macro pulse still remained rather healthy at the end of year, while it might continue to moderate in 1Q12**
- **In 2011, Russian banking sector's aggregate loan portfolio expanded by 28% and deposits grew by 24%**
- **Poland and Lithuania both successfully placed 10-year Eurobonds in USD**
- **Kazakhstan's regulator released credit-neutral banking sector results**
- **Corporate news: Promsvyazbank, Evraz, BTA, MHP**

Average market* spread



Source: JP Morgan

Spread last week:
-16bp to 514bp

Yield last week:
-28bp to 6.4%

General news

During the previous week the Federal State Statistics Service reported various Russia's macro performance indicators for December and the whole of 2011. Among other data, industrial production demonstrated the weakest performance as it advanced only by 0.1% m/m on a seasonally-adjusted basis and grew 4.7% y/y in 2011 (+8.2% in 2010), which was below the consensus estimated 5.0%. Investment activity continued its recovery after a sluggish start in 2011 and delivered a 6.2% y/y growth over 2011 (+6.0% in 2010). Monthly data on demand side was more upbeat, as retail sales grew by 9.5% y/y in December and were up 7.2% y/y during 2011 (+6.3% in 2010). However, it seems that the pickup in spending was mostly financed through credit growth, as real wages increased only moderately: +4.9% y/y in December and +3.5% in 2011 (+5.2% in 2010). Positively, unemployment rate dropped to 6.1% at the end of the year from 6.3% in November. All in all, Russia's macro pulse still remained rather healthy at the end year, while we expect it will continue to slow in 1Q12.

In December, Russia's banking sector loan portfolio growth decelerated to +2.1% m/m compared to 2.9% m/m growth in November. In 2011, the sector's aggregate loan portfolio expanded by remarkable 28%. As in previous years, deposit growth intensified at the end of the year and reached 4.9% m/m growth in December and delivered +24% y/y in 2011. Loan portfolio quality continued to improve for the second consecutive month – the share of overdue loans dropped to 4.8% from 5.0% in November. According to the CBR, total profits of Russia's banking sector in 2011 increased by 48% y/y to RUB 850bn (or roughly USD 29bn). We stick to our view that loan portfolio growth could shrink to mid-teens in 2012 amid the expectedly slower growth of the economy this year.

During the previous week, two neighbouring countries Poland and Lithuania successfully made use of the window of opportunity to borrow on Eurobond markets. Poland (composite rating A-) tapped its outstanding 10-year USD-denominated bond by $1bn, while investors' demand hit $4.8bn. The paper was priced 295bp over US treasury or at a yield of 4.9%. Lithuania (composite rating BBB) issued a new 10-year bond worth $1.5bn. The bond was priced at a yield of 6.75% or 125bp lower than initially planned. The majority of bond proceeds will be used to redeem the EUR 1bn ($1.3bn) bond due in May.

Committee on Financial Control and Supervision of Kazakhstan (AFN) released banking sector results for December. Loan books advanced by 2.8% m/m, while deposits slightly increased by 1.2%, resulting in the overall increase of the loan-to-deposit ratio by 2% m/m to 87%. The share of liquid assets in banking sector shrunk by 1% m/m to 20.8% based on our calculations, while asset quality measured by overdue loans slightly improved as NPLs dropped by 0.4% m/m to 30.6% of total loans, although provisioning level worsened by 0.6% m/m as well, resulting in a slight reduction of NPL coverage ratio to 104.4%. In our view, the overall results are credit-neutral as slight improvements in the deposit inflow and profitability side of the banks were offset by the still excessive burden of non-performing loans. Among separate issuers, Halyk bank outperformed the market retaining high liquidity cushion and reporting a deposit growth of 5.1% m/m, while loans advanced 6.4% m/m.

[*] 50% EMBI Global Diversified Europe region and 50% CEMBI Diversified Europe region

Corporate news

During last week, news regarding shareholder changes in two Russia's banks appeared. First, Germany's Commerzbank revealed its plans to sell its 14.4% stake in Promsvyazbank to the current majority shareholders brothers Ananievs. As a result, brothers will control over 88% of the bank's capital with the remaining share held by EBRD. In general, the news is slightly negative, as previously Commerzbank and EBRD jointly held a blocking stake in the bank's capital. We continue to perceive Promsvyazbank's Eurobonds as unattractive. Second, Mikhail Prokhorov's ONEXIM Group announced plans to acquire a 30% share in Commercial bank "Renaissance Capital". In general, this is positive news for the bank's credit quality as Mr.Prokhorov is deemed to be an investor with a strong ability to support the bank. Currently, the bank's sole Eurobond maturing in April'13 trades at a yield of 12% and seems attractive for risk-loving investors, in our view.

Rating agency Moody's at the end of previous week upgraded credit ratings of Russia's steelmaker Evraz. The corporate family rating was upgraded by one notch to Ba3 from B1, while rating on the company's Eurobonds was lifted to B1 from B2. According to Moody's, Evraz's Eurobonds are structurally subordinated to the company's other obligations, as some of other obligations are secured. The company's ratings outlook was changed to stable from positive. Moody's cited improving Evraz's financial metrics over the last two years that has led to a steady debt reduction. Currently, Evraz's Eurobonds (except at the long-end of the curve) trade in line with Severstal's Eurobonds, hence we prefer the latter's due to its better credit quality.

Kazakhstan's BTA bank published a presentation to creditors following the failed General Shareholder meeting on January 26. Although none of the amendments were approved at the EGM, bank still emphasizes the restructuring under Kazakhstan's law as the only viable solution and assumes the lack of active participation of GDR holders in the meeting to be the critical reason for rejecting the proposed resolutions. Since mid-November 2011 BTA has experienced deposit outflow from legal entities (around $11m a day) and the capital shortfall reached $3.9bn in 2011E. The planned submission of the approved restructuring plan to the Regulator is set for the summer of 2012, although the cumbersome process required for the formation of a Steering Committee poses a risk of prolonging the process. The likely impairment of the Bank's investments in subsidiaries and high operating expenses are expected to lead to a further deterioration of capital shortfall to $4.5-5bn in 2012E aggravating creditor debt restructuring perspectives.

MHP, the vertically integrated poultry producer in Ukraine, released production plans for 2012 and operating results for 4Q11. Poultry sales volumes to third parties dropped 11% q/q, which was partly offset by a 5.6% q/q growth of net price. The company plans to increase production by mere 2.6% in 2012, while an exponential growth of 15% is expected in the upcoming years based on previous announcements. The first line of the CAPEX-intensive Vinnytsia project is expected to be launched in test mode contributing just 4% to production output in 2012. Although production results are in line with the previous forecasts, the ability of the company to generate sufficient free cash flow for debt payment remains uncertain, which may lead to a need of refinancing. In our view, this risk is not sufficiently priced in MHP's Eurobonds at the moment.