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Research

Research Briefing
Emerging markets

CEE corporate bonds
Untapped potential but challenges remain

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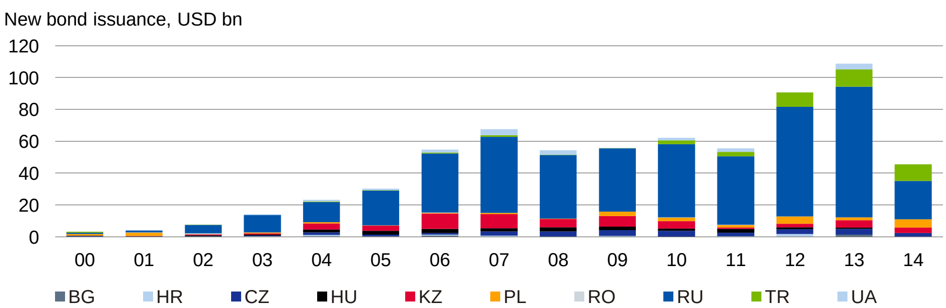
Corporate bond issuance in Central & Eastern Europe (CEE)[1] increased sharply in the decade up to 2013, prior to a significant decline in 2014 and Q1 2015 against the backdrop of the Russia crisis. In terms of size the market[2] is small in an international comparison. CEE financial markets remain largely bank-based, with underdeveloped bond and stock markets.

Russian corporate issuers dominate CEE bond markets in USD terms, while the largest market relative to GDP is Kazakhstan. Of the USD 437 bn in corporate bonds outstanding as of April 2015 over 60% correspond to Russian entities. The market is concentrated in a few issuers: in most of the countries the top 10% accounts for almost 70% of outstanding corporate bonds. Most of the largest issuers belong to the oil & gas and financial sectors.

The bulk of CEE corporate bonds have short maturities and are issued in foreign currency. Except in Czech Republic and Kazakhstan, CEE corporate bonds have maturities shorter than 10 years. Issuance in foreign currency dominates, save in Czech Republic with its local-currency corporate bond share of almost 60% followed by Poland and Romania with more than 45%. Factors such as low inflation and strong legal rights seem positively correlated with local-currency shares.

Countries need to develop a strong investor base. A large and diversified source of demand is a key ingredient of more sophisticated bond markets. Progress in this respect has been mixed in CEE. Notably, the reversal of pension reforms in several countries, which in part led to the transfer of assets from private pension funds to the public sector, can be seen as a step back.

Corporate bond issuance fell sharply due to Russia crisis 1

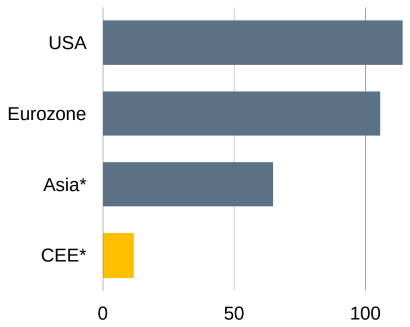


Sources: Dealogic, Deutsche Bank Research

[1] Unless indicated otherwise, CEE includes Bulgaria, Croatia, Czech Republic, Hungary, Kazakhstan, Poland, Romania, Russia, Turkey and Ukraine.
[2] It includes bonds issued by financial and non-financial companies both directly and via special purpose entities, and excludes sovereign bonds.

CEE corporate bond market still small 2

% of GDP, Q3 2014



*Asia/ aggregate includes CN, MY, TH, SG and HK
CEE includes HR, CZ, HU, PL, RU and TR
due to limited data availability from BIS.

