BCS GLOBAL MARKETS

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Corporate Ruble Bonds:

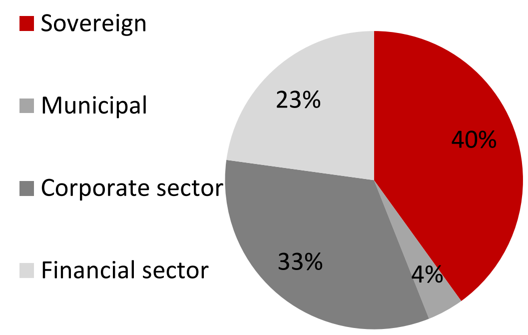
The ugly duckling of 2009 is not a beautiful swan yet

April 2017

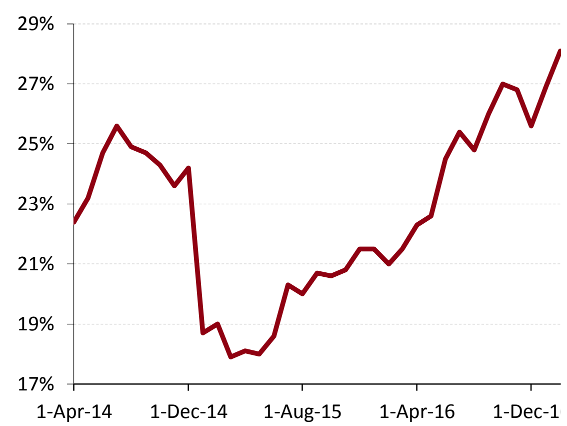
Local market remains attractive

- Total ruble bond market reached Rb16 tn (~$285 bn) as of Jan 2017 up from Rb2.6 tn (~$89 bn) in 2008. 40% is government OFZ market.
- OFZ carry-trade and good liquidity (15-20bps spreads in the long end) brought foreign share in OFZ to 28.1% in January. The foreign share increased from virtually zero in 2006 to 25% at end of 2013. There was a drop to 18% in first quarter of 2015.
- The credibility of CBR inflation targeting framework helps the investors in their Rb LCY portfolio allocations although key interest rate cut lags decrease in inflation
- Inflation in 2016 declined to 5.4% vs 13% in 2015. The inflation target for 2017 is set at 4%
- Inflation decelerated – March y/y inflation was down to 4.3% from 4.6%.

Structure of RUB bond Issuers



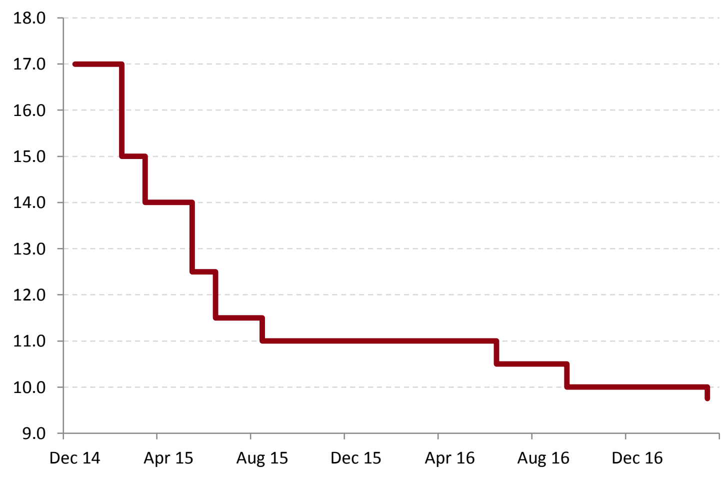
Share of foreign investors in OFZ



Source: BCS, IMF, Expert RA

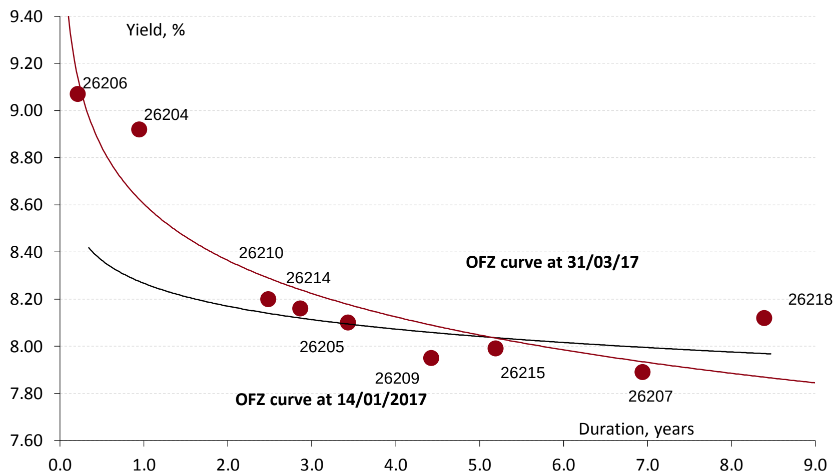
Real interest rates still high

Key rate evolution (%)



