December 22, 2017

Large businesses migrate towards bond market

Large Russian corporate business debt analysis

- **The average effective interest rate on the loan portfolio of large corporate businesses amounted to 8.6% in 1H2017**, which is mere 0.1% and 0.5% less than in 2015 and 2016, respectively. The decline in the interest rates has not impacted the cost of debt yet, as the spread between the effective rate for large business and the bank rate has become negative for the first time (minus 0.5-1% against 1.5-2% in 2012-2015). This will force the companies to actively refinance their obligations, on the bond market mostly, which may put a significant pressure on the net interest margin in the banking sector in 2018.
- **In 2017, corporate bonds comprised 35% of total borrowings by large businesses,** which is 5% higher than in 2015-2016. The bond market has been growing faster than corporate lending: corporate bonds market has grown by 160% since 2012, while the portfolio of loans granted to non-financial companies has grown by less than 50%. ACRA expects that the accessibility of the bond market will grow for a wider circle of corporate issuers, supported by the growing risk appetite of non-bank financial companies and the growing demand from individuals driven by the developing sector of financial intermediaries.
- **In 2017, the share of currency-denominated debt of large businesses has stabilized at 61%, and the share of floating-rate borrowings at 45%.** Regardless that the inflation is at a historic minimum, the Agency expects the monetary policy to remain moderately strict and the interest rates to remain positive in the next 2-3 years; therefore, the spread between ruble denominated and currency denominated borrowings is likely to remain high enough to prompt large businesses to maintain substantial volumes of currency denominated debts.
- **Large businesses' leverage will continue to decline.** Irrespective of the substantial growth from pre-crisis levels caused by ruble devaluation, the current leverage does not exceed 2.2x of FFO before interest and taxes (on average for the sample under review), which is by 0.2x less than in 2016. The electric power industry has remained the least borrower (1.2x), while for other industries, except machine building, the figure does not exceed 2.5x. ACRA expects that in 2018-2019, the leverage will continue to decline, as positive real interest rates do not induce higher investments from businesses.

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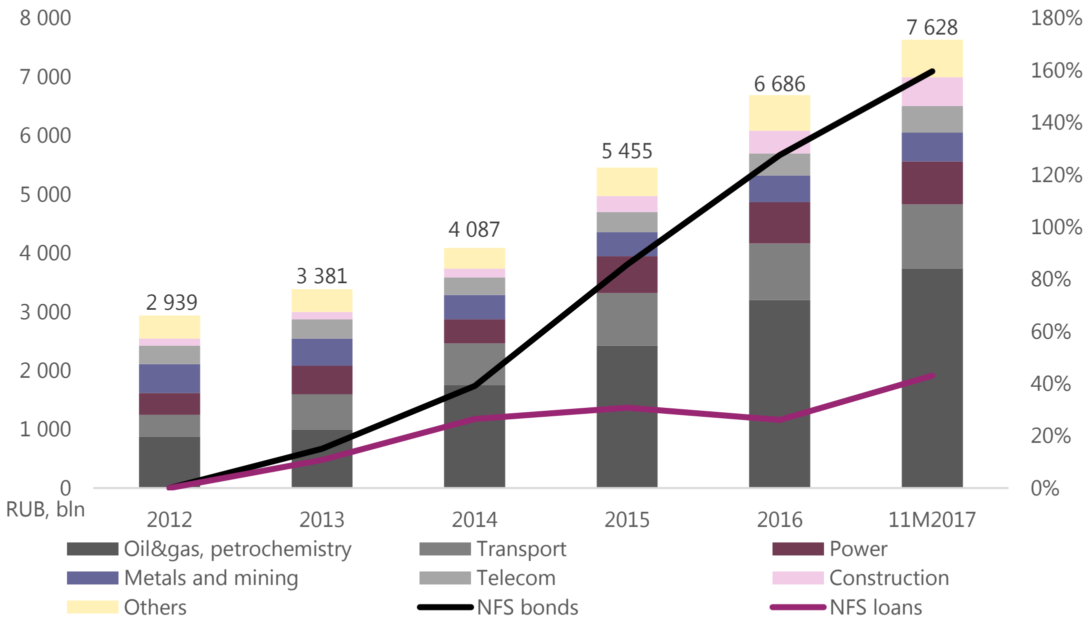
Corporate bond market outpaces corporate lending

The sample includes 80 large companies whose revenues totaled RUB 38.5 tln or 35% of the total revenues of Russian non-financial companies in 2016.

