November 11, 2016

Large businesses keep borrowing in foreign currency

Russia's large corporate sector debt: Structure analysis

- **As of 1H2016, 70% borrowings by Russia's large corporate sector were made in foreign currency.** In absolute terms, the sector's total volume of foreign currency-denominated debt decreased by only 2.5% since 2014 and by 10% since 2013, although observations show that external foreign currency corporate debt is being replaced with domestic bank debt. Considering the high share of foreign currency revenues earned by the extractive and mineral processing industries, ACRA expects that the share of the large corporates' foreign currency debt will stay high as well.

- **As of 1H2016, the average effective interest rate of the large corporates' loan portfolio amounted to 8.7%,** having gained only 1.8 bps since 2013. In the times of financial markets volatility, large businesses were able to avoid sizable interest expense spikes due to substantial shares of fixed rate long-term debt in their portfolios. The current costs of borrowing reduction trend has not yet affected the average cost of debt for most industries (with the exception of trade), but the effect will manifest itself as early as 2017.

- **In 2016, the share of floating rate borrowings in large corporates' loan portfolios has climbed to 45%.** In 2012, it registered at only 35%, owing to the slowed corporate activity on the bond market (the portfolio share went down from 39% at YE2012 to 31% at 1H2016) and the banks' overall strategy of switching to floating interest rates. ACRA points out that given the observed interest rate reduction trend, this factor will help reduce debt servicing costs, but on the whole, it adversely affects companies' credit profiles due to costs of borrowing becoming more sensitive to interest rate fluctuations.

- **Debt load of large businesses stays at a comfortable level.** Despite its RUB devaluation-driven growth compared to the pre-crisis level, the current debt load across the analyzed sample does not exceed 2.3x FFO (funds from operations) before interest and taxes. Oil & gas, power & utilities, telecommunications, and retail remain the least heavily indebted industries (within 2.0x), while for the other sectors with the exception of machinery & equipment, this indicator does not exceed 3.5x. ACRA anticipates that in 2017, debt load of large businesses will remain on a comparable level.

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The analyzed sample was comprised of 80 large corporates with the total 2015 revenue of roughly RUB 38 trillion, which equals 35% of total revenues earned by Russia's non-financial institutions.

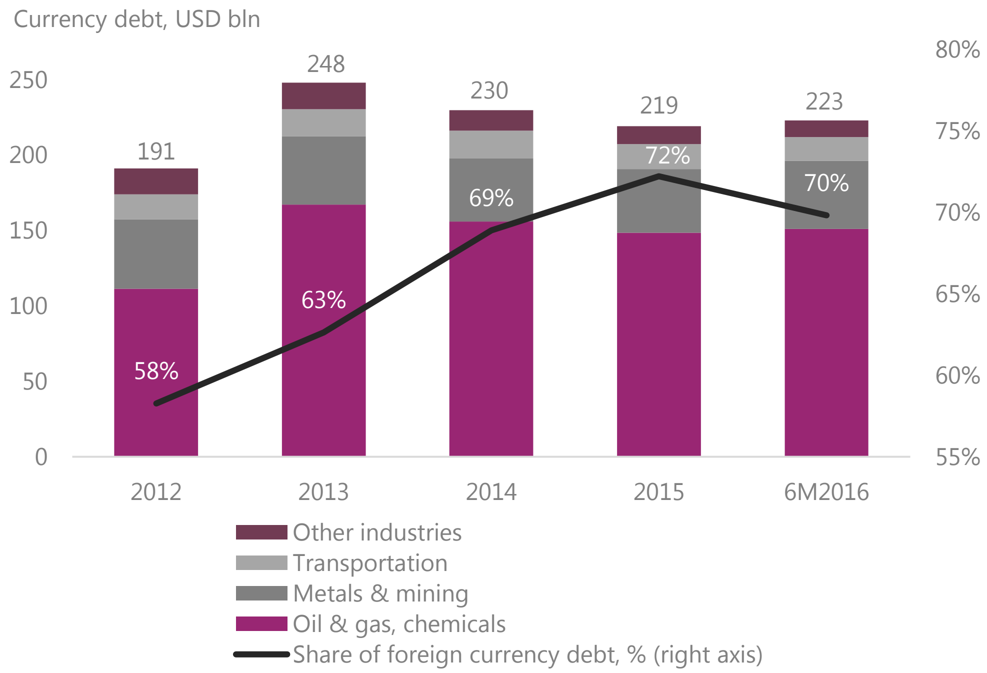
Borrowings by oil & gas, chemical, and metals & mining industries make up to 90% of total foreign currency debt

