Advantages and Disadvantages of the Local Ruble Bond Market

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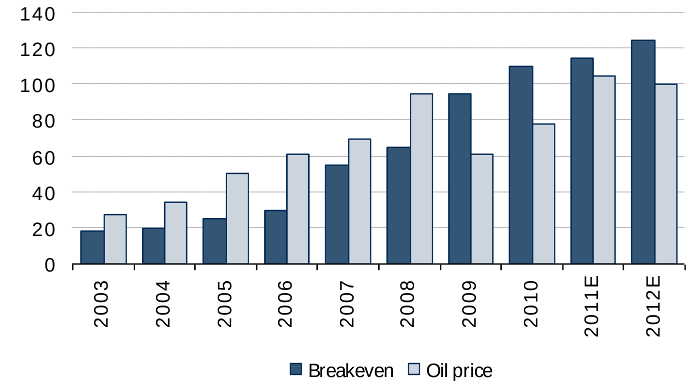
Russia is looking for new money

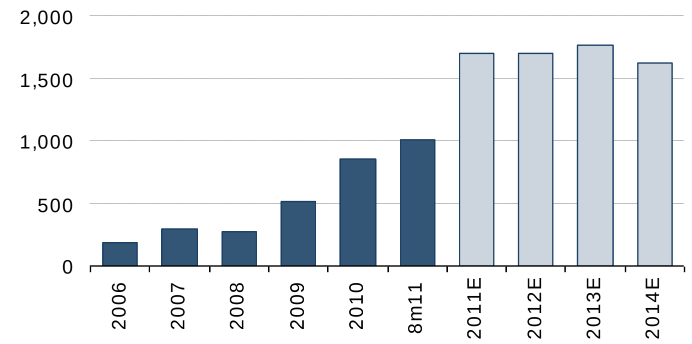
- **Budget deficit for 2012 set at 2.7% of GDP** (projections for 2013 and 2014 are 2.7% and 2.3%, respectively) versus less than about 0.5% this year. The main expenditures are military (up 20.5% y-o-y), state security (up 37.2% y-o-y) and social outlays (up 20.4% y-o-y), while spending for the national economy is decreasing, in contrast to previous years.
- **Authorities plan to increase State Reserve Fund by R164 bln in 2012 and R51 bln in 2013** (versus R750 bln this year).
- **The breakeven oil price for 2012 will be about $120-130/bbl Urals**, while all revenues are calculated on the assumption of $93/bbl.
- **Russia plans to finance deficit with help of borrowing (about R1.6 trln annually in net terms)** and privatization (R300 bln annually). The Sovereign debt/GDP ratio will grow from 11.2% in 2012 to 17% in 2014. Domestic debt is considered the main source of funding. To increase potential demand, the authorities have decided to open the local bond market for foreigners.

Breakeven oil price, $/bbl



Source: Troika

Sovereign ruble issuance, R bln*



* for 2012-14 official projections, assuming the placement of hard currency Eurobonds worth up to $10 bln annually

Source: Troika

Local ruble bonds to be settled via Euroclear

- **Changes in legislation.** The first is in granting foreign depositaries access to the domestic financial market. This assumes that international clearing systems will have the opportunity to open nominee accounts in Russian settlement entities. Therefore, international investors will automatically have the opportunity to trade, via Euroclear or CEDEL, all types of securities (bonds and stocks). But this is not enough to start properly trading ruble Sovereigns, which requires other regulatory amendments.

- **OTC trading for local Ruble Sovereigns.** The second necessary change is the start of proper OTC settlement for OFZs. At the moment, only trading on MICEX on a separate floor is allowed for domestic ruble Sovereigns.

- **Taxation.** We do not rule out the possibility that the Russian authorities will also consider unifying taxation for ruble corporate and Sovereign bonds, which would ease accounting problems for investors.

- **Bylaws.** Completion of the legal part of the process will require various regulators to adopt bylaws (in addition to amendments made at the legislative level). Of course, regulation on this level might be done in a way that essentially kills its purpose, but we believe the chances for proper implementation are high.

- **Timing**. Legislative changes to be made in autumn, trading via Euroclear/CEDEL to start by year end or early 2012.

