

State Support for Indebted Firms Poisons Russia's Sovereign Bonds

By [The Moscow Times](#)

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An aerial view from the Federation Tower shows other buildings of the Moscow International Business Center also known as "Moskva-City" in the capital Moscow, Dec. 9, 2014.

LONDON — As Russia confronts financial crisis, investors in its sovereign dollar bonds are braced for things to get worse before they get better, even though few expect a full-blown sovereign default.

The Russian state, they say, is a diligent payer of debts, however belligerent the rhetoric of its leaders. But Russian companies are heavily indebted, and with Western sanctions over Moscow's role in Ukraine making it hard for them to access capital, the national balance sheet may have to shoulder much of the burden.

Optimists will point to Russia's 1998 crisis, when oil hovered at \$10 a barrel and hard currency reserves fell below \$15 billion. Through crippling recession, ruble collapse and a huge domestic debt default, Russia faithfully honored its international 'Eurobond' debts.

Sixteen years on, Moscow has \$400 billion on its books, or four times the total debt due next year. Hardly anyone believes it will default. Yet its sovereign bond spreads, a gauge of the risk premium over U.S. Treasuries, are over 500 basis points, or well above those of junk-rated Jamaica or Lebanon.

What's more, those prices are probably justified, says Michael Cirami, emerging debt portfolio manager at investment managers Eaton Vance.

What changes the equation from 1998 is the rise in Russian companies' external indebtedness.

"The concern we had here was that in the event of a crisis this corporate paper was going to migrate over to the sovereign balance sheet," Cirami said.

"We're going to see trouble in the Russian corporate sector ... The question is to what extent does the state step in and support key entities, at which point it puts another dent in the credit metrics of the sovereign," he said.

"It wouldn't surprise me to see spreads widen out again," Cirami added.

Investors are already treating Russia as being as risky as a junk-rated credit. The cost of insuring exposure to Russian debt via five-year CDS has tripled this year to 450 basis points, or 300 bps higher than what is usual for BBB/BBB-minus investment grade credits.

And debt yield spreads have risen 300 bps since end-November while some bonds, such as the 2020 issue, are trading at 95 cents in the dollar, versus 115 cents in January.

"At current spreads, Russian sovereign debt is some of the cheapest investment grade credit out there," said Peter Marber, head of emerging debt at fund manager Loomis Sayles.

Marber says Russian bond prices are getting "interesting" but he remains underweight, meaning he holds less Russian debt than the country's weight in benchmark indexes.

Investors were significantly underweight Russian sovereign debt, JPMorgan's client survey showed at the end of November.

Long-Term

Older investors recall that those who bought Russian dollar bonds at 50 cents in the dollar in 1999 reaped rich rewards. That trade may work again — provided one is patient.

"For investors that can get access to Russian assets, and have long-term holding periods, we believe these are attractive levels to own Russian sovereign credit," UBS analysts said.

Firms meanwhile are exploring ways to repay or restructure debt terms, with pipe maker TMK saying for instance that it was "studying various options to reduce debt." State-run oil giant Rosneft has soothed nerves by repaying a \$7.6 billion bank loan this month.

"A lot of people are commenting as if it's 1998 all over again, but that's not true," said Salman Ahmed, global fixed income strategist at Swiss bank Lombard Odier, who has increased Russia

allocations.

"The balance sheet is significantly better, their net external position is way better, and compared to 1998, the cost of default will be far higher," Ahmed said.

Mark-to-Market

For all that, Russia remains a tricky proposition for anyone unable to stomach short-term losses.

David Hauner, EEMEA head of fixed income and economics at Bank of America/Merrill Lynch, advises staying underweight, citing the volatility in Russian assets, which can make a fund manager's life very difficult.

"Sovereign Eurobonds account for 2 percent of Russia's GDP. What is the likelihood they will default? Very, very small. But most asset managers have to watch mark-to-market," Hauner said.

Under the mark-to-market accounting practice, a fund's net asset value (NAV), usually computed at the end of each day, is based on current valuations.

But when markets are volatile or illiquid, that valuation may be skewed, often forcing an investor to sell or minimize holdings of an asset to preserve his fund's NAV and performance against the benchmark.

Investors will be all the more reluctant to wade in because agencies have hinted Russia's rating may be cut to junk. Loss of investment grade usually leads to a 40-60 bps widening in spreads, Bank of America/Merrill Lynch estimates.

"Russia has given benchmark managers headaches all year long," said Marber. "With the wide bid-offer spreads, anything you buy can immediately result in a mark-to-market loss."

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