As of June 30, 2016, roughly 70% of total debt of the sample companies was incurred in foreign currency. It should be noted that due to the RUB devaluation, this figure has grown significantly compared to its 2012–2013 levels (58% and 63%, respectively). In real terms, volume of foreign currency debt is decreasing steadily although somewhat slowly. As of June 30, 2016, foreign currency borrowings by the sample companies amounted to around USD 223 bln (47% of the corporate sector total), dropping by 10% and 2.5% versus 2013 and 2014, respectively.

Export-oriented industries are the leading foreign currency borrowers. The oil & gas, chemical, and metals & mining sectors make over 80% their borrowings in foreign currency, with 88% of total foreign currency debt being incurred by these industries. Transportation and telecommunications also have large shares of foreign currency debt — 56% and 38%, respectively. Other industries claim 10–15% of total, at the most.

The two largest sample companies make up 37% total debt and 48% foreign currency debt, respectively. Net of these two, foreign currency borrowings by the sample companies amount to 58%.

Figure 1. Foreign currency debt is decreasing steadily if somewhat slowly



Source: IFRS reporting by the 80 sample companies, ACRA calculations

Total foreign currency borrowings across the entire corporate sector mirror those of large businesses. Since YE2014, their share has shrunk by no more than 4%, and as of 1H2016, according to the Bank of Russia data, amounted to USD 475 bln. That said, the share of foreign currency debt in total loan portfolio is below that of large corporates, namely, 50% across the sector against 70% across the analyzed sample. While absolute volumes of currency-denominated debt remain unaltered, its structure is changing. Following the sanctions imposed in 2014, the volume of external foreign currency borrowings by corporates shrank considerably (-12% since YE2014), while foreign currency bank debt showed a growth of 11% during the same period, which, inter alia, was backed by foreign currency liquidity injections by the Bank of Russia.

Current interest rate reduction trend has not yet affected total cost of debt

During the first six months of 2016, the average loan portfolio effective rate within the analyzed sample amounted to 8.7%, or +0.2% year-on-year. Overall, during the period of financial markets volatility of 2014–2015, effective rate showed moderate growth of around 1.8 bps against the 2013 figure. A positive difference was made by the well-structured loan portfolio: at YE2013, the average share of short-term debt incurred by the sample companies did not exceed 21%, and their fixed-rate liabilities amounted to 61%. A number of companies used hedging tools in order to manage interest rate risk of their floating rate borrowings, which also helped balance off the negative effect.

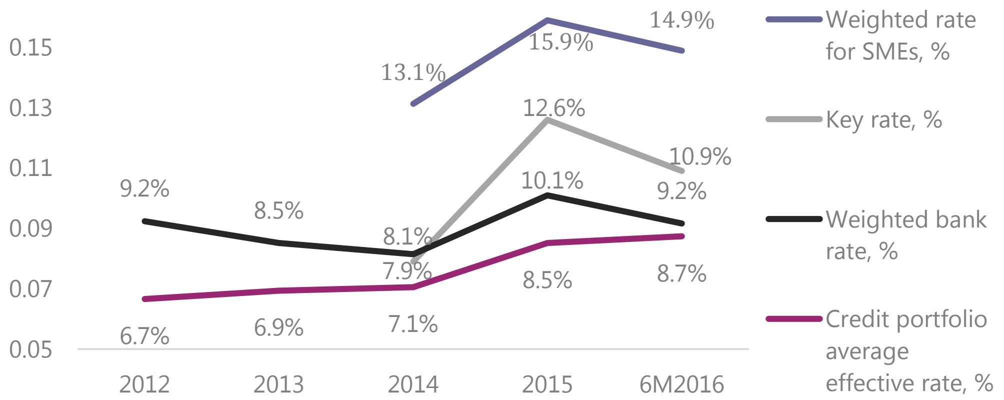
The large corporates' effective rate spread does not exceed 1.5% of currency-weighted average bank rate, wherein the difference with that of small and medium-sized businesses (SME) can reach 6–7%, considering the latter's negligible share of foreign currency borrowings.

All quoted interest rates are averaged for year.