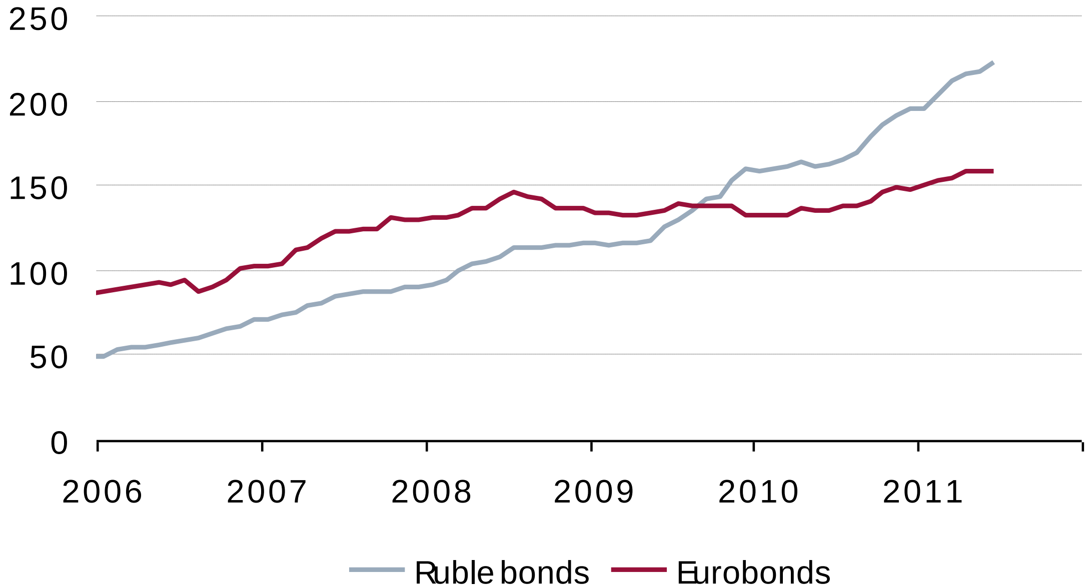
Advantages and disadvantages

Local ruble bond market – advantages	**Local ruble bond market – disadvantages**
Large number of issuers (367 borrowers versus 92 on the Eurobond market).	**Credit spreads over the Sovereign yield curve are tighter** on the domestic market
Certain names (such as investment-grade Federal Grid Company or the State Mortgage Agency) are only available on the local market.	**All local bonds are issued under Russian law**. The protection of investors' rights is weaker.
Full-fledged yield curve is available on the local market, while the only option on the Eurobond market is the Russia 18 RUB.	**No covenants**. The bulk of local prospectuses contain no covenants.
Liquidity. The local bond market is very liquid, and it is supported by CBR repo.	**A lot of unrated issuers**, especially in the second and third tiers.
Active primary market, the volume of placements was $36 bln in 1H11.	

Bond market features

	Domestic ruble bonds		Eurobonds	
	Sovereign**	Corporate	Sovereign	Corporate*
Number of issuers	1	367	1	90
Number of issues	39	778	6	208
Amount outstanding, $ bln	109.1	119.9	35.9	117.5

