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Pakistan's Euro Bond: A Resounding Success

by

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Introduction

On February 12, 2004, Pakistan made a successful return to the international capital markets for the first time in more than five years. The Islamic Republic of Pakistan issued US $ 500 million 5 year Regulation S Eurobond due 2009, lead managed by Deutsche Bank, JP Morgan and ABN Amro Bank. This transaction attracted strong demand from high quality and diversified international investors resulting in four times oversubscription and consequent tightest possible pricing of the bond in comparison to similar rated sovereign offerings for 5 year new issues. The success of this transaction reflects a vote of confidence by the international investor community on Pakistan's economic policies and reform agenda.

Pakistan's initiative and the outcome of the transaction was highly appreciated by international and local print and electronic media. The local influential English dailies wrote editorials on the success of the transaction. It is, however, not uncommon to find dissenting views from some commentators. While sifting through the newspapers one can find the following points raised by these commentators: (a) what was the need to *"borrow"* $500 million from international capital market when the country's foreign exchange reserves were over $ 12 billion; (b) the 6.75 percent interest rate paid by Pakistan on its Eurobond was exceptionally high because global interest rates are very low; (c) if there was a need to *"borrow"* the Government could have borrowed at a much cheaper rate from the IMF and the World Bank; (d) the Government has *'borrowed"* without any underwriter; and (e) the Government should have borrowed at LIBOR and not at US Treasury rate because the former is much lower than the latter. As will be seen later, these views are based on limited understanding of the mechanics and the conventions for the issuance of sovereign bond. Undoubtedly, the working of bond market, its pricing mechanism, execution strategy, marketing and distribution tactics are highly complex. Unless one has fair degree of understanding of the subject, there exists a high degree

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of possibility of committing error in passing judgment. The purpose of this article is to educate the readers on a few fundamental bond issues and in the process dispel the aforementioned impressions formed by some commentators.

The plan of the article is as follows: I shall begin by providing the rationale for going to the international capital market followed by the key objectives of floating Eurobond. How the prices of sovereign bond are determined in the market will be the next item followed by a discussion on going to the market with or without underwriters. Should LIBOR instead of US Treasury Rate be used as reference interest rate? Would the yield of the bond differ if one decides to use LIBOR or US Treasury rate? This issue will also be clarified.

II. RATIONALE FOR GOING TO BOND MARKET

Pakistan has lived through difficult and testing period in the not too distant past. Our economy was fragile, the balance of payments were highly vulnerable to external shocks, the country's debt burden was reaching alarming proportions, foreign exchange reserves were poised on knife's edge and the country was facing difficulties in financing next month's import bills, financial indiscipline was the order of the day, relations with International Financial Institutions (IFIs) were in disarray, and international Credit-Rating agencies had downgraded Pakistan's credit rating to Selective Default (SD) level. Pakistan's dependence to IFIs for financial support was complete. With that, the country had almost lost its financial and economic sovereignty.

After four and a half years of hard work the complexion of Pakistan's economy has changed altogether. The economy is no longer fragile. Indeed, it is witnessing sharp acceleration in growth. The country's balance of payments is much stronger today than ever before; foreign exchange reserves are almost $ 12.5 billion – sufficient to finance almost 12 months of imports; the country's debt burden is declining and moving towards the sustainable level; the country has pre-paid $ 1.17 billion high cost external debt, financial discipline is maintained; relations with IFIs are very cordial; confidence of the private sector has been restored; and Pakistan has been upgraded by international rating agencies.

Having laid the foundation for a strong economy and taking it to a take-off stage, the Government of Pakistan decided to graduate itself from the IFI-dependent economy to an economy which has the ability to raise capital from international market. It is well-known that Pakistani authorities have already informed the IMF that the current on-going PRGF Program will be the last Program, ending in November 2004. Therefore, there is all the more reason to diversify its funding sources from primarily IFIs to international capital market. The mature economies around the world, when need funds, they go to international capital market and not to the IFIs. The economies in distress go to the lender of last resort because they are not in a position to raise capital from the market. Pakistan's economy is no longer in distress; rather it is now a stable economy and needs to return to the fraternity of international investors. This was the rationale behind making strategic re-entry into the international capital market.