Bank rate is currency-weighted pro rata identical to currency/RUB debt share in the sample.

SME rate accounts for share of foreign currency debt in the SME sector debt structure (10%).

Figure 2. Lower interest rates have not yet affected total cost of debt for large businesses



Source: IRFS reporting by the 80 sample companies, Bank of Russia data, ACRA calculations

ACRA expects a further decrease of key rate and cost of debt (see the September 12, 2016 ACRA research entitled "Russian Economy: No Knock Out to Recession Yet. Russia: Economic Outlook 2020 Update.")

The fact that the observed interest rate reduction trend has not yet affected loan portfolio effective rate is attributable to the delayed influence of market interest rate changes on the cost of debt for companies; however, this trend will manifest itself as early as 2017. Nevertheless, as of the first six months of 2016, an effective rate decline became apparent within a number of industries featuring higher shares of short-term debt — namely, retail.

Effective rate spreads between industries remain fairly stable, meaning that the way creditors regard various levels of industry-related risk stays the same.

Figure 3. Industries with higher shares of short-term debt are seeing their effective rates start to go down

Source: IFRS reporting by the 80 sample companies, ACRA calculations

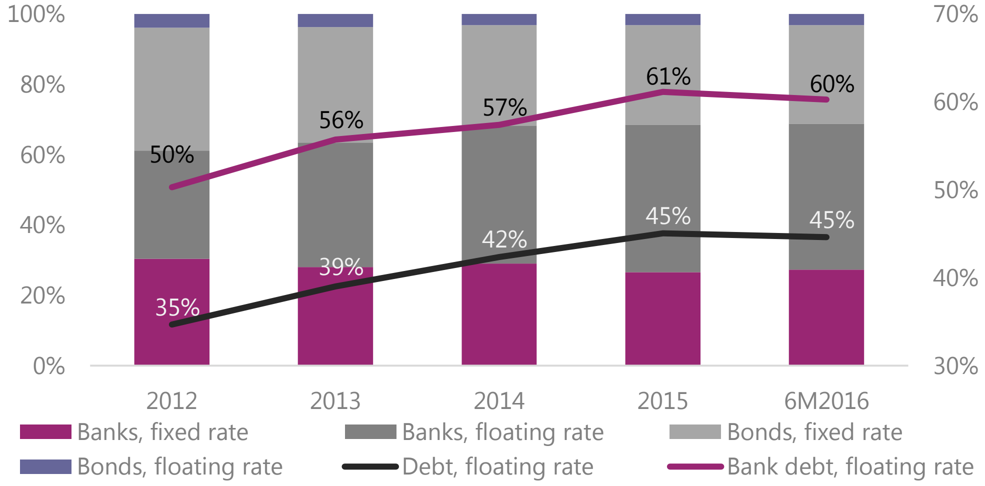
Share of floating rate bank loans is growing

In the recent years, loan portfolio structure dynamics has been characterized by a sizable surge of the share of floating rate loans: from 35% in late 2012 to 45% in H12016 (within the sample). This trend stems from activity slowdown on the bond market, where the share of floating rate loans has historically been low (within 10%). Thus, the share of bonds in the loan portfolio structures of large businesses included in the sample has declined from 39% at YE2012 to 31% as of H12016 (the share of bonds in total debt incurred by the corporate sector does not exceed 10%, with large businesses generating almost the entire volume of bonds).

Another just as important reason has been banks' strategy of switching to floating rate lending in order to minimize their interest rate risk exposures. Thus, the share of such loans in the sample banks' loan portfolio structures went up from 50% in 2012 to 60% as of June 30, 2016.

Net of the two largest companies in the sample, between 2012 and 1H2016, its share of floating rate debt grew from 33% to 39%, share of floating rate bank debt went up from 45% to 50%, and share of bonds dropped from 36% to 28%.