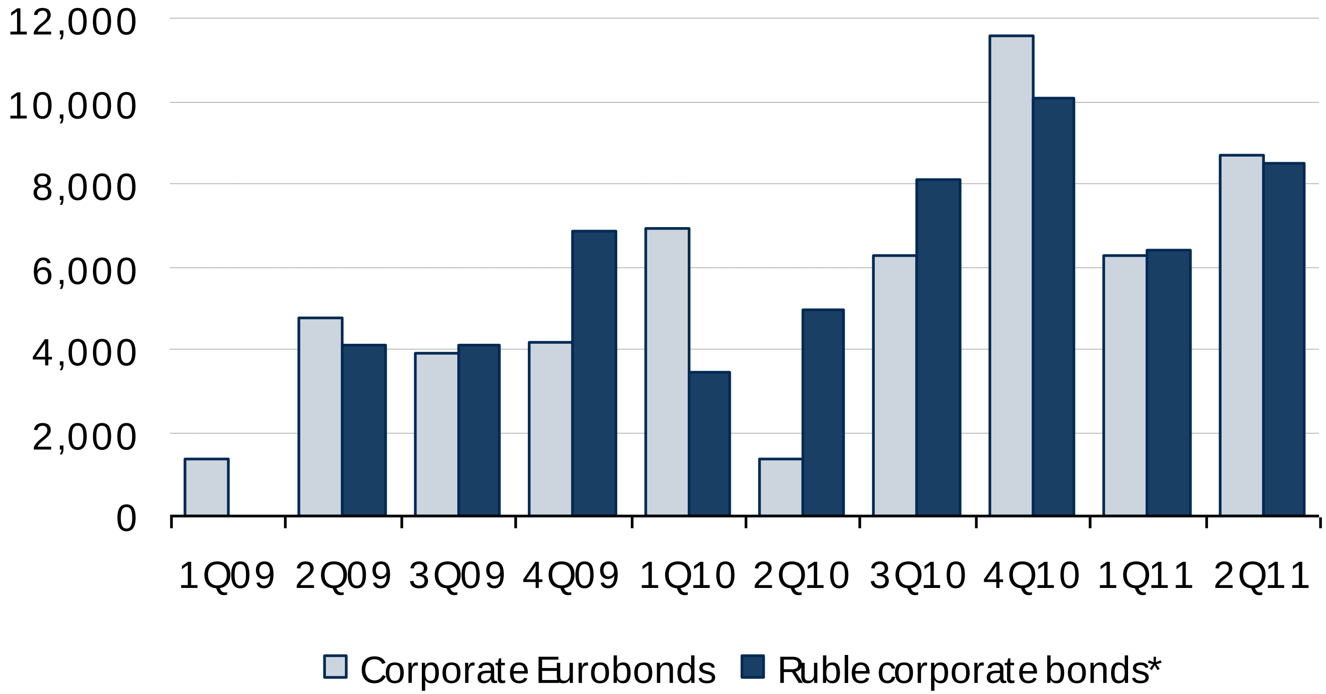
Market volumes, $ bln



* excluding ABS, CDO and convertibles
** excluding non-tradable GSOs
Note: As of July 15.

Source: Troika

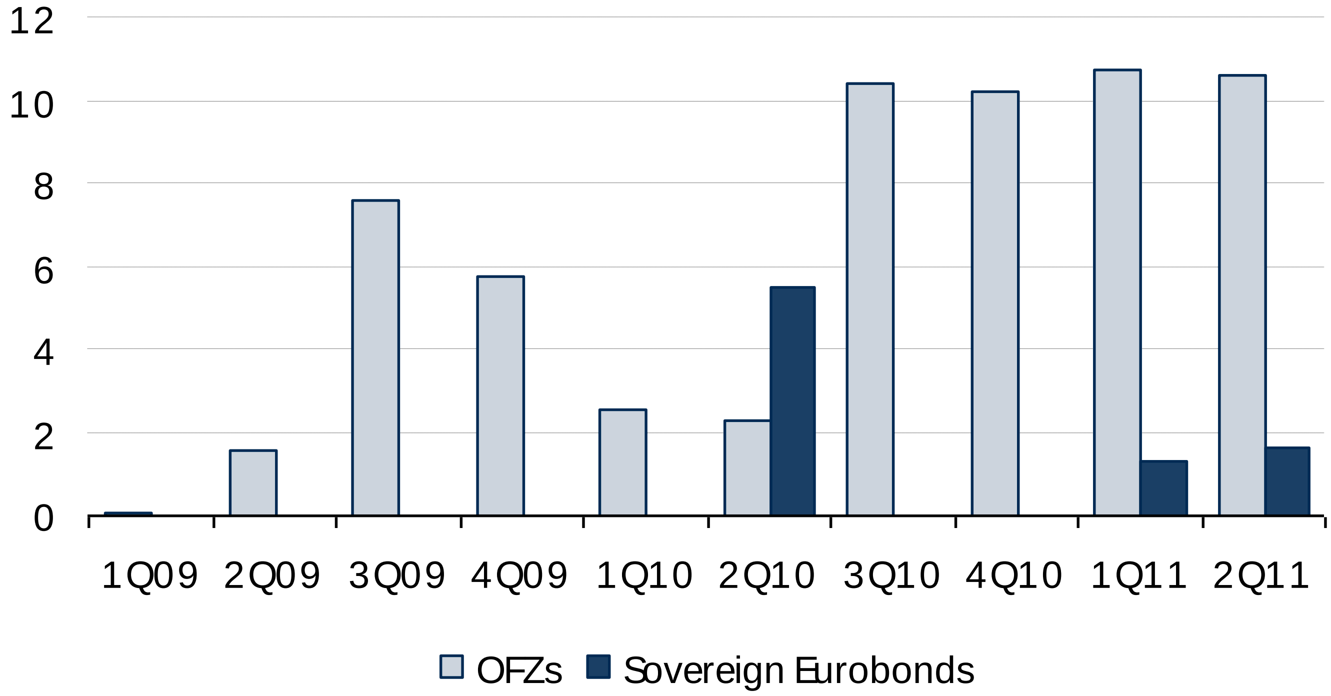
Corporate bond primary placements, $ mln