In 2017, bonds comprised about 35% of liabilities of the sample companies; the share has increased from 30% as of the end of 2016. Large business is the main borrower on the bond market (the sample companies account for up to 80% of all corporate bonds), while the share of bonds in the total corporate debt does not exceed 12%. The bond market has showed significant growth rates over the past five years: the cumulative growth of bonds issued by non-financial companies amounted to 160% since 2012, while the lending to the non-financial sector has grown by less than 50%.

The largest borrowers in the bond market are oil and gas companies—about 50% of the entire volume of bonds issued by the non-financial sector as of December 01, 2017. Other major borrower industries include transport (14%), electric power (10%), metals and mining (6%), telecommunications (6%), and construction (6%).

Figure 1. Corporate bond market significantly outpaces corporate lending



Source: CBR data, cbonds.ru, ACRA estimates

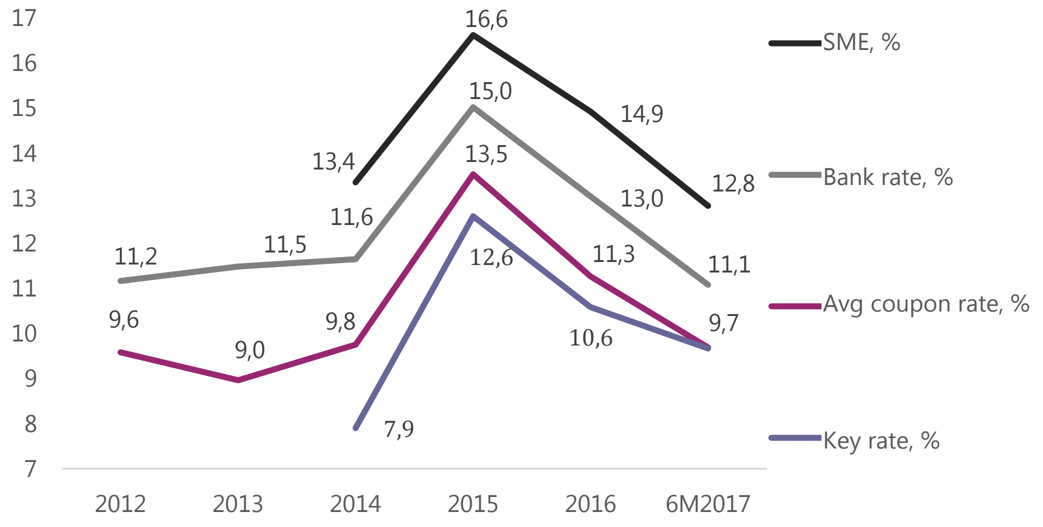
The spread between the average ruble coupon rate and the average bank rate is 1.5-2%, because borrowers in the bond market show higher credit quality. For companies with moderately high and high creditworthiness, the cost of borrowing at the bond market is comparable with bank rates, and for borrowers with moderately low and low creditworthiness, coupon rates may be more attractive.

See ACRA research [Lower interest rates to drive demand for MIFs](#) published November 23, 2017.

According to ACRA estimates, the demand for bond borrowings from large business will grow due to the need to refinance the loan portfolio amid falling interest rates. Moreover, the Agency expects that the bond market will increase be more available for a wider range of corporate issuers. This will be facilitated by both an increase in risk appetite from non-bank financial institutions (pension funds, insurance companies) and an increase in the demand from individuals facing declining interest rates with the development of financial intermediation institutions like mutual funds.

All rates are annual average.

Figure 2. Spread between the average ruble coupon rate and the average bank rate is 1.5-2%, which is due to a higher credit quality of borrowers in the bond market