Figure 4. Share of floating rate bank loans is growing

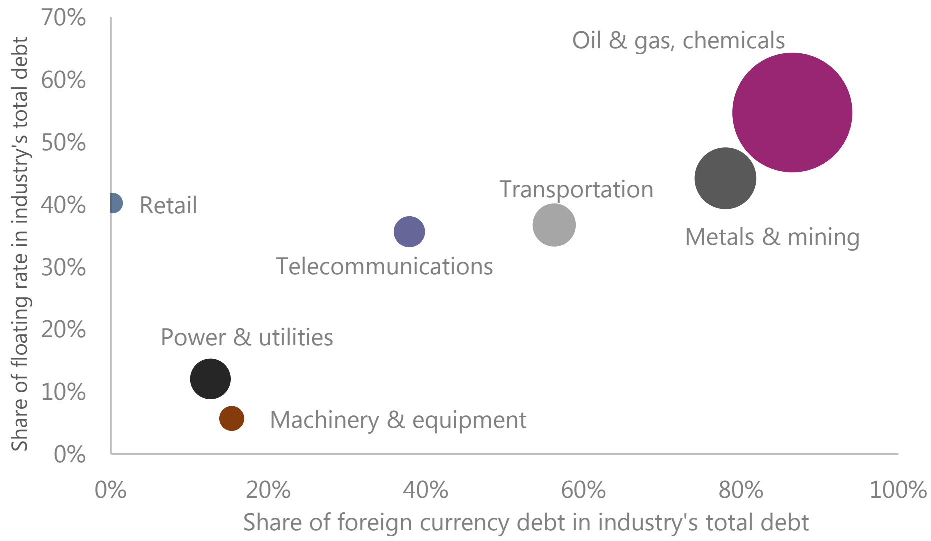


Source: IFRS reporting by the 80 sample companies, ACRA calculations

From the industry viewpoint, floating rate is prevalent mainly for foreign currency borrowers, however in some industries, specifically in retail, a significant share of floating rate loans may be present within an exclusively RUB loan portfolio.

FFO (funds from operations) before interest and taxes equals operating cash flow before changes in working capital, interest payments, and taxes. It is the same as the more commonly used EBITDA, except that it does not account for non-cash items that are usually included in EBITDA.

Figure 5. Floating rate is typical primarily for industries that borrow in foreign currencies (shape sizes indicate industries' shares in total debt)



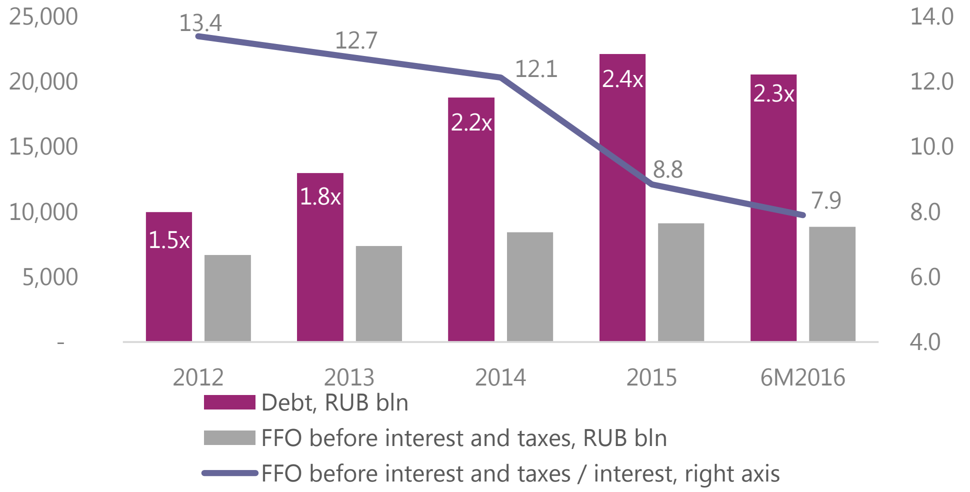
Source: IFRS reporting by the 80 sample companies, ACRA calculations

Debt load stays at comfortable level

As of June 30, 2016, net of the oil & gas industry, the sample companies' Total debt/FFO before interest and taxes ratio amounted to 2.7x, and FFO before interest and taxes/Interest payments amounted to 5.0x.

Although during the period under review, debt volume has grown significantly, the primary cause of which was a surge of foreign currency borrowings due to the RUB devaluation, the overall debt burden of large corporates remains at an acceptable level. Thus, in H12016, the analyzed sample-weighted Total debt/FFO before interest and taxes ratio amounted to 2.3x against 1.5x in 2012 (a slight decrease against 2015 was related to the RUB appreciation effect). Level of coverage was decreasing more rapidly due to the growing effective interest rate: in H12016, the FFO before interest and taxes/Interest payments indicator plummeted to 7.9x from 13.4x in 2012.

