January 25, 2018

Debt of Russian regions to remain expensive

Prospects for refinancing public debt of Russian regions

- **Debt refinancing is the key trend in the Russian financial market.** Although the key rate of the Central Bank of the Russian Federation is still higher than the pre-crisis level, long-term loan rates are already lower for the majority of borrowers. For instance, regional bonds yields at placement declined from 15%-16% in 2014-2015 to the weighted average of 8% as at end-2017.

- **However, up to 24% of the commercial debt of the regions will stay expensive and will not be refinanced.** These are fixed-coupon bonds providing for no early repayment at the offering price. Current pricing exceeds offering prices of almost 48% of the regional bonds in the market by 3-30 bps (the share of comparable bonds in the corporate sector is 2.3%). Primarily, these are bonds issued during the crisis period of 2014-2015.

- **In view of unavailable refinancing for expensive bond issues of previous years, losses of regional budgets would reach as much as RUB 30 bln in 2018-2023**. Of that amount RUB 9.1 bln fall on 2018 (around 7%-9% of debt servicing expenses of the regional budgets in 2018) and RUB 7.5 bln on 2019. Further key rate cuts will be the driver.

- **Ten regions account for 70% of the total losses related to servicing expensive bonds.** In particular, the Krasnoyarsk Krai would have the largest amounts to be overpaid: around RUB 3.7 bln in 2018-2023, of which RUB 1.4 bln fall on 2018. The Moscow and Nizhniy Novgorod Regions will overpay RUB 3.0 and 2.6 bln, respectively, for the above period, and the Orenburg Region to overpay around RUB 2.1 bln. Budgets of the Samara Region, Udmurtia and the Republic of Komi would lose around RUB 1.9 bln each.

- **Unavailability of refinancing for expensive bond issues of the previous would put pressure on the credit quality of specific regions for four more years.** Such regions have limited capabilities for debt maneuvering and reducing debt load level. Mostly these are regions with strong and moderate credit quality that were less focused on financial aid from the federal government in the crisis years of 2014-2015. This, in turn, helped the federal government to increase support of other regions that needed financing then.

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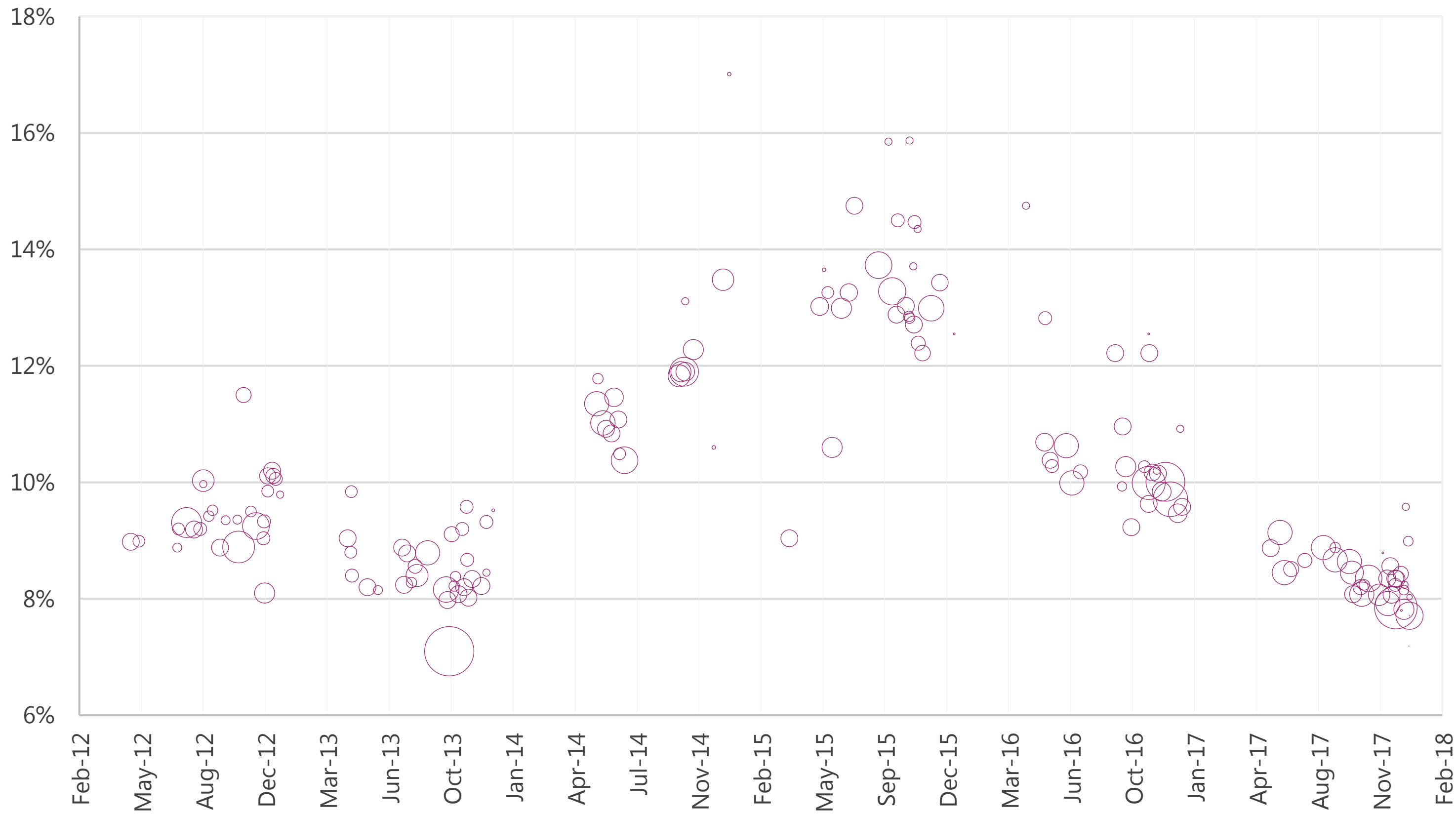
Yield at offering of regional bonds declined to pre-crisis level

