



EASTERN EUROPE FIXED INCOME: WEEKLY OVERVIEW

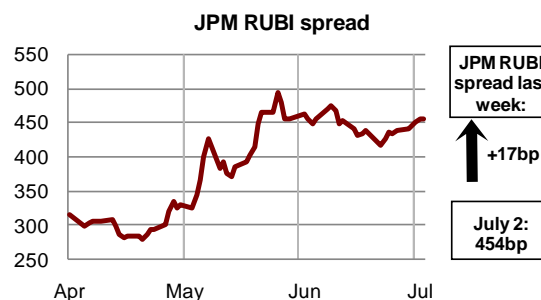
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- **Russia's fixed income market was flat during the week, although spreads continued to widen**
- **Telecoms outperformed, while banks underperformed within the RUBI Index**
- **Ukraine and Kazakhstan underperformed Russia**
- **Lending activity in the Russian banking sector continues to recover, while the government will cease its unsecured lending at the end of this year**
- **Ukraine close to securing a new \$14.9b IMF programme**
- **Corporate news: primary placements, NCSP, Metinvest, MHP, Kazakhgold**
- **We believe the importance of security selection has risen. Country-wise we prefer Kazakhstan and Ukraine. Russia as a whole lacks the idiosyncratic factor in our view, but due to Russian market's breadth, interesting opportunities can still be spotted**



General news

Published Russian banking sector statistics revealed that lending activity in May continued to pick up the pace. Aggregate retail loan portfolio increased by 1.2% m-o-m and corporate loan portfolio grew by 1.9% m-o-m. Nevertheless, the change in asset quality continued its trend, with overdue loans increasing and reaching 6.7% of gross loan portfolio. On the separate note, the CBR made known that it will terminate the unsecured lending to banks starting from 2011. Currently around RUB 50bn of this anti-crisis measure is still utilized by banks, where struggling IIB is responsible for ca. 60% of that amount. Hence, this move is neutral for the overall Russian banking system, in our view, given the current high level of liquidity.

IMF announced that its mission to Ukraine reached a staff-level agreement on the new policy programme supported by \$14.9b stand-by loan. Ukrainian government agreed to cut budget deficit to 6.5% (including Naftogaz deficit) in 2010 and to 3.5% in 2011. The news is positive for the eurobond market, lowering budget financing shortfall risks, thus lowering sovereign default risks.

Corporate news

The previous week was rich of bulky eurobond placements in Russia's quasi-sovereign space. First, the largest Russian financial institution Sberbank placed a 5-year \$1bn issue at yield of 5.499%. Later, the state's development bank VEB issued its debut eurobond also \$1bn in size with 10-year maturity and yield of 6.9%. Currently, both placements trade slightly above par (+1%), indicating some primary placement premium. In Russian quasi-sovereign banking universe, we still see more value in VTB eurobonds.

Last Friday one of the largest Russian privately owned banks Promsvyazbank sold 6-year subordinated \$200m bond at the yield of 11.25%, offering investors attractive premium over slightly shorter bank's subordinated bond with maturity in 2015 and the yield of 10.2%. Following the placement, the new bond trades 25bp over the par, this translates into the yield of 11.2%.

Russian sea port operator NCSP released strong 1Q10 financial results. Its top line increased by 12% y-o-y and adjusted EBITDA moved upwards by 5% y-o-y to \$121m. The company's credit metrics are very strong with leverage (debt/EBITDA) ratio slightly below 1x and liquid assets covering short-term debt 3 times. NCSP's eurobond with maturity in 2012 and the yield of 5.1% seems fairly valued, in our view.

Ukraine's largest vertically integrated iron ore and steel holding Metinvest announced it will form a partnership with Ukraine's largest steel factory MMKI where Metinvest will hold a 75% stake. Such a corporate combination would create the largest steel holding in the CIS. Metinvest plans to invest \$2b over several years to modernize the outdated plant. It is hard to judge whether the news is positive for the bondholders of Metinvest, however it once again demonstrates the extent of power and ability the Akhmetov's business currently enjoys.

Russia's State agro inspection allowed Ukraine's leading poultry producer MHP to import poultry to Russia. Combined with an earlier similar permit from Belorussian authorities, this means that MHP is on its way of establishing export markets. The company's planned ambitious Vinnytsia project is too large for Ukraine, where the company already controls over 40% of the market, meaning it is most likely looking for significant export possibilities, although the company denies that. In our view, the news is positive for MHP 2015 eurobonds, which are yielding an attractive 11.2%.

Polyus Gold, the major shareholder of Kazakhgold and the guarantor of Kazakhgold's eurobonds, launched the so called reverse takeover. Kazakhgold will acquire its parent Polyus Gold to form a new company called Polyus Gold International Limited. As a result, Russia's largest gold miner will get London listing and registration. Although Kazakhgold previously created at least three events of default on its eurobonds, only now, due to another potential event of default, the company offered its creditors a consent solicitation. The company will pay 0.5% of par to those creditors who are willing to forgive the company all previous and one coming breach of its obligations. Kazakhgold's 2013 bonds with a call option in November 2010 can be bought at over 7% YTW, which is an attractive opportunity, in our view. Kazakhgold/Polyus bonds are among the cheapest gold producer bonds in the world, despite significantly above-average efficiency of Polyus' gold operations. We believe Polyus is likely to call the bonds in November 2010, as cheaper sources of financing are easily available for the company.

Our strategy

The correction of the markets was not a surprise and in our view was even "healthy" after the strong and long-lasting rally so far. In our view PIGS debt story was simply a catalyst. While we expect Eurozone and the IMF will eventually fetch up a deal and PIGS default/restructuring will be avoided at least for the nearest year or so, potential further escalation of the sovereign risks is possible. Nevertheless, it appears too early to call for any meaningful impact of the PIGS debt story on the ongoing global economic recovery. Therefore, we believe the correction and the (temporary?) resolution of the European debt saga presents attractive entry points to the markets. In general categories we still view Kazakh and Ukrainian issuers as more attractive relative to Russia, while the previous wisdom still holds – broad-based "easy" gains seem behind us, importance of security selection has risen.

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