CREDIT MARKETS SPECIAL | CORPORATE BONDS| CEE

CEE corporate bond rally

The spread pickup of EUR IG non-financial corporate bonds from CEE over the EUR IG non-financial corporate bond market as a whole widened significantly as a result of the outbreak of war in Ukraine. It peaked in autumn 2022. Since then, the risk premium of CEE bonds has fallen compared to the broader market. It is approaching the level seen before the war started.

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EUR IG Corporate Bonds in comparison

Non-Fin. Corporate Bonds	EUR IG	EUR IG CEE
Ø Mod. Duration (years)	4.9	3.4
Ø Yield (%)	3.7	4.4
Ø Spread vs. Bund (bps)	118	175
Ø Rating	A/BBB	BBB

Source: Market data provider, Erste Group Research
Data as of 04/17/2024
IG = "Investment Grade"

Link to analyses for selected CEE issuers

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Note: Information on past performance is not a reliable indicator of future performance.

CEE risk premium falling continuously since 4Q22

CEE corporate bonds are in demand again

As the spread development for CEE EUR corporate bonds shows (on average), sentiment towards EUR corporate bonds from CEE has improved significantly over the last one and a half years. However, risks remain. This is because some issuers are still sourcing oil & gas from Russia or are benefiting from the transmission as pipeline operators. However, the issuers concerned are increasingly better prepared for an end to supplies.

Outbreak of Ukraine war burdens CEE corporate bonds

While the outbreak of the coronavirus pandemic made little difference to the relative valuation of corporate bonds from the CEE region compared to the broad market as a whole, the outbreak of the war in Ukraine put corporate bonds from the CEE region under strong pressure. While the spread premium of CEE EUR corporate bonds over the broad EUR corporate bond market as a whole was still 15 basis points (bp) on average as of December 31, 2021, it widened significantly to 196bp by March 31, 2022, following the outbreak of the war in Ukraine on February 24, 2022.

The CEE "risk premium" peaked (~270bp) in autumn 2022 and has since been steadily approaching the level seen before the outbreak of war in Ukraine. It currently stands at around 60bp. If the war does not escalate and CEE countries such as Hungary manage to become less dependent on Russian oil & gas supplies as planned, there is spread tightening potential. Poland, for example, is already independent of Russian oil & gas imports.

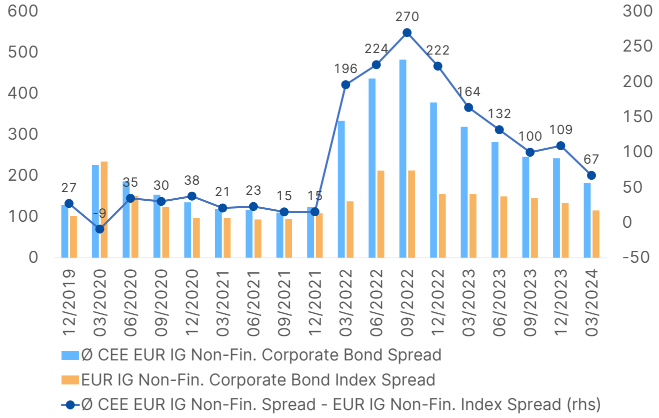
At BBB, the average rating of CEE issuers is somewhat weaker than the average rating on the EUR IG corporate bond market as a whole (A-BBB). On the other hand, the modified duration of bonds on the overall market is higher on average at 4.9 years than in CEE (3.4 years).

Rally is entirely justified

The recent strong performance of CEE corporate bonds is underpinned by fundamentals. The CEE issuers, which are primarily from the utilities and oil & gas sectors, have good credit ratios in a peer comparison. Dependence on Russia is gradually being reduced. Incidentally, the recent escalation in the Middle East conflict did not lead to an increase in the CEE spread "pickup".