The average weighted yield of the initial bond offerings by Russian regions that took place in December 2017 stands at 8%. The most recent large offerings of 2017 were five-year bonds of the Moscow Region, seven-year bonds of the Khanty-Mansiysk Autonomous Okrug – Yugra and nine-year bonds of St. Petersburg, with yields at offering ranging from 7.7% to 7.85% (coupon rates of 7.5% to 7.7%). These yields are nominally comparable to pre-crisis level: the average weighted yield of initial offerings was around 8.2% in 2013.

Figure 1. Nominal yield of initial regional bond offerings returned to pre-crisis level by end-2017



Note: circle size corresponds to issue volume.
Source: cbonds.ru, ACRA estimates

Bonds accounted for 24% (RUB 491 bln) of the direct debt of regional budgets and 5.3% (RUB 17 bln) of the direct debt of municipalities as at December 1, 2017.

The total of 29 regions and 3 municipalities placed bonds in 2017, with the aggregate amount of placed bonds exceeding RUB 209 bln.

Regional bonds of past years have become expensive for servicing and early repayment

See the ACRA February 14, 2017 research titled "Russian Regions to Favor Bonds"

Amid stable or prone-to-increase interest rates, it is more attractive for the regions to use bonds rather than bank loans. Initial bond offerings by Russian regions are usually priced at 100% of the notional, and the amount of coupon payments is fixed at the offering, i.e. with no dependence on the following interest rate dynamics. This independence from the market environment protects regional budgets in case of interest rate growth. However, if the rates decline substantially, the independence from the market environment grows from an advantage into a disadvantage, as it provides no flexibility for savings in debt servicing.

In contrast to the terms and conditions of bank loans, regional bonds, as a rule, have no options for early repayment at the offering price and coupon rate downward revision in case of a substantial decrease of the key rate of the Bank of Russia. Therefore, the only option for a region to repay a bond issue early is to repurchase bonds form the market at the current market price. For instance, the Orenburg Region repurchased a portion of bonds issued in late 2012 in December 2015: by virtue of the then existing market environment the region was able to repurchase bonds at a price slightly below the notional.

Overall, regional bonds issued in 2014-2016 have a coupon rate 2%-7.5% higher than the current level (i.e. standing at 9.5%-15%).

According to ACRA estimates, bond issues with the current market (or indicative) price of over 103% reaching as much as 117%-130% of the notional account for around 48% of the regional bonds market (around RUB 261 bln in monetary terms), which makes early repayment at the offering price impractical for bond holders.

The most expensive regional bonds at the current moment are bonds of the Orenburg Region placed in July 2015 with a 14% coupon and maturity in July 2025. The indicative issue pricing stands at 130.3% of the notional. The yield at offering of 14%-15% was acceptable in July 2015, as the Russian regions have been raising bank loans at 16.5%-24% as far back as in March and April 2015.

By repurchasing bonds at prices substantially exceeding their prices at offering the regional authorities may face reputational risks, and draw notice from controlling and audit agencies. As a result, regions that financed their budget deficits by tapping the bond market rather than fiscal loans or bank financing in 2014-2016 have in fact become "prisoners of high interest rates".