Source: CBR data, cbonds.ru, ACRA estimates

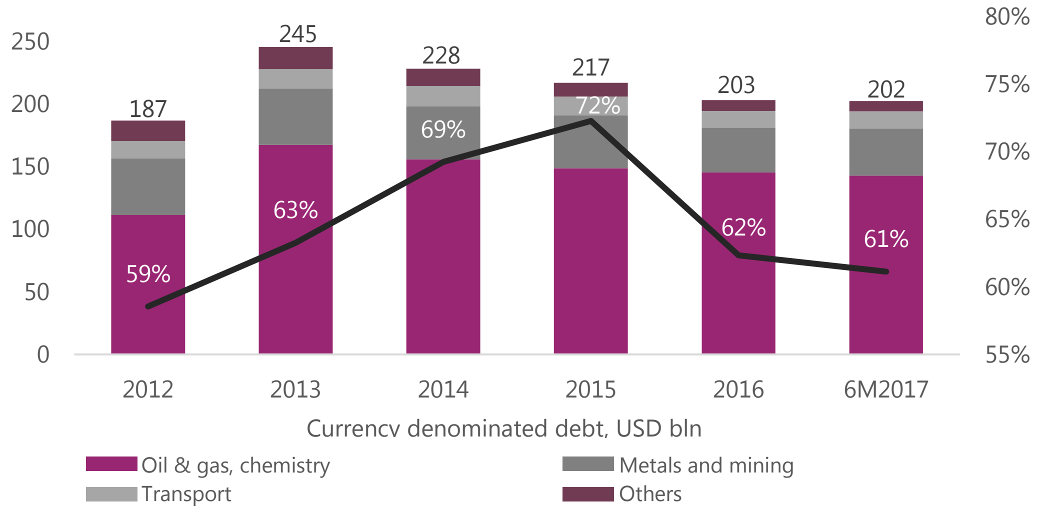
Currency-denominated debt and floating rate borrowings stay high

In 2017, about 61% of sample companies' debt was formed by currency borrowings. At the same time, the share has declined against the 2014–2015 levels (69% and 72%, respectively) due to a stronger ruble. In absolute terms, the currency denominated debt has declined gradually but slowly. As of June 30, 2017, currency denominated borrowings of sample companies amounted to about USD 202 bln (44% of all currency denominated borrowings in the corporate sector), which is 7% and 11% lower than in 2014 and 2015, respectively.

Leading currency borrowers are export-oriented industries. Over 70% of borrowings made by oil and gas, chemical, and metals and mining industries are denominated in foreign currencies; such industries comprise 89% of the total currency debt.

Two largest companies in the sample form 42% of the total debt and 53% of currency denominated debt. Without such companies, the share of currency borrowings is 50%.

Figure 3. Currency-denominated debt has stabilized

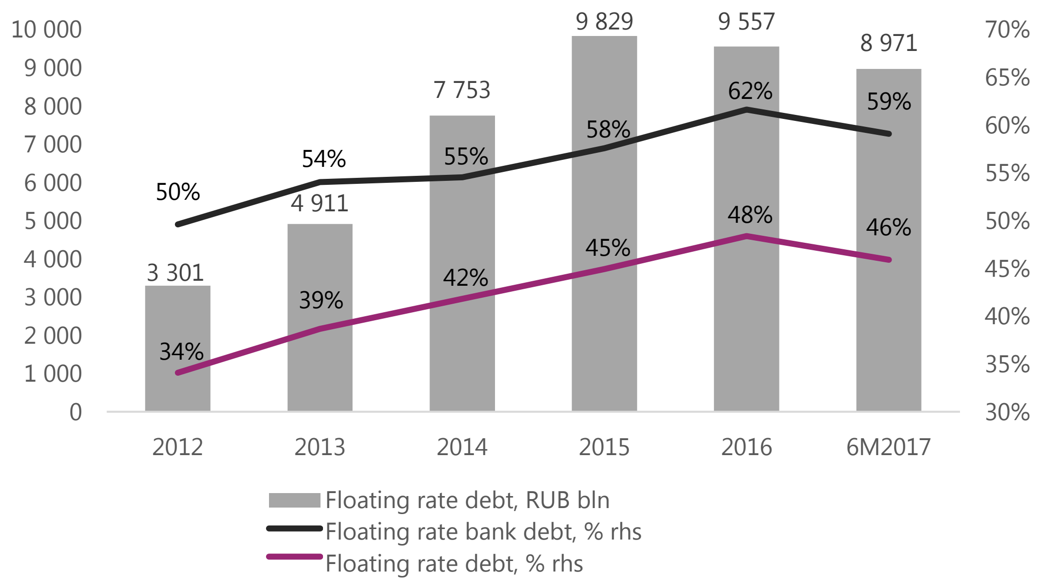


Source: IFRS statements of 80 companies, ACRA estimates

A significant share of foreign currency debt causes a significant share of floating rate borrowing in large businesses. In 2015-2017, the share of floating rate borrowings was 45-48% for the sample companies. The floating rate prevails in bank borrowings (58-62%), while the share of floating rate bonds does not exceed 20%. In terms of industry, the floating rate prevails among currency borrowers, including oil and gas (59%), chemical (58%), transport (38%), and metals and mining (43%) industries.

