

Challenges and prospects for the Russian market: are borrowers winning?

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THE RUSSIAN SYNDICATED LOAN MARKET EMERGED IN THE MID-NINETIES. BEFORE 1997, MAJOR RUSSIAN BANKS WERE THE MAIN BORROWERS, WITH FOREIGN FINANCIAL INSTITUTIONS AS THEIR ONLY LENDERS. AS A RULE, LOANS ALLOCATED TO BANKS WERE UNSECURED AT THAT STAGE OF MARKET DEVELOPMENT, WHILE LOANS TO REAL SECTOR ENTERPRISES WERE BACKED BY EXPORT RECEIPTS.

The majority of external syndicated loans raised by Russian borrowers were launched in the pre-crisis of 1997 and totalled US\$10bn (the market grew forty-fold compared to US\$250m in 1996). Sixty five percent of the total constituted the loans of the state-owned gas monopoly Gazprom. The first syndicated loan arranged by a Russian bank was Alorsa's deal signed in 1998. The US\$25m facility was arranged by Eurofinans Bank, a subsidiary of the French BCEN-Eurobank.

The financial slump of 1998, partly triggered by the crisis in South-East Asia, undeniably affected the Russian syndicated loan market. In 1999 the market volume was reduced to the level of 1996, only reaching US\$230m and it was not until the second half of 2000 when the trend reversed. The total of syndicated deals in 2000-2001, in fact, exceeded US\$1bn, around 20% of which was syndicated by Russian banks. Between 2002 and 2007 the market posted substantial growth, as illustrated in Exhibit 1.

Market dynamics in recent years

The volume of loans raised during 2007 exceeded the respective figure for the entire of 2006. However, while analysing this data we should keep in mind Rosneft's largest syndicated bridge facility of US\$22bn raised in

March 2007. Alongside Gazprom's US\$13.08bn deal signed in 2005, it accounts for the lack of linear growth in loan volume over the last three years.

The number of deals has been on the rebound in recent years. Even the global liquidity crisis had little effect on the number of deals in 2007. Since the beginning of the year, the Russian market has seen over 100 syndicated loans.

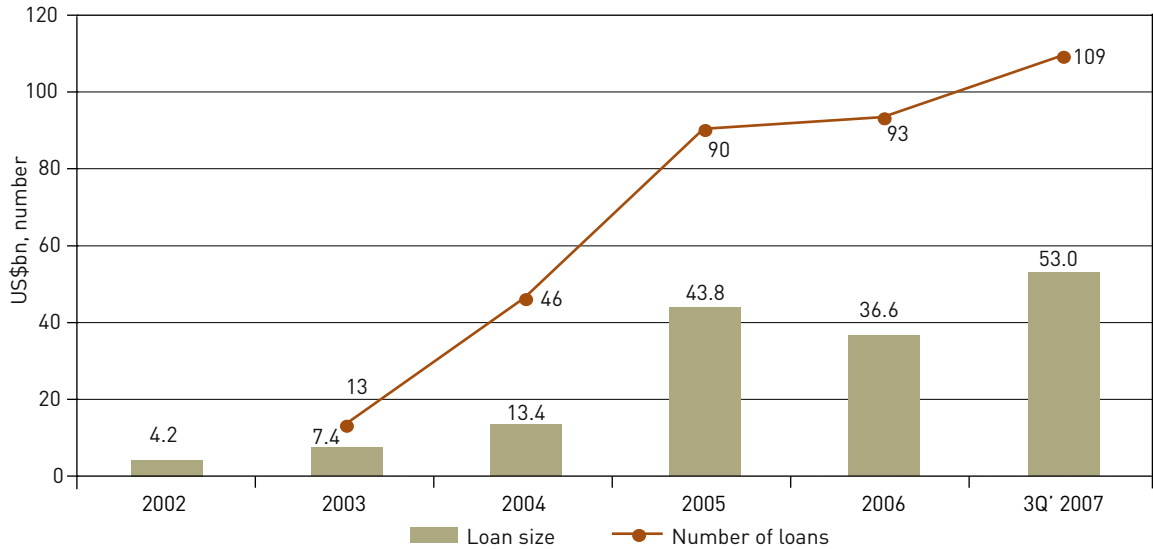
In fact, during the crisis the deals had somewhat increased in number, as borrowers flocked from the crisis-stricken Eurobond market towards syndicated loans that proved to provide more stability. In July, when the market was still firm, there were 11 loans, with a further 15 and 14 issued in August and September, respectively. According to recent research by Cbonds, there was a material slowdown in the market in October and November – both in the number of syndicated loans and their size. One of the reasons for this was a rate increase beyond the level critical for many borrowers.

