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Eastern Europe Fixed Income: Weekly Overview

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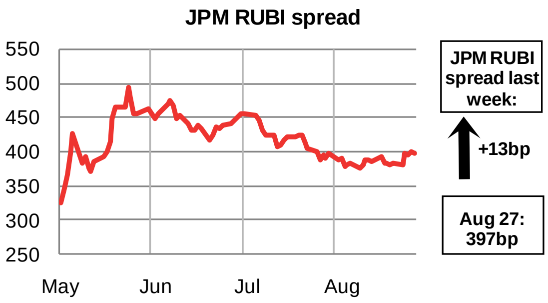
- **Russia's fixed income market lost 0.95% during the week, while spreads widened by 13bp (JPM RUBI)**
- **Metals & mining was the only sector with positive performance within the RUBI Index**
- **Ukraine was flat, while Kazakhstan dropped in line with Russia (TDI indices)**
- **The Economy Ministry of Russia improves GDP growth forecasts for 2011-2013**
- **Naftogaz to settle gas dispute with its former gas trading intermediary RosUkrEnergo**



- **Corporate news: EuroChem, Alliance Oil, Sberbank, MTS, BCC, KKB, Avangard**
- **Our positive view of the market for Q3 at the start of previous month has proven correct. Many security prices are already at their all-time highs and in our opinion correction risks once market participants return from beaches to their trading desks are increasing. We thus suggest more conservative approach to investing in Eastern European debt over near term, while over medium-to-longer-term we are still positive**

General news

Deputy of the Minister of Economics of Russia revealed that seasonally adjusted GDP in July dropped by 0.3% m/m, thus affirming weakening recovery trend of the country's economy. Nevertheless, the Ministry has just updated its macro forecasts for the next three years, where GDP growth for 2011 was improved to 4.2% from previous estimate of 3.4% and for 2012 to +3.9% from 3.5%. However accelerated inflation is expected to return earlier, thus forecasts for 2010 was revised from 6-7% to 7-7.5% and for 2011 from 5.5-6.5% to 6-7%.

Naftogaz finally developed a scheme to settle its gas dispute with the former gas trading intermediary RosUkrEnergo (RUE). As a result of the scheme, Naftogaz will secure gas supplies for the heating season, while RUE (50/50 owned by Gazprom and local oligarch Dmitry Firtash) will book a profit of around $900m. In our view, the news that Naftogaz is opting to respect the ruling by Stockholm Arbitration Court is positive for the company's eurobonds and Ukrainian eurobond market in general. Naftogaz is likely to receive another equity injection by the State to make the necessary payments to RUE, thus we believe the news is neutral for Naftogaz eurobonds.

Corporate news

During the previous week a reporting season of second quarter 2010 financial results started in CIS. On Monday, Russia's fertilizer manufacturer EuroChem released credit-neutral 1H10 financial results. Its top line and EBITDA increased by 24% and 26% y-o-y, respectively, amid higher selling prices and volumes. EuroChem's leverage, calculated as total debt to annualized 1H10 EBITDA, is moderate at 1.6x. Besides, recently the company has demonstrated good access to long-term debt markets as it secured two ECA-backed facilities, attracted $250m credit line from Nordea and issued ruble bonds, thus mitigating liquidity risks. Following results, yield of its Eurobond with maturity in 2012 increased by roughly 20bp or in line with the market. Overall, the bond seems slightly undervalued and currently we have a neutral view on it, as new Eurobond supply is possible, in our view.

On Tuesday, mid-size Russian oil producer, Alliance Oil Company published weaker than expected 1H10 financial results. The company's revenues jumped by almost 50% y-o-y, while EBITDA increased by just 2% y-o-y. Alliance Oil Company's diminishing profitability was one-off due to 50-day planned maintenance works at its Khabarovsk refinery, since the company was forced to buy gasoline from third parties at market prices. According to the management, next planned works are scheduled for 4Q10, thus implying relatively stronger 3Q10. Due to the ongoing modernization of Khabarovsk refinery and upstream investments, the company's leverage is increasing and at the end of 1H10 reached 2.4x (total debt/LTM EBITDA) and 1.6x (net debt/LTM EBITDA). Moreover, after the reporting date it finally signed $760m long-term loan from VEB and placed $165m equivalent of ruble bonds. Hence, it has practically safeguarded all required funds for its long-term CAPEX programme, however, as a result its total debt in 2011-2012 could peak even above 4-times EBITDA. In our view, the company's Eurobond with maturity in 2015 lacks short-term catalyst for growth, while it is attractive for medium term hold due to high yield (8.8%) in absolute terms.