Without two largest companies in the sample, the share of floating rate debt amounted to 34% in 6M2017, and the share of floating rate bank debt amounted to 42%.

Figure 4. Floating rate borrowings comprise up to a half of the debt of large business



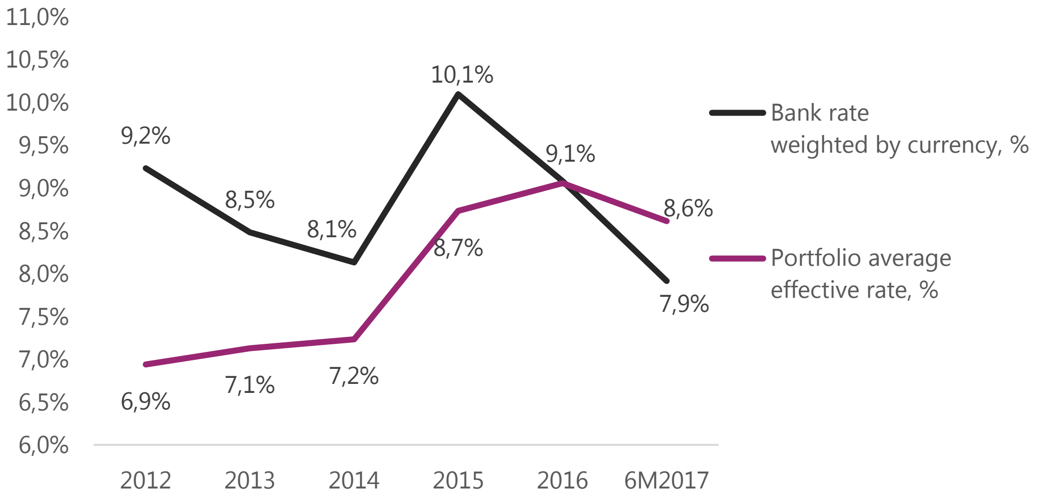
Source: IFRS statements of 80 companies, cbonds.ru, ACRA estimates

Sliding interest rates have not impacted yet the cost of debt for large businesses

In 6M2017, the average effective interest rate on the loan portfolio in the analyzed sample was 8.6%, having declined by just 0.1% and 0.5% compared to 2015 and 2016, respectively. The decline in interest rates has not yet affected the cost of borrowing. The spread between the effective rate of large corporate business and the average banking rate weighted by currency was about 1.5% in 2013-2015. In 2016, the bank rates became equal and in 6M2017 the bank rate outperformed the effective rate of large businesses. First of all, this is caused by a significant share of long-term borrowings in the portfolio of large business (more than 70%), which, on the other hand, has made it possible to avoid a significant rise in the cost of debt in 2015-2016. According to ACRA estimates, in 2018, the corporate sector will actively refinance the debt portfolio with cheaper borrowings, primarily bond issues, which will exert a considerable pressure on the net interest margin of Russian banks.

See ACRA research [Stagnant net interest margin to hold back creditworthiness of Russian banks] published November 30, 2017.

Figure 5. Lower loan rates have a partial impact on the total cost of debt of large business

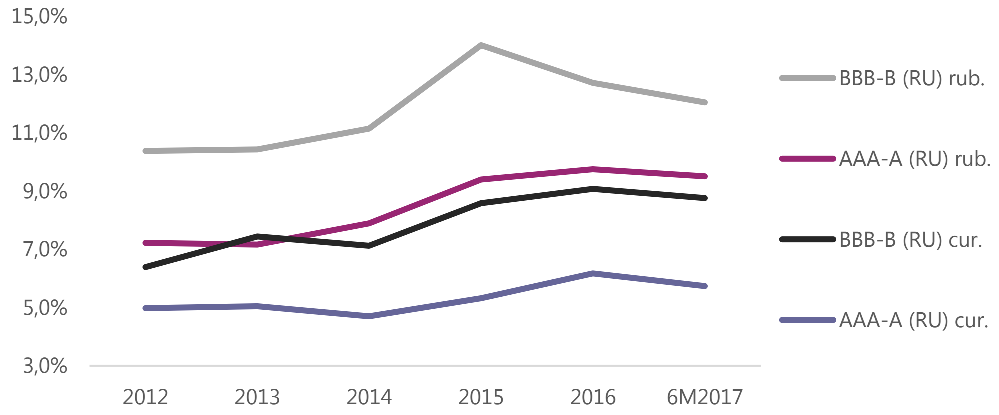


Source: IFRS statements of 80 companies, CBR data, ACRA estimates

The bank rate is weighted by currency in a proportion identical to the share of currency/ruble obligations in the sample under review.