Sources: BIS, IMF, Deutsche Bank Research

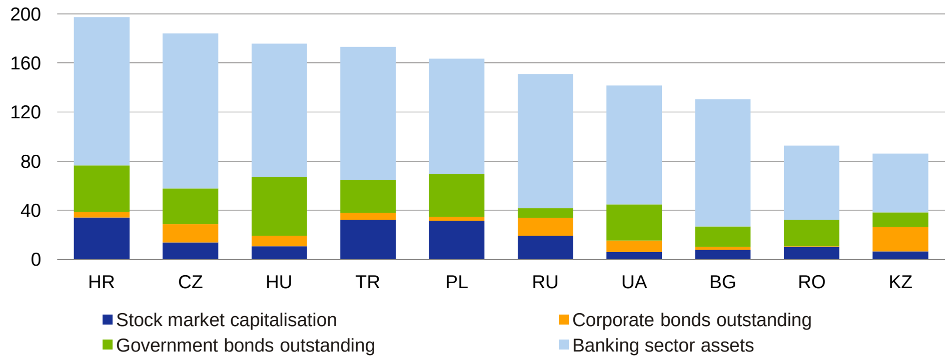
Sharp rise in bond issuance

In the ten years up to 2013 Central and Eastern European (CEE) companies increasingly raised funds on domestic and international bond markets (chart 1). After the global financial crisis issuance stagnated but in 2012-13 it mounted sharply, reaching a peak of USD 109 bn. However, the trend was interrupted by the crisis in Russia (including international sanctions on Russian companies) in 2014. In Q1 2015 CEE new corporate bond issuance stood at USD 6 bn or roughly half the size of new issuance in Q1 2014.

Regarding outstanding bonds as a percentage of GDP, the CEE corporate bond market is very small in an international comparison. Data from the BIS puts the size of the market in a sub-set of CEE countries at only 12% of GDP, versus over 60% in Asian countries and over 100% in industrial countries (chart 2). CEE financial markets remain largely bank-based, with bond and stock markets underdeveloped (chart 3). As of 2014, the size of corporate bond markets ranged from 1% of GDP in Romania to 20% of GDP in Kazakhstan.

CEE financial markets by segment 3

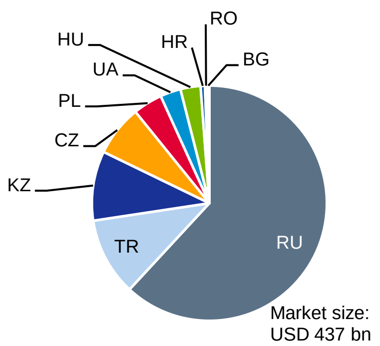
% of GDP, 2014



Sources: Bloomberg, Reuters, IMF, national authorities, CEIC, Deutsche Bank Research

Russian corporations dominate the CEE bond market ... 4

% of total outstanding as of April 8, 2015

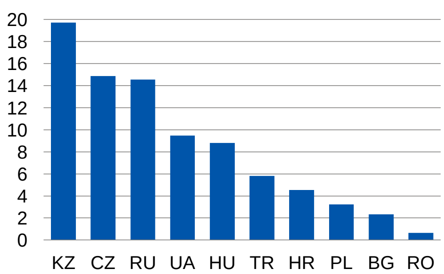


Sources: Thomson Reuters Eikon, Deutsche Bank Research

Although capital markets do not play a dominant role in financing CEE companies yet, they are a potentially important source of long-term funding which can help companies improve risk management, render them less dependent on bank funding (e.g. in the event of a credit crunch or an external shock as in 2008-9), and offer diversification benefits for domestic private and institutional investors.

... but in relative terms Kazakhstan is the leader 5

% of 2014 GDP



Sources: Thomson Reuters Eikon, IMF, Deutsche Bank Research

Stylised facts: High issuer concentration, short maturities

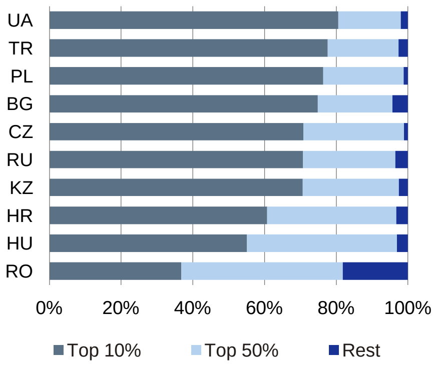
Russian issuers dominate CEE bond markets in USD terms (accounting for 62% of total outstanding bonds, chart 4), while Kazakhstan is the country with the deepest corporate bond market in comparison with the size of the economy, followed by Czech Republic and Russia (chart 5).[3]

Non-FI corporations make up 23% of CEE bonds outstanding, while banks account for 27% and other financial institutions for 50%.[4]

