Russia is on the edge of a boom in municipal bonds. Driven by a lack of central government funding, obscure regions are beginning to look to what are regarded as the sexy international capital markets, especially given the success of earlier deals. Ted Kim reports from Moscow

Clamour for glamour

Russia is on the edge of a boom in municipal bonds as a result of the fall in rouble interest rates to below 20%, the success of Moscow's debut Eurobond and a proposed budget requiring regions to hand over to the Kremlin the bulk of their locally collected tax revenues.

The 89 separate municipal regions of Russia – comprising oblasts, krais, okrugs, and semi-autonomous republics – have varying degrees of independence from the federal government. But all have popularly elected governors who, in theory at least, can negotiate external debt financing.

Some regions even have the authority to negotiate with foreign governments. The potential wave of regional debt coming onto the international capital markets has been considered by the ministry of finance, which must give explicit permission before each issue can be sold to foreigners.

"We have been energetically discussing this within the ministry. My idea is that there should be a single set of borrowing regulations for all municipalities rather than [allowing] each separate entity to decide for itself," explains Anatoly Chubais, Russian finance minister. "I have instructed my people to prepare a new presidential decree to allow, within certain requirements, all regions to borrow from the capital markets."

The draft budget submitted by the government to the Duma, the Russian parliament, in September envisages raising more revenues for central spending requirements at the expense of the regions. At present, regions may keep two-thirds of locally collected tax revenues. This proportion is likely to decrease significantly leaving municipalities with less money to spend.

The 10 economically strongest regions receive little or no net funding from the central government. They face dwindling treasury revenues and, at the same time, a credit rating that analysts argue should be, in many cases, greater than that of the sovereign debt. These factors make several of the regions likely candidates for a Eurobond or syndicated loan offering. Seven of the top 10 regions are net donors to the federal budget, and nine have announced plans to launch debut or even second external debt issues.

The city of Moscow tops the list both in terms of underlying financial strength as well as completed debt transactions. This is not surprising, given that a disproportionately large amount of Russian gross domestic product comes from the Moscow area. Historically and culturally, the city has always considered itself an independent mini-state, insulated from the social and economic problems of the rest of the country. Officially, the city holds a Standard & Poor's and Moody's credit rating identical to that of the central government. However, this limit is due only to the standard convention that no municipal or private borrower should be rated at a level greater than that of the local sovereign debt.

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In terms of the debt finance raised from foreign institutions, Moscow has received a combination of dollar and Deutschmark syndicated loans, as well as a $500m Eurobond making for a total of nearly $1bn. A $500m Eurobond tranche is expected to be issued before the end of this year. Moscow municipal Eurobonds trade at a spread to three-year Treasuries of 265 basis points (bps), having tightened from an initial spread of 315bps when first offered in May. More than 30 firms have submitted a tender to manage the next $500m Eurobond tranche, which is expected to be offered at razor-thin margins.

In terms of rouble municipal instruments, Moscow has nearly $150m of notes in circulation within the domestic economy. These are referred to as MVZs to differentiate them from the notes of other municipalities, which are known as MKOs. Even with the city's conservative approach to raising debt finance, Moscow's total rouble debt market should approach $500m in capitalisation in the next year. The city has ambitious plans to use its cost-effective debt-raising ability to fund developing projects in the regions. In October 1996, when the domestic rouble bond was first authorised, the city council set a ceiling of about $1bn in MVZs and $350m in savings bonds. The notes

pay a floating rate of interest, recently set at 20%.

Only a few million dollars in savings bonds, which have a maturity of two years, have so far been issued. "The domestic rouble debt programme has only just begun," says one banker. "Moscow rouble instruments are not as liquid as those in St Petersburg or Orenburg. But, as the programme develops, and as more and more of the notes and bonds are issued, I expect liquidity to develop."

Michael Mikulin is director of Denholm Hall, which acts as a technical adviser for Moscow and a number of other municipalities in debt management. He says: "What Moscow's domestic debt lacks is market infrastructure and liquidity. This slow development reflects the very cautious, prudent attitude taken by the city officials."

Even with the next $500m Eurobond issue, the city's debt programme is expected to be more geared towards tapping the domestic rouble market. The limit set by the federal government in a presidential decree last April means that Moscow's debt should not exceed 30% of its annual revenues and debt service payments should not exceed 15%. The city's council has set a maximum debt, both internal and external, of 25% of annual revenues. So far, just 20% of the total limit for domestic debt has been tapped.

