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GLOBAL LOCAL DEBT MARKETS

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Local currencies — more important than ever

After a strong start to the year, global emerging market local currency debt issuance has taken a beating amid the volatility sparked by fears of a reduction in US quantitative easing. Local currency markets are more important than ever — but for stability to be achieved, the institutional investor base must broaden. **Philip Moore** reports.

IS THE EMERGING market currency party over? It may certainly feel that way if you're an Indian or Brazilian entrepreneur with unhedged US dollar debt, which is much more expensive now than it was before May 22. That was when US Federal Reserve chairman Ben Bernanke appeared to call time on the era of very accommodating monetary policy that had unleashed unprecedented flows of cross-border liquidity.

So far he is still to follow up with concrete action, having decided against a reduction in the country's asset purchase programme at the most recent Federal Open Market Committee meetings in mid-September. His next opportunity will be in December, but whatever the timing, markets know that it is on the way.

"We believe these markets will continue to develop, given that emerging markets now account for more than 50% of global GDP"

Chris Jones, HSBC

After a buoyant period in the primary market between January and mid-May, the Bernanke announcement prompted a sharp deceleration in the issuance of globally distributed bonds in emerging market currencies. By the middle of August, according to data published by CMD-Portal, international bond issuance denominated in the top 10 emerging market currencies reached just under $57bn.

That is a marked increase on the $35bn in the same period of the previous year, but the headline numbers mask the slide in issuance following the Bernanke comments. In the three months after May 22, issuance amounted to $11.34bn, compared with $13.4bn in the same period in 2012, which represents a 15% year-on-year decline.

It was not just the Bernanke bombshell that cast a cloud over emerging market debt. Throw one or two local difficulties into the mix — including worries over the shadow banking sector in China and unrest in countries such as Turkey and Brazil — and the immediate outlook for global local currency issuance certainly looks less rose-tinted today than it did at the start of the year.

The obvious question raised by this slowdown is whether it will curtail the rise in issuance of local currency debt sold simultaneously to domestic as well as overseas investors, which has been a striking feature of the international capital market in recent years. According to Chris Jones, managing director and head of local currency syndicate at HSBC in London, over the last five to six years the share of non-G4 currencies has risen from 7% to about 23% of total global fixed income issuance.

"Today we may be at a crossroads post the QE tapering announcement," says Jones. "Are we going to see a continued rise in the issuance of global local currency debt, or are we now going to see the increase in non-G4 volumes go into reverse?"

Some argue that investors' recent jitters about the impact of tapering on emerging markets simply underscores even more forcefully the importance of developing local currency bond markets.

"The recent volatility in a number of emerging markets should reinforce our commitment to our capital market development agenda," says Monish Mahurkar, director of treasury client solutions at the International Finance Corporation (IFC), which has issued recently in markets ranging from Zambia to the Dominican Republic. "The recent crisis has been a reminder that borrowers without US dollar revenues should not be encouraged to take on US dollar debt," he says.

Mix and mismatch

This particular lesson was learned the hard way across a number of central and eastern European markets a number of years ago. "Because there was a general expectation that a number of CEE countries would join the single European currency, with many of those countries' debt redenominated in euros, currency mismatches were not given sufficient attention," says Isabelle Laurent, deputy treasurer at the European Bank for Reconstruction and Development (EBRD).

"During the crisis, there was a realisation that having an income in local currencies and outflows in hard currencies can be very problematic," she says. "It meant that a number of countries in the Baltics and central Europe had limited room for manoeuvre in terms of preventing overheating. If central banks raised interest rates in response to inflationary concerns it simply created a greater differential between local and hard currency rates. That in turn encouraged borrowers to issue more hard currency debt, aggravating the problem of currency mismatches."

This, says Laurent, has made it doubly important for emerging countries in central and eastern Europe to continue to build their local currency markets, as well as to encourage the evolution of more durable domestic institutional investor bases capable of protecting local markets from intense volatility when external sentiment turns sour.

This historical precedent supports the opinion of those who are persuaded by the long term case for global local currency debt. "My own view," says Jones at HSBC, "is that this is a short term retracement in a much longer term growth story. We believe these markets will continue to develop, given that emerging markets now account for more than 50% of global GDP." Rising issuance in local currencies, he says, has been a natural by-product of this rising share of the global economy, although this can only explain part of the breathless expansion in non-core currency issuance, or of investor demand for the asset class.

"Capital flows into emerging markets show an upward trend both in US dollar terms and as a percentage of EM GDP in the past three decades," notes a recent HSBC report. "Given the growing share of EM in world GDP, this would suggest a growing share of DM [developed market] GDP is now invested in EM."

However, the same HSBC analysis adds that since 2008, these capital flows have been driven largely by so-called "push" factors, such as ultra-low rates in the US, rather than "pull" factors, which would include improving credit quality. "We believe it has been the 'ugliness' of DM over the 'prettiness' of EM that has been the major driver of inflows post-crisis."

That may be. But there appear to be a number of reasons for believing that from the standpoint of investor demand, there is still plenty of gas in the local currency issuance tank.

One of these is that investor demand for geographical diversification remains a conspicuous long-term trend. This has been most evident in the shifting allocation of central bank holdings in recent years, which have progressively challenged the status of the US dollar as the world's number one reserve currency. That is a status the US currency still holds, and will continue to hold for a number of years to come. But it is diluting demand for dollars and increasing holdings of currencies such as Australian and Canadian dollars.

There has also been a discernible rise in central bank demand for a handful of emerging market currencies – most notably for Chinese renminbi. Symptomatic of this trend was the announcement in April by the Reserve Bank of Australia (RBA) of its plans to invest up to 5% of its total foreign currency assets in Chinese sovereign bonds.

A similar pattern is unfolding throughout the world. "We were making a presentation a couple of months ago to an African central bank which told us it would be making a significant allocation of RMB to its reserve base," says Jones at HSBC.

Diversification

It is not just central banks that have been signalling an increasing commitment to diversification in recent years. Other institutional investors across a range of developed and emerging markets have also been expanding their horizons – driven by a combination of regulatory change, rising assets and a change in investment strategies.

Assets under management at Latin American pension funds, for example, are growing at a breathless rate, with those in Chile, Colombia and Peru combined having seen their assets grow from a little over $100bn in 2008 to more than $270bn at the end of 2011. Assets at Mexico's pension funds (Afores) have doubled over the last four years and are projected to more than double again by 2019. That will increase pressure on the local regulator to increase the limit of their assets they can invest overseas, which is now set at 20%.

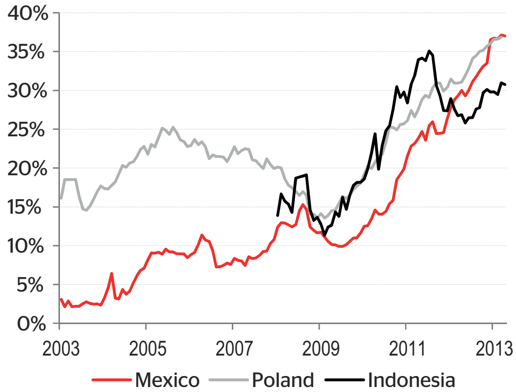
In Asia, meanwhile, one reason why the Malaysian fixed income market has shown such explosive growth in recent years, for example, has been the surge in assets under management among heavyweight institutional investors. According to the Malaysian credit ratings agency (MARC), the local Employees Provident Fund (EPF) and KWAP fund combined recorded a compound annual growth rate (CAGR) in the total investable size of their funds of 7.4% from 2007 to 2011. Over the same period, takaful and conventional insurance funds posted CAGRs of 20.3% and 9.4% respectively.

The result is that local institutions are outgrowing even the Malaysian debt and equity markets. The EPF, for example, increased its exposure to global real estate, bonds and equities by $1.3bn in the first quarter of 2013, which it said was part of its longer term diversification strategy. Announcing its first quarter results, EPF's CEO explained that "the fund's investment assets now exceed half a trillion ringgit and continue to grow at an average of 8%-9% yearly. The constraints in the domestic market makes it imperative for us to find suitable investments globally that fit our long term diversification programme. This will enable the fund to build a more balanced portfolio in accordance with our risk appetite."

EPF still has plenty of room to add to its international exposure. At the end of the first quarter of 2013, overseas assets accounted for 17.55% of its assets under management (AUM), well below its permitted maximum of 23%.

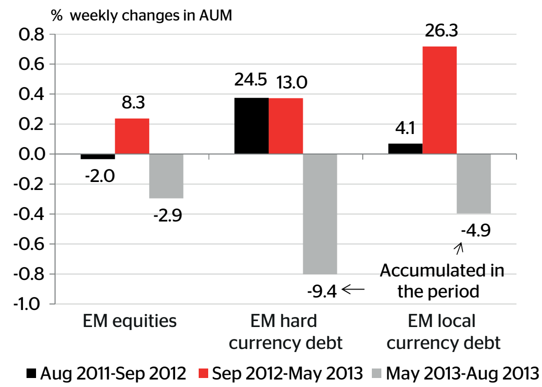
More broadly, there has also been a notable increase in demand for fixed income exposure among institutional investors across the emerging market universe. Again, Asia provides the clearest example. In its most recent analysis of trends in fixed income trading in Asia, published in January, Greenwich Associates reports that in the year ending July 2012, trading volumes in Asian fixed income increased by 13%. Over the same period, fixed income assets under management among institutions in Asia (excluding Japan) grew by 33%.

Foreign participation in local fixed income markets



Source: Official websites

Investors are leaving the emerging markets



Source: EDFR

"While the surge in institutional assets under management obviously reflects market-driven valuation increases within institutional fixed income portfolios, it also provides a clear demonstration of the market's long term momentum," says Greenwich, which gives three specific reasons underpinning this trend. These are a 55% increase in G7 government bond trading, the continued growth in trading volumes generated by Asian banks, and — perhaps most significantly — a 29% increase in turnover in the domestic currency Asian bond market. As Greenwich observes, "local currency bonds are emerging as a viable source of funding for issuers and as a critical component of the Asian fixed income market."

A rising preference for fixed income has not been confined to Asian institutional investors, with retail investors also acquiring a taste for bonds. Even among famously speculative Chinese retail investors, for example, there is evidence of a growing demand for fixed income over their beloved equities. According to a recent Boston Consulting Group (BCG) analysis, bonds accounted for 7% of HNWIs' assets at the end of 2012, compared with just 3% in 2011. Over the same period, the share of equities dipped from 30% to 21%, while holdings of cash and deposits fell from 18% to 16%.

There are a number of sound, fundamental reasons warranting this longer term migration into a wider range of currencies and into a more diversified cluster of asset classes — chiefly but not exclusively fixed income. As Schroders argues in a recent white paper on Asian bonds, their intrinsic strengths include a demonstrably superior currency-hedged risk-return profile versus developed market bonds, allied with relatively low correlations to other risk assets. "We are... not concerned about the high levels of foreign ownership of Asian local currency bonds as past experience has shown that Asian bond markets have been able to absorb sharp foreign selling pressures and FX weakness," adds Schroders.

Asian currencies have similarly compelling properties. As currency specialist Merk notes in a recent white paper on Asian currencies, "Within the emerging market currencies, Asian currencies have demonstrated favourable risk-return profiles for US-based investors with what we believe are comparably attractive risk-adjusted returns, low volatility, and low correlation with US equities.

"Despite recent risk aversion, we believe Asian currencies may weather increased volatility triggered by speculation surrounding Fed policy better than other EM currencies. Furthermore, over the longer term, we believe Asian currencies may outperform other emerging market currencies as a result of Asian countries' transition to a higher value added and more consumption-oriented growth model." ▲

Promoting local currency bond markets

THE WHEELS of supply of local currency debt have been greased by a growing number of governments in recent years, albeit with varying degrees of fervour.

"Asia's local currency bond markets fall into two broad categories," says Alexi Chan, managing director of debt capital markets for Asia Pacific at HSBC. "The first are those that can easily be tapped using EMTN programmes without additional documentation or approvals, and are therefore readily accessible to global borrowers, such as the Hong Kong and Singapore dollar markets."

"The other local markets tend to have their own specificities around approvals, governing laws and regulations," Chan adds. "International issuers require an extra degree of navigation to access these markets successfully."

On balance, Chan says that governments in Asia have been highly supportive of local currency bond markets for a number of very compelling reasons. "I think there is a huge commitment to the development of bond markets in Asia, which is very positive," says Chan. "One of the lessons that was learned from the Asia crisis back in 1997 was the importance of encouraging the development of a well-functioning local currency bond market, which led to a number of initiatives on a regional basis as well as by individual governments and regulators."

An early milestone in the evolution of local currency bond markets in Asia came in November 2002, with the establishment of the Asian Bond Market Initiative (ABMI) by the Association of South East Asian Nations (ASEAN), together with China, Japan and Korea, collectively known as ASEAN+3. Under this initiative, the Asian Development Bank (ADB) launched its $10bn Asia Currency Note Programme in 2006, allowing it to issue local currency bonds in Singapore, Hong Kong, Malaysia and Thailand using the same documentation governed by British law.

A more recent initiative was the establishment in 2010 of the Credit Guarantee and Investment Facility, which provides guarantees for local currency corporate bonds issued in the region. 2010 also saw the launch of the ASEAN+3 Bond Market Forum (ABMF), which brings together depository and exchange institutions, market associations and local and overseas market participants from the public and private sector in order to "foster standardisation of market practices and regulations in the local currency bond markets."

Another key landmark in the development of Asia's bond markets, says HSBC's Chan, has been the emergence of the offshore RMB – dim sum – bond market. "We expect the offshore RMB market to go from strength to strength, as the RMB continues its path of internationalisation," he says. ▲

Why do it? The five reasons for local issuance

Issuers look at local currency issuance for a variety of reasons, whether it be a manufacturer financing a foreign operation or a development bank looking to promote growth. One way or another, all are looking to take advantage of opportunities not available elsewhere, writes **Philip Moore**.