[3] Outstanding corporate bond data are based on Thomson Reuters Eikon, downloaded on April 8, 2015 and converted into US dollars using the exchange rates of the same day.
[4] “Other financials” include the following sectors: Independent Finance, Leasing, Life Insurance, Mortgage Banking, Property and Casualty Insurance, Real Estate Investment Trust, Securities

High issuer concentration 6

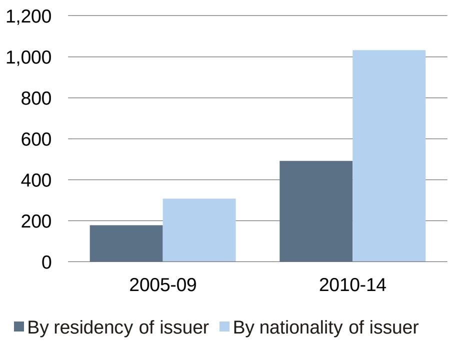
Largest corporate issuers' bonds, % of total outstanding as of April 08, 2015



Sources: Thomson Reuters Eikon, Deutsche Bank Research

Issuance of international debt securities by EM corporations 7

USD bn



Sources: BIS, Deutsche Bank Research

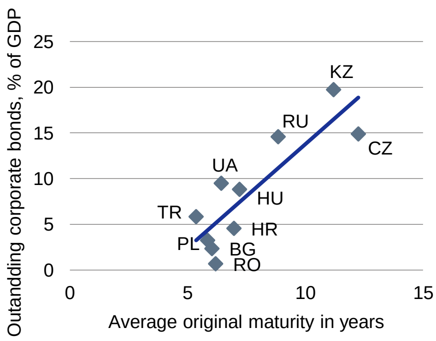
High market concentration by country and, within countries, by issuer, point to existing potential for market deepening. The top 10% of issuers account for almost 70% of outstanding bonds in CEE economies (see chart 6). The Appendix on page 7 shows the 20 largest CEE corporate issuers, together responsible for 40% of outstanding bonds. They belong predominantly to the oil & gas sector as well as the financial sector (mostly state-owned) in Russia and Kazakhstan, followed by Turkey and Czech Republic.

We use a broad definition of corporate bonds, including those issued by entities (e.g. subsidiaries, special purpose vehicles) not domiciled in the borrower's country. This modality is especially prevalent in Ukraine, Russia and Poland. The relevance of this segment is evident when considering that, of the top-four CEE corporate bond issuers by amount outstanding, three are offshore entities (see table in the Appendix). For CEE as a whole, 43% of outstanding corporate bonds belong to non-domiciled entities. The emergence of this "offshore" borrowing is not particular to CEE but seems to be the case for other emerging markets as well[5] (chart 7).

With respect to maturity, CEE corporate bonds remain relatively short although not out of line with those of other emerging markets or even some developed markets. Average (weighted) original maturities vary from 5 to 12 years. Broadly speaking, countries with a deeper bond market have been able to issue bonds with a relatively long maturity (see chart 8). Among issuers, mostly financial institutions (FIs) – e.g. those in the mortgage business – have issued long bonds, with maturities of over 20 years and even reaching 50 years. In the Czech Republic covered bonds issued by FIs have played an important role in lengthening maturities, thus helping to avoid balance-sheet maturity mismatches.

Whether longer maturities are preferably reached via domestic or external issuance depends on the country (chart 9). Turkey and Kazakhstan seem to have been able to secure longer-term borrowing through Eurobonds, while for Czech Republic, Bulgaria and Russia the opposite is true.

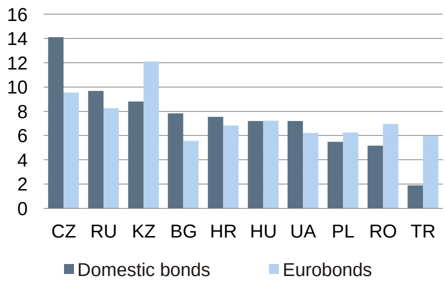
Deeper markets correspond to longer maturities 8



Sources: Thomson Reuters Eikon, IMF, Deutsche Bank Research

Maturity by jurisdiction type: no clear pattern 9

Original maturity, years



Sources: Thomson Reuters Eikon, Deutsche Bank Research

Development of local (currency) bond markets: Macro-stability and good governance are crucial