Market dynamics outlook

About 25 syndicated deals for a total of US\$7.5bn were in the pipeline for the fourth quarter of 2007, but it has become obvious that many of them will not be closed this

Size and number of syndicated loans

Exhibit 1



Source: loans.cbonds.info, BIS

year, and some are simply not meant to be. Nonetheless, we expect market conditions to stabilise in the first two quarters of 2008, and an increase of the syndicated lending market volume in 2008 is forecast to reach US\$40-US\$45 not taking into account any particularly large deals.

Characteristics of the market

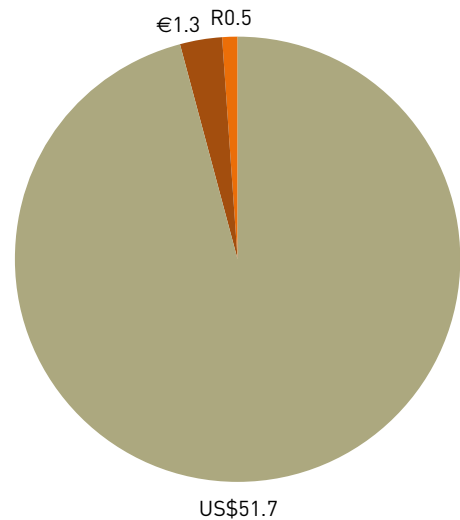
Loan currencies

The US dollar is the major currency used for syndicated borrowings on the Russian market. In the three quarters of 2007, US dollar syndicated loans exceeded US\$51bn, while only 900m was raised in euros (US\$1.3bn), and even less in Russian roubles – around US\$12.5bn (about US\$500m).

The share of US dollar syndicated loans has surged when compared to 2006. In 2006, euro loans accounted for 4.25% of this market, and rouble loans' share was 1.59%. Meanwhile, in the three quarters of 2007 these figures were 2.62% and 0.84%, respectively. This happened not due to reduced borrowing in these currencies, but rather a step-up

Distribution by loan currency in 2007 (US\$bn)

Exhibit 2



Source: loans.cbonds.info

in dollar syndications. 2007 also saw pending deals in currencies exotic for this market such as the Japanese yen.

The development of a local currency market is accompanied by the application of the MosPrime rate as an alternative to Libor for rouble syndications. MosPrime (Moscow Prime Offered Rate) is a benchmark rate at which rouble financing is provided on the Moscow market. It is based on the offered rates of Russian rouble loans (deposits) as quoted by the leading participants of the interbank market – first-tier financial institutions. In 2007, there were two small deals amounting to a total of R2.15 that were priced based on MosPrime. However, fixed income instruments still dominate the market. There have been nine fixed-rate loans in 2007 totalling approximately R4bn (US\$160m).

Industrial distribution

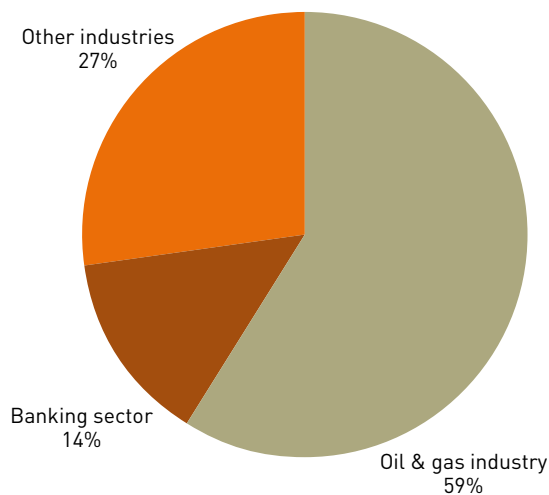
The Russian banking sector, naturally, leads in the quantity of syndicated loans, with 70% of all deals arranged in 2007. However, the oil and gas sector dominates in terms of volume. Enterprises of this industry rarely raise less than US\$1bn. In 2007, the oil and gas sector attracted

approximately 59% of syndicated financing in Russia calculated by size, while banking institutions took only 14%. The fairly large size of ‘other industries’ is attributed to massive loans of metallurgical, mining and retail Russian businesses.