Source: CBR

OFZ yield curve



Source: MOEX

- Despite a decline of inflation in 2016, the key rate was only cut twice, declining by 100bp to 10%. In March 2017 CBR reduced the key rate further by 25 bp to 9.75%
- OFZ yields reflect a bet on an aggressive key rate decline
- Stable oil price and ruble appreciation increase attractiveness of the local market

Ruble non-sovereign bond market - local Banks remain key players

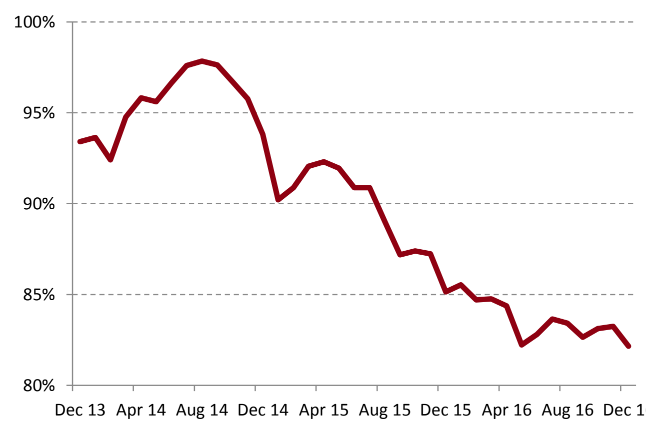
- The size of ruble non-sovereign bond market is significant Rb9.6 tn (~$171 bn) up from Rb1.47 tn (~$50 bn) in 2008.
- Crisis 2008-2009 brought a massive cleansing wave to ruble non-sovereign bond market and we saw the pick on defaults in 2009.
- Local corporate bonds are still dominated by local banks
- Excess of liquidity in the banking system
- The demand for traditional loans from the companies fell and the banks have refocused on ruble corporate bonds as a viable HY alternative
  - Primary market is a main source for buyers
  - Buy and hold strategy is doing just fine for banks
  - Preference is given to the local bonds that are part of Lombard List
  - Mark to market of ruble bond positions is not enforced in all cases by CBR and the bonds had a history of being reclassified as part of hold-to-maturity portfolio

The peak of defaults fell on 2009

	2008	2009	2010
Total Defaults Rb bn	34.3	148.7	68.3
Unrestructured Rb bn	23.1	77.6	51.7

Source: Expert RA

Loans to deposits ratio

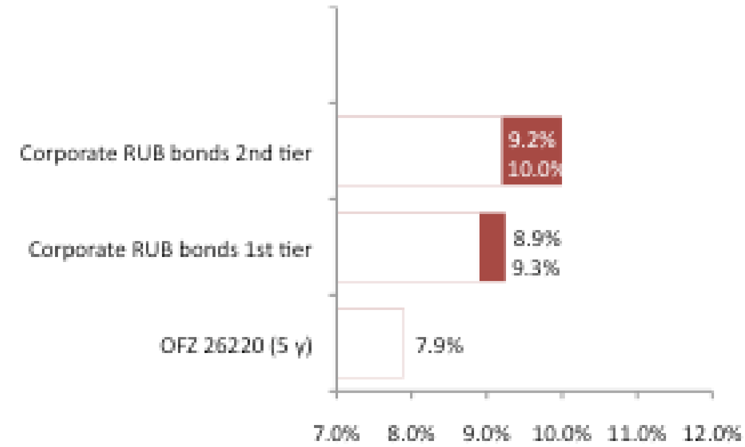


Source: CBR

Attractive spreads in ruble corporate bonds are not enough to lure international investors

- Ruble corporate bonds trade with a premium over government curve, but the liquidity remains limited
- Daily flow remains sporadic
- About Rb200-300mln is traded per day in a single paper in the 1st tier bonds and Rb100-200mln per day in a single paper in the 2nd tier bonds. Third tier bonds are even more illiquid
- To attract foreign investors the liquidity has to improve significantly
- The role of market makers should evolve to play more important role in the market liquidity
- Current requirements for market makers are negligible and hardly provide the liquidity