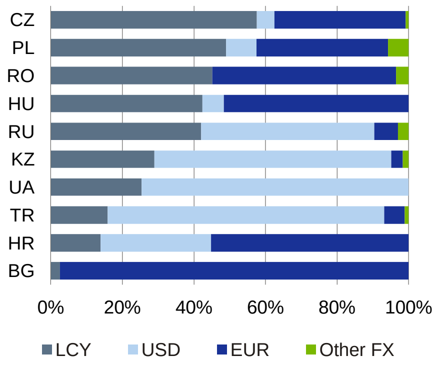
Issuing in local currency allows firms to better manage their funding risks by mitigating the impact of international financial market shocks or – in the case of

and Financial - Other. Please note that "Financial - Other" may include bank or non-FI corporate debt issued via non-domiciled entities and thus its share may be overestimated.

5 Chui, M, Fender, I. and Sushko, V. (2014). "Risks related to EME corporate balance sheets: the role of leverage and currency mismatch", BIS Quarterly Review.

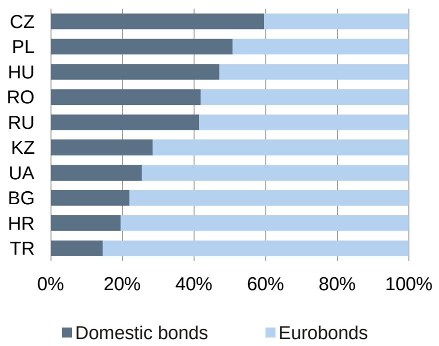
Currency composition: relatively high reliance on FX borrowing 10

% of outstanding corporate bonds



Sources: Thomson Reuters Eikon, Deutsche Bank Research

Domestic bond markets not dominant 11



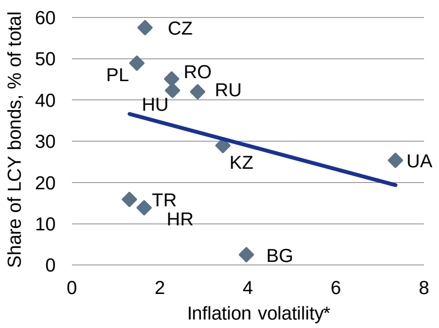
Sources: Thomson Reuters Eikon, Deutsche Bank Research

non-exporters – to avoid currency mismatches between their revenues and their debt payment streams. The EBRD's Local Currency and Capital Markets Development Initiative, launched in May 2010, aims at increasing the share of domestic funding in CEE.[6] Key focus areas here are knowledge transfer, lending in local currency and development of a domestic market infrastructure.

In CEE the categories "local-currency bonds" and "domestic bonds" can be used almost interchangeably, except for Bulgaria, where corporations issue in euros in the domestic market, too, given the country's currency board arrangement (charts 10 and 11).

A sound and sustainable macroeconomic framework is a prerequisite for the flourishing of local debt markets.[7] Good-quality institutions are equally important. CEE seems to roughly confirm these principles. For example, countries which have lower inflation volatility (chart 12) or better legal rights (chart 13) also have a higher share of local-currency (LCY) bonds in total corporate bonds. Czech Republic is in the lead with almost 60% of corporate bonds issued in local currency, followed by Poland and Romania with more than 45%.

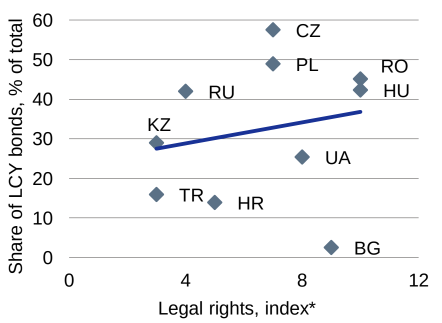
High inflation volatility negatively correlated with LCY bond share 12



* Inflation volatility is the standard deviation of annual CPI inflation growth over 2005-2014

Sources:Thomson Reuters Eikon, Deutsche Bank Research

Strong legal rights positively correlated with LCY bond share 13



* The index ranges from 0 to 12, with higher scores indicating that a better framework is in place

Sources: World Bank Doing Business, Thomson Reuters Eikon, Deutsche Bank Research

The public sector needs to foster market infrastructure and develop a benchmark yield curve