The 4-5% spread between the foreign currency and ruble rates for large businesses is stable, which causes a low differentiation in the cost of borrowing among ruble and foreign currency borrowers, depending on their creditworthiness. Borrowers from the most stable infrastructure industries that borrow in rubles have a significantly higher rate in comparison with commodity sector borrowers that are subject to high volatility. Moreover, in certain cases, the borrowing rate of foreign currency borrowers with a moderate or moderately low creditworthiness is often lower than the rate of ruble borrowers with a moderately high or high creditworthiness.

Figure 6. A substantial spread between currency and ruble rates remains stable



Source: IFRS statements of 80 companies, ACRA estimates

See ACRA research [Low inflation in Russia to force the government and businesses to seek new forms of flexibility](#) published October 9, 2017.

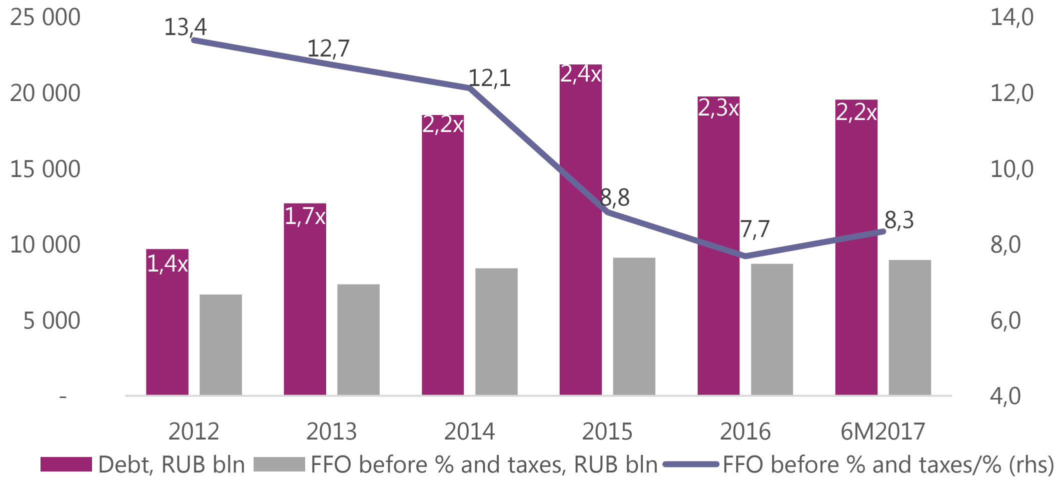
Despite the decline in inflation to a historic low, the Agency expects the monetary policy to be moderately tight and real interest rates to remain positive in the next 2-3 years, which will support a significant spread between the cost of ruble and foreign currency borrowings. This will encourage large businesses to maintain significant amounts of debt denominated in foreign currencies.

Large businesses' leverage will continue to decline

FFO before interest and taxes = funds from operations before working capital changes, interest and taxes. FFO is similar to EBITDA, but excludes non-cash items.

Despite the fact that the leverage increased significantly in 2014-2015 (due to growing foreign currency borrowings following the devaluation of ruble), the leverage of large corporate businesses, on the whole, has remained at an acceptable level and is gradually decreasing. Thus, the ratio "Total debt/FFO before % and taxes" weighted for the sample under review equaled to 2.2x in 6M2017 versus 2.4x in 2015. The coverage of interest payments by cash flows from operations is also at a comfortable level: the ratio "FFO before % and taxes/interest" was 8.3x for 6M2017, which slightly higher than in 2016.