THERE ARE five principal reasons for issuers to tap into local currency bond markets. The first, and perhaps the purest, is to raise local currency to finance operations outside a borrower's home market. One of the most regular exponents of local currency issuance in order to raise funding to support local operations is the US heavy machinery manufacturer, Caterpillar, which has issued recently in currencies ranging from Argentine and Mexican pesos to Russian roubles and Chinese renminbi.

While corporate borrowers like Caterpillar raise local currencies directly, many others do so through development banks or export credit agencies, which has also bolstered liquidity in a number of markets. One example is Sweden's SEK. Petra Mellor, a director in the funding department at its Stockholm headquarters, says that raising local currency funding for on-lending is becoming increasingly important for SEK.

"Our strategy is to match-fund our borrowing and lending in terms of maturities, and we think we will do so more and more in local currencies as well, as regulation makes currency swaps more expensive," she says.

"Our most prominent investor base is central banks, which have been diversifying out of core currencies in recent years"

Petra Wehlert, KfW

At the same time, says Mellor, demand for lending is rising as alternative sources of funding for exporters have become more scarce or more costly. As SEK explains, "demand has been affected by some banks being less willing than before to provide long term lending and many purchasers of Swedish exports requiring long term financing."

This was a contributing factor to overall lending at SEK reaching Skr56.2bn in 2012, the second highest annual total the group's history, of which Skr38.6bn — in 262 deals — was accounted for by end-customer finance. According to SEK, "there has been significant demand within direct finance for lending in local currencies, and we conducted around 120 different deals in local currency [in 2012], with a total lending volume of approximately Skr3bn."

A clear example of companies' funding requirements feeding through into local capital market activity has been SEK's issuance in the offshore renminbi (RMB) market. Its debut transaction was an Rmb200m three year bond led in January 2012 by Citic Securities, with the proceeds on-lent to Volvo, which has ambitious plans for its operation in China.

SEK returned to the RMB market in May 2012, raising Rmb500m in a three year transaction arranged by HSBC and TD Securities, priced at a coupon of 2.375%.

"These issues are another step for SEK in establishing itself on the Chinese market so that it has the capacity to meet the financing needs of a number of Swedish exporters in local Chinese currency," says Mellor at SEK. "Previously, Swedish companies operating in China were only able to access local currency financing from banks in China, but this was expensive and, in particular, was over much shorter maturities than SEK was able to offer."

This suggests that SEK may be a regular borrower in the RMB market in the future, but Mellor says that the potential of a number of Latin American local currency markets is also being scrutinised by SEK. This is because a notable component of its increased lending last year was what SEK describes as "significant interest in financing for Swedish exports to Latin America", which accounted for Skr5.7bn of total lending in 2012.

"The more we can match-fund, the better, which is why we may also look at funding in local currencies such as Brazilian reais, as well as Chilean, Mexican and Argentine pesos," Mellor says.

Regulatory pressure

There are regulatory as well as commercial reasons why borrowers' requirement for local currency funding is rising. Chris Jones, managing director and head of local currency syndicate at HSBC in London, points out that banks, for example, are under increasing regulatory pressure to ring-fence their balance sheets across geographical borders, which is leading to more issuance from multinational banks' local units rather than via the holding company.

Mellor says that issuing local currency funding to on-lend is part of SEK's two-pronged policy in non-core markets. The other part, which makes up the second and third reasons most regular borrowers have for funding in a range of currencies, is the dual objective of capitalising on arbitrage opportunities and diversifying the investor base.

The two often go hand in hand, because by accessing a completely new group of investors borrowers can reduce their overall funding costs by leveraging their scarcity value in a given currency and relieving pressure on their core funding currencies.

That is the principal reason why

SSA borrowers with large funding requirements routinely explore a wide range of funding options outside their core markets.

Take the example of one of the biggest of them all, Germany's KfW, which has recently revised its funding requirement for 2013 down to between €65bn and €70bn, compared with an annual total over the last five years in the €74bn-€79bn range.

Petra Wehlert, head of new issues for public markets, says that as a rule of thumb KfW aims to complete around 80% of its annual funding in its two core markets, which are dollars and euros. In the dollar market, she says, Basel III liquidity requirements have meant that KfW has been a notable beneficiary of demand from bank treasuries. "In euros, bank treasuries have always played an important role in KfW's benchmark transactions," says Wehlert.

That still leaves about €10bn-€15bn to find in a range of other markets, which explains why, at the last count, KfW had borrowed in 13 different currencies in 2013. That compares with 15 in 2012, although Wehlert says that in previous years it has tapped as many as 20 different currencies. The non-core share has been lower in 2013 than in 2012, she adds.

Much of KfW's requirement outside the US dollar and euro markets has been met in recent years by issuance in what may be termed semi-core markets, where KfW has been able to respond to growing demand from central banks, as it has in the market for core currencies.

"Our most prominent investor base is central banks, which have been diversifying out of core currencies in recent years," says Wehlert. "Demand for Australian dollars has been particularly strong, and has in previous years been driven both by domestic demand and international investors. In 2013, this has shifted, with about 75% accounted for by international demand, much of it from central banks."

This combination of international and domestic demand has made the Australian dollar market very fertile ground for global local issuance by a number of frequent borrowers. Jens Hellerup, head of funding and investor relations at Nordic Investment Bank (NIB) in Helsinki, for example, says that the Australian dollar has accounted for about 18% of NIB's funding this year, after contributing over 20% in 2012.

Wehlert says that while KfW has a strategic approach to the Australian dollar market, which involves a commitment to maintaining a yield curve, funding outside the home market still needs to be competitive on an after-swap basis. "We have a natural need for euros, and the euro market has provided very good funding opportunities this year. Other currencies need to compete with KfW's euro funding conditions, which is why our activity there is largely dependent on the basis swap," she says.

Another market that has resurfaced as an attractive funding source outside KfW's core currencies is the Canadian dollar market. KfW returned to the market for the first time for just over a year in early June, launching a C$1bn five year global issue via HSBC and RBC Capital Markets that was the largest Canadian dollar bond ever from a non-domestic SSA borrower. Shortage of supply in Canadian dollars underpinned strong demand, notably from central banks, which accounted for 78% of distribution.

Robust demand for Canadian dollars allowed KfW to follow this transaction with a C$750m three year global issue via RBC Capital Markets and TD Securities in July. Increased from an originally planned minimum of C$500m, this was priced at the tight end of guidance, or 3bp over mid-swaps, with 34% of the bonds taken up by central banks.

The strength of demand from official institutions for non-core currencies is clear from data collated by the IMF. According to its most recent numbers, the dollar's share of central banks' reserves, which was 71.5% in 2000, had fallen to 62.2% by the end of the first quarter. Much of that slack has been taken up by the euro, but central banks' holdings of so-called "other currencies" — which include Australian, Canadian and New Zealand dollars — has new passed 6%, compared with 1.8% at the end of 2007.

In other currencies, says Wehlert, KfW pursues the same issuance policy as it does in semi-core strategic currencies. "At the end of the day our issuance reflects global investor demand," she says. "If that demand is sufficiently strong and if there is a liquid swap market allowing us to issue at a reasonable cost we will consider doing so."

Those are big ifs. Consider, for example, KfW's experience in the fashionable offshore RMB market, where it launched a debut offshore Rmb1bn two year bond via HSBC in May 2012 at a 2% coupon, the proceeds of which were swapped into euros.

KfW said at the time that it had no intention of making its RMB issue a one-off, but returning to the market on a cost-effective basis has been easier said than done.

"The biggest bottleneck we have encountered in the offshore RMB market in Hong Kong has been finding swap counterparties," says Alexander Liebethal, head of new issues private placements at KfW in Frankfurt. "We'd love to do more in the RMB market but funding costs and the availability of swap opportunities are limiting factors. We're monitoring the market and are confident about its future growth, however, given the long term potential for wealth creation in China."

"We'd love to do more in the RMB market but funding costs and the availability of swap opportunities are limiting factors"

Alexander Liebethal, KfW

Building profile

Beyond the proceeds-driven and price-driven motives for accessing new, often non-core markets, for some borrowers there are also reasons for accessing local currency markets that are not directly of commercial benefit.

One of these — and fourth reason borrowers may have for accessing local currency bonds — is that it can help to enhance an issuer's profile in a given country or region. As Jones at HSBC says, issuing in an emerging currency such as RMB can be a very constructive way of doing this, especially for borrowers that achieve the kudos of being first-time issuers from their country or sector. For many, that can be a more powerful influence on the decision to issue in a local currency than size or pricing.

"In some local currency markets, borrowers will often be prepared to pay a wider spread to where they would price in benchmark currencies if it ensures they're the first or the biggest issuer in the market," says Jones.

For example, the Canadian province of British Columbia has been eyeing up the potential of becoming the first government or sub-national issuer to access the RMB market. Jim Hopkins, assistant deputy minister in the provincial treasury of BC's Ministry of Finance, says that the province announced its interest in issuing in the dim sum market in December 2012, and has since followed up with meetings with government officials in Beijing and with investors in Hong Kong and Singapore.

"We invest a lot of time and effort in areas that will benefit the development of the market"

Heike Reichelt, World Bank

BC is interested in the CNH market as a way of further diversifying its investor base and to access new sources of liquidity. A new issue is likely to be modestly sized, but would cement trans-Pacific relations between BC and China.

"Further, the province values the global emergence of China as a trading partner and the internationalisation of the RMB because these developments play to the province's strengths as a North American gateway to the Asia Pacific with significant cultural and family ties with China and Asia more broadly," says Hopkins.

"The CNH market in 2013-to-date has not yet offered a cost-effective borrowing opportunity for highly-rated, international public sector issuers," Hopkins adds. "The province plans to build on the strong reception it received from CNH investors last year and continues to monitor the CNH market for a benchmark-sized opportunity."

Promoting growth

The fifth reason some borrowers have for accessing local markets is linked to their mandates to promote regional growth and development, principally in emerging markets. Development banks such as the World Bank, International Finance Corp, European Investment Bank, European Bank for Reconstruction and Development, African Development Bank and others have all played an essential role in helping to create and promote capital markets across the world — be they in Eurobond or local currency format.

The motives these borrowers have to access local currency bond markets are an amalgamation of some or all of the five reasons issuers have for exploring opportunities outside their core currencies. The IFC, for example, borrows in local currencies and on-lends the proceeds in those currencies to local private sector borrowers (*see profile article on page 17*).

The World Bank, by contrast, has only on-lent local currency bond proceeds in back-to-back transactions once, which was in Uruguayan pesos. Heike Reichelt, head of investor relations and new products at the World Bank in Washington, says that at the last count, it had issued in 56 local currencies to raise financing for on-lending to governments — which is the Bank's mandate — rather than to the private sector. In almost all cases, says Reichelt, the proceeds of the World Bank's local currency bond issuance are swapped into dollars.

In common with other supranational borrowers, the World Bank's developmental role in local currency markets does not mean that it is insensitive to price. Quite the opposite. "We have a fiduciary duty to borrow at the most competitive rates we can, because our borrowing rates determine our lending rates, and the markets of those countries we are aiming to develop are also the beneficiaries of our loans," says Andrea Dore, lead financial officer at the World Bank.

At the same time, the Bank is also committed to supporting the evolution of local markets' capital market infrastructure and encouraging the development and expansion of its institutional investor base.

"We have other, more strategic reasons for issuance in addition to funding at competitive levels," says Reichelt. "In markets where we are among the first or earliest issuers we invest a lot of time and effort in areas that will benefit the development of the market over the medium term, such as documentation and clearing systems."

Tangentially, the World Bank's support for the nurturing of local currency markets also means exploring ways of developing very illiquid swap markets. "Finding the currency swap is of course one of the challenges of local currency issuance, because obviously the cash markets develop much more quickly than derivatives markets," says Dore.

While much of the World Bank's local currency issuance has been in the form of Eurobonds rather than under local law, Dore insists that this is not inconsistent with the Bank's developmental role, for two reasons. First, she says that for many investors, buying triple-A supranational bonds is a helpful way of gaining familiarity with a new market. "We find that many investors initially welcome the opportunity to separate credit risk from currency risk," she says. "This gives them the comfort they need to take both risks at the same time in later issues."

Second, Dore says that triple-A issuance in Eurobond format can have an important role to play in helping to build and extend local yield curves. "We issued the first Turkish lira bond immediately after the redenomination of the currency at the end of 2004 and a few years later we did a 10 year lira issue," she says. "At the time, the government curve was only up to five years, and by issuing 10 year debt in lira we were able to establish a longer benchmark which the government was able to follow later on." ▲

New formats offer LatAm issuers new possibilities

Latin American companies have been busily diversifying their funding sources in recent years, attracting strong demand for local currency bonds sold to global investors. That demand is having a big effect on what is achievable: coupons have fallen and tenors have risen, making global local deals a viable alternative. **Philip Moore** reports.

LATIN AMERICAN local debt markets have been attracting foreign inflows at a rapid clip since the 2008-09 financial crisis, according to research published by HSBC. Peru and Mexico, notes HSBC, are now the markets with the highest level of foreign participation in the region, with 56% and 37% of foreign ownership as a percentage of domestic debt outstanding, respectively.

"Of the four largest local markets in LatAm," HSBC adds, "Colombia remains the one where foreign investors are the least involved. We expect that the recent easing of foreign investors' taxation will significantly change that."

Katia Bouazza, managing director and co-head of capital markets for the Americas at HSBC in New York, says that the recent evolution of the market for globally targeted local currency bonds in Latin America can be traced back to 2007. "Back in 2007 we opened this market with deals for América Móvil and Televisa, both of which captured demand from the international investor community by issuing in Europeso format," she says. "That was a popular and efficient way for international investors to gain exposure to the currency."