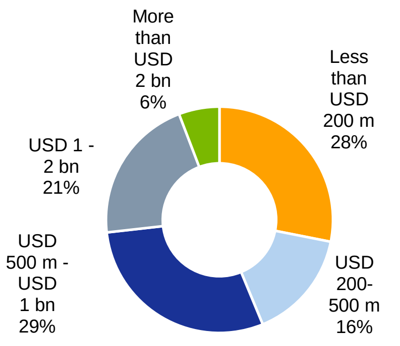
Besides the macro-stability and governance issues mentioned above, the government can employ a wide range of tools in building up the market infrastructure and boosting the development of corporate bond issuance, including setting up effective clearing and settlement facilities (e.g. the Catalyst platform for non-Treasury securities trading set up in Poland in 2009), or implementing adequate taxation policies, among others. Moreover, the government plays an important role in establishing the risk-free yield curve that serves as a benchmark for pricing corporate debt securities issued on the same market. From this point of view, it is important to develop a liquid benchmark yield curve that covers the whole spectrum of maturities. In CEE, most of the government bond issues bear below 10-year tenors. According to Thomson Reuters Eikon data on benchmark sovereign yield curves, Czech Republic is the only country in CEE issuing long-term bonds with maturities of 25 years or more (reaching even 50 years).

[6] Jäger-Gyovai (2014). "Capital Market Development in CESEE and the Need for Further Reform", OeENB.
[7] Burger, J. D. et al (2012). "Emerging Local Currency Bond Markets", Financial Analysts Journal 68, no. 4.

Low liquidity is another big challenge for CEE corporate bond markets. There is a lack of regular and transparent issuance, and of supply of uniform bonds through public offerings that would allow corporate bonds to be fungible.[8] Issue sizes smaller than USD 200 m, which tend to be more illiquid, account for as high as 28% of total bond issuance in CEE (see charts 14-15).[9] Poor disclosure standards and low coverage of the companies in the region by rating agencies act as additional impediments to the bond markets' development in CEE.

One quarter of the market rather illiquid 14

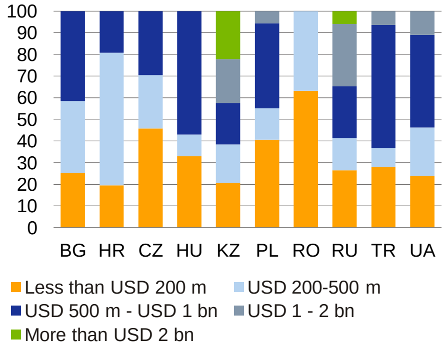
Issue size, % of outstanding corporate bonds



Sources: Thomson Reuters Eikon, Deutsche Bank Research

Small is not beautiful 15

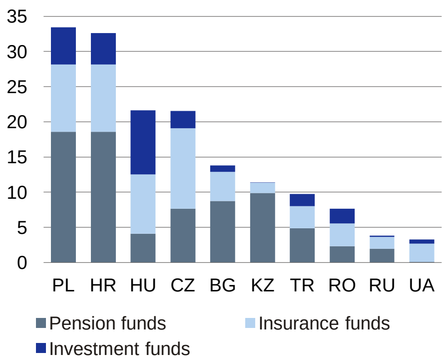
Issue size, % of outstanding corporate bonds



Sources: Thomson Reuters Eikon, Deutsche Bank Research

Institutional investors' assets 16

% of GDP



Note: Data latest available 2011-2013

Sources: OECD, WB, ICI, Deutsche Bank Research

Reversal of pension reforms as a step back for bond market development

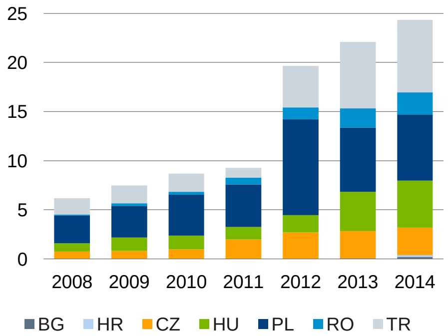
A diversified investor base is another important factor for the development of (local) bond markets, helping to increase demand and create more stable funding sources.[10] In particular, having a solid institutional investor base, i.e. insurance companies and investment and pension funds, is helpful.