* excluding technical issues

Source: Troika

Sovereign primary placements, $ bln



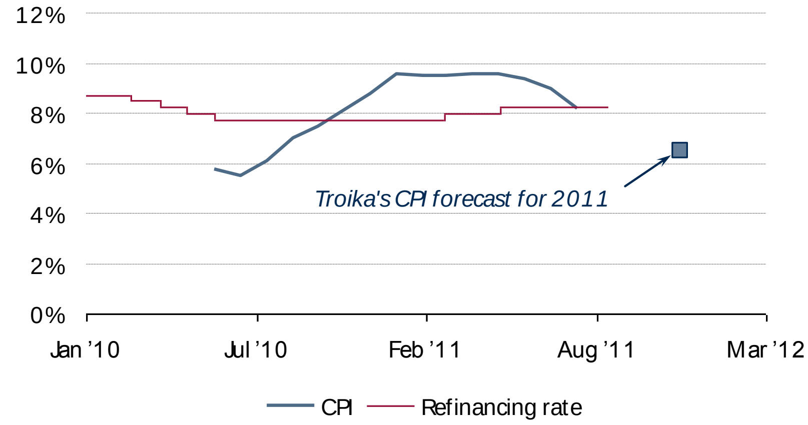
Source: Finance Ministry

Consequences for the local bond market

- **Sensitivity to external factors.** The share of international investors could increase sharply, especially if commodity prices remain high and disinflation is in place. This might increase the market's sensitivity to external factors, which are more important for foreigners than local investors.
- **More attention to fundamentals.** The macro view on the country is more important for international investors than many local features. Hence, we expect the market to be moved more visibly by fundamentals.
- **Wider opportunities for first-tier borrowers.** The potential inflow of foreign capital to the domestic bond market will lead to further diversification of the investor base. First-tier borrowers from this category may enjoy better rates and greater opportunities to place longer-term paper.
- **Problem of hot money.** Conversely, if economic conditions deteriorate, foreign capital would leave the ruble bond market quickly. Moreover, we expect more speculative money to use this new access, at least in the initial stages. This so-called "hot money" may go in and out rapidly, which would create general instability. This requires more attention from the regulator.
- **Reduced ruble-denominated Eurobond issuance.** International investors' direct access to the local bond market would make ruble-denominated Eurobonds less valuable as a method of raising funds. Domestic bond issuance is much cheaper than Eurobonds, which means it makes more sense to borrow domestically.

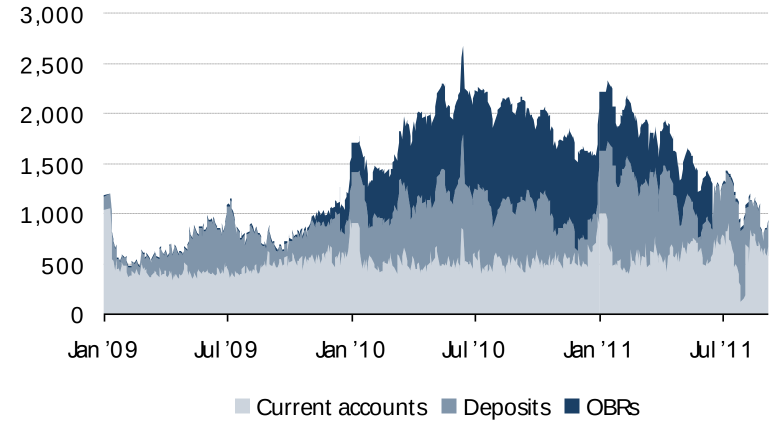
Local market color

CPI, y-o-y



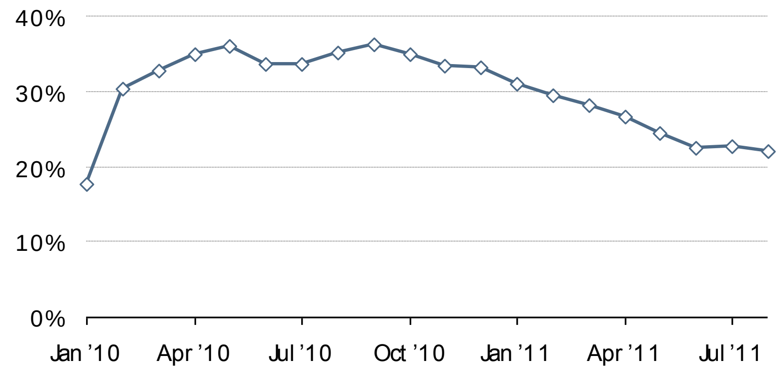
Source: State Statistics Committee, Troika estimates