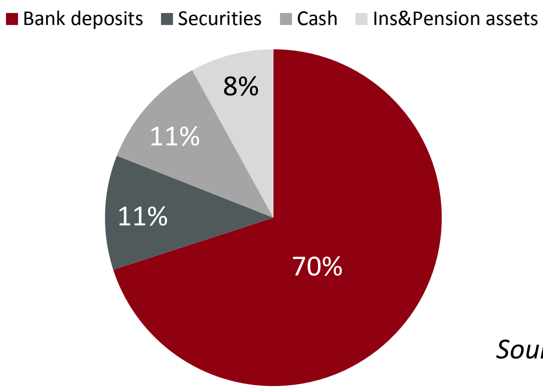
Ruble local currency bond yields (5-7 y)



Is there an alternative investor to the local bonds?

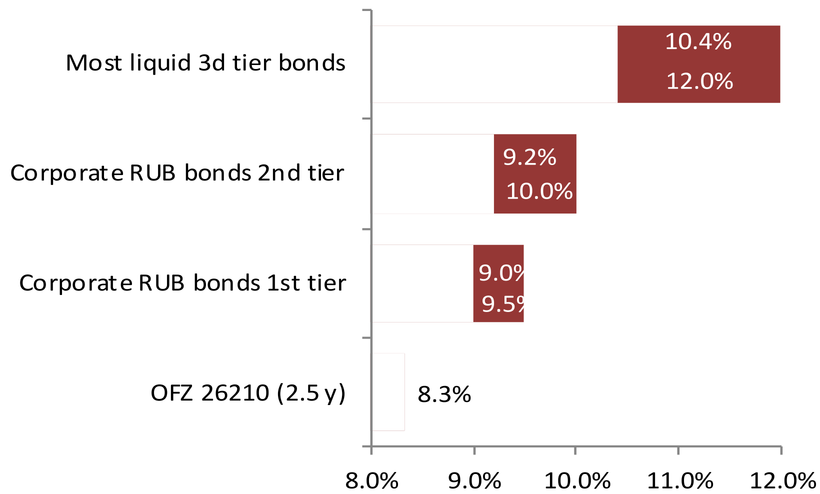
- Russian population still keeps 70% of savings in deposits, where income is tax free, but early termination leads to wavering interest
- As of 1 Mar 2017, the total number of Rb deposits of 1y and longer reached Rb 7.460 tn and Rb 3.7 tn in hard currency
- To stimulate Russian ruble corporate bond market the State Duma has adopted in the third reading a law to exempt coupon payments from ruble corporate bonds from individual income tax for the bonds issued in 2017- 2020
- $ Deposit rates keep falling and 1 year deposit rates are down from 2.3-2.5% to 1.0.1-.2%.
- Rb Deposit rates for 1.5-2 years are down to 7.5% - 8.0% (2-3% lower y/y)

Individuals' savings structure



Source: MOEX

Ruble local currency bond yields (1.5-2 y)



Selective ruble corporate high yield bonds where BCS Global Markets is a market maker

- Element Leasing is a universal leasing company
- Home Credit Finance - one of the top players in the consumer finance market in Europe
- PIK Group – one of the major developer, selling residential real estate with a focus on economy class in Moscow and Moscow Region
- Polyplast Group – the leader in the market of chemical additives for the construction and non-construction sectors with more than 15 years of track record

Issuer	Issuer rating	Issue size (mln Rb)	Coupon	PUT	YTP	Maturity
Element Leasing BO-3	S&P: B	2 000	14.50%	30.05.2017	14.50%	28.05.2019
HC Finance	Fitch: B+	1 500	13.50%	28.06.2018	12.30%	26.12.2019
PIK Group	S&P: B	13 000	13%	28.02.2020	11.44%	25.02.2022
Polyplast B003	NR	650	16%	11.05.2018	16.46%	05.11.2021

CONTACTS

New York

1270 Avenue of the Americas
New York, NY 10020

Phone: +1 212 421 7500
www.bcsgm.com

London

Tower 42
25 Old Broad Street
London, EC2N 1HQ , UK

Phone: +44 207 065 2020
London@bcsgm.com

Moscow

69 bld. 1, Prospect Mira
Moscow, 129110, Russia

Phone: +7 495 785 7476
Moscow@bcsprime.com