Tenors and sizes of loans

The share of short-term loans (up to two years) is traditionally high, having increased to 63% in 2007 from 58% in 2006. These loans are usually raised by banks to support their liquidity and refinance outstanding debt. The share of long-term loans (over five years) is growing as well: in the three quarters of 2007 it comprised 7.5% of the market, against 2.9% in 2006. Long-term loans share is gaining momentum due to substantial growth in the demand for long financing, the stabilisation of the Russian economy in recent years, and the syndicated lending operations of EBRD in this segment of the Russian market. Medium-term loans (from two to five years) comprised 69% of the market in 2007, having reduced their share by 10% since 2006. It should be noted that loan extension options are very typical for the Russian market. The options can be

Loan size distribution by industry Exhibit 3



Source: loans.cbonds.info



Sergey Zobov



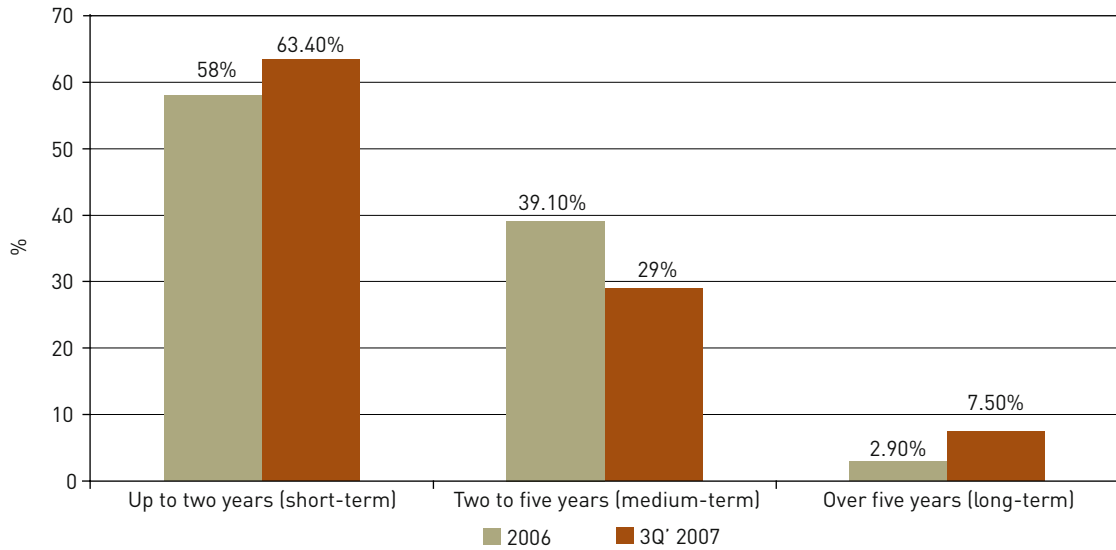
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Loan distribution by tenors