Figure 7. Leverages of large businesses continue to decline



Source: IFRS statements of 80 companies, ACRA estimates

Except machine building, almost all sectors under review demonstrate an acceptable leverage not exceeding 2.5x of FFO before % and taxes. The most significant decrease in the leverage is demonstrated by the metals and energy sectors, most of which have completed their capital expenditure programs and are generating significant free cash flows. At the same time, the electric power industry, telecommunications and retail trade remain the least borrowers (with the leverage not exceeding 2.0x of FFO before % and taxes). According to the Agency estimates, the leverage will continue to decline in 2018-2019, as positive real interest rates do not create incentives for high investment activity of businesses.

Table 1. Energy sector is the least borrower

Industry	Debt/adj. FFO			Adj. FFO/%		
	2012	2015	6M2017	2012	2015	6M2017
Oil & gas	0.9	2.1	2.2	31.1	17.1	14.1
Chemical	1.5	2.7	2.6	14.4	9.6	7.3
Metals and mining	3.0	3.2	2.3	5.8	5.9	5.7
Transport	1.9	3.3	2.5	9.4	4.8	6.3
Energy	2.0	2.1	1.2	7.8	5.2	8.3
Telecom	1.7	2.0	1.9	8.6	6.8	6.2
Machine building	2.5	72.1	7.1	5.5	0.1	1.2
Retail trade	2.2	1.9	2.0	5.3	4.7	5.1

Source: IFRS statements of 80 companies, ACRA estimates

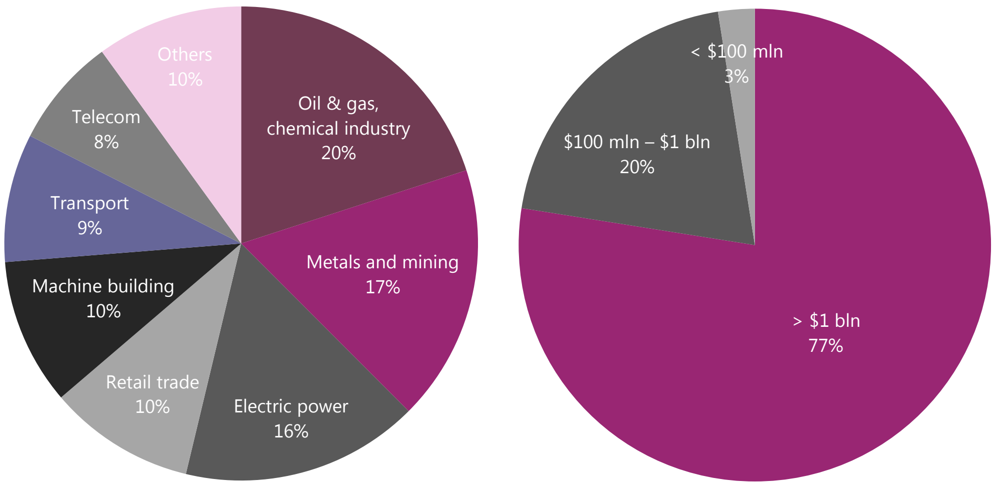
In terms of maturity, the long-term debt is dominant in the portfolio, while the share of short-term debt does not exceed 30% for the entire period under review. The highest share of short-term debt falls on the retail trade (39%), and the share of the transport sector is the lowest (15%).

Sampling and estimation methods

Trends outlined in this research are applicable, first, to large corporate businesses. Loan portfolio dynamics and profile in smaller companies may differ significantly.

The sample includes 80 companies that are large corporate businesses. In 2016, three quarters of such companies had revenues of more than $ 1 billion, and the total revenue of the sample companies was about RUB 38.5 trillion (35% of the total revenue of Russian non-financial companies). As for the industry affiliation, 37% of the sample companies belong to the mining and processing sector, 16% to the electric power sector, 8-10% to each of the engineering, transport, retail trade and telecommunications sectors.

Figure 8. Sample profile by industry and company size



Source: IFRS statements of 80 companies, ACRA estimates

To calculate financial indicators and analyze corporate loan portfolios, IFRS/US GAAP reports were used with corresponding notes, while financial indicators were calculated and interpreted in accordance with the ACRA approaches, in some cases, adjustments were applied to certain items contained in the financial reports.

In terms of currency, interest rate, and type of borrowing, debt profiles were determined based on a detailed analysis of loan portfolios of each company in the sample. The effective interest rate on the loan portfolio was calculated by mapping the accrued interest expense against the weighted average leverage for respective periods for each company.