Today, says Bouazza, this successful template has evolved into what she describes as a new, improved version. "This is the global format, with dual registration with the CMV locally (for Mexico) and the SEC in the US," she says. "The new format is the most liquid and most attractive way to sell local debt internationally, but this does not mean it will be the only way to do so."

"We've started to see some borrowers issue on a cross-border basis within the region, which is the next logical step for the market's development"

Katia Bouazza, HSBC

Corporate borrowers from the region have made innovative use of increasingly liquid local currency debt markets to diversify their funding sources. Last Novem-

Despite the volatility, foreign investors still like Brazil

SOVEREIGN borrowers have been among the most active users of the global-local issuance format. For Brazil, it has been a structure that has played a pivotal role in helping to diversify international ownership of the republic's debt, enhance liquidity in its global real curve and simultaneously to reduce the government's funding costs.

It achieved all three objectives in April 2012 when it launched a R$3.15bn 2024 transaction at a yield of 8.6%, which was a historic low for Brazil in the global real market.

The order book for the Brazilian global reached R$5.5bn, allowing for pricing to be set at the tight end of its revised guidance of 8.6%-8.65%, and for the deal to be increased from an originally planned R$2bn.

According to research published by HSBC, there is now about $7bn of global real bonds outstanding, providing investors that have no access to local debt instruments in Brazil with exposure to Brazilian local yields. "Though formally external debt, global BRL-denominated bonds have become popular with international investors because these provide exposure to local rates without being subject to access constraints and taxes associated with domestic debt instruments.

"Hence, global BRL bonds trade at a significantly lower yield than their domestic counterparts," adds the HSBC note.

More broadly, however, Brazil remains committed to increasing the participation of overseas investors in its domestic local currency market, which accounts for 95% of the government's debt. Paulo Fontoura Valle, deputy treasury secretary at the Brazilian National Treasury in Brasilia, says that as of the end of July, foreign investors' share of real-denominated government debt had reached 15.5%.

This total participation is still well below overseas investors' holdings of Mexican government debt, but comfortably above international ownership of Chilean local currency bonds — demonstrating that local currency debt does not need to be Euroclearable (as Mexico's is) to attract international investors.

Valle says that far from choosing to reduce their exposure to real debt in the wake of the threat of US tapering and unrest in Brazil earlier this year, foreign investors have continued to add to their holdings.

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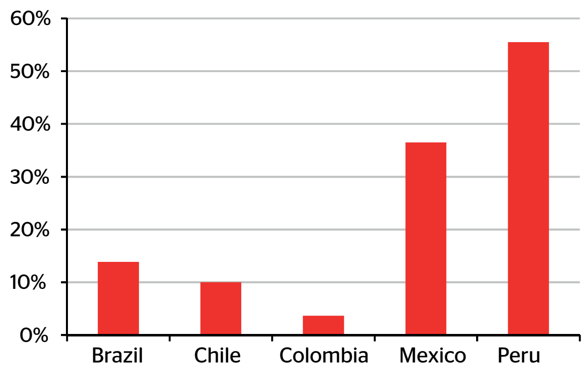
ber, for example, América Móvil tapped into the broadest possible investor base when it launched the largest ever cross-border corporate bond from the region at the time. This was a Ps15bn 10 year deal registered with both the SEC and the Mexican regulator. The bonds can be settled both through Euroclear and the local clearer, Indeval, and the issue generated total demand of $4bn. “América Móvil has acted as a pioneer in a number of markets, and this structure was very different from standard Europeso issuance,” says Bouazza.

In April, meanwhile, fast-growing retailer Falabella broke new ground when it became the first corporate to issue a cross-border bond denominated in Chilean pesos. Falabella currently has 298 stores in Chile, Peru, Colombia and Argentina and has recently entered the Brazilian market. Between 2013 and 2017, it plans to open 231 stores and 20 malls, calling for a total investment of $3.9bn.

Falabella’s $500m 10 year and $200m-equivalent Chilean peso issue for the same maturity was led by Citi, HSBC and Itaú and generated total demand of more than $4bn.

Foreign participation as % of local debt outstanding



Source: HSBC

Colombian rarity

International investors’ appetite for exposure to Latin American currency risk before the announcement in May by Federal Reserve chairman Ben Bernanke that the US might look to reduce its bond buying this year was in evidence the following month, when BRF Brasil Foods chose to add an R$500m five year tranche to a $500m 10 year transaction.

Regional diversification of supply of globally-targeted debt issuance was also provided in January with a rare issue from the Colombian corporate sector. This was a debut $300m-equivalent 10 year Colombian peso 144A issue from the fixed line telephone and broadband company, Empresa de Telecomunicaciones de Bogota (ETB), which is 88% owned by the District of Bogota. Led by Deutsche

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“Foreign participation has been increasing gradually since 2006,” he says.

Although US investors are unsurprisingly the main constituents of the international buyer base for real bonds, Valle says that demand has been strong from all areas of the globe. Asian investors ranging from Japanese retail fund managers through to large government-owned institutions such as CIC in China and GIC in Singapore have all been increasingly active participants in the real market. These investors have also become noticeably better informed about Brazil’s economic fundamentals, and about the local currency auction process.

“When we’ve roadshowed in Asia, I’ve been very impressed at how knowledgeable investors are about the local market, and at how detailed and specific their questions have been about our auction process,” says Valle.

Higher liquidity

Andre Proite, manager of investor relations at the Brazilian Treasury, says that the strength of demand for domestic local currency debt suggests that Euroclearability seems to be a “minor” influence on investment flows into Brazilian real debt.

More decisive factors, he says, are higher yields twinned with liquidity in the domestic market. “Size matters,” he says. “While we have issued almost R$15bn in a single regular auction in the domestic market, it would be hard to see offshore operations reaching such meaningful amounts for debt financing objectives. Thus, liquidity is much higher in the local debt market.”

Valle acknowledges, however, that recent months have been challenging for Brazil’s local currency market. “We haven’t seen wholesale withdrawals from the market, but we have clearly been affected by rising volatility,” says Valle. “We have introduced a number of measures to counter this volatility, such as buying back some longer dated debt in order to reduce overall duration.”

Valle says that although he has no target for foreign ownership of real bonds, he believes the share of overseas investors in the local currency market will continue to expand, especially now that the 6% IOF tax on foreign purchases has been scrapped.

“It was necessary to introduce the IOF back in 2009 in order to reduce short term inflows which were putting upward pressure on the currency,” says Valle. “But we believe that by eliminating the IOF we will attract a number of investors who were deterred by the tax. This, combined with the fact that Brazilian rates are now very competitive, makes BRL bonds attractive to foreign investors.” ▲

“When we’ve roadshowed in Asia, I’ve been very impressed at how knowledgeable investors are about the local market”

Paulo Fontoura Valle, Brazilian National Treasury

Bank and Goldman Sachs, the ETB transaction priced at a 7% coupon, well below the guidance range of 7.25%-7.5%, having generated demand of almost $2.5bn.

Some 140 investors participated in the ETB issue, with the US accounting for 58% of demand. Of the balance, 19% was placed in Latin America, 15% into the UK, 6% in Continental Europe and 2% in Asia. Demand was led by fund managers and pension funds, which bought 72%, with hedge funds taking 18% and private banks 7%.

Among other LatAm corporates, Mexican road concessionaire Red de Carreteras de Occidente (RCO) chalked up a notable landmark in May when it became the first borrower from the region to issue a structured transaction in global pesos. This Ps7.5bn ($602m) issue, led by Goldman Sachs and Morgan Stanley, with BBVA, HSBC and Santander acting as passive bookrunners, was secured against toll roads.

Priced with a 9% coupon, the tight end of guidance, this novel transaction was another vivid illustration of the strength of demand for issuance in global local format, generating orders in excess of Ps11bn. About half of the bonds were placed with US investors, with 30% distributed in Latin America and the rest sold in Europe.

Long dated milestone

Another indication of the growing capacity of the market across the yield curve came in May, when Televisa stretched the maturity in the peso market out to 30 years, issuing a Ps6.5bn 30 year bond led by Citi, Deutsche, HSBC and Morgan Stanley that generated demand of Ps40bn. The transaction was issued off Televisa's Ps10bn programme, which has dual registration with the SEC and the CNBV, creating a fungible instrument between the international and local markets and thereby broadening its accessibility for regional as well as international investors.

The long dated Televisa deal represented an important milestone for the local global market because as the first 30 year Europeso transaction, it effectively opened the long end of the peso financing market. Oversubscribed within an hour, the Televisa bond was priced at a coupon of 7.25%, which according to HSBC was the lowest coupon on any 30 year global local currency notes issued by a Latin American corporate. 60% of the bonds were distributed in North America, with 30% sold in Latin America and 10% in Europe and Asia.

Televisa captured demand from international investors to print the first 30 year Europeso transaction

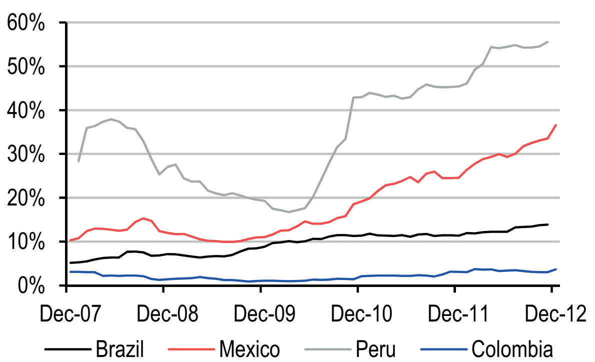
As in other regions, simultaneously generating demand for local currency issuance from different pockets of investors, local and international, ought to optimise a borrower's funding costs by creating price tension. "Any time you broaden the investor base, be it through dollars or local currency, you automatically create a benefit for the issuer," says Bouazza. "But that's only half the story. The main benefits these issuers have been able to generate are size and tenor."

"The Televisa deal is a classic example of that," she says. "It would not have been able to issue a 30 year bond in anything like the size it achieved had it not been for the strong participation of international investors. When companies look at their funding strategy, they look for strategies that can help them meet criteria, such as a broader investor base, pricing advantage, tenor and appropriate size for the issue."

The trend of Latin American borrowers targeting local currency issuance at the international investor base has dovetailed with a rise in overseas allocation by the region's pension funds, which have encouraged more investment in regional markets as well as dollars. Chile's pension funds, for example, have close to 40% of their assets overseas.

"We've started to see some borrowers issue on a cross-border basis within the region, which is the next logical step for the market's development," says Bouazza. As an example, she points to Banco BCI, which in May 2011 became the first Chilean bank to issue in the Mexican peso market, printing a Ps2bn three year deal. In 2012, BCI returned with a shorter Ps1bn two year transaction. ▲

Foreign ownership of LatAm local markets



Source: HSBC

Euroclearability opens doors for corporate issuance

The outlook for Turkish Eurolira trades, which had been expected to be bright until investors took fright at the unrest in the streets earlier this year, now seems more challenging. In Russia, meanwhile, the hope is that the recent change to make government bonds Euroclearable can pave the way for easier issuance by corporates, writes **Philip Moore**.

UNTIL POLITICAL and social unrest gripped parts of the country in the middle of this year, Turkey was regarded as one of the most promising countries for global local currency issuance. The first issuer to tap international demand for Turkish lira debt, at the end of January, was Baa2/BBB rated Akbank, which is projecting a compound annual growth rate in its loans of 20% between 2013 and 2015, with deposits expanding over the same period by 16%.

This projected expansion mirrors the broader forecast growth in the Turkish banking industry over the next few years, which is expected to ensure that the leading banks continue to explore a broad range of funding opportunities. International issuance by Turkish banks more than trebled in 2012, from $2.5bn to $7.9bn.

Initial price guidance on the five year Reg S/144A Akbank issue, led by Bank of America Merrill Lynch, Citi, Deutsche Bank, HSBC and JP Morgan, was in the 7.6% area, which equated to 127bp over the Turkish sovereign. The final order book reached around TL2.9bn ($1.5bn) from more than 100 accounts, allowing for pricing a TL1bn deal at 7.5%, the tight end of revised guidance, or 111bp over the sovereign.

The Akbank notes are clearable through Euroclear and Clearstream, with principal and coupon payments made in Turkish lira. Investors also had an irrevocable option of electing to receive the principal and coupons in US dollars, giving investors more flexibility. Distribution was well-diversified, with 46% placed in the UK, 38% in the US, 7% in Germany, 5% elsewhere in Europe and 4% in Turkey, the Middle East and Asia.

Demand was led by funds, which took 82%, followed by banks and private banks (11%) and pension funds and insurance companies (7%).

The Akbank curtain-raiser was followed soon after by the first transaction in the lira market from a Russian bank, with Sberbank issuing a five year Reg S TL550m bond via HSBC, JP Morgan and Sberbank CIB. This was another landmark for the market as it was the first ever Turkish lira transaction for a non-Turkish emerging market borrower. The Sberbank issue priced at 7.4%, which was 10bp through the Akbank deal despite being in Reg S-only format.

Again, UK investors led demand, accounting for 39% of distribution, with 14% going to Germany/Austria, 12% to Switzerland, 11% to Asia and 24% to other European markets.

"The bond allows international investors to take a complex view on FX exposure to Turkish lira across the most high-quality Russian quasi-sovereign credit," notes an HSBC deal review. "This is a unique opportunity that was unthinkable a couple of years ago and proves the ever-increasing role of EM credit in investors' portfolios."

A notable feature of Sberbank's Eurolira trade was that the proceeds were not swapped, even though the borrower achieved significant arbitrage of at least 75bp versus its US dollar curve. The objective of the transaction, however, was always to generate local currency funding to channel into its Turkish subsidiary, Denizbank, which Sberbank has recently acquired from Dexia.