Figure 6. Coverage ratios has significantly decreased during the period under review



Source: IFRS reporting by the 80 sample companies, ACRA calculations

Practically all of the analyzed sectors, with the exception of machinery & equipment, demonstrate acceptable debt volumes not exceeding 3.5x FFO before interest and taxes. Coverage ratios are also staying at a comfortable level. The least heavily indebted industries (in which debt load does not exceed 2.0x FFO before interest and taxes) are still oil & gas, power & utilities, telecommunications, and retail.

Table 1. Energy sector is still the least heavily indebted sector

Industry	Debt change since 2012	Percentage change since 2012	FFO change since 2012	Debt / Adjusted FFO		Adjusted FFO / %	
				2012	1H2016	2012	1H2016
Oil & gas	167%	158%	25%	0.9	2.0	31.1	15.0
Chemicals	224%	207%	69%	1.5	2.9	14.4	7.9
Metals & mining	79%	80%	67%	3.0	3.2	5.8	5.4
Transportation	70%	182%	38%	2.5	3.1	9.4	4.6
Power & utilities	43%	146%	58%	2.0	1.8	7.8	5.0
Telecommunications	-2%	35%	-2%	1.7	1.7	8.6	6.3
Machinery & equipment	211%	297%	-101%	2.5	negative	5.5	negative
Retail	65%	116%	96%	2.2	1.9	5.3	4.8

Source: IFRS reporting by the 80 sample companies, ACRA calculations

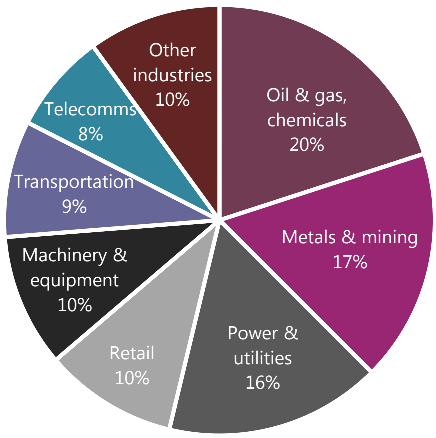
In terms of maturity, long-term debt consistently dominates in portfolio structures, while short-term debt does not exceed 25% for the entire period under review. The highest shares of short-term debt are incurred by power & utilities (28%), machinery & equipment (36%), and retail (39%) sectors, whereas oil & gas and chemical sectors are in the lead with the lowest shares (18% each).

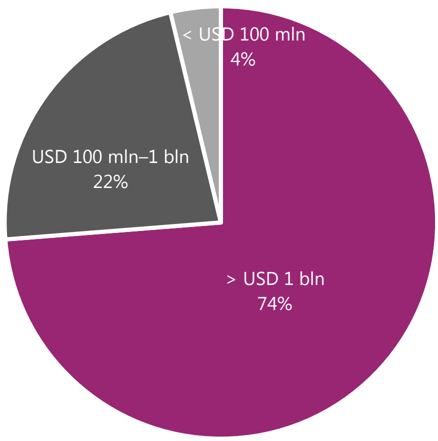
Sample parameters and calculation methodology

The trends outlined in this research are applicable primarily to large corporates. Dynamics and structures of loan portfolios of smaller size companies may differ quite drastically.

The analyzed sample was comprised of 80 large corporate sector companies. That said, in 2015, three quarters of those companies earned revenues in excess of USD 1 bln. The total revenue of the sample companies at YE2015 amounted to RUB 38 trillion (35% of total revenue earned by Russia’s non-financial companies). In terms of sectoral affiliation of the sample group, 37% companies represented the extractive and mineral processing industries, 16% represented the power & utilities sector, and machinery & equipment, transportation, retail, and telecommunications accounted for 8–10% each.

Figure 7. Sample structure by industry and company size





Source: IFRS reporting by the 80 sample companies, ACRA calculations

For calculating the financial ratios and analyzing the loan portfolio structures of the sample companies, ACRA used IFRS/US GAAP statements with appropriate notes; it should be noted that since calculation and interpretation of financial ratios were made in line with the ACRA methodology, wherever needed ACRA had adjusted individual items on the sample companies’ financial statements.

In terms of currency, interest rates, and loan types, ACRA determined debt structure on the basis of a detailed analysis of each sample company’s loan portfolio. Loan portfolio effective rates were calculated by dividing the accrued interest expenses by the average-weighted debt for the relevant period for each company.

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