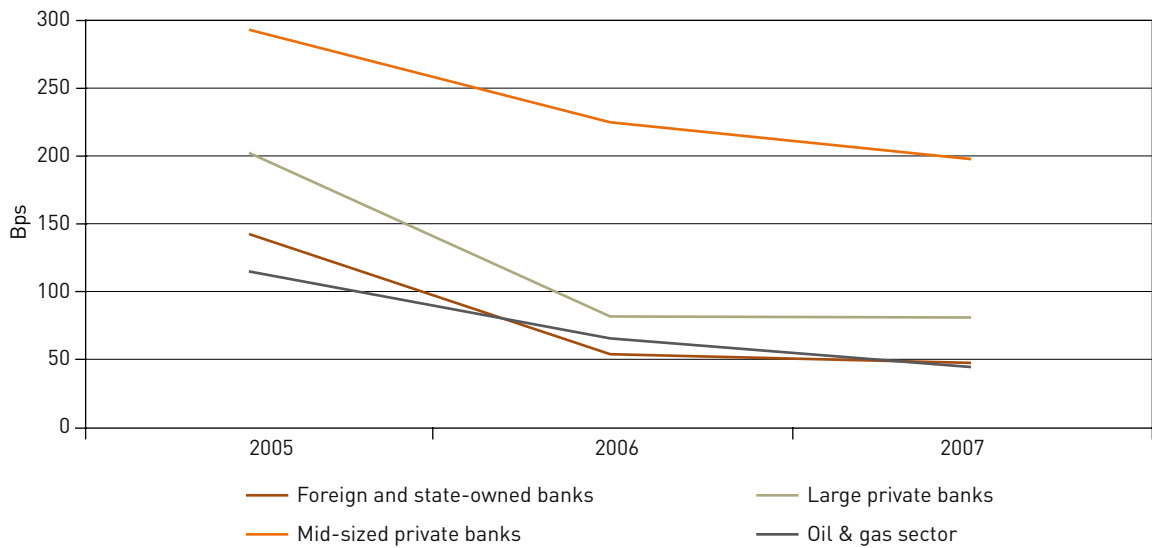
Exhibit 4



Source: loans.cbonds.info

Dynamics of average loan rate paid over Libor, in basis points

Exhibit 5



Source: loans.cbonds.info

often found in one-year deals and allows extending them for the same term.

Distribution by loan size remains steady as time passes. For the purposes of our analysis, let us break down the loans into three groups by size: under US\$100m, US\$100m to US\$500m, and over US\$500m. In 2007, the number of deals in the first and second groups is close – 46% and 39%, respectively. Consequently, the deals sized US\$500m and more occupy 85% of the market. Last year, the percentage ratio was approximately the same, with a difference of 2%-3%.

Deals structure

Dual-tranche financing is very common in the Russian market. Meanwhile, multicurrency loans, club loans and other types of syndicated instruments are becoming popular. Bridge loans account for a large share in lending volumes; their total value has grown this year to US\$22.5bn from US\$22.5bn the year before. Russian banks receive most of their financing for the purposes of refinancing and trade financing. Project financing in the real estate sector has seen very modest gains. The bulk of loans are raised by real sector borrowers for general corporate purposes and mergers and acquisitions.

Cost of loans for Russian borrowers

Borrowers fixed the margin

In 2007 Russian borrowers failed to achieve the dynamics of the previous year in the reduction of margins to be paid over Libor. For instance, while such leading borrowers as banks and the oil and gas sector enjoyed an average margin decrease by 70-100 points in 2006, borrowers have gained only 10 to 30 points in 2007. However, the stall in margin tightening should not be considered a negative development. It is more a case of fixing rates at levels fair for corresponding credit ratings of Russian companies.

The oil and gas sector has demonstrated the highest rate of margin reduction – in 2007 the margin shrank by 30% versus the 2006-year level and the margin reduction appears to be the most stable as well. In 2006, the leaders behind these positive market dynamics were large state-owned and private banks. Their margins tightened

by over 60%, but in 2007 Russian banks' margins fell by less than 10%. However, borrowers failed to significantly increase the tenor of financing, while keeping the margins at previous levels, i.e. there have been longer loans in each peer group, but the average terms have hardly changed.

Risk premium is included in lead arranger fees

The main reason why there are no further positive moves and margins, and tenors are frozen at old levels, lies, of course, in the global credit crunch, which resulted in lack of liquidity for Russian banks. Thus, in the 3Q, the Eurobond market was almost non-existent and the local rouble market faced problems as well. Borrowers turned to the syndicated lending market.

Nonetheless, despite the excessive demand for loans, average rate levels remained the same, and the market, represented by lenders, decided to take a risk premium in the form of an arrangement fee. While in 2006 the fee rarely exceeded 50-60 points, with an average level of 30-40 points, in 2007 fees sometimes reached as much as 100 points, with an average of 60-70 points.

During the crisis, Russian borrowers in the syndicated lending market managed to fix rates at relatively low levels and find required financing even in these conditions, having paid an acceptable premium of about 50 points.

Loan arrangers

Cbonds league table

Cbonds started publishing the league table of syndicated loan arrangers in 2006. Since then, the range of league tables has grown substantially. Currently, Cbonds provide league tables for both the size of borrowing, and the number of loans arranged. The tables are composed separately for Russia, Kazakhstan and Ukraine, as well as the CIS as a whole. A separate league table is compiled for arrangers of rouble syndicated loans.