Voluntary reserves, R bln



Source: Central Bank

M2 growth, y-o-y

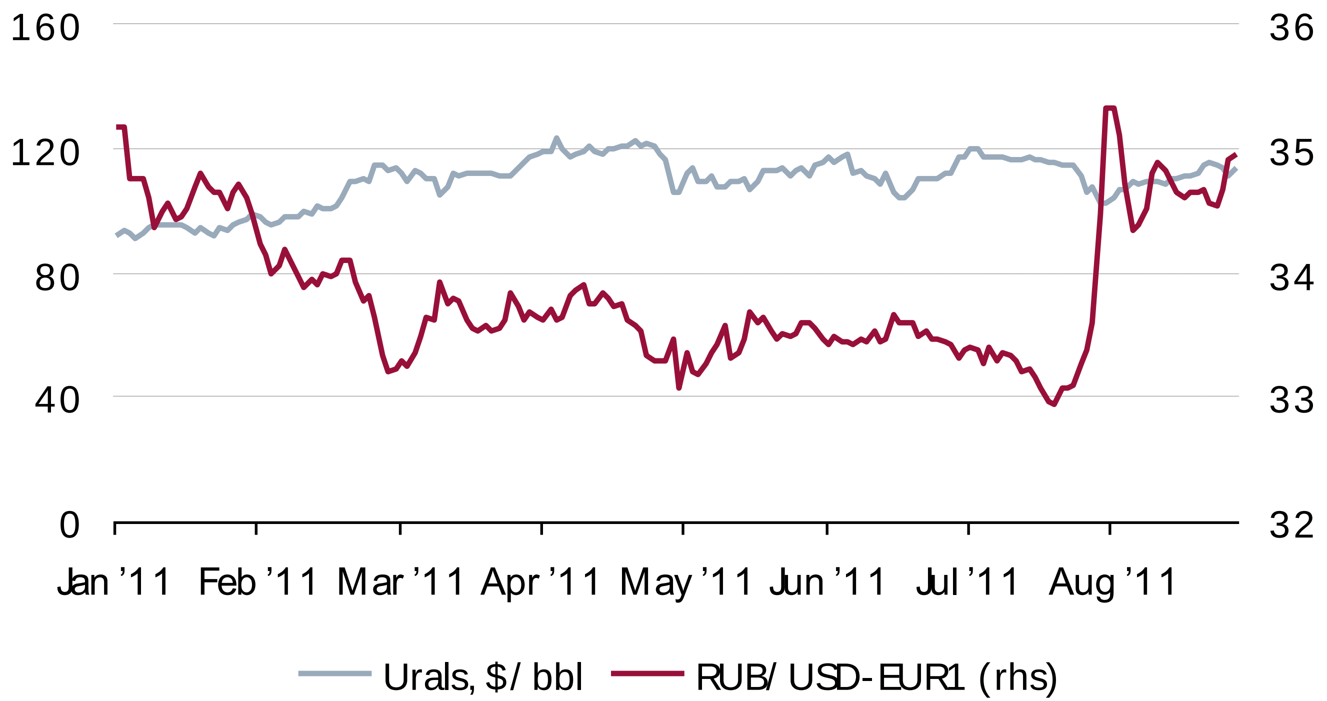


Source: Central Bank

Ruble vs basket

Source: Bloomberg

Ruble has room for appreciation



Source: Bloomberg

Ruble bonds are attractive for foreigners and locals

- **Ruble may appreciate.** On the back of high oil prices, the ruble has some potential for appreciation, especially after serious weakening in August. From August 7 to September 7, the ruble lost 5.5% versus the bi-currency basket, while Urals dropped by about 1%.

- **We expect CPI to decelerate.** The budget is running a surplus due to high oil prices and is sterilizing liquidity. As a result, M2 growth has dropped from 33-36% y-o-y in 2010 to 22% y-o-y in July 2011. We expect the CPI to be 6.5% at end 2011.

- **Budgetary expenditures likely to support liquidity.** The budget surplus was R760 bln in 8m11. For 2011, we expect a small deficit and assume that expenditures are likely to exceed revenues by around R800 mln in last four months of the year. These injections are likely to support domestic liquidity and fuel demand for ruble bonds.

- **Central Bank may cut interest rates in 2H11.** If our CPI forecast is correct, the Central Bank will have more reasons to cut rates this autumn by 25-50 bps. This would likely push down yields on the bond market. The potential disinflation story is not priced in.

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