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# New Gazprom SEN (BBB-) is Fair-to-Attractively Priced

- **Using price guidance of 7.5% yield, the new Gazprom notes are attractive for crossover investors, however, Gazprom '13s offer more upside for dedicated investors**
- **The SENs are 110-120bp tighter than Gaz '13s, in line with the spread differential of 118bp between 7-10 year US Corp BB and BBB, and 50bp wide of Russia**
- **As the only Russia corp bond with IG ratings, the SEN should be attractive to crossover investors, but unclear to what extent this will be**
- **Supply risk for unsecured Gazprom paper has fallen, but the SENs could still represent crowding out risk for Gazprom debt of any kind**
- **The SEN is positive for Gazprom credit risk, however, more secured debt may be in the pipeline**
- **The level on SENs: 7.5% yield, spread duration of 5.5, z-spread of 283bp; the z-spread on the yield of 7.25% and 7% are 258bp and 232bp, respectively**

**The Gazprom Structured Export Notes (SEN) permit Gazprom to access the market for long-term funding at rates that would not be available for unsecured debt.** Given concerns about oversupply of Russian corporate debt in general and Gazprom debt in particular, the company now chooses to issue structured notes apparently for the following reasons:

- To lower incremental borrowing costs relative to funding on an unsecured basis, and
- To broaden the potential investor base. The investment-grade rating of the notes should make them eligible investments and attractive for some investors who are ratings-constrained.

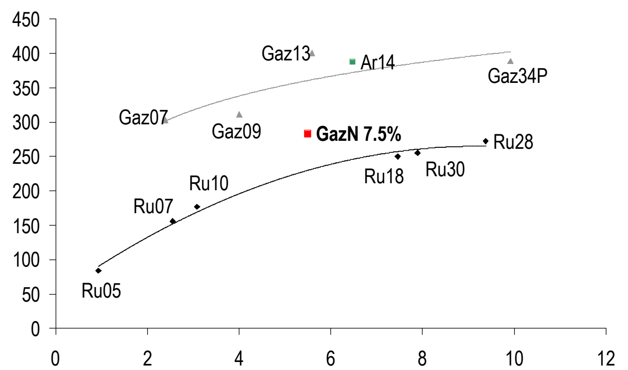
Therefore, the SENs potentially stand to improve both the fundamental and technical risks of a Gazprom investment, both in an absolute sense and, especially, as compared with a scenario where the company issues more unsecured paper.

## Valuation: the new bond is fair-to-attractive

As measured by swap spreads, the SEN is priced around 110-120bp tighter than Gaz '13s, in line with the differential between 7- and 10-year US Corp BBB and BB bonds. **However, the majority of the spread differential between US Corp BBB and BB is due to a lower default risk and, in contrast, the differential between Gazprom unsecured and the SEN is based on the SEN's higher recovery rate.** In our estimation, a 100bp spread difference requires the recovery rate 15-20 cents higher than for Gazprom unsecured. This difference in recovery value is relatively small in our view, especially in a context of improving macroeconomic fundamentals in Russia.

**Chart**

Swap Spread Curve




Source: JPMorgan

## Fundamentals: Positive for Now

While the new notes will not be the company's cheapest source of funding (short-term trade finance remains cheaper), the notes help improve the term structure of debt and will be cheaper than similarly-dated unsecured funding.

**The new SEN notes do not represent a departure from Gazprom's internal limits for secured debt and therefore do not increase subordination of unsecured notes relative to our long-term assumptions.** Gazprom confirmed to JPMorgan this week that, following the issuance of the SENs, secured debt would remain within the internal limit of one third of total debt. The company had been reducing secured debt in advance of this deal,

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specifically, in order to make room for such an issue. **Nevertheless, the new SENs raise a concern with respect for the sustainability of Gazprom's secured debt limit.** The company has confirmed that any further issuance of secured debt would elevate secured debt above one third of total debt, potentially resulting in a material subordination of unsecured debt relative to historical levels. It seems clear that a major motivation for utilizing the SEN structure is that unsecured funding is not available in the size, tenor, or cost that the company requires. As such, potential future issuance of secured debt cannot be ruled out and, to a certain extent, would be influenced by factors outside the company's control. **This could have a negative impact on credit ratings of unsecured Gazprom, especially in the case of Moody's who have already rated Gazprom unsecured debt (Ba2) one notch below the Senior Implied rating (Ba1).**

## Technicals: the new bond is somewhat attractive

If the new SENs ultimately attract a significant number of new investment-grade players who are not currently involved in Gazprom, this would represent a strong positive for the entire Gazprom curve by mitigating supply risk. However, it is too early to measure the extent to which the ratings in and of themselves would materially broaden the potential investor base for the SENs. Investment-grade players have only limited familiarity with Russia as an off-index bet and might be wary to invest in Russian corporates of any kind in light of the Yukos case. Investment-grade managers might view the SENs as too far outside their mandate other than as a diversification play. In addition, it remains unclear whether or not the SENs would be included in the Lehman Aggregate and Merrill Lynch investment-grade indices. Nevertheless, the bonds are priced attractively for their ratings, 120-130bp wide of US BBB corporates.

As an additional supporting technical, approximately $2.5 billion of cash will be coming into the market from the buyback of structured PDVSA notes. At the time of issuance, these notes, like the Gazprom SENs, were rated investment-grade. We expect that some investors participating in the buyback will put their cash to work in the SENs.