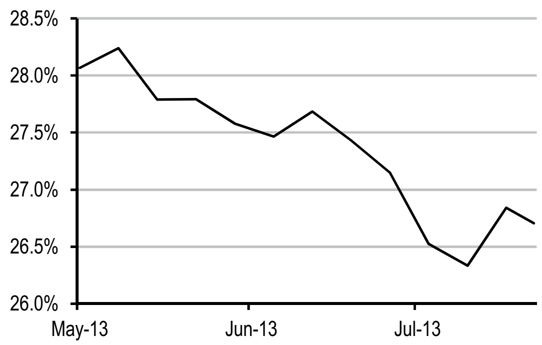
The third issuer in the Eurolira market in 2013 was Garanti Bank, which launched its TL750m five year debut deal in early March via BNP Paribas, Deutsche, Goldman Sachs and Standard Chartered. The coupon on the Garanti issue was 7.375%, and demand reached TL1.2bn, with UK investors accounting for 38% of allocation, 29% going to the US, 27% to Europe and 6% to Asia and the Middle East. As with the other Eurolira deals, asset managers were the drivers of demand, taking 79% of the Garanti trade.

Selim Kervancı, head of banking and capital financing for Turkey at HSBC in Istanbul, says that although the long term prospects for issuance of internationally-targeted transactions in Lira are bright, the immediate outlook is not encouraging, given expected policy changes at the Fed coupled with the unrest in Turkey, which have led to portfolio outflows and pressure on the currency.

According to a note sent by Standard Bank's Tim Ash to clients in August, between the middle of May and mid-August, net outflows from Turkish bonds and equities reached $3.3bn. "Given the huge starting stock ($165bn, 20.6% of GDP), this is moderate," noted Ash.

"Following the successful deals for Akbank, Sberbank and Garanti, there were a number of other banks that were interested in issuing, but that interest has fallen away for the time being," says Kervancı. "Over the short to medium term I think the market for issuance of Eurolira paper will remain challenging. Until

Turkey: Modestly declining foreign ownership



Source: Central Bank of Turkey, HSBC

the currency market settles down, it's unlikely that we will see any issuance."

For now, that will mean that Turkish banks continue to be the dominant issuers in the local bond market. "The local bond market is growing very gradually," says Kervancı. "Last year, total issuance was around TL22bn, out of which about TL20bn was issued by the banks. In 2013, year-to-date issuance has already reached about TL18bn. Again this has been dominated by the banks which have accounted for about TL15bn of the total."

"The other theme we're seeing in the local bond market is the extension of tenors," adds Kervancı. "The average tenor of issuance last year was about one year. This year it has been extended to about 1.2 years. This increase in average tenor is being driven by the expansion of the Turkish investor base with demand growing from pension funds, asset managers and to a certain extent insurance companies."

Russian potential

The market for local currency rouble bonds has come a long way since the European Bank for Reconstruction and Development placed the first issue in the market by an international financial institution in May 2005. Proceeds from the Rb5bn floating rate transaction, led by Citi and Raiffeisenbank Austria, were used to meet the growing funding needs for the renewal of Russia's crumbling municipal infrastructure, as well as the financing of SMEs with little or no foreign currency income.

The EBRD announced at the time that it had been tapping the local currency market for short term promissory notes for some years, but that it had also been working with the government and market authorities to "prepare access for foreign issuers including financial institutions to longer term rouble resources that the bond market [could] provide."

Since then, rouble funding and the development of the local rouble market has remained an important part of the EBRD's broader issuing strategy. "We've been issuing in domestic and Eurobond format since 2005, because Russia is our largest country of operation," says Isabelle Laurent, deputy treasurer at the EBRD in London. "10% of our total lending is in local currencies, with the rouble the most important of these."

"Back in 2005 the investor base was purely domestic, and was dominated by banks," she adds. "Since then the investor base has broadened and foreign buyers are much more active, although foreign demand has been very volatile at times of political uncertainty."

To date, international participation in the rouble bond market has been limited to dedicated EM accounts that have set up arrangements with a domestic agent bank to clear in the local market, MICEX. Those unable or unwilling to do so have had the alternative of offshore Eurorouble bonds issued by multilaterals.

That may be about to change, because an important landmark for the development of local currency global bond markets was passed in February when Russian government bonds — OFZs — became Euroclearable. "That has removed a big headache for international investors because it does away with the requirement to appoint local custodians and local agent banks to settle the bonds and handle the currency," says Jones at HSBC.

According to research published by HSBC, in anticipation of Euroclearability, foreign ownership of OFZ bonds more than doubled between mid-2012 and June 2013, from 10.7% to 27.7%.

The expectation at the time was that eligibility for settlement via Euroclear would soon be extended to Russian corporate borrowers, adding considerable depth and variety to the rouble market. At Citi, vice president and head of local debt capital markets for Russia, Yury Kiselev, says that Euroclearability outside the government bond space is not yet a done deal.

"There are plenty of arguments for and against Euroclearability, and there is still no agreement on when this will become effective," he says. "It was originally expected on January 1, 2014, but there are still some uncertainties to be resolved on tax issues."

Kiselev says, however, that the longer term impact of Euroclearability ought to be positive for the broader Russian capital market. "Euroclearability is an important step towards making the market more transparent, but it needs to be coupled with improved corporate governance," he says. "We are also waiting for agreement on and introduction of trustee and tax gross-up language."

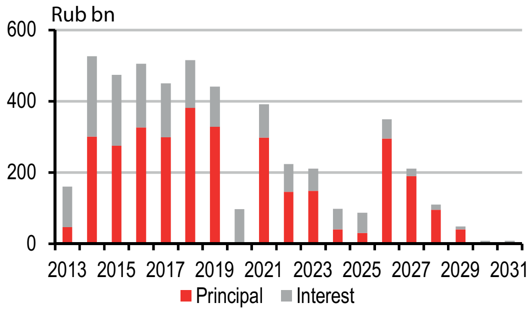
Another barrier to Euroclearability across much of the Russian corporate sector, says Kiselev, is that in many instances denominations are too low. "We still have bonds with denominations below Rb1,000, which means that by default they will be subject to the retail directive, preventing them from being opened up to global investors," he says.

This, he adds, is one reason why in the case of a recent Rb20bn transaction for Vnesheconombank (VEB), regarded as an important test of international demand for rouble debt, distribution was limited to select accounts rather than on a global basis. The VEB issue, priced at a coupon of 7.65%, which was led by Citi, Raiffeisenbank and VTB Capital, and generated total demand of Rb52.4bn.

While domestic banks accounted for more than 60% of the book, the most notable element of demand was the 13.4% that came from overseas. VEB announced at the time that it was "particularly pleased" to have seen "many foreign investors who did not participate in local issues in the past."

It is issues of this kind, say bankers, that will open up a much wider globally-targeted market for rouble debt more effectively than supranational issuance. "Sophisticated investors looking for Russian risk don't want to buy supras at 50bp through OFZs," says Jones at HSBC. "If they like Russia they want to get paid for holding Russian credit." An increasing supply of Euroclearable paper may give them many more opportunities to do so. ▲

Russian central government domestic debt maturity profile



Source: HSBC

Asia prepares for life after QE

The last few years have been a gift to Asian local currency markets as issuers and investors turned to the region while G3 markets struggled to find their feet. But with the US Federal Reserve indicating its willingness to reduce its bond buying programme when it can, the region has to prepare for what life will look like without quantitative easing, writes **Lorraine Cushnie**.

ASIA LOCAL currency bond markets have boomed in the years since the region's financial crisis in 1997 and been one of the main beneficiaries of the collapse of Lehman Brothers and the subsequent credit crunch.

This was no accident. The events of 1997 forced the countries of the region to focus more attention on developing their own bond markets, meaning they were better positioned to cope with the fall-out from 2008. Much of this work was driven by the Asian Development Bank under the auspices of its Asean+3 Bond Market Forum (ABMF).

Working with the 10 countries that make up the Association of South East Asian Nations (Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Vietnam), as well as China, Korea and Japan (the +3), the ABMF is trying to standardise market practices and harmonise rules across the region to make it easier to issue bonds.

"During the Asian financial crisis the big issue was a currency mismatch: firms borrowed in foreign currency, their domestic currencies depreciated and many of these companies went bust," says Thiam Hee Ng, senior economist in the ADB's Office of Regional Economic Integration. "One of the ways we looked to solve this issue was to promote the use of local currency bonds and the idea of greater inter-regional issuance."

Local currency DCM volume for Asia ex-Japan stood at $224.7bn in 2008, up from $137.6bn the previous year. Since then it has risen consistently, apart from a dip in 2010, according to Dealogic. Volumes hit a high of $714.6bn in 2012, compared to the $110.7bn worth of issuance in 2005 (*see graph*).

Because Asia's local currency markets remained open for business during the credit crunch, this made them much more attractive to outside borrowers, not to mention investors taking part in the well documented hunt for yield that drove so much capital into the region.

Dim sum in demand

One of the biggest success stories in Asian local currencies has been the offshore renminbi (CNH) or dim sum bond market. As part of China's efforts to internalise its currency, it was launched in 2010. Bond volumes grew to almost $14bn in 2012 and are set to see further growth this year. It has also been successful in attracting inter-regional borrowers and those from outside Asia, as well as Chinese credits. Borrowers include Caterpillar, Ford and Renault.

Raising currency to fund onshore operations is one of the primary reasons multinational companies (MNCs) issue dim sum bonds. "What drives international issuers is if they have business or investments in China, then it makes sense to issue in renminbi in order to match their exposure," Ivan Chung, senior credit officer at Moody's. "If MNCs try to borrow in China they may find difficulties. Highly rated MNCs, which in most other countries could get a lower cost of funds, won't be able to in China because the banks feel much more comfortable lending to state-owned enterprises."

Using the proceeds onshore was the reason BSH Bosch und Siemens Hausgeräte wanted to launch a dim sum bond, according to Andreas Stolzenburg, director and department head corporate finance and M&A at the company.

"We've completed two issues in renminbi and this was based on the fact that we do have a substantial and growing onshore business with a significant cashflow in renminbi," he says. "Consequently, we saw this as a good opportunity to finance our onshore subsidiary."

BSH raised a combined Rmb3.25bn ($529m) across two multi tranche deals in September 2011 and July 2012. The bonds were preceded by roadshows in Hong Kong and Singapore to select money managers and banks and it took six months from BSH first considering the bond to printing the first deal.

"A wide range of companies in southeast Asia with equity market visibility are now considering the SGD market for their debut debt deals"

Jon Pratt, Barclays

The other driver is arbitrage, which can require careful monitoring of a market which remains prone to liquidity squeezes. This was certainly the case for the International Bank for Reconstruction and Development, part of the World Bank group and which made its debut in January 2011 with a Rmb500m two year bond.

"Issuers have to be ready to issue or monitor the market," says James Fielder, head of local currency syndicate, Asia, at HSBC, which led the deal. "For the World Bank we were monitoring the CNH market for a year, once we got to within the range of where they were happy to price we were able to pull the trigger very quickly."

But while offshore renminbi grabs most of the headlines, other markets have also managed to attract foreign issuers. Thailand is one example, despite all the hurdles it forces issuers to jump through, and has attracted a growing number of non-Thai names. Korean borrowers including Export-Import Bank of Korea and Korea Development have been particularly active in the market, coming in when the after-swap costs look attractive. Thailand was also home to the first international bond issue from Laos (*see box*).

Singapore has also emerged as one of the region's most liquid and developed local currency markets, with borrowers from around Asia targeting it for long dated funding and corporate hybrids such as Malaysian casino operator Genting's S$1.8bn ($1.4bn) perpetual from March 2012. Malaysia, meanwhile, is now the world's biggest sukuk market, with a growing roster of issuers from the Middle East and across Asia.

Credit risk differences

Non-domestic issuers do not have it all their own way when it comes to local currency bonds. Much has been done to develop and deepen Asia's bond markets, but they remain relatively illiquid due to a lack of diversity in the investor base, and with limitations on what size and maturities borrowers are able to achieve, especially if the proceeds need to be swapped.

The average deal size of Thai baht bonds from foreign borrowers was Bt3.7bn ($116m) in 2012, while for offshore renminbi the same figure for non-Chinese issuers was Rmb640m ($105m).

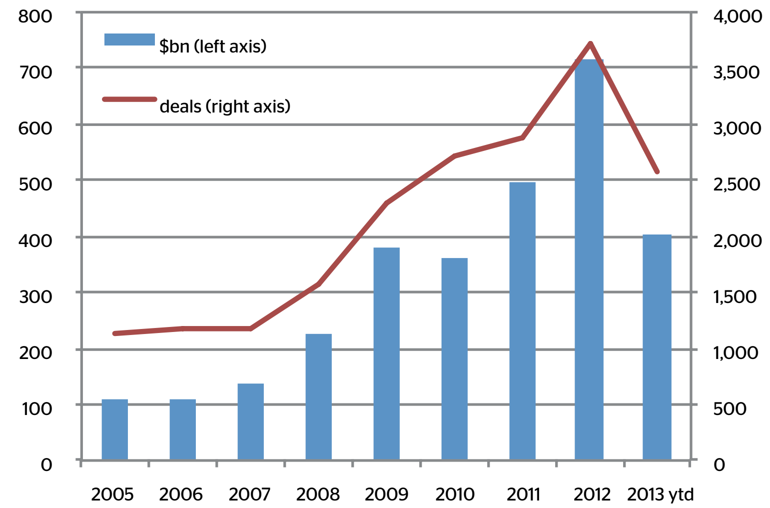
Domestic investors can also view credit risk very differently, much to the disadvantage of international borrowers. "In most cases investors want a pick-up to the local name otherwise they would rather buy the local credit, and that's frustrating for the double-A or triple-A rated names because they don't get the benefits of that rating," says HSBC's Fielder. "In baht, for example, you need to offer 30bp or 60bp or more over Thai govvies otherwise local investors won't buy, so the key is to find the credits that fit in the middle."

With a few exceptions, such as supranationals and Korean policy banks, many borrowers are yet to become regular issuers of Asian currency bonds.