The corporate bonds sector has a similar problem. The amount of ruble-denominated bonds of Russian banks and companies in circulation placed in 2014-2016 totals around RUB 707 bln (6.7% of the corporate ruble-denominated bond market), and they are currently priced (indicatively) by the market significantly higher above 100% of the offering price (from 103% to 132%).

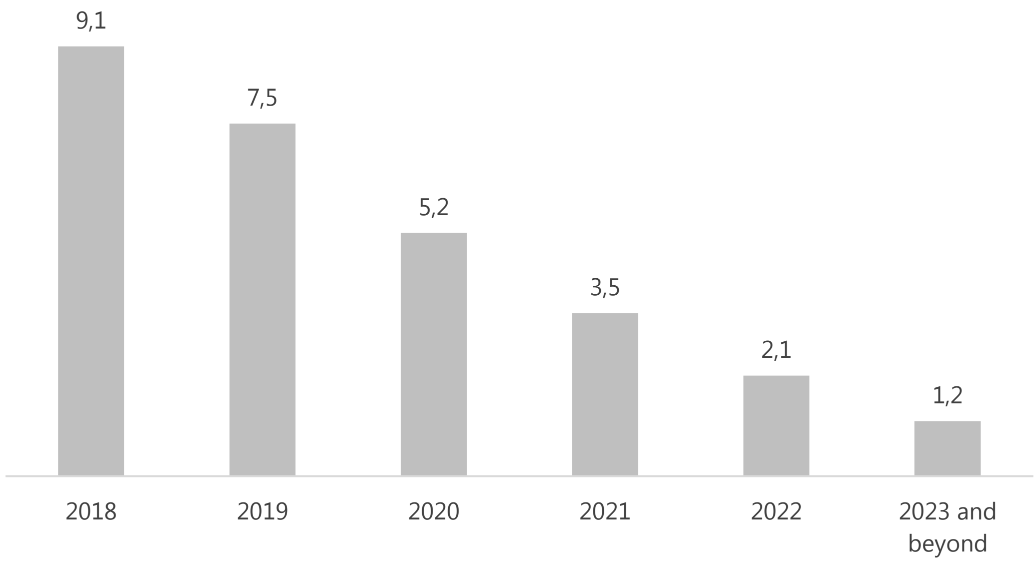
However, around RUB 394 bln out of the above RUB 707 bln represent bond issues that have both buy-back and coupon rate amendment options (either using the formula with reference to the current yield of respective government bonds, or the issuer-defined coupon). The amount of expensive corporate bonds issued in 2014-2016 with the coupon rate fixed at the offering and no buy-back option (i.e. a similar configuration as regional bond issues have) is around RUB 243 bln, which, although comparable to the volume of expensive regional bonds (RUB 261 bln), has a significantly lower share in their respective market. Similar bonds account for only 2.3% of bonds in circulation in the corporate bonds market.

Regional budgets to lose around RUB 30 bln in servicing expensive bond issues

According to ACRA estimates, due to inability to refinance expensive bond issues of previous years, regional budgets would lose around RUB 30 bln in 2018-2023 (the aggregate amount of coupon payments under expensive bond issues is around RUB 99 bln). ACRA estimates that the key rate of the Bank of Russia would decline to 7%-7.25% in 2018.

We calculated losses from servicing expensive bonds as the difference (accumulated and by years) between the flow of actual coupon payments of specific bond issues and coupon payments at 7.8% coupon rate (the average weighted coupon rate of regional bonds offered on the market in December 2017)