Poland and Croatia stand out in CEE, with institutional investor assets accounting for more than 30% of GDP, while other countries have a much smaller investor presence (chart 16). For comparison, institutional investor assets in emerging Asia represent 50% of GDP.[11]

Investment funds are the smallest segment among CEE institutional investors. However, they have risen sharply in recent years, with assets under management (AUM) in bond investment funds almost quadrupling since 2008 (chart 17).

Bond funds in CEE 17

AUM, USD bn



Sources: EFAMA, ICI, Deutsche Bank Research

Pension funds started to grow as several CEE countries moved away from public pension schemes at the turn of the millennium. However, after the global financial crisis several countries began to reverse pension reforms[12] and, at least partially, transfer assets back from private to public funds. Just to name two examples, Poland, which was among the first ones in CEE to move away from the pay-as-you go system in 1999, has partially reversed the private

8 IMF, WB; EBRD, OECD (2013). "Developing Local Currency Bond Market: A New Diagnostic Framework".

9 "Emerging Market Corporate Bonds. Assessing some of the world's most dynamic growth opportunities", Aberdeen (2013).

10 Iorgova, S. and Ong, L. L. (2008). "The Capital Markets of Emerging Europe: Institutions, Instruments and Investors," IMF Working Paper.

11 Levinger, H., Li Ch. (2014). "What's behind recent trends in Asian corporate bond markets?" Deutsche Bank Research. Current Issues.

12 Whitehouse, E. (2012). "Reversals of Systemic Pension reforms in Central and Eastern Europe: Implications"; OECD; G20 meeting (2014). "2nd Annual Note on Recent Developments in Local Currency Bond Markets (LCBMs)."

pension pillar. And in Kazakhstan, private pension fund assets equivalent to about 10% of GDP were transferred to a state-controlled pension fund last year (albeit there is a plan to have the fund managed by private companies). Overall, this trend in the pension market should be seen, at best, as a missed opportunity to develop a robust local investor base in CEE.

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Appendix

20 largest private issuers in CEE 18

Issuer name	Borrower country	Country of domicile	Affiliation	Amount of outstanding bonds, USD bn	Sector*
Gaz Capital SA	Russia	Luxembourg	Gazprom OJSC	24.6	Financial - Other
NK Rosneft' OAO	Russia	Russia	-	22.2	Oil and Gas
SB Capital SA	Russia	Luxembourg	Sberbank of Russia OJSC	14.9	Financial - Other
VTB Capital SA	Russia	Luxembourg	JSC VTB Bank	10.7	Financial - Other
NK KazMunayGaz AO	Kazakhstan	Kazakhstan	-	10.0	Oil and Gas
GPB Eurobond Finance Plc	Russia	Ireland	Gazprombank OJSC	9.6	Financial - Other
VEB Finance PLC	Russia	Ireland	-	9.1	Financial - Other
BTA Bank AO	Kazakhstan	Kazakhstan	-	8.9	Banking
RZD Capital PLC	Russia	Ireland	Russian Railways	6.9	Financial - Other
RSHB Capital SA	Russia	Luxembourg	Russian Agricultural Bank OJSC	6.8	Financial - Other
Turkiye Is Bankasi AS	Turkey	Turkey	-	6.5	Banking
CEZ as	Czech Republic	Czech Republic	-	6.0	Electric Utility High Quality
Lukoil International Finance BV	Russia	Netherlands	LUKOIL OJSC	5.6	Financial - Other
Turkiye Garanti Bankasi AS	Turkey	Turkey	-	5.1	Banking
FSK YeES OAO	Russia	Russia	-	5.0	Utility - Other
UniCredit Bank Czech Republic and Slovakia as	Czech Republic	Czech Republic	-	4.9	Banking
Turkiye Vakiflar Bankasi TAO	Turkey	Turkey	-	4.9	Banking
Akbank TAS	Turkey	Turkey	-	4.6	Banking
Yapi ve Kredi Bankasi AS	Turkey	Turkey	-	4.3	Banking
Hypotecni banka as	Czech Republic	Czech Republic	-	4.0	Banking

* Sector classification according to Thomson Reuters Eikon

Sources: Thomson Reuters Eikon, Bloomberg, Reuters, Cbonds, Deutsche Bank Research

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