"A reason why we may not see repeat issuers is that issuers use local currency deals for a specific funding exercise," says Henrik Raber, global head of debt capital markets at Standard Chartered. "For example, when a foreign company issues in CNH, that deal could fulfil the company's requirement for a number of years.

"Deals in some local currencies are done on standalone documentation, and not all local markets operate with the typical EMTN programme. Thereby, doing domestic documentation can take longer time."

Up, up and away
Asia (ex-Japan) local currency DCM Volume



Source: Dealogic

Going global

For their part, Asian countries have not simply been waiting for investors and borrowers to come to them. Increasing investor interest in the region over the last few years, combined with improving credit profiles has led to the emergence of bonds denominated in local currency but sold globally. Most notable are the Philippines' global peso bonds from 2011 and 2012 (*see profile on page 24*) and Thailand's amortiser from December and inflation linker from March.

However while these bonds have had a good reception from investors, they are yet to be followed by other sovereigns in the region such as Indonesia, Malaysia or Singapore. One reason could be the fairly high barrier to entry.

"A sovereign needs to come along and do something different to justify using a bank syndicate — for example, Thailand did an amortising bond and an inflation linker," says HSBC's Fielder. "Investors want to know that the sovereign will be a frequent issuer, the last thing they want to do is set up global fund and find out the supply dries up.

And while these bonds may have a role to play in raising the international profile of countries such as the Philippines, the ADB's Ng is less convinced that they do much to develop local currency markets.

"Global bonds are a second best option, they make it easier for investors, but it doesn't encourage those investors go into the local markets. The key is to make it easier for investors to access the local currency markets," he says.

Surinder Kapthalia, managing director, Asean, at Standard & Poor's, takes a more optimistic view. "Global issues of local currency sovereign bonds can be a teaser to that market," he says. "Once global investors have an appreciation for that market they will start to look at corporate issuers in that country's local bond market. Such issues can also help countries manage their FX exposure."

But if the last five years has been a triumph, the next five could be

"Issuers have to be ready to issue or monitor the market. For the World Bank we were monitoring the CNH market for a year"

James Fielder, HSBC

much trickier. Asia's local currency markets have borne the brunt of investors' changing approach to risk ever since Federal Reserve chairman Ben Bernanke suggested in May that quantitative easing could start to be withdrawn.

There have been a number of repercussions. Investors that had over-allocated to emerging markets are now moving to a neutral or underweight position, which in Asia has caused bond spreads to widen and currencies to depreciate — in some cases severely. This means that arbitrage opportunities are now few and far between for borrowers that need to swap the proceeds, as well as generating a negative perception among investors.

The internationalisation of local currency markets has also taken a hit. Until September, there had not been a single non-Chinese issuer in the dim sum market since June, while Malaysia, Singapore and Thailand's bond markets have become noticeably more domestic in their make-up during this period.

This preference for hard currency is expected to continue for the time being, although Jon Pratt, head of DCM, Asia at Barclays believes the CNH and Singapore dollar markets will still be attractive.

"The Singapore market is one that holds up in times of stress and the other positive is that it provides access to long dated funding for a broad range of credits," he says. "For many companies, it's a good alternative to the US dollar high yield market. Through our discussions with clients, we are aware of a wide range of companies in south-east Asia with equity market visibility but have never issued public debt. They are now considering the SGD market for their debut debt deals."

Meanwhile, offshore renminbi retains its position as a market of strategic importance as the currency continues to internationalise. And while there is a realisation that Asia's local currency markets may lose some of their international flavour over the next few months, the consensus is that they are in stronger position than ever before and will be ready as soon as international borrowers decide to return.

"On the one hand you have more opportunistic issuers which look at markets from the point of view of whether they will be able to get cheaper funding," says Andrew Stephen, head of private placements and local currency issuance, Asia at Deutsche Bank.

"On the other hand, you have people on the asset liability management side who will have to come to market anyway because they have a need to fund in these currencies. It's the opportunistic side that is more susceptible to a slowdown in difficult markets." ▲

Perseverance pays off for Laos

For all the rhetoric about interregional bond issuance, the examples of Asian borrowers that have issued in local currencies are few and far between. One notable exception is the Lao People's Democratic Republic, which in May this year made its international bond market debut with an offering in Thai baht. It is set to follow that up with a second issue later this year.

The process certainly was not a quick one. Supported by the ADB's Asean+3 Bond Market Forum (ABMF), Laos first floated the idea of issuing a bond in one of Asia's local markets in 2003. Thailand was an obvious choice, says an official at the Laos external debt management division in the Ministry of Finance.

"Since 2003 we have been making the case for Laos to issue bonds and we were looking at Thailand because of its proximity to Laos and the strong trading relationship," says the official. "But at that time the Thailand Ministry of Finance had restrictions only allowing rated issuers."

It took nine years, but in December 2012 Thailand changed the rules to allow sovereign issuers to sell bonds without a rating. Laos' Bt1.5bn ($47m) three year bond followed in May 2013, paying a 4.5% coupon and coming in 2.7 times oversubscribed. It was offered at 175bp premium to underlying Thai sovereign bonds, which are rated BBB+.

Thailand's TMB Bank was the sole lead manager and Laos firm Twin Pine Consulting came on as adviser. The deal made Laos the first sovereign to issue in Thailand's domestic market and the first non-rated issuer.

"It was difficult to base the pricing on Laos bonds because of course they are denominated in kip, so we looked at where other issuers in the market were pricing, including the Thai government," says the official. "Laos also used to borrow term loans from Thailand so we looked at those as well. I told TMB the range in which I was happy to price in and we were able to come to the market."

Thai investors already had some familiarity with Laos, but the country decided to go on a roadshow. Eventual buyers of the bonds included the Stock Exchange of Thailand as well as high net worth individuals, banks and funds, according to the official.

Thailand was a natural first choice for Laos, but it did consider some of Asia's other local markets – although was deterred by the pricing.

"We did do some work looking at markets such as Malaysia and Singapore, but if we had had to issue in Singapore, the yield we would have had to pay would had been higher than the yield we paid in Thailand," says the official. "After the swap we got a level of 3.9% for our Thai baht bond. We definitely want to go into other markets but the main priority for us is the price."

Laos is now looking to establish a curve in Thai baht. In September it received approval from the Thai MoF to sell a second bond for up to Bt3bn and is considering a five or seven year deal. It hopes to act as an example to other unrated sovereigns in Asia and to develop its own domestic bond markets.

"Our bond is not much if you look at the size compared to other issues in the market," he says. "But it's not about financing, it's about development – finding out where the yield curve is so we can set an example to other countries like Myanmar and Cambodia." ▲

AfDB: Africa's role model fosters development of local markets

Africa's local currency markets may well be the continent's best chance for securing the kind of investment it needs. Buyside interest in the region is growing, helped by the work of the African Development Bank, but there is much more to be done. **Philip Moore** reports.

AFRICA TAKES the development of its local currency bond markets very seriously, not least because it regards them as having a pivotal role to play in addressing the formidable problem of Africa's creaking and antediluvian infrastructure. To date, much of the revival that has characterised African economies in recent years has been driven by the global commodities boom. Sustainable long term growth, however, will need to be more broad-based. That won't happen without inward investment on a large scale. And inward investment on any meaningful scale outside the natural resources sector won't happen without very significant improvements to Africa's infrastructure.

There is already evidence that infrastructural shortcomings are discouraging and in some instances even preventing much needed FDI inflows. As the African Development Bank (AfDB) observes in a recent report, "international investors in fast-growing African countries are increasingly facing infrastructure bottlenecks. In Mozambique, for example, transport, power and other deficiencies have caused large industrials such as Rio Tinto to write down the value of investments."

The AfDB's exhaustive study on African infrastructure reports that the continent will need to invest $68bn between now and 2020. This is based on the assumption that Africa grows at 6% a year between now and 2040, lifting per capita income over the same period to more than $10,000 across the continent.

If Africa is to expand at this rate on a sustainable basis, it will need to meet an increase in power demand from 590TWh in 2010 to over 3,100TWh by 2040, increasing capacity from 125GW today to almost 700GW by 2040. It will need to cater to transport volumes that will increase by between six and eight times (considerably higher in some of Africa's landlocked countries). And it will have to upgrade its ports to make them capable of handling over 2bn tonnes of freight by 2040, compared with less than 300m today.

According to the AfDB, the sources Africa has available now amount to approximately $30bn. That leaves a shortfall of $38bn. Some of this will be plugged by bank finance, export credit agencies, funding generated through privatisation and foreign direct investment. Some will also be met through issuance in the international capital markets, which have been increasingly receptive to African sovereign borrowers over the last 18-24 months.

One striking example came in April 2103, when Rwanda launched its debut bond in the international capital markets. The order book for this 10 year $400m bond, led by BNP Paribas and Citi, reached $3.5bn, more than half of Rwanda's GDP of $6.9bn.

Although opportunities for new issuance from emerging market sovereigns have been restricted in the wake of concerns over when the US Federal Reserve might begin to reduce its bond buying programme, the long term prognosis is for more African sovereigns to harness international demand for exposure to the region. As Moody's comments in a recent piece on African sovereign debt ratings, the agency also believes more issuance will lead to "the wider participation of local governments, corporates and financial institutions in international debt capital markets."

AfDB support

While the response to issuance has been an important vote of confidence in Africa's economic prospects, hard currency deals leave borrowers exposed to currency risk and do little to foster the development of domestic capital markets. And with issuance windows for EM borrowers opening and shutting in line with capricious international sentiment, funding through the Eurobond market is also potentially hostage to execution risk.

That is why a growing number of African governments are hopeful that an increasingly meaningful proportion of the necessary funding will also come from local capital markets. That, in turn, is why the AfDB is committed to supporting the development of capital markets across Africa by issuing in local currencies. "More and more, clients are coming to us with projects that are generating local currency revenues," explains Max Magor Ndiaye, principal treasury officer at the AfDB. "It's the role of the AfDB to help those clients reduce their exposure to foreign exchange risk by providing matched funding in local currency.

"At the same time, it is important for the AfDB to help to stretch the yield curve in local currency markets, where local banks' funding is very seldom available beyond four or five years," says Ndiaye. "So our additional role in local currency markets is to establish new benchmarks and to provide role model transactions in terms of execution and distribution. We've been doing this for many years in the South African rand market, but more recently we have also supported the expansion of a number of other local currency markets."

A notable recent example has been the AfDB's issuance in Uganda, where the bank set up a 125bn Ugandan shilling medium term note (MTN) programme in July 2012. The first issue from this shelf was a 10 year, Sh12.5bn bond (about $5m), which was described by the AfDB at the time as a landmark issue. This was because, unlike its previous bonds linked to African currencies, all coupon and principal payments are made in shillings, with no currency swap attached to the transaction. AfDB followed up on its pledge to be a regular issuer in the Ugandan shilling market in May 2013, with another transaction with the same size and maturity.

Pricing on both deals adopted the same formula, with the coupon set at 85% of the yield on the two year Ugandan government bond. "Because the local currency proceeds are on-lent to local businesses, an important aspect of our strategy is that we leverage our triple-A rating to fund at the best possible price for the client," he says. "In the case of the Ugandan shilling issue, we priced at about 200bp below the government curve."

Ndiaye says that AfDB is now setting up a similar MTN programme in the Nigerian naira market and is planning similar initiatives in Zambia, Ghana, Tanzania and Kenya.

Pension funds under-resourced

To date, AfDB has placed all its Ugandan shilling issuance with local investors. That is in line with AfDB's objective in local currency markets, which is to promote the growth of market infrastructure in some of the less developed African markets. Distributing its bonds locally also meets AfDB's aim of helping to support the expansion of the domestic institutional investor base in general, and pension fund participation in particular.

Although they are growing rapidly, pension funds across the continent remain woefully under-resourced. According to the AfDB, aggregated pension fund assets in its eight target markets now amount to $40bn, compared with $320bn in South Africa alone. That leaves banks to take up much of the supply in the local currency markets, which in turn explains why demand has been concentrated chiefly at the short end of the curve.

Ndiaye says, however, that AfDB also aims to support the growth of local currency capital markets by placing bonds internationally. "Ideally, we're looking to attract a combination of domestic and international investors, because we recognise that by bringing in overseas investors we can lower pricing," he says. "Much of the proceeds are used to finance local infrastructure projects in Africa. The lower the cost of our local currency funding, the better it is for the country concerned."

Ndiaye acknowledges, however, that the small size of AfDB's Ugandan shilling transaction made international participation impractical. "One of the challenges we face is to attract foreign investment into relatively illiquid markets," he says. "Our Nigerian and Zambian programmes, however, will be for as much as $1bn and $500m, and we are talking to a number of international banks about developing ways of encouraging international investors to take part."

Another initiative that the AfDB is now undertaking with a view to making African markets more investable, Ndiaye says, is the creation of the African Domestic Bond Fund (ADBF) that will invest in African local currency denominated sovereign and state guaranteed sub-sovereign bonds.

"It is envisaged that the ADBF will be an index tracker fund," he explains. "Therefore the scope of this project also includes the development of the African Domestic Bond Index (ADBI) as the benchmark that will be replicated by the ADBF as far as possible in order to generate returns closely correlated to the ADBI while maintaining a similar risk profile."

The ADBI is being constructed as part of the African Financial Market Initiative (AFMI) and includes bonds listed in seven countries — Botswana, Egypt, Ghana, Kenya, Namibia, Nigeria and South Africa.

Better understanding

Bankers are confident that over the longer term international investors will play an increasingly active role in Africa's local currency markets. "I definitely see more demand from international investors for a number of reasons," says Florian Hartig, global head of debt capital markets at Standard Bank. "First, because international understanding of African credit has improved dramatically in recent years. Five years ago, smaller local currency markets like Zambia and Tanzania often didn't appear on research analysts' radar screens. Today, they are as well-informed about these markets as they are about the largest economies such as Nigeria and South Africa."