III. WHAT WERE THE OBJECTIVES?

What was the need to *"borrow"* $ 500 million from international capital market when the country's foreign exchange reserves were all time high at over $ 12.0 billion? This question has been raised by some commentators because the objectives of going to the bond market were not clear to them. Let me state the objectives for going to the bond market. Borrowing from the capital market was certainly not the objective because Pakistan did not need forex as it was already carrying reserves of over $ 12.0 billion. What were the objectives then? The first and foremost objective was to put Pakistan's name on the radar screen of the international capital market by making a strategic re-entry. This would enable international investors, credit rating agencies, research analysts etc. to observe Pakistan's economic performance on a permanent basis and allow our collective success as a nation to be effectively projected to global investors. Pakistan's recent economic performance has been impressive — not only in relation to its past but also in comparison to many better rated peers, especially on external front. The favourable dynamics generated by the strong economic rebound provided an ideal opportunity to greatly expand international awareness of Pakistan's progress and improving credit fundamentals. The wide dissemination of Pakistan's credit story through the radar screen of the international capital market is of particular importance given the interruption to country's access to international private capital that occurred in the late 1990s as a result of severe external payment pressures.

The second objective of going to the international bond market was to establish a pricing benchmark. A benchmark of global bond serves as a gauge of economic and financial health of the country for a range of investors. This can also be a *'beacon'* for other investment into the country. The third objective was to capitalize on a confluence of favourable developments and smoothly prepare Pakistan to graduate from the IMF Program. Of the 37 countries on a PRGF Program as of end-February 2004, most are economically fragile and graduation from the IMF Program would reinforce the positive international perception regarding Pakistan. Furthermore, Pakistan has been termed as one of the few prolonged user of the IMF resources, therefore, graduation from the IMF Program would remove Pakistan's name from such list.

From the above listed objectives it is absolutely clear that Pakistan did not go to the bond market to *'borrow'* $ 500 million. The objectives have been of strategic nature. Why $500 million and not less? No one, at least to the best of my knowledge, has raised this question. But let me respond any way. A country cannot be included in the Emerging Market Bond Index (EMBI) unless it issues a minimum of $ 500 million bond. Pakistan wanted its name to be included in the EMBI so that its bond continues to be traded in the market. The EMBI is a bond index which is used as benchmark by investors in the emerging market. By virtue of being part of the EMBI, Pakistan's bond and consequently its economy will remain active on the radar screen of the international investor community.

Let me return to the second half of the question that is, why borrow from the market when the country has over $ 12 billion foreign exchange reserves. This question basically presumes that if countries have comfortable levels of foreign exchange reserves then they should not go to the international capital market to raise funds. If this is the case then why did China with reserves of more than $ 400 billion, Korea with $ 130 billion, Malaysia and Thailand with $ 37 billion each enter the international capital markets and are recongnized as frequent issuers of sovereign bonds? Why did oil rich countries like Bahrain, Iran and Qatar issue sovereign bonds? Why do financially strong economies like UK, Finland, Austria, Italy, Spain, etc. issue bond frequently? The fact is that there is no relation between comfortable level of reserves and frequent issuance of bond. These countries go to the market to maintain their presence on the radar screen of the international capital markets. They want to remain in touch with global investors – a key instrument to attract foreign direct investment.

With regards to the rate of interest *(6.75%)* paid by Pakistan which is considered *'exceptionally high'* by some commentators, this judgment is based on lack of understanding of how bond prices are determined in the international capital markets. There are two components of bond price: (i) a benchmark interest rate and (ii) the country's political and economic risks represented by the spread. The US Treasury serves as benchmark interest rate in international capital markets. One commentator has argued that LIBOR, instead of US Treasury, should have been used as benchmark interest rate. This has not been the international practice because the maximum LIBOR is of 12 months, while bonds are generally issued of much longer tenor, 5, 10, 20 years etc. for which no LIBOR exist. However, it should be noted that bond pricing can be mirrored into LIBOR based spreads and quoted *'for* reference' as a guide to banks who are the main users of LIBOR benchmarks in pricing for syndicated loans but not for bonds. The second component, i.e., spread is determined by several factors. First and the foremost is the prevailing credit rating of the country by the international credit rating agencies *(Moody's and Standard & Poor's)*. Besides, market familiarity, that is, whether the country is a frequent issuer of bond or not influences the spread. Furthermore, the quality of investors and geographical distribution of bond also influences the spread.