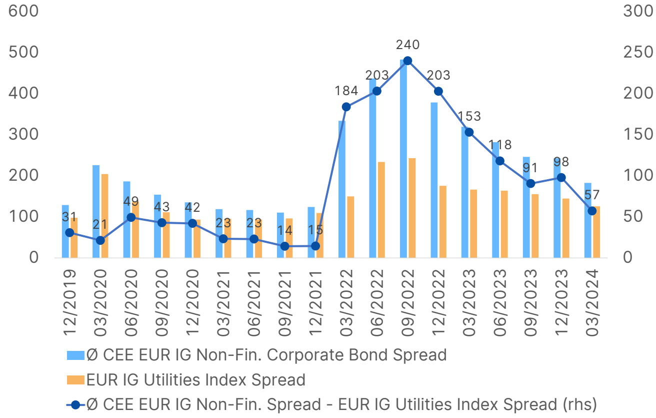
Many governments in the CEE region hold shares in issuers that are important for the state energy infrastructure. This usually supports their credit quality indirectly. For example, the Czech government holds 70% of the shares in the utility CEZ, which accounts for around 30% of the CEE EUR IG corporate bond volume. For the members and weightings of the EUR IG Corporate Bond universe in CEE analyzed here, please refer to the appendix.

Risk premium of CEE EUR corporate bonds has been...
Spreads* to Bund & CEE risk premium in basis points



Source: *Markit, Erste Group Research*
**of benchmark-eligible EUR Corporate Bonds; data per end of quarter*

... falling continuously since 4Q22, also vs. utilities
Spreads* to Bund & CEE risk premium in basis points



Source: *Markit, Erste Group Research*

Comparison with utilities index also shows CEE risk premium

Due to the high proportion of utilities in the CEE corporate bond universe (around 70%), a comparison of CEE EUR corporate bond spreads with those from the entire utilities sector is even more meaningful. This "fairer" comparison also clearly shows a CEE risk premium (see chart above right).

Level of CEE risk premium also reflects general risk appetite on market

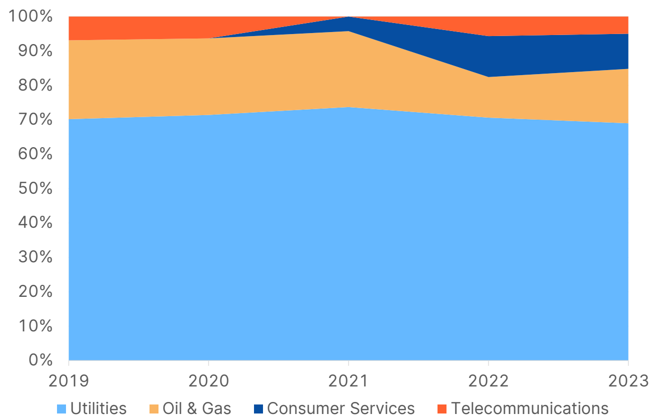
It is not only the Ukraine war and Russian oil & gas that are decisive for the CEE risk premium. It is also determined by the general risk appetite of credit market investors. This is shown by the connection with the iTraxx Crossover CDS Index. It reflects the default risks of large but somewhat less creditworthy EUR corporate bond issuers.

The expectation that the ECB will soon cut key interest rates has stimulated risk appetite in recent months. The declining inflation rate increases the probability of an interest rate cut in June.

Dependence on Russia is being reduced

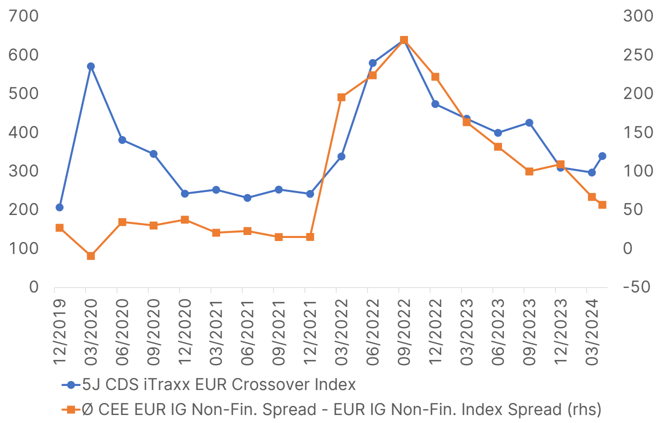
For some CEE issuers, an end to Russian oil & gas supplies remains an important risk factor in the short term. We describe the progress made by some of the affected issuers in becoming independent from Russia.

Utilities dominate in Central & Eastern Europe
Share of CEE EUR IG benchmark corp. bond volume



Source: *Markit, Erste Group Research*

CEE risk premium correlates at times with HY CDS index
5Y iTraxx XOVER-CDS index vs. CEE risk premium, in bp



Source: *Markit, Erste Group Research, Data until 04/17/2024*

Case studies

CEE corporates reduce dependence on Russia

Affected CEE issuers are working to make themselves independent of Russian oil & gas supplies and sales from the transit of Russian gas.

eustream

Russia risk is crucial and has been partially priced out

The EUR 500mn bond of the Slovak gas pipeline operator eustream (Ba1/BBB), which matures in 2027, has been among the five best-performing benchmark-eligible, investment grade-rated EUR corporate bonds since the beginning of the year.

