Azerbaijan Bond Market

15.06.2016

Pasha Bank: Introduction

Pasha Bank is the largest corporate bank in Azerbaijan with about **US$ 1,500 mln** in assets, and more than **US$ 300 mln** of shareholders equity.

The Bank provides wide range of banking services targeting mostly corporate and HNWI segments: from general banking services to brokerage, underwriting, M&A advisory, investment management and investment advisory, Islamic finance, etc.

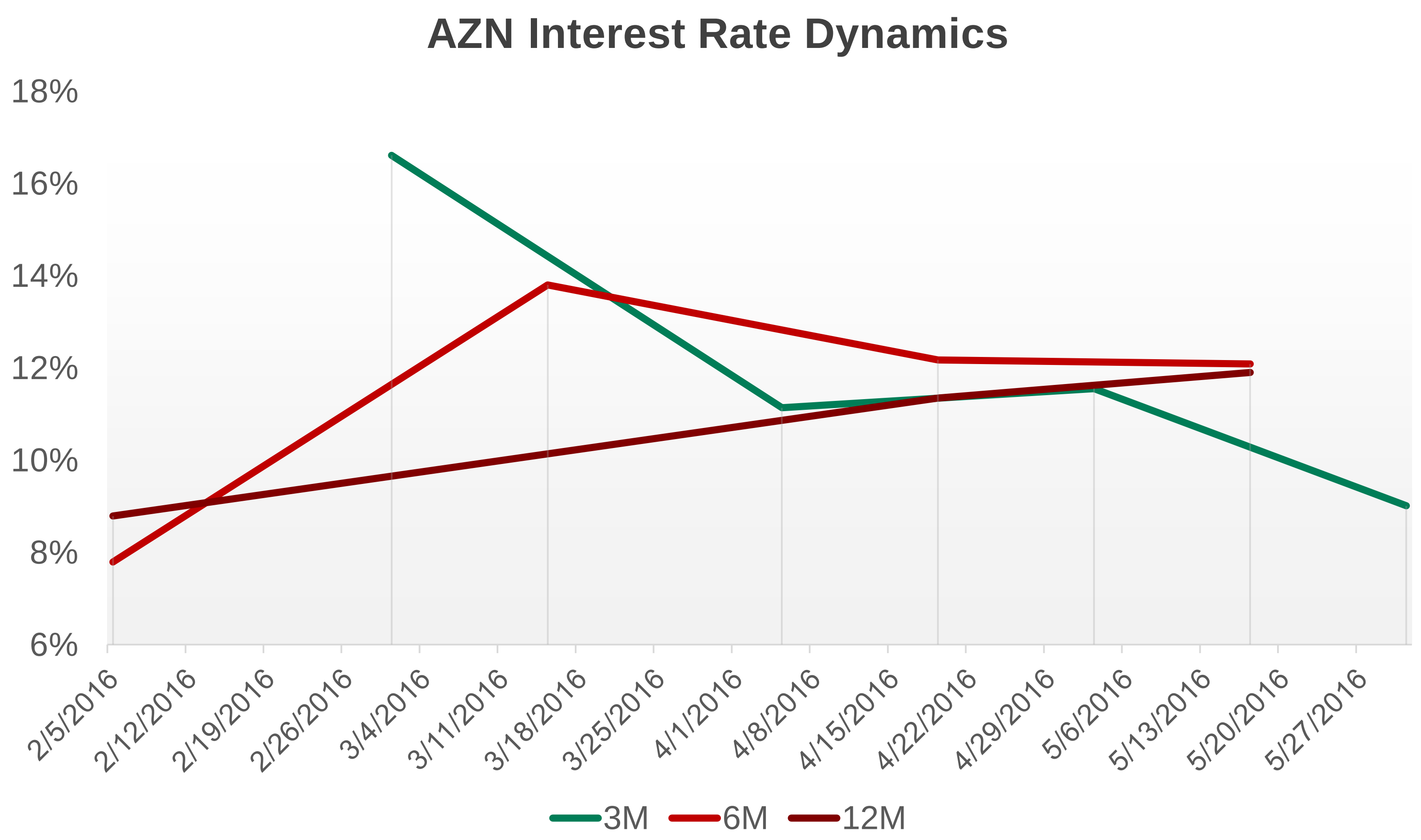
The Bank and its subsidiaries is the leader on the local bond market, underwriting virtually **all significant local placements** (both in AZN and USD).

