EASTERN EUROPE FIXED INCOME: WEEKLY OVERVIEW

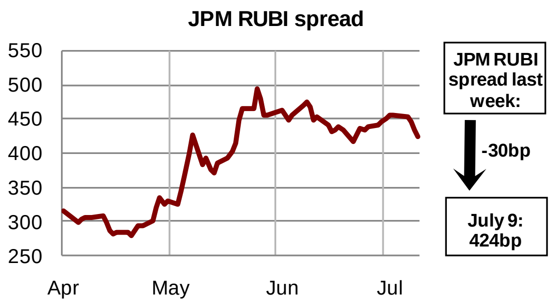
5 – 11 JULY 2010

2a Republikas square, Riga, Latvia, LV-1522
Tel. +371 67010810, Fax +371 67778622
www.parexgroup.com

Edgars Lao
Fixed Income Analyst: Russia
Edgars.Lao@parex.lv

Igors Danilovs
Fixed Income Analyst: CEE excl. Russia
Igors.Danilovs@parex.lv

- **Russia's fixed income market rallied 1.27% during the week, while spreads tightened by 30bp (JPM RUBI)**
- **Telecoms outperformed, while banks underperformed within the RUBI Index**
- **Kazakhstan outperformed, while Ukraine performed in line with Russia**
- **Recovery in Russian car-making industry is gaining momentum**



- **Fitch upgrades Ukraine and most corporates by one notch to B**
- **Corporate news: IIB, Georgian Railway, Kazakhstan Railways**
- **We foresee generally favourable environment for emerging market debt for the nearest term, yet the "easy money" appears to be behind us. In Eastern European debt markets we continue to prefer Ukraine and Kazakhstan to Russia, yet in all markets security selection remains critical. As usual, in Central Europe's eurobond market bottom-up approach is the basis for investing**

General news

Eventually this year's cumulative sales dynamics of new passenger cars and LCVs in Russia have printed a positive figure – in the first half of 2010 sales increased by 3% comparing to the same period in 2009. In June, auto industry faced improving market conditions for the fourth month in a row and increased sales by 10.8% m-o-m, according to the Association of European Businesses (AEB). The most improvement came in the second quarter due to the government's cash-for-clunkers programme, improving macroeconomic situation and returning customers' confidence. Currently, the government and the AEB sees that Russian car-making industry could rebound by approximately 15% in 2010, while at the beginning of the year the association was more conservative and forecasted no growth comparing to 2009.

Fitch rating agency raised Ukrainian sovereign rating from B- to B, following the news that the staff-level agreement on a new stand-by programme between IMF and Ukraine was reached. The agency noted that the new IMF deal reduces risks of macroeconomic and financial instability. After the rating action main rating agencies share the same view on Ukrainian credit profile: Ukraine carries B rating from S&P and B2 rating from Moody's. The rating action was followed by across-the-board upgrades of local corporates by Fitch.

Corporate news

Last Tuesday International Industrial Bank (IIB) had to redeem its EUR 200 million Eurobond. However, it was not a surprise the bank failed to do it and consequently released default notice on its both outstanding Eurobonds. Later, it reached an agreement with the CBR to restructure RUB 32bn ($1bn) unsecured loan with 6-month maturity extension, sinking fund structure and shares of IIB majority shareholder's shipbuilding assets as collateral. Next, IIB turned to its overdue Eurobond holders with restructuring proposal. In particular, the bank in return for a one-year maturity extension proposed to maintain 9% annual coupon and pay 5% consent fee to bondholders that vote in favour until July 14. Moreover, the restructured bond will be carry the guarantees of nine companies registered in the British Virgin Islands that indirectly control the same shipbuilding assets that are offered as collateral to the CBR. In case these assets are sold, the bank is required to redeem the restructured bond within 20 days. In our view, the collateral's legal and economic sense is questionable, as according to the Russian legislation, the CBR is prioritized to receive funds from the realization of collateral. Nevertheless, due to coordination problem, in our view each bondholder individually is better off to vote in favour of the proposed restructuring terms and to receive 5% early instruction fee and 9% accrued coupon in two days after the restructuring is finalized. Officially, IIB has not turned to the 2013 eurobond holders with any restructuring proposal, however, reportedly a group of these bondholders is trying to achieve a restructuring proposal from the bank as well.

Georgian Railway is on a roadshow to tap international eurobond market with the help of JPMorgan and BoA Merrill Lynch. The company's roadshow ends on 12th of July in Switzerland. The B+ rated company plans to issue $250m of 7- or 5-year eurobonds to fund a modernization project and a Tbilisi bypass project. In our view, the news is positive for another Georgian issuer – Bank of Georgia – which is currently the only corporate eurobond issuer in Georgia, as the issue by Georgian Railway would increase the importance of the country in emerging markets universe.

Kazakhstan's state-owned railways monopoly Kazakhstan Railways (Temir Zholy) released positive 2009 IFRS financials. According to the results, the company's debt/EBITDA slightly increased to 1.57 from 1.38 a year earlier. Despite subsidizing other industrial sectors, Temir Zholy managed to significantly increase its EBITDA margin to 23% from 20% a year earlier. We believe Temir Zholy 2011 and 2016 bonds yielding 4.3% and 6.7% respectively are attractive, especially compared to the overleveraged quasi-sovereign KazMunaiGaz, which is much more expensive all over the yield curve.

Our strategy

We foresee generally favourable environment for emerging market debt for the nearest term, and we expect some further gains, yet the "easy money" appears to be behind us – the markets are not cheap. Our global inflation outlook foresees that liquidity will remain abundant for a prolonged period of time. On growth front we do expect negative surprises in H2'10, yet we do not subscribe to the "double-dip" thesis. Sovereign risks will continue to weigh on the market sentiment, but should also indirectly support emerging markets where fiscal fundamentals are indeed stronger. On relative terms, in Eastern European debt markets we continue to prefer Ukraine and Kazakhstan to Russia, yet in all markets security selection remains critical. As usual, in Central Europe's eurobond market bottom-up approach is the basis for investing.