Exhibit 6 shows the top 10 league tables for the Russian market, based on the size of borrowing and number of loans syndicated. A few words on the league table

Size of loans arranged

Exhibit 6

# 3Q 2007	2006	Investment bank	Size, US\$bn	Number of borrowers	Number of loans
1	6	BNP Paribas	7,582	12	19
2	1	ABN AMRO	6,208	11	17
3	5	Calyon	5,293	13	18
4	2	Citigroup	4,811	7	11
5	17	Societe Generale	3,980	9	15
6	-	Goldman Sachs	3,872	2	5
7	3	Barclays Capital	3,740	4	7
8-9	12	JP Morgan	3,372	1	4
8-9	-	Morgan Stanley	3,372	1	4
10	37	Credit Suisse	1,021	4	5
		Top 10 total	43,251		

Source: loans.cbonds.info

Number of loans arranged

Exhibit 7

# 3Q 2007	# 2006	Investment bank	Number of loans	Number of borrowers	Size, US\$m
1	1-2	RZB Group	27	22	870
2	4-5	Standard Bank	25	20	1,013
3	9-12	BNP Paribas	19	12	7,582
4-5	15	Calyon	18	13	5,293
4-5	3	Commerzbank	18	14	875
6-7	1-2	ABN AMRO	15	10	6,133
6-7	17-18	Société Générale	15	9	3,980
8	16	VTB	14	13	744
9	6	UniCredit Group	13	11	381
10	4-5	Citigroup	11	7	4,811

Source: loans.cbonds.info

methodology. It is compiled only for MLA, and the loan size is distributed among arrangers on a pro rata basis. The league table is published based on results for one quarter, in the first decade of the next month.

The first aspect to be mentioned is the low overlap of the arrangers' positions in tables based on the size and number of loans. The explanation lies in the fact that one group of investment banks works with major Russian borrowers, signing a few large and extra-large loans. Meanwhile, another group of banks specialises in relatively small deals arranged in quantity.

Leading positions are held by the largest European investment houses operating on the Russian market as well. The only Russian bank in the league table based on the number of syndications – the state-owned VTB Bank – is in eighth place, having arranged 14 loans worth US\$744m over three quarters of 2007, which is 10 times less than the table leader. International financial groups, such as RZB Group, UniCredit Group and others, also operate in the Russian market through their local subsidiary banks.

The struggle for leadership between BNP Paribas and ABN AMRO has been the case for almost a year. ABN AMRO led the chase based on 2006 results and from that point the number one position changed every quarter. In the third quarter the French bank outperformed its Dutch competitor again, having arranged 19 loans worth over US\$7.5bn in 2007. The league table based on the number of loans is currently led by two banks – RZB Group and Standard Bank. In 2006, RZB was the absolute leader in all league tables of this kind. However, in 2007 Standard Bank improved its position and even outperformed RZB in the CIS league table for three quarters.

Challenges and prospects for the market

We remain rather positive about the development of the syndicated lending market for Russian borrowers. Our view is based both on the positive trends that remain in spite of the recent crisis, and on the generally optimistic sentiment of market participants. The market could be considered

sufficiently resistant to external shocks, it shows good performance in terms of the size and number of loans, and borrowers are yet again winning the day with favourable loan terms.

As for expected new trends, we see them as follows. Deteriorating market conditions, as recent experience shows, are compensated by premiums and fees paid to arrangers. On the one hand, it allows the bulk of borrowers to preserve borrowing costs at current levels, at least until the anticipated sovereign rating upgrade or improvement of the global market environment.

On the other hand, the upward momentum in fees is sure to attract an ever larger groups of banks – both domestic and foreign. In particular, we may see more Japanese and other Asian banks. The improving positions of local banks among arrangers will help improve representation of various Russian industries in the market and boost local currency borrowing. Evidently, this will result in more borrowings at a floating Mosprime rate. Secondary market liquidity is also bound to increase, due to the growth of the market itself and the less unequivocal positive market conditions.

Lengthening of loan tenors and qualitative development of the market

In spite of fairly rapid quantitative development of the syndicated lending market, qualitative market formation is still lagging behind – perhaps, in part due to the domination of the oil and gas sector, whose massive bridge loans add to the competitive struggle for foreign investors among other sectors. Amidst other challenges is the high share of refinancing – up to one third of the market, which means limited growth of the 'new money' in the market. Loan tenors are still lengthening very slowly, even in spite of individual achievements of certain borrowers. General tenor levels are changing insignificantly, although loans provided by international organisations – such as A/B structures of EBRD – have been very helpful for Russian borrowers.

We expect this market environment to improve, and to see more three-year deals in the banking sector and five- to seven-year ones in the corporate sector, provided the

global conditions are favourable. At the same time, lenders' requirements to credit ratings will increase. We forecast more flexible terms of agreements and covenants.

Among new trends in the market we expect to see the involvement of the syndicated loan market into other deals of Russian companies, such as the use of warehouse facilities in securitisation deals and the quality use of financing in M&A and LBO deals.

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