Nearly **100%** of all the bond placements this year were carried out by Pasha Bank this year.

The only issuer this year is the state government, which borrowed about AZN 150 mln equivalent (mostly AZN-denominated), which is about **US$ 100 mln**.

To compare this in nominal terms, the last monetary action by CBAR (Central Bank of Azerbaijan) this Monday (13th of June) collected about **AZN 130 mln** in 1 month notes.

Interest Rates and Macro Environment



Interest Rates and Macro Environment

Since the beginning of the year the short-term interest rates in AZN has dropped from about **16.5% to 9%** on the government borrowings, while CBAR's recent 1 month placement was priced at **6.5%**.

- As time passes since the last devaluation, and devaluation/inflation expectations ease interest rates are drifting towards 9-10% level.
- GDP continues **contraction** at about **4.5%**, even despite oil price bouncing back to US$ 50 / barrel.
- Inflation at about 10.5% level.

Despite shrinking oil revenues, the current state budget for this year is filled out with a **surplus** at about **4.2%** of GDP, mostly due to significant spending cuts at the beginning of this year.

This, however, will most likely reverse, as spending grows at much faster rate, while revenue is pretty stable, but at this point, it means that the government has very limited needs in local borrowing.

Since the beginning of the Y2016, local borrowings were about **2.8%** comparing the total budget spending.

Supply Side

- State government is the only issuer on the market since the beginning of the year.
- With low issuance volumes and budget surplus as of to-date it is more likely that the **real intention was** more to test the market, its appetite and technical abilities to absorb offered volumes.
- Potentially some large local private banks may follow the Ministry of Finance and test the market themselves with AZN 20-50 short-term placements.
- Liabilities side diversification is the other purpose for the banks to offer their bonds.

However, even with this potential revival of the corporate placements this year, we do not expect significant offerings, as most banks already have about **15-20%** of their balance sheets financed by other banks and financial companies.

At the same time, **20-40%** of their assets are also placed with other banks.

With very limited investment opportunities and balance sheet contraction, we see this liabilities rebalancing as quite limited too, at most about **AZN 260 mln (US$ 170 mln equivalent)** or up to 2.5% of the liabilities side of top 10 banks (ex IBAR).

Demand Side

- Past years investors were enjoying double digit deposit interest rates in hard currencies, that makes them harder to accept the new reality.
- With falling US$ and AZN local rates and growing number of banks defaults, investors are seeking diversification out of the country, or at least corporate credit risk as a number one priority.
- Switching from AZN to US$ deposits, and diversifying the country risk together with repayment of the FX-denominated liabilities has recently reversed net foreign position **from US$ -2 bn to US$ +1.3 bn**.

Local practices of so-called ‘market-making’ which in fact was put option offered by the underwriter to the holder, had fueled even more short-term investment view and decision-making horizon, which is now one of the major drivers of the term structure of the bond market.

In addition to that, most of the institutional demand is coming from treasury departments rather than investment ones, which is also one of the main factors defining the term structure of the local fixed income market.

Challenges and Perspectives

Perspectives

- Attractive regulatory environment, low capital flows barriers allow investors relatively easily invest in local bond market. Some our clients have earned pretty good on the recent AZN rates decline.
- With local rates stabilizing at this point, more domestic corporate borrowers are willing to borrow, and will test the market.
- More investors are switching from pure deposits allocation into quality corporate and government bonds.

Challenges

- Short-term decision making and particular behavioral aspects will continue making the decisive influence on the market.
- Continuing balance sheet and economy contraction as well as other ‘external’ factors are mostly negatively influencing the market.
- Low yield environment is pushing investors pushes investors more into safer assets, at the same time significant part of investors is still looking for some premium and takes unjustified risk, with very few in the middle.

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