"Moscow's domestic rouble debt trades at slightly higher yields than the federal government's GKOs, which implies that Moscow debt has slightly greater risk. But, a closer examination of all the statistics [shows that] Moscow has a greater debt repayment ability," Mikulin says. "The key difference between GKOs and Moscow rouble debt is that, if the worst comes to the worst, the federal government can always print more roubles to pay GKO interest – a privilege not available to any municipality in the world."

Relatively speaking, the city has a small debt load. Because rates are declining, time is on its side when it comes to deciding when to issue more rouble debt. More important, Mayor Yuri Luzhkov has consistently pledged that debt will never be issued to fund current operating expenditures, such as the running of schools and hospitals. Instead, the city government is clearly committed to see that debt finance is used only for capital-intensive infrastructure projects that will make a predictable return on investment well in excess of debt service requirements.

The most interesting aspect of Moscow's finances involves the equity stakes it controls in dozens of major enterprises. The city has always been comfortable wearing two hats: one of tax collector and another of business partner. Such an active, interventionist approach to managing the city's commerce is directly due to Luzhkov, who is widely believed to be a strong candidate for the presidential elections in 2000.

"The city goes into commercial enterprises not only for profits: job creation is also a very important factor," explains Pavel Teplukhin, chief economist at Troika Dialog, which recently produced a survey of Russia's regional financing prospects. "Over the past few years, the city took niches that nobody really wanted to take, like investing in infrastructure." Although taking a costly equity involvement in the giant Zil truck factory may have guaranteed thousands of jobs, it is not clear what the public benefit was in owning part of Russkoe Bistro, a Russian fast-food chain – other than pure and simple profit.

In contrast with the wheeling-and-dealing combination of communism and capitalism in Moscow, the picture is decidedly more sedate in St Petersburg, which in May became the second municipality to tap the Eurobond market, with its $300m issue.

The picture in St Petersburg is decidely more sedate than in Moscow

Unlike Moscow, which has a budget surplus, the St Petersburg budget deficit relative to revenues has been rising sharply in recently. Internal and external debt finance is being funnelled into paying off the 23% deficit for this year. On the positive side, St Petersburg receives only a small amount of federal funds and has managed its debt responsibility so as to make default unlikely. The St Petersburg Eurobond trades at a spread to treasuries of 279bps, about 10bps higher than that of Moscow.

The offer price of the St Petersburg Eurobond, slightly less than Moscow's initial 315 point spread, did not reflect St Petersburg's greater credit risk. Rather, it indicates how much investor interest there is in Russian debt. Proceeds from the offer are intended to refinance the current MKO debt burden at a lower cost and longer maturity. In mid-August, it was paying 11.74% annualised in dollars on its one-year municipal bonds as opposed to 8.85% over five years, which it expects to pay for its Eurobond.

In terms of domestic rouble instruments, St Petersburg has the largest debt programme: nearly $300m of bills outstanding, trading at yields slightly more than Moscow's MVZs. With the gradual reduction of expensive internal debt in favour of cheaper debt raised via the Eurobond, the city is likely to sustain a solid overall debt servicing ability.

A number of municipalities have issued their own rouble instruments,

Moscow mayor Yuri Luzhkov (far left) is responsible for the city's active, interventionist role in managing its commerce. George Nianias (left), managing director of Denholm Hall, is advising regions on debt management

but so far, foreign fund managers have demonstrated little if any interest. "Outside of Moscow and St Petersburg, I do not think the MKOs issued by other municipalities are very attractive," say a Moscow-based analyst at WestMerchant Bank. "You cannot hedge, and the markets are very small and illiquid. The regional rouble instruments may have some appeal to highly specialised niche hedge funds, but probably not other major portfolio investors."

George Nianias, managing director of Denholm Hall, adds: "Bond fund managers can get excited about getting a pick-up of even an extra 50bps. In looking at Moscow's rouble debt, the risks between GKOs and MVZs are about the same. If you want to be in GKOs, then the 50bps to 150bps pick-up with MVZs will be worth it. For the MKOs of other regions, even a 500bps pick-up might not make up for the increased credit risk as well as the significant market infrastructure and liquidity problems."