Despite the outbreak of the war in Ukraine and falling gas transit volumes, particularly from Russia (FY22/23: 17bcm; -52.4% y/y; 11bcm of which flowed to Austria), eustream continues to receive capacity payments from its major Russian customer Gazprom on the basis of a long-term contract. Sales in FY22/23 (until July 31, 2023) declined to EUR 226.5mn (-61% y/y). Although operating cash flow fell to EUR 43mn (-89% y/y), eustream generated slightly positive free cash flow (around EUR 27mn) thanks to its low investment requirements.

eustream is building up liquidity

According to Moody's, eustream was able to increase its cash position from EUR 100mn to around EUR 300mn between the end of March 2022 and the end of 2023. The probability that eustream will be able to redeem a EUR 500mn bond from the financing vehicle SPP Infrastructure Financing, which it guarantees and which matures in February 2025, from its cash increases with the continuation of the Gazprom payments.

Moody's upgraded eustream's rating outlook from negative to stable in January 2024

On January 26, 2024, Moody's raised the outlook on eustream's Ba1 rating from negative to stable, citing the development of its liquidity position. eustream is a wholly-owned subsidiary of SPP Infrastructure. SPP holds a 51% non-controlling interest in SPP Infrastructure. The remaining 49% is held by EP Infrastructure. SPP is in turn 100% owned by the Slovak Republic.

If required, support from parent SPP Infrastructure is possible

Moody's also justified the rating confirmation for eustream in January with the expectation that the parent company SPP Infrastructure could support eustream in the event of payment difficulties. According to the rating agency, SPP Infrastructure had cash and cash equivalents of EUR 900mn at the end of 2023 (including eustream's cash and cash equivalents).

eustream can supply CEE countries with gas from Norway and via LNG terminals

Moody's also sees the possibility that eustream will be able to compensate for the loss of gas and cash flows from Russia in the medium to long term through capacity bookings from other customers. However, it remains uncertain when and to what extent this could succeed. eustream has invested in its gas pipelines in recent years. These can now transport gas in both directions. This means that gas from Norway and from LNG terminals can be transported via the north-south corridor from Poland to Slovakia and neighboring CEE countries. This not only increases the energy security of the CEE region, but also eustream's resilience in the event that gas deliveries and transit fee payments from Russia fail to materialize.

The yield on the eustream bond remains the fourth highest in the EUR IG corporate bond market. This reflects the still high geopolitical risk. This is because the Ukrainian gas transit supply contract with Gazprom expires at the end of 2024 and is unlikely to be extended.

SPP-distribucia, EP Infrastructure benefit from eustream's improved liquidity position

eustream's sister company SPP-distribucia also benefited from the change in outlook. Moody's also raised the rating outlook on SPP-distribucia's Baa2-rated bond from negative to stable. With eustream's improved liquidity position, the risk that SPP-distribucia, Slovakia's leading gas supplier, will be called upon to provide financial support to its sister company has decreased.

EP Infrastructure's rating outlook (Ba1/Fitch: BBB-) was also raised from stable to positive by Moody's on January 26, 2024, due to the improved credit quality of the gas transit subsidiary eustream.

Fitch changed eustream rating outlook from negative to stable as early as October 2023

Fitch confirmed eustream’s' BBB rating on October 12, 2023, and changed the rating outlook from negative to stable, also citing continued "ship or pay" payments from main customer Gazprom and the improved liquidity position. At Fitch, the company benefits from a one-notch rating lift, due to its stronger parent company SPP Infrastructure and its potential support for eustream.

MOL

MOL (Baa3/BBB-/BBB-) is an integrated oil & gas group in Hungary with a business focus on downstream activities. The Hungarian state holds an indirect stake of around 30% in MOL.

MOL's refineries are to be able to process 100% non-Russian oil with complete flexibility by 2027

MOL's refineries still mainly process Russian oil (approx. 60%). MOL is pushing to diversify its oil procurement (via the Mediterranean), but must also invest in adapting its refineries to process non-Russian oil. By 2027, MOL wants to be able to process 100% non-Russian oil and be independent of Russian oil imports.