The second reason Hartig gives for his optimism about the prospects for African debt markets is the growth outlook. "We're very bullish on Africa, where we have seen average annual growth of between 5% and 7% over the last few years," he says. "We believe there will continue to be similar growth in the years ahead."

A third is the palpable interest that international investors have shown in African local currency Eurobonds issued by top-rated supranational and agency borrowers. "I know these are different from local debt in that they have different ratings and prospectus and listing requirements, but they are an important first step because they give investors access to the yield curve in local currencies," he says. "Already, we are seeing signs that international investors' appetite for local currency as well as local credit risk is rising. For example, we are seeing an ever-increasing uptake by international investors in Nigerian government bond auctions, among other local currency markets."

Another reason why analysts believe African local currency debt may become increasingly popular as and when the current bout of unease about emerging markets passes is its relatively low correlation with other comparable asset classes. According to research published recently by Standard Bank, "while Africa's Eurobonds remain correlated to the rest of EM, African FX, local bonds and equities remain relatively uncorrelated, potentially offering outperformance during the present profit-taking." ▲

Medium and long term bonds

	2005	2006	2007	2008	2009	2010	2011	2012
Total amount issued (US$ bn)	24.91	23.98	24.77	26.12	46.79	68.13	57.23	57.69
1-5 year bonds	4.79	8.40	11.27	4.59	16.96	19.65	18.36	16.65
5-10 year bonds	5.50	6.50	7.09	5.96	10.82	17.15	8.81	16.41
> 10 year bonds	14.62	9.08	6.41	15.57	19.01	31.33	30.06	24.63
Total amount issued per capita (US$)	37.81	35.58	35.93	37.03	64.84	92.31	75.80	74.11
Total amount issued as % of GDP	2.85	2.44	2.16	1.98	3.68	4.55	3.44	3.31
Total outstanding amount (US$ bn)	121.05	128.65	135.32	125.11	171.67	234.12	248.28	273.94
Total outstanding amount as % of GDP	13.84	13.08	11.78	9.46	13.51	15.63	14.94	15.73
Average coupon of bonds issued	7.70	8.65	8.58	8.14	8.83	8.05	7.35	10.83
Average issue yield	6.76	8.56	9.62	11.23	9.15	7.98	9.34	11.72
Average tenor of bonds issued (years)	12.04	8.24	6.49	10.12	7.68	8.73	9.61	9.37

Source: African Development Bank

IFC applies the power of three to funding strategy

The International Finance Corporation has been instrumental in helping to develop capital markets across the emerging markets, and nowhere more so than in Africa, where the infrastructure investment requirement is so great. **Philip Moore** analyses the organisation's three-pronged approach to local currency issuance.

IT IS DOUBTFUL that any organisation has done more to underpin the growth of local currency bond markets than the International Finance Corporation (IFC). That should not come as a big surprise. Its mandate, after all, is to promote the development of the private sector in its 184 member countries — the majority of which, by definition, are emerging or frontier markets.

That has called for a substantial commitment to lending in local currencies, although its total portfolio is "overwhelmingly" concentrated in dollars (71%) and euros (15%), according to a recent Moody's analysis.

"The proportion of our local currency-denominated lending is still relatively low," says Jingdong Hua, who joined IFC as vice president and treasurer after an eight year stint at the Asian Development Bank (ADB) in Manila, latterly as head of funding. "This is partly because in many countries where we lend, capital markets are still non-existent. But it is also because in frontier markets, nominal interest rates in local currencies are much too high because of inflationary pressures. From an internal rate of return (IRR) perspective, it makes no sense for borrowers to pay double-digit rates plus a spread.

"This means that in many countries, borrowers still have no choice but to borrow in dollars," says Hua. "The problem with this is that although nominal rates may be much lower in hard currencies, it exposes borrowers to huge foreign exchange risk." This has been in very clear evidence in recent months, with currencies in a number of high current account deficit countries nose-diving against the dollar since May, when global markets began to fret about the possibility of a reduction in US quantitative easing later this year.

This FX risk is what drives the IFC's ambition of nurturing the expansion of local capital markets. "The vast majority of our clients are successful entrepreneurs whose objective is to grow their businesses, add value and create jobs without incurring currency risk," Hua adds. "It is very clear to us that these private sector clients want bespoke solutions that match their own cashflows."

At a broader macroeconomic level, Hua says, there are other compelling reasons for supporting the growth of local capital markets. He points to a recent IMF study on African capital markets that found there was increasingly strong evidence that well functioning corporate bond markets make an important contribution to economic prosperity.

The result, says Hua, is that over the last 10 years the IFC has provided more than $10bn in local currency funds in almost 60 currencies. "By a big margin we've provided more local currency funding than any of our peers."

Much of that lending has been raised locally, in a series of ground-breaking issues with appropriately colourful names, ranging from El Dorado and Inca bonds in Colombia and Peru, to Atlas bonds in Morocco and Panda bonds in China.

Three point approach

The IFC's total local currency issuance needs to be seen in perspective. Its funding strategy is based on what it describes as a "three point approach". The most important of the three, by volume, is issuance in core markets such as US and Australian dollars. In 2012, for example, 60% of its $10bn funding for the year was accounted for by three global US dollar bonds. This year, the IFC expects its total funding to rise to $14bn, with dollar benchmarks playing a larger role than in previous years.

The second prong of IFC's funding strategy is ensuring it retains access to a wide range of markets "to benefit from opportunistic and competitively priced transactions". The Uridashi market is one example: in the first half of 2013, the IFC raised $900m in 19 bonds targeted at Japanese retail investors.

This leaves the promotion of emerging capital markets by issuing bonds in local currencies as the third component of IFC's funding strategy.

"We need to work with local regulators, stock exchanges, banks and investors to put the essential building blocks in place, currency by currency, market by market"

Jingdong Hua, IFC

The absolute volumes issued by IFC locally are less important for the evolution of individual capital markets than the contribution they make to the development of the essential infrastructure needed to support their growth.

"Even a triple-A borrower like the IFC needs to ensure that in order to have unimpeded access to local currency capital markets the necessary regulatory framework needs to be established," says Hua. "This means that we need to work with local regulators, stock exchanges, banks and investors to put the essential building blocks in place, currency by currency, market by market.

"It also means that issuance in an individual currency is not our only objective," he adds. "As well as issuing local currency bonds, we are also committed to supporting the development of the full gamut of complementary capital market products, such as credit guarantees and swaps."

Issuance by the IFC in local currency markets is of limited benefit if it is done on a one-off basis. As Hua acknowledges, an initial transaction by the IFC will only do its job of supporting the development of local capital markets if it is able to issue on a follow-on basis, and — over the longer term — if this issuance acts as a benchmark or reference point for other borrowers.

Hua says there can be no better example of a country where the IFC has accomplished much of what it set out to achieve in the local currency market than China, where it issued its first Panda bond in October 2005. Some five years in the making, this Rmb1.13bn ($140m) 10 year bond led by CICC and Citic, and issued at the same time as a debut ADB offering, may not have led to the explosion of issuance from foreign borrowers in the onshore RMB market that some were predicting at the time.

But Hua says that the Panda initiative was an important step in the development of the local currency market. "I'm not implying that there was any causality, but when we went to China for the first time in 2005, the corporate bond market there was nascent, representing about 5% of GDP," says Hua.

"Now it's worth about a quarter of the economy. Since we went in and created a dialogue about the importance of the local capital market as a means of financing infrastructure, a regulatory framework has taken shape and a vibrant capital market has developed. The same has happened in a number of other Asian markets, triggered partly by international borrowers such as IFC, and partly by regulators determined not to allow a repeat of the Asian crisis to happen."

Liquidity please

Where possible, this means issuing in liquid format, which has informed IFC's strategy in a key market such as Nigeria, which with a population of 158m is Africa's largest country. It is the continent's largest oil exporter. And although growth slowed to 6.6% in 2012, compared with 7.3% in 2011, the economy continues to expand at a healthy clip, with Standard Bank forecasting growth for 2013 of 6.7%.

"You do a market no justice if you misprice credit, and there are often compelling reasons why our pricing should be below the government benchmark"

Andrew Cross
IFC

At the same time, however, Nigeria remains blighted by widespread poverty, high unemployment and GDP per capita of $1,500, well below comparably rated countries. Nigeria is also hampered by the low level of diversity in its economy, with 65%-70% of government revenues generated by oil. It is also handicapped by its hopelessly inefficient infrastructure. As Moody's comments in its most recent review, "despite elevated levels of investment, the country continues to face a chronic infrastructure deficit that weighs on productivity and competitiveness".

That all adds up to a fairly long list of reasons why Nigeria is crying out for a deeper, more liquid and more transparent capital market. The good news is that both internationally and domestically, Nigeria's capital market continues to expand. In 2011, it launched its debut internationally-targeted bond, a $500m 10 year transaction led by Citi and Deutsche that generated total demand of $1.25bn and was intended as a benchmark for other borrowers to follow.

Domestically, meanwhile, according to the IFC, debt markets have become "crucial sources of capital funds". It notes that between the end of 2008 and December 2012, Nigeria's total outstanding debt stock rose from N2.3tr to N6.tr, which is an increase from 9% of GDP to 15% in the four year period. The growth of the market has also paved the way for important initiatives such as the recent launch by Lagos State of N167.5bn debt issuance programme to finance in-state infrastructural development.

The bad news is that even after this impressive growth, Nigeria's capital market still punches below its weight, and the absence of local currency issuance by IFC looked increasingly irrational given the importance of its lending programme in the country. Hua says that this year, IFC has made about $1.5bn of new loan commitments to Nigeria, which represents about 30% of its entire sub-Saharan African portfolio, which has itself expanded from about $200m nine years ago to a little more than $5bn this year. "Just imagine how beneficial it would be to the Nigerian capital market if half of that had been in local currency," says Hua.

IFC kicked off its issuance in the naira market in February with a transaction that started life as an N8bn ($50m) five year bond and met with sufficient demand to warrant an increase to N12bn ($76m). Standard Chartered Bank Nigeria and the Nigerian investment bank, Chapel Hill Denham, led the IFC's curtain-raiser in the Naira market, which was offered at a coupon of 10.2%.

Andrew Cross, manager of treasury client solutions for Africa, Latin America and the Caribbean at IFC's Washington headquarters, says that the naira bond, which was placed entirely with domestic investors, was priced through the local government curve. Cross says that IFC adopts a pragmatic approach to pricing local currency bonds in markets which have credit ratings well below its own triple-A rating, but which also have at least two key privileges that neither IFC nor any other supranational has.

Given that national governments determine tax laws and print money, there is an argument that their bonds should be regarded as the local risk-free asset, irrespective of their rating.

This would therefore imply that all other credits issuing in the local currency should price at a spread to the local government curve. That, however, would make the pricing of local currency bonds hopelessly uneconomic for a zero risk-weighted issuer like IFC, and would in turn hamper its efforts to support the development of local currency markets.

"We're very conscious of the role we play in helping to develop local capital market, part of which is helping domestic investors to analyse and price credits," says Cross. "But the pragmatic part is that you do a market no justice if you misprice credit, and there are often compelling reasons why our pricing should be below the government benchmark."

Besides, Cross says that pricing below the government curve can be beneficial for local currency markets. "In some markets where we've been able to price through the sovereign, the domestic market has rallied quite aggressively, thus helping to reduce the government's financing costs," he says. "We're careful not to claim direct credit for that, but we have been told that one of the reasons for this is that the presence of an IFC bond in the local currency market provides greater clarity about pricing risk."

Some investors say that to invest in a triple-A issuer such as IFC in local currency in an emerging or frontier market defeats the purpose of taking exposure to the market in the first place. Cross says, however, that an IFC issue can act as a helpful introduction to a new market for investors. "IFC local currency bonds appeal to investors looking to familiarise themselves with settlement systems and credit mechanisms in new markets," he says. "So they can be helpful for investors who want to take a gradual and methodical approach to putting new risks on their books."

The naira initiative is one of several being undertaken by IFC across sub-Saharan African local currency markets. This has included setting up a pan-African domestic medium term note (MTN) programme allowing it to issue debt instruments with maturities of three months or longer in Bostwana, Ghana, Kenya, Namibia, Rwanda, South Africa, Uganda and Zambia.

In July, Zambia's Securities and Exchange Commission granted approval for the issuance of up to 2.5bn Zambian kwachas ($460m) under the MTN programme. The following month, IFC announced that it had been granted permission by the Ghanaian regulator to issue regular cedi denominated bonds for up to a total of $1bn under the same pan-African initiative.

Not just Africa

While much of IFC's recent focus has been on quite under-developed markets in Africa, it has also chalked up a number of other firsts in local currency bond markets over recent months. In Russia, for example, it launched its inaugural Volga bond in November 2012, raising Rb13bn (around $410m), soon after being granted approval by the Russian Federal Service for Financial Markets to issue rouble denominated bonds in the domestic market up to Rb23bn ($730m).

Keshav Gaur, manager of treasury client solutions for Asia, Europe, Middle East and North Africa (EMEA) at the IFC in Washington, says this five year bond was significant not just because it was its first rouble denominated bond. It was also a breakthrough for the Russian capital market as it was the first issue of its kind with a coupon linked to an index that broadly approximates the performance of the Russian Consumer Price Index.

"The idea was to create a bespoke inflation basket catering to the demands of Russian investors who need protection against the adverse impact of inflation on real returns," says Gaur.

"The transaction was warmly welcomed by the Russian government which believes it could play a key role in widening the range of instruments available in the local capital market," he adds. "We hope to issue several repeat transactions with the same structure."

While local currency issuance by IFC in populous countries such as Nigeria and Russia has the obvious benefit of helping to grease the wheels of capital markets with very substantial potential long term growth potential, with a population below 10m the Dominican Republic is at the opposite end of the spectrum.