On Wednesday, Russia's largest bank Sberbank reported credit-neutral 1H10 financial results, despite the fact that it slightly missed consensus earnings estimates due to tighter margins on corporate loans. In 1H10 the bank's gross loan portfolio remained almost flat, as corporate loan portfolio shrunk by 1%, while retail portfolio advanced by 2.9%. At the same time, NPLs increased to 9.1% from 8.5%, while provisions continued to move up and reached 12.5% from 10.7% of gross portfolio, as the bank's management remains rather cautious on further asset quality dynamics. Sberbank has experienced rapid retail deposit inflow, thus its loan-to-deposit ratio has dropped to 81% at the end of 1H10. Hence, it enjoys healthy liquidity profile and good capitalization with CAR of 17.3% at the end of 1H10, even though it repaid RUB 200bn subordinated debt to the CBR before maturity. Among Eurobonds issued by quasi-sovereign Russian banks we still prefer VTB'18 (put option in 2013) and VTB'35 (put option in 2015).

On Thursday, Russian leading mobile operator MTS issued solid 1H10 financial results. The group's revenues increased by 19% y-o-y and EBITDA rose by 16% y-o-y. According to the management, MTS leverage (total debt/LTM OIBDA) dropped to 1.5x at the end of 1H10 from 1.9x FY09, while net debt/OIBDA went even below 1x from 1.3x. Overall, the recent results affirm the strong credit quality of MTS, which is also appreciated by its lender Sberbank, which earlier in the previous week reduced interest rates on its loans to MTS. Nevertheless, MTS Eurobonds currently seem overvalued and are not attractive, in our view.

During the previous week two Kazakh banking issuers presented unaudited IFRS reports for 2Q10 – Bank CenterCredit (BCC) and Kazkommertsbank (KKB). Results of BCC brought nothing new to the table: overliquidity is squeezing bank's margins. Cash was 16% of assets, while cash and investment portfolio (mostly Kazakh government bonds) was 43% of assets – excellent figures for the bondholders. The negative side of overliquidity is bank's falling margins – BCC's net interest margin (NIM) continued to fall reaching 1.5% and profit for the quarter was near zero. The bank deleveraged to "sustainable lending" level with Loans/Deposits of 89%. Asset quality was in line with previous regulatory figures, remaining best in the industry, although cash collection hinted at the ongoing loan portfolio restructuring. On the other hand, capital adequacy of 25% largely solves near-term provisioning problem. In our view, BCC bonds remain the "best buy" in Kazakh banking universe.

KKB in many respects is an antipode of BCC. Liquidity at KKB deteriorated in 2Q10 with cash to assets ratio dropping to 2.7% and cash and investment portfolio decreasing to 8.9% of total assets. On the positive side, during the second quarter the bank has been repurchasing debt with total debt redeemed at around $300m or 1.9% of total assets. Despite its debt repurchases, bank's Loans/Deposits ratio remained at an elevated level of 155% (moreover, a large share of deposits is due to State-owned entities). The bank increased provisioning to 20.3%, as, according to regulatory figures, its asset quality continues to deteriorate, while capital adequacy is at a comfortable 20.6%. To sum up, in our view there is a good reason for KKB bonds to be trading 200bp above BCC and ATF, thus we currently find them fairly priced.

Ukraine's largest chicken egg producer Avangard plans to issue $200-250m eurobonds to redeem short-term debt and invest in CAPEX. The company, which controls 40% of Ukrainian chicken egg market, has not yet finalized the mandate. Meanwhile, Fitch assigned B credit rating to Avangard after the company conducted a successful London IPO this May. The company's best peer is MHP. Avangard is slightly smaller than MHP, but has a much lower leverage: Total Debt/ LTM EBITDA of 1.6x compared to MHP's 2.7x. Moreover, almost the entire debt of Avangard is UAH denominated, while MHP has a heavy currency mismatch on its balance sheet due to large FX borrowings. We believe the company can be successful in its placement plans and could place its bonds around MHP's levels. To note, both companies are expected to suffer margin contraction due to this year's poor grains harvest.

Our strategy

Our positive view of the market for Q3 at the start of previous month has proved correct. From the current price levels, however, we think the positive fundamental factors that continue to support Eastern European debt are being increasingly balanced by the more worrying technical factors. While the secular deflationary trends globally continue and further monetary stimuli can be expected, many security prices are already at their all-time highs and in our opinion correction risks once market participants return from beaches to their trading desks are increasing. We thus suggest more conservative approach to investing in Eastern European debt over near term, while over medium-to-longer-term we are still positive.