According to Fitch, Russian gas covers 80% of Hungary's demand. If routes via the EU are cancelled, MOL can obtain (Russian) gas via the Turkstream pipeline. LNG could also be sourced via EU routes.

MVM

Hungary can obtain (Russian) gas via Serbia, non-Russian gas e.g. via LNG terminal in Krk

Hungary's largest electricity and gas supplier MVM (BBB-/BBB) has already been able to compensate for a temporary decline in Russian gas deliveries via Austria with (Russian) gas deliveries via the Serbian route (see also the section on MOL). In addition, LNG can be sourced via the terminal in Krk.

Orlen

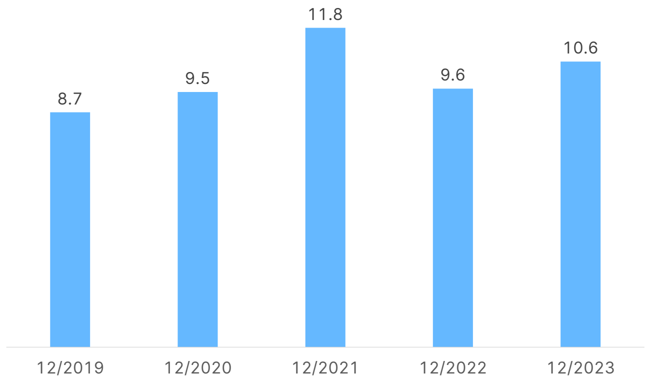
Orlen is already independent of Russian oil & gas in Poland

The leading Polish oil & gas group Orlen (A3/BBB+) has not received any more Russian oil in Poland since the end of February 2023. Orlen diversified its procurement early on and receives the raw material from the North Sea, West Africa, the Persian Gulf and the Gulf of Mexico, among others. In the Czech Republic, the group still processes Russian pipeline oil, but is supporting the Czech government in its efforts to obtain more oil from sources other than Russia. The Czech Republic is modernizing its pipelines.

Orlen has also stopped sourcing Russian gas in Poland since the beginning of 2023. Gas is sourced via the Polish LNG terminal from Qatar and the US, via Lithuania and via pipelines from Norway. Orlen is investing in its own LNG tankers.

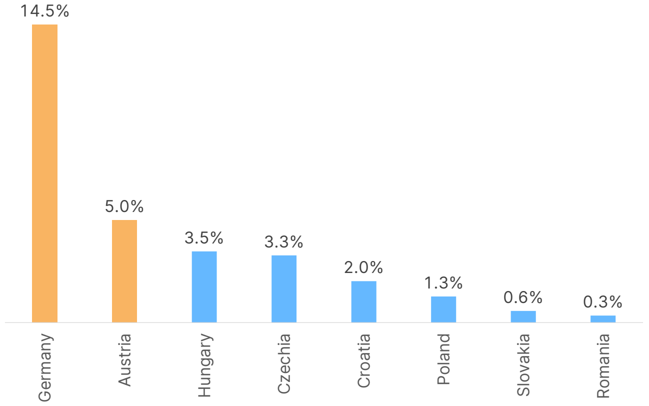
Appendix

CEE EUR corporate bond volume* grows only slowly
EUR corporate bond volume* in CEE (EUR bn)



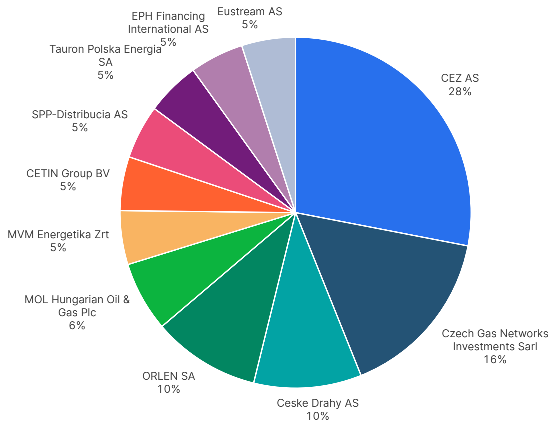
Source: Market data provider, Erste Group Research

CEE: catch-up potential for corporate bond utilization
Current outstanding corp. bond volume (% of GDP 2022)



Source: Market data provider, Destatis, Erste Group Research, own calculations

Benchmark-eligible CEE EUR IG Corporate Bonds
Composition CEE EUR IG Corporate Bond Index



Source: Market data provider, Erste Group Research, own calculations

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