Nizhny Novgorod, the third Russian municipality to enter the Eurobond market, is springing back after its economy slipped by 2.6% last year and 16.5% in 1995. In the early days of privatisation, the region had been the flavour of the year among international equity investors. Before the end of this year, the city plans to issue $50m worth of MKOs. This amount will add to the $100m raised in September from the five-year Eurobond issue that was offered by ING Barings at a spread of 280bps above Treasuries. Standard & Poor's gave Nizhny Novgorod a BB- rating and Moody's awarded a Ba2, the same as that for sovereign debt. The presidential decree of April 1997 gave permission for Nizhny – as well as Moscow and St Petersburg – to issue Eurobonds. These three cities have a "first tier" image among foreign institutions.

"A good thing about these three municipalities is that they are all involved in formalising their overall debt by looking at their entire debt structure – in particular their accounts payable system, which can be flexible but which is highly costly," Nianias explains. "A debt burden arising from accumulated accounts payable, such as to Gazprom, can be renegotiated in private and a minor default might not adversely affect future borrowing. Thus, there are advantages and disadvantages for a municipal formalising its debt all at once."

Sverdlovsk will shortly become the next municipal Eurobond market participant with an issue managed by WestMerchant Bank. The region plans to issue $100m in six- to seven-year Eurobonds in the next month. The regional administration is undertaking a roadshow to investors. Over the next few years, up to $300m of Eurobonds will be issued. The proceeds have been earmarked for investment projects, including the conversion of defence enterprises to civilian production and the production of medical equipment. WestMerchant is also managing a medium-term note (MTN) programme for Sverdlovsk.

Tyumen, along with the semi-autonomous districts of Khanty-Mansiand and Yamalo-Nenetsk situated within Tyumen, is one of Russia's richest regions. It may be the next hot spot for both debt and equity investors. For instance, the shares of Tyumen Telecom, operating within a sector known for its notoriously low prices fixed by the state regulator, is rated by Alfa Capital, the Russian investment bank, as one of the strongest buys within the industry. Oil and natural gas, the main industries in the area, have created substantial wealth in comparison with many other outlying regions, which have stagnated since the collapse of the Soviet Union. Monthly wages in the three regions are three to four times higher than in Moscow.

Nearly all of the country's largest vertically integrated oil companies have an operation in Tyumen territories. The region is the country's largest exporter: it accounts for 70% of Russia's oil output and 7% of its gross domestic product.

Fund managers have taken full advantage of equity investment in the region. Among the stellar performers of the Russian stock market are several Tyumen-based energy companies. The next phase in equity investment is expected to be the introduction of level 1 American Depositary Receipts for many second-tier Tyumen shares. In terms of external debt, an announcement was made this year by the Yamalo-Nenetsk authority of a $150m Eurobond offer, but no date or lead manager has been set.

While the first four municipal Eurobond issuers – the three that have already issued and Sverdlosk – sailed through the process of gaining approval from the ministry of finance, it may not be clear-cut for other regions looking to issue debt externally. "We have probably heard about a number of Eurobonds that will never actually be issued. Once the guidelines set by the ministry of finance are set out, it will be very clear which regions will qualify to issue Eurobonds and which will not," says one Moscow-based investment banker.

This argument gains strength from the disparity between the string of announcements made this year regarding imminent Eurobond issues as opposed to the number of tombstoned transactions fully completed so far. Even though nine of the 10 regions listed on the table compiled by Moscow brokerage Troika Dialog have made announcements about a Eurobond issue this year, by next January, only four are certain to have completed a deal.

Addressing the government's concern about flooding the market with too much Russian paper, the banker says: "There is enough capital on the markets to absorb all types of Russian issuers. We saw earlier this year that Moscow, St Petersburg and the federation have issued debt at about the same time without any surprise jump in yields."

In addition to concerns about flooding the market, another issue for the ministry is imposing spending and taxation requirements on the municipalities to promote financial stability throughout their regions.

Such concern for regional financial stability may have drawbacks, says Denholm Hall's Nianias. "The danger is that the ministry of finance may put up barriers and set requirements that are so difficult to meet in terms of budgetary reforms that it may unnecessarily delay access to external financing for several regions.

"It will take time to introduce regulations that make sense. However, the ministry might want to introduce the new rules all at once rather than imposing them gradually over two years as they should do."

Eventually, issuing external debt on the Euromarkets may slowly lose the intensely glamorous appeal it now holds for regional governors. Nianias adds: "As rouble interest rates steadily come down, municipalities may start looking at concentrating more on rouble debt instruments for their financing needs. The interest will always be higher than for external dollar debt, but there is no currency conversion risk with a rouble instrument." ■