At the end of last year, IFC launched a so-called Taino bond for 390m Dominican Republic pesos, led by Citi. This was the equivalent of about $10m — which is microscopic, in comparison with most supranational public bonds, but as Cross says, enormous in the context of the local capital market. As well as being the first domestic placement by a triple-A rated issuer in the Dominican Republic, this was also the first IFC bond in the Latin American-Caribbean region which raised proceeds for on-lending to the local private sector. As the IFC announced at the time: "This creates access to local currency finance for the private sector while providing a viable channel for domestic savings to be directed into productive long term investments."

"The Russian government believes it could play a key role in widening the range of instruments available in the local capital market"

Keshav Gaur, IFC

Hua says that the significance of the Taino bond stretches well beyond the $10m it raised, because it will support expansion and innovation in the Dominican Republic's financial services industry. "The proceeds were on-lent to commercial banks that in turn used the funds to create fixed mortgages in the country for the first time," says Hua. "That has helped to stimulate competition in local market for affordable housing lending." ▲

América Móvil thinks big to find liquidity home and away

Unhappy with the lack of liquidity available in conventional Europeso bonds, Latin America's best-rated corporate América Móvil came up with a novel instrument — sold seamlessly to domestic and international investors — that would allow it to increase the proportion of its financing raised in local currency. **Olly West** reports.

MEXICAN telecommunications company América Móvil has long been a fan of issuing in Latin American currencies, having become the first foreign company to issue in the domestic bond market in Chile in 2009, for example. But though the company had sold Mexican peso-denominated bonds to international investors before last year, it had never been quite happy with the result.

The main issue, according to Carlos García Moreno, CFO since 2001, was illiquidity — a common affliction of local currency bonds.

But América Móvil — one of the largest corporates in LatAm and controlled by Carlos Slim — could afford to "think big", says García Moreno. Its funding needs are large enough that it could effectively create a new instrument on its own and maintain sufficient liquidity. A US shelf allowed América Móvil the ability to be completely flexible with its dollar issues: so why couldn't it do the same with Mexican peso bonds?

The company came up with the idea of registering bonds with the Comisión Nacional Bancaria y de Valores (CNBV) in Mexico as well as the SEC in the US, allowing the borrower to sell the deal to both domestic and international investors.

This is the beauty of the format, according to both the company CFO and DCM bankers who have worked on the deals, which went well from the start.

"The Mexican bank and securities commission was supportive and changed its procedures to back the idea," says García Moreno. "It was not something that had been tried before anywhere, but the willingness of authorities showed that everyone had much to gain with this format."

And so the *títulos de crédito extranjeros* were born. In November 2012, América Móvil attracted more than Ps50bn ($3.9bn) of orders for a Ps15bn ($1.17bn) note due 2022. The borrower paid 93bp over Mbonos — or a yield of 6.45% — for the bond led by Deutsche Bank, HSBC and Morgan Stanley.

Some 120 investors from 13 countries participated, with the majority of demand coming from the US (58%) and Latin America (33%), and some interest from the UK (8%) and Europe (1%).

Designed to trade

In its first step to ensure liquidity, América Móvil announced that it would try to tap the notes quarterly as it expected to raise Ps100bn ($7.8bn) through the programme in five years. The borrower duly re-opened the notes for a further Ps7.5bn in February 2013, pricing at 75bp over Mbonos — or a yield of 5.76%. BBVA Bancomer, Banamex (Citi's Mexican subsidiary) and Credit Suisse were bookrunners on the tap.

While the first issue went much more to foreign investors, the re-opening was more balanced towards domestic investors.

"These balances will always change as pockets of appetite come and go, but for an ideal balance we would be half domestic investors and half international investors," says García Moreno.

Although market conditions did not allow the company to re-open the bonds in the second quarter of 2013, Ps100bn is still the target.

The quest for liquidity went well beyond just opening the bonds up to more investors. The six bookunners on the programme are also hired as the borrower's market-makers, and all have made commitments in terms of providing bid-offer prices in the secondary market.

> **"It was not something that had been tried before but everyone had much to gain with this format"**

But unlike the peso denominated government debt markets, the sale of these bonds does not use an auction but a bookbuilding process — another liquidity play that allows the borrower more control over allocations.

"To have liquidity you need more than just market-makers, you also need different types of investors," says García Moreno. "If only pension funds hold the bonds there'll be little trading anyway."

Indeed, the order book in the first issue comprised 61% fund managers, 22% pension funds, 10% banks, 4% hedge funds, 2% retail and 1% insurers.

And América Móvil ensured its peso notes would contain further features to distinguish it from global local currency bonds

"Most global local currency bonds are denominated in the currency but settled in dollars, meaning traders have to agree on an exchange rate," says García Moreno. "The créditos are denominated and payable in pesos, which makes for smoother trade. We can also deliver pesos across the world by way of Euroclear, which also means cleaner trading."

For the borrower, the benefits are clear. The proportion of América Móvil's peso denominated funding should rise from 25% to 35% by the end of the Ps100bn programme, says García Moreno.

"For us as a company it also made a lot of sense — a lot of our funding was in dollars but being swapped into pesos," he says. "Raising funds directly in pesos is more cost-effective because we reduce swap costs, and it also avoids counterparty risk."

"For an ideal balance we would be half domestic investors and half international investors"

Carlos García Moreno, America Movil

It did not take long for a compatriot to follow. Media company Televisa, rated BBB+/BBB+, replicated the *títulos de crédito extranjeros* structure in May 2013 to sell Ps6.5bn of 7.25% of 30 year bonds at 99.757 to yield 7.27%, after attracting Ps40bn of demand. Citi, Deutsche Bank, HSBC and Morgan Stanley — all mandated on América Móvil's programme — led the bond.

Televisa's success came despite making no promises to regularly tap its new notes, and García Moreno believes there is scope for more companies without the firepower of América Móvil to copy the issuance.

"Some bankers have said to me that this product can only work for very large issuers, but I'm not so sure," he says. "Because there is already an established international presence in the large Mbonos market and our bonds, it is not that much more work for investors to look at other credits."

Mexican mould

Indeed, Mexico certainly lends itself to the new product. In Mexico the market for fixed rate government securities — Mbonos — has developed "tremendously" since it started in 2000, says García Moreno. Since that year, the Mexican government has formed a well defined yield curve and liquid market, while the country is easy to access for investors in terms of FX and public debt markets.

Finally, "the peso has been a clean open currency for more than 20 years. Investors like the fact that they don't have to be second-guessing the government or central bank", the CFO adds.

The attraction of Mexican local currency markets meant nearly 60% of investors in Mbonos were foreign at the time of América Móvil's first créditos issue in November 2012.

"We saw the significant appetite from international investors to take positions in the local currency — especially since 2009 — and thought we could come up with alternative to Mbonos that could offer diversification from government securities," says García Moreno. "The 10 year part of the curve was where there was most overlap between international and domestic investors."

But if the first transaction was designed to tap surging demand for Mexican local currency paper from international investors, the market environment since changed harshly. The sell-off in emerging market debt that followed the US Federal Reserve's indications in May 2013 that it might start tapering its asset purchase programme included a severe widening in the Mbonos market, as well as a depreciation of the Mexican peso.

There had been no global local currency bond issues from Latin America since the sell-off began until the time *EuroWeek* spoke to García Moreno, and indeed the borrower could not tap the bonds in the second quarter of 2013 as it had promised.

Yet this had not disappointed investors, and market volatility should not dampen appetite for Mexican denominated debt in the long term.

"Although we had hoped to tap the bonds every quarter, you have to be sensible," says García Moreno. "Investors realise there are exceptional moments in the market when it doesn't make sense to aggravate the problem by bringing even more supply. We thought it was prudent not to issue and investors were happy, but we believe we will be able to return to regular issuance."

Mexico's strong fundamentals — with strong growth, stable politics, and low debt to GDP — mean its currency can still be an attractive investment for foreign buyers.

"Financial volatility clearly moves exchange rates, but without fundamental problems investors believe exchange rates will return to around normal," says García Moreno. "And the investor community recognises that Mexico is in good shape and has a well-managed currency."

The CFO believes more investors are seeking exposure to local currency, and that the lesson from the summer's sell-off in local currency bonds is that investors must differentiate between currencies.

"Not all currencies are equal, and Mexico is one of the strongest," he says.

Different maturities mulled

Approaching the end of the third quarter, América Móvil was considering another tap of its créditos. And reverse inquiry for shorter-dated paper means that this time it may look to adjust its plans slightly and issue five year bonds alongside the re-opening.

"Before the end of the third quarter we expect to tap the 10 year bonds, but we have had feedback that the market is also interested in five year paper, so we will open up this option and print at that maturity if it makes sense," says García Moreno.

"When we began the programme we thought liquidity was the most important thing, so believed we would stick to the 10 year. Now we are thinking it would pay to have a yield curve with a five year and maybe eventually 15 or 20 year bonds."

Nevertheless, the 10 year remains the priority, as it provides a "good anchor" for the bonds and is where most demand is found. ▲

Garanti finds rich rewards for taste of adventure

Turkey's big five banks — Akbank, Isbank, Garanti Bank, Vakifbank and Yapi Kredi — seem to be in a debt capital markets arms race. All five jumped into dollar bonds a few years ago, then Eurolira this year. But in terms of local currency issuance, Garanti is streaking ahead, hawking its paper via its new MTN programme in a way that would make even the most experienced Bazaar vendor look coy. **Francesca Young** finds out what the bank has its eye on next.

TURKISH CIVIL unrest, US Federal Reserve tapering fears and the potential for the eruption of a war with Syria have provided a truly cacophonic backdrop for Turkey's banks and corporates in the debt capital markets this summer. Garanti Bank, though, has taken the resulting lull in dollar benchmark appetite to expand into private placements in a variety of non-G3 currencies.

Since mid-May, the bank has been picking up funding in the MTN market not just in dollars, but also in Turkish lira, Swiss francs, Australian dollars and most recently a Ck340m (17.6m) three year floating rate note.

The timing of the launch of Garanti's $2.5bn global medium term note programme was lucky — it was established on April 19, shortly before the sovereign won its second investment grade rating from Moody's, which swept Turkish bond yields to record lows. The Turkish sovereign is now rated Baa3/BB+/BBB-. Garanti is rated the same by Moody's and Standard & Poor's but carries a BBB rating from Fitch.

With the new programme in place and investors looking afresh at Turkey, the bank saw interest in its instruments spike. And aside from printing private placements, Garanti is using demand in that market as a gauge of wider appetite, as it did for its A$175m 5.5% 2018 deal placed in May.

"We have no restrictions on which currencies we can print, it just depends on pricing," says Batuhan Tufan, head of financial institutions at Garanti Bank. "Our dealer banks have been fielding enquiries for us even in Czech koruna, Mexican pesos and Romanian lei. We'd probably want to see the demand in private placements first before going to the benchmark market, like we did for the Australian dollar deal. That trade started as a private placement but was turned into a public market transaction as demand was so good for it."

The most important public market for Garanti away from dollars is the Turkish lira market. This is because the majority of the bank's loans to its customers are extended in this currency. The durations available in Eurolira are longer than can be achieved in the local market or via the bank's deposits, so the format offers a rare opportunity for the bank to match its assets and its liabilities both in currency and tenor.

Lira trades hit turmoil

But despite a good start this year with Akbank, Garanti and Isbank issuing the first ever bonds of this type, the market suffered as US Treasury rates rose and the Turkish lira weakened. The TL750m 2018s Garanti sold in February via BNP Paribas, Deutsche Bank, Goldman Sachs and Standard Chartered Bank were priced at 99.487 but had sunk to 86 shortly before the Federal Open Markets Committee Meeting on September 18. The decision by the Fed not to reduce its quantitative easing pushed them back up to 90.35.

The lira/dollar exchange rate jumped from TL1.7 to TL2.1 to the dollar over the summer, though there was some rebound in the second half of September to around TL2.0 to the dollar.

"It's an enormous loss because you've lost not just 14% on the price of the Turkish lira Eurobond but also more than 20% on the dollar/Turkish lira FX — so all in all, that's a negative 35%-40%," says an origination official in London.

Primary markets for EM local currency Eurobond instruments have effectively been shut since the Fed announced its plans to start tapering quantitative easing, says Tommaso Ponsele, an origination official at Citi in London. While the Fed's move in mid-September has helped rebuild confidence, the rebound has not been strong enough to reverse the damage done.

"The inevitable consequence of higher US rates is a lowering of the opportunity cost of holding dollars, so investors have been generally reducing their exposure to EM currencies, which in turn has put EM exchange rates under pressure," he says. "This doesn't provide a great backdrop for local currency Eurobond issuance."

"We have no restrictions on which currencies we can print, it just depends on pricing"

Batuhan Tufan, Garanti

An imminent return to that market looks unlikely for Garanti, or any other Turkish issuer for that matter. "When we printed our Eurolira deal, there was high interest from investors," says Tufan. "Now, there are so many expectations with regards to what the Fed will do that Eurolira now looks very expensive. When we printed our Eurolira deal, the rate was better than we would have achieved by swapping dollar funding."

The TL750m note was priced at 99.487 with a coupon of 7.375% to yield 7.5%. The bank's last dollar issue before that was a dual tranche deal placed in September 2012, comprising a $600m 4% 2017 and a $750m 5.25% 2022.

But Chris Jones, global head of local currency syndicate at HSBC, says that while the appetite for new local currency debt is not high, Garanti's Turkish lira deal has been resilient paper for investors compared to the bank's notes in other currencies.

"When the Turkish lira deal printed, its dollar cross-currency equivalent pricing level was around 100bp inside where Garanti's dollar bonds are trading," said Jones in early September. "If you look at the cross-currency levels for Garanti Bank now, the Turkish lira deal has actually been outperforming the bank's other notes. Its dollar levels are around 325bp over dollar Libor, its Aussie dollar trade is at 300bp over the same reference curve and its Turkish lira trade is at 160bp over."