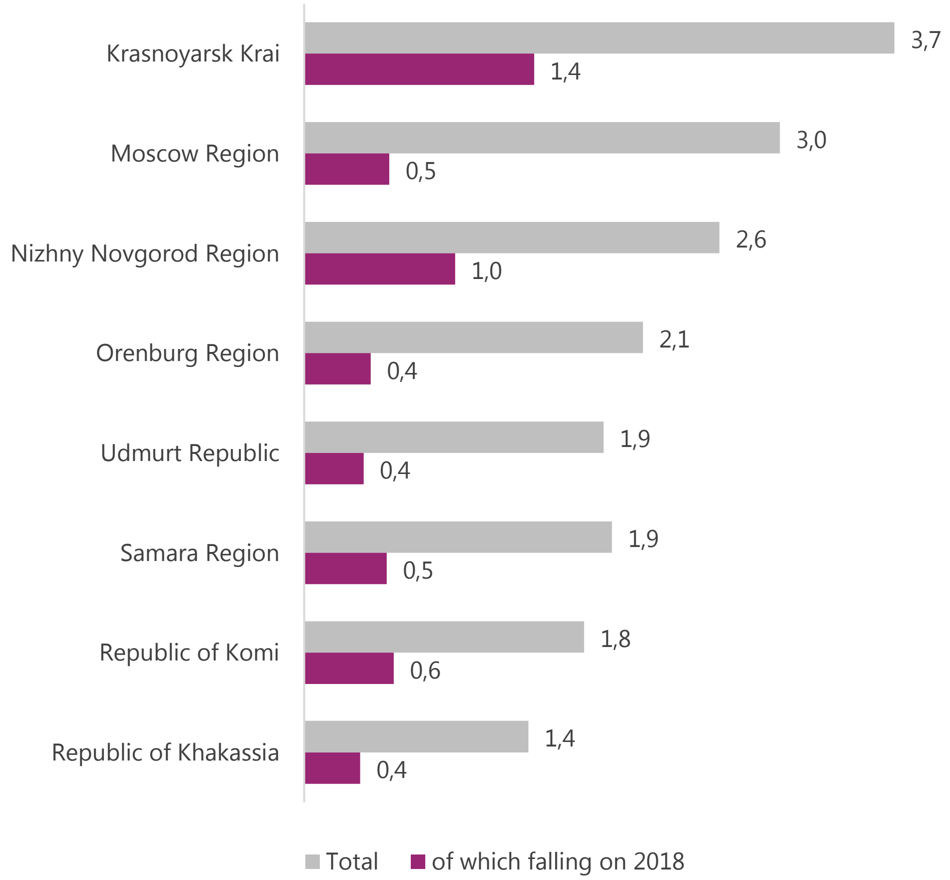
Figure 2. Key losses of regional budgets from servicing expensive bond issues fall on 2018-2020 (RUB bln)



Source: cbonds.ru, ACRA estimates

Ten regions account for 70% of the total losses related to servicing expensive bonds. The Krasnoyarsk Krai would have the largest overpayment: around RUB 3.7 bln in 2018-2023, with RUB 1.4 bln of which falling on 2018.

Figure 3. Cumulative* losses of eight regions from servicing expensive bonds would exceed RUB 1.4 bln



*For 2018-2023 and subsequent years.
Source: cbonds.ru, ACRA estimates

Credit quality of specific regions is under pressure from expensive bonds

According to ACRA estimates, the number of regions experiencing budget surplus would significantly increase following the 2017 performance. A portion of this surplus was used to reduce debt load, which allowed a number of regions to save on debt servicing costs and noticeably decrease the debt load risks.

See press release of December 26, 2017 entitled [ACRA assigns AA-(RU) to the Chelyabinsk Region, outlook Stable]()

For instance, the Chelyabinsk Region (AA-(RU)) has fully repaid bank loans owing to the budget surplus of around 3.3% of tax and non-tax revenues (ACRA estimates) in 2017: planned repayment amounted to RUB 0.83 bln in 2017, and RUB 4.05 bln were the early repayment of loans maturing as early as in November 2019. The Chelyabinsk Region has no bond issues in its portfolio. As a result, the region's debt to operating balance ratio has improved in 2017 reaching the level corresponding to the minimum risk (according to the ACRA methodology). In absolute terms, the region's direct debt has decreased by 30% (around RUB 4.2 bln) in 2017.

See press release of December 27, 2017 entitled [ACRA affirms A+(RU) to the Samara Region, outlook Stable, and to bonds issued by the Samara Region]

ACRA expects the Samara Region (A+(RU)) to record a surplus of around 5% of tax and non-tax revenues. This surplus allowed the Region to be quite successful in maneuvering its bank debt and generating additional revenues from placing temporarily available cash into deposits. The region has refinanced expensive bank loans raised in 2014, the interest rate on which was at 10.75%-11.2% and with maturities in 2020-2021, which, in turn, saved the region around RUB 1 bln in 2017. At the same time, around 30% of the direct debt of the Samara Region are bond issues of 2014, 2015, and 2016 with the coupon rate at 9.64%, 10%, and 12.4%, respectively. ACRA estimates the region's losses (in 2018-2023) resulting from the inability to refinance expensive bond issues at current interest rates to amount to around RUB 1.5 bln, with RUB 463 mln of which falling on 2018. The Samara Region has decreased the absolute amount of its direct debt by 4.5% (by around RUB 3 bln) in 2017, while financial capabilities of the region, according to ACRA estimates, were sufficient to reduce this figure even more. The inability to repay expensive bonds early at offering prices halted any further debt reduction. Partly due to that, the debt to operating balance ratio of the region corresponds to a medium risk level according to the ACRA methodology.

Generally, the inability to repay expensive bond issues early limits the options for Russian regions in maneuvering their debt and in reducing their debt load level, which creates headwinds for their credit quality.

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