He said that while Garanti would struggle to raise more benchmark funding in Turkish lira now, as would other Turkish issuers, the market was not completely closed to them. He said there were opportunities for smaller deals or private placements in \$25m-\$50m clips.

Treasurers are eager for this market to re-open as the local market in Turkey provides no opportunity to get large amounts of Turkish lira funding done in long maturities.

"We have around TL2.6bn of bonds in the local market, but the maturities available there are six months to a year, much shorter than are achievable in the Eurobond market," says Tufan. "A few years ago Turkish banks weren't allowed to use the local market at all."

Even with the yield on Garanti's outstanding Eurolira note having hit 11.5%, origination officials say that funding in the currency would be attractive if there was substantial primary market appetite at this level. This is because the Turkish bank can pass on the cost via their Turkish lira loans.

But while Turkish lira is a natural funding currency for the bank, Garanti surprised the market this year when it printed the first ever Australian dollar bond from the country in May — a A\$175m (\$173m) 5.5% May 2018 via HSBC.

Embracing diversity

"The Australian dollar trade came about as a proposal from us," says Jones. "We've had quite a lot of success for emerging market issuers in Aussie dollars — the first LatAm name in Australian dollars for Pemex in April 2012 for example. Since then we've seen issuance for several Korean, Indian and Russian names in the currency. At the time when we placed the [Garanti] deal, high yielding currencies were working well paired with high EM spreads to bring a very high yielding product to investors. Aussie swaps were at 230bp and it made sense for investors."

Jones says that, in a similar way to its Eurolira funding, Garanti used the Australian dollar market to get in longer term financing compared to the domestic market and deposits.

Other banks were less certain of the success of that transaction, though. The note's cash price sank immediately after pricing at 99.574, steadily declining before hitting a low of 90.7 on July 9. They have not recovered much and were trading around 92.57 at the start of September. One syndicate official said the lead might have overestimated demand, but another attributed the performance to US Treasury volatility pushing investors into a more risk-averse mode.

While Garanti has already been adventurous with niche currencies, there are some avenues left for the bank to pursue. Asian currencies are a potential next step, say bankers, or benchmark issues in Swiss francs.

"When the market fundamentals and perception of Turkey Inc is better, doing a benchmark Swiss franc deal may be an option for Garanti," says Jones. "In the Swiss franc market, because the yields are so low, the investor base has slipped down the credit curve to try to pick up higher yields, so EM is looking more and more attractive to them."

Ponsele says that for the moment, though, even the low yielding Swiss franc market is not an option for the bank.

"The Swiss franc swap market has also been volatile; even in that market you would need spreads to be quite a bit better than in dollars to justify the economics," he says.

"The bank's assets are primarily in Turkish lira, dollars and to a lesser extent in euros, so funding needs to make sense once it's swapped back to those currencies."

But bankers are unfazed by the rocky time that Garanti's non-G3 currency bonds have had over the last few months. They say that Brazil provides a good example of how exchange rates can bounce back fast — its currency sold off to a four year low of R\$2.41 to the dollar in August, but it has recovered to R\$2.20. They say that when the fundamentals of the country improve, local currency debt could be snapped up. In the meantime, the bank will need to rely on the dollar market, its strong bank lending lines and its deposits.

"Australian dollars and Swiss francs have been raised for diversification purposes," says Ponsele. "The bank is very well funded via deposits, so can afford to be price-sensitive in any currency. Unlike some other more wholesale-funding dependant banks in EM, Garanti has much less of a necessity to tap a wide variety of currencies."

He says that this makes the pressure on the bank to diversify bond funding across different pockets weaker than for others. Garanti is an experimental but logical issuer. Diversity is all very well but is not a rationale on its own — the bank won't do a trade unless it makes clear financial sense. ▲

Garanti local currency issues

Deal Total Value € (Proceeds)	Deal Total Value \$ (Proceeds)	Deal Pricing Date	Market Type	Maturity Date	Coupon	Currency Code
133,584,653	172,290,390	16 May 13	Euro market public issue	23 May 18	5.5	AUD
80,460,233	104,449,551	15 May 13	Euro market PP	26 May 15	3-mth Libor +105bp	CHF
68,393,949	89,084,525	04 Jun 13	Euro market PP	12 Jun 15	3-mth Libor +105bp	CHF
316,112,735	413,575,645	28 Feb 13	Euro market public issue	07 Mar 18	7.375	TRY

Source: Dealogic

Philippines adds glamour with synthetic sparkle

With dollar remittances pouring into the country from its citizens working overseas, the Philippines has been able to use global peso bonds to reduce its cost of borrowing. The synthetic deals have also given international investors an attractive way to play a well performing currency, although for the moment the sovereign looks unlikely to be followed by many corporates. **Adrian Murdoch** reports.

WHILE OTHER sovereigns have played with the idea of offshore bond issuance in their currency, it is the Republic of the Philippines (RoP) that has consistently tapped international markets — so far three times since 2010 — and to great investor demand.

"We have taken advantage of the healthy market appetite for Philippine paper to issue debt in the form of Global Peso Notes," says Philippine finance secretary Cesar Purisima. "This has been a successful way for us to reduce our exposure to foreign exchange risk further and to re-denominate our foreign exchange liabilities to local currency."

"The government has a lot of room for domestic players to increase issuance"

Wick Veloso, HSBC

The country's debut GPN was in September 2010, and was the first of its kind of Asia, a synthetic peso bond where coupon and principal payments are linked to the performance of the peso against the dollar, but where payments are made in dollars.

"Latin American sovereigns had printed offshore currency bonds — the Philippine offshore peso note printed in the slipstream of issues from Colombia and Chile," explains Avanti Save, vice president of credit strategy at Barclays in Singapore.

That deal certainly made its mark. The $1bn-equivalent SEC-registered 10 year was a coup for the republic. The 5% yield was comfortably inside not only where the Philippines had ever priced a US dollar global but also inside where onshore 10 year government paper was trading. More to the point, the more than 13 times oversubscription pointed to strong international demand, allowing the leads to allocate primarily to institutional investors.

For investors, one main attraction was exposure to the name. While many had long wanted to hold onshore paper, they had balked at the 20% withholding tax and the complexities of onshore custodian accounts and counterparty risks. "A global peso is considerably easier for investors," says Barclays' Save.

A more significant attraction, however, has been the currency play. "The market has increasingly demonstrated preference for the Global Peso Notes with expectations of peso appreciation," says Purisima. In 2012, for example, the peso appreciated 6.6% against the US dollar and was the second best performing of the 11 most-traded currencies in Asia, according to *Bloomberg*.

"In many ways Philippine offshore peso notes have been a good access vehicle to take a view on the PHP currency and [central bank] RPGB rates. They are denominated in peso, but they deliver in US dollars," says Andrew Stephen, head of private placements and local currency issuance, Asia at Deutsche Bank.

The enthusiasm for peso-denominated Philippine debt carried over to 2011, when, in January, RoP opened the Asian primary market at the very start of the year with a $1.25bn-equivalent 25 year GPN. The longer tenor and the tight pricing — the 2036s were priced at the tight end of the 6.25%-6.375% guidance after reaching a book of $3.6bn — showed continued confidence in the country. The pricing was 185bp inside where equivalent paper was trading in the domestic market. Indeed it was a sign of the mood that soon after the bond was issued international ratings agency Moody's put the country's Ba3 rating on positive outlook.

And in November last year, the Philippines sold its third GPN, a $750m-equivalent 3.9% 10 year via Credit Suisse, Deutsche Bank and HSBC. This was a step up for the sovereign in the evolution of its debt. The seven times oversubscription on the deal pointed to the continued attraction that the name had, but it was also a sign of a maturity and development of the market. It was the first time that the sovereign had offered GPNs as part of a liability management exercise to lower interest expenses and retire more expensive debt in dollars and euros.

"The exercise will reduce interest costs for the Republic, avoid bunching up of maturities, and extend the duration profile of the Republic's outstanding debt portfolio," said National Treasurer Rosalia De Leon in a statement at the time.

Corporate complexities

While the sovereign has been a regular borrower in the offshore peso market, it is perhaps a surprise that few corporates have followed suit. In the wake of the first global peso deal for RoP, both Petron Corporation and Export-Import Bank of Korea, better known as Kexim, dipped their feet in the water, but there has been nothing since then.

Petron Corp, the Philippines largest oil refiner, went first, only two months after the sovereign. It sold a Ps20bn ($475m) seven year Reg S bond at 7% via Credit Suisse, Deutsche Bank, HSBC and Standard Chartered. As it was for the sovereign, the appetite was certainly there. The book was 2-1/2 times oversubscribed.

A few weeks later, Kexim appeared, explicitly saying that a peso-denominated issue could offer investment grade risk with attractive currency exposure. It sold a $263m-equivalent 4% 144A/Reg S five year bond as a private placement from reverse enquiry. The pricing, via JP Morgan, was attractive too. It came in around 25bp inside where Kexim's outstanding five year paper was trading.

The lack of corporate issuance since then has less to do with lack of interest or the structure of the bond and rather more to do with the regulatory issues and the complexities of a peso liability that is then settled in dollars.

While straightforward for the sovereign, it requires corporates to register with the central bank to service the dollar flow, something that adds to the cost of borrowing. Most corporates have, say bankers, simply tapped the domestic bond market for their needs.

Part of the continued attraction of GPNs to investors has been consistent and justifiable global confidence in the economy. In the second quarter of this year, the economy grew 7.5%, according to the government, and the country had a current account surplus of $1.2bn in March, according to the central bank. Remittances from Filipinos working overseas, a significant issue for the diasporic workforce, also remain high; they were up $572m on the same period in 2012.

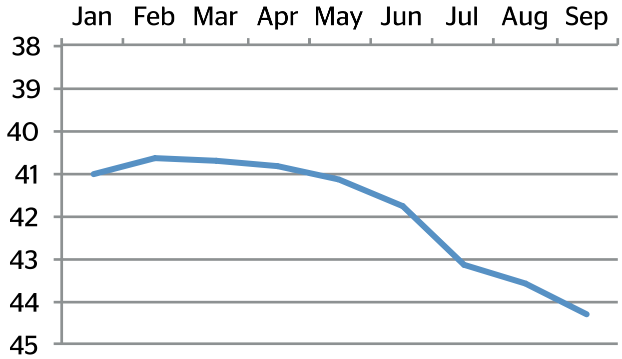
At its most obvious level, sign of economic success can be seen in that the Philippines is now rated investment grade by two of the three main ratings agencies. At the beginning of May Standard & Poor's upgraded the Philippines to BBB- from BB+. This followed an upgrade to BBB- in March from Fitch.

At the time Fitch noted: "Improvements in fiscal management begun under President Arroyo have made general government debt dynamics more resilient to shocks. Strong economic growth and moderate budget deficits have brought the general government debt/GDP ratio in line with the BBB median."

Only Moody's still has the sovereign at Ba1, one notch below investment grade. And even there an upgrade is a matter of "when" rather than "if". The country was put on review for upgrade at the end of July.

Not as bad as some

Philippine peso to US dollar 2013



Source: Reuters

Unlike the rout seen in other Asian sovereign bonds this year, the RoP offshore notes have performed solidly in secondary. On September 10, the 21s were quoted at 104.312/105.625 to yield 4.259/4.055%; the 22s were at 97.002/98.822 to yield 4.297/4.054% while the 36s were at 107.054/109.257 to yield 5.688/5.523%. "The paper is not heavily traded — the paper mostly went to buy-and-hold investors," says Lynette Ortiz, Philippines head of global markets at Standard Chartered. Another banker points out that it was rare to see trades of more than $10m each day.

Next up?

With this kind of performance, unsurprisingly, a new GPN either for late 2013 or early 2014 has been on the agenda for some time. Pricing would be moderately straightforward and any new issue would simply price off the curve that has been established. Syndicate heads suggest that a new issue premium would be around 25bp-30bp. A 10 year could get away comfortably with a coupon of under 5%.

Purisima will not be drawn on timing, saying that GPN issuance "serves as a vehicle for us to access peso issuance if the sentiment in the local capital markets is not opportune" and that it depends on a number of factors.

This is all good news, but there are a couple of problems. Although a bid remains for offshore bonds, it is niche. Few doubt that were a new GPN to emerge, RoP would go for another 10 year. "It is the safe tenor," says Wick Veloso, president and chief executive officer of HSBC Philippines.

But with another 10 year in play, the question must be asked to whom the RoP is appealing. "There is no talk at all of a five year issue, so RoP is not planning to target banks as investors. Because of this, it wouldn't be targeting a new issuer base," says one regional banker.

More significantly, since May 22 when Ben Bernanke, chairman of the US Federal Reserve, indicated that he intended to begin reducing quantitative easing, Asian currencies have sold off. The Philippine currency has weakened only 6.7% against the dollar this year, compared to an 18% plunge in the Indian rupee and a 10% drop in the Indonesian rupiah, again according to *Bloomberg*. But it has dropped. Given these ructions, "bonds start to lose their lustre as a peso play," says Standard Chartered's Ortiz.

Deutsche Bank's Stephen notes how this has played out over the past few months. "Recently it's been short dollar and long Asia, but that is beginning to reverse," he says. "Investors have become more positive about the US and the currency, which means that there is more interest in US dollar products."

In this light, and with admirable prescience, Purisima has been pushing the domestic onshore bond market, which grew by 19.8% year-on-year in the first quarter this year, according to the Asian Development Bank. And this despite high issuance costs of Ps812,500 plus 0.025% of issue amount for issuance of over P1bn and an approval time of six to eight weeks. "We don't want our banks to be saddled with non-performing loans and create risk for the banking system. That's why it is important for the bond market to grow," he said in a speech at the ADB earlier in the year.

"The government has a lot of room for domestic players to increase issuance," agrees HSBC's Veloso. With the domestic market booming and a currency play taken out of the equation, all eyes for the rest of the year are likely to remain on the domestic market. ▲