Pakistan has issued a 5 Year Bond, therefore, 5 year US Treasury Rate served as benchmark interest rate. On February 12, 2004 when Pakistan's deal was closed, the 5 Year US Treasury was 3.046 percent. The current credit rating of Pakistan is B_2/B, that is, B_2 by Moody's and B by Standard and Poor's. When the Pakistani Team was on roadshow, the international investors were looking a 5-year Republic of the Philippines bond for guidance (or reference). A Philippines bond due March 2009 was quoted around the time of pricing of Pakistani bond at 420 basis points (bps) above 5 years US Treasury. It may be pointed out that Philippines' rating is Ba_2/BB — three notches above Pakistan. A comparison of Pakistan's pricing with other comparables is reported in the Table:

Issuer	**Ratings**	**Spread Over 5 Yrs. UST as on February, 12**	**Yield as on February, 12**
Brazil	B_2/B	494 bps	7.82%
Pakistan	B_2/B	370 bps	6.75%
Philippines	Ba_2/BB	420 bps	7.26%
Colombia	Ba_2/BB	402 bps	7.14%
Turkey	B_1/B^+	372 bps	6.72%
Ukraine	B_1/B	469 bps	7.68%

Brazil with same rating was priced at 494 bps above UST. Pakistani bond was priced at 370 bps above US Treasury *(3.046%)* to yield 6.75 percent which looked very tight when compared with emerging market peers. Pakistani bond was priced some 50 bps inside the Philippines, despite the fact that it is rated three notches lower. It also looked tight against Turkey (B_1/B^+) which is rated one notch above Pakistan. Turkey's bond was quoted at a yield of 6.72%, suggesting that Pakistan's pricing came 3 bps wider than Turkey. Given Turkey's rating, Pakistani bond should have been priced 30 bps — 40 bps wider and not merely 3 bps. Pakistani paper was tightly priced when it is also compared with the weighted average spread of 435 bps for the Emerging Market Bonds at the time of Pakistani deal.

Thus, from the emerging markets point of view, Pakistan's bond was very tightly priced. The reason for tight pricing was the rapidly improving Pakistan's economic story. Global investors in Asia, Europe, and Middle East believed Pakistan's success story and as such actively participated in the transaction. Accordingly, the order book swelled to $2.0 billion resulting in four times oversubscription and hence, tightest pricing possible at par. It may also be noted that despite Pakistan's single B rating (S&P) the pricing of Pakistani bond pierced through secondary trading levels of BB rated Emerging Market sovereign bonds. Pakistan also achieved the objectives of investor diversification through broad and diversified distribution of the offering, whereby 54 percent of the bonds were placed into Europe, 24 percent into Asia and 11 percent each into offshore US and the Middle East. The high quality order book comprised investors ranging from Fund Managers, Banks, retail players, hedge funds and other investor types. It is heartening to note that Pakistani bond was priced at par with a coupon of 6.75 percent on February 12, 2004 and it was traded in the market at 102.5 on March 6, 2004 — that is, on premium. This is an indication of the persistence of investors' interest in Pakistani paper.

As regards the third point, that is, if there was a need to *'borrow'* the Government could have borrowed at a much cheaper rate from the IMF and the World Bank *(don't forget the conditionalities)*. By now it should be clear that Pakistan did not go to the market for borrowing. The objectives for this exercise have been clearly spelt out at the outset.

Let me turn to the fourth point, that is, the Government went to the market without any underwriter. This assertion is based on lack of understanding of the subject matter. Going to the capital market with an underwriter is a sign of weakness. This indicates that the issuer of the bond is not sure about its own economic story. It has no confidence on its own economic management. The market will exploit its weaknesses by charging higher spread on the one hand and the issuer of the bond will also have to pay the underwriter fee. Pakistan did not need any underwriter because it was confident of its economic story. The four time oversubscription of the order book by high quality and diversified investors manifest the confidence of international investors on Pakistan's economic management and the country's robust growth prospects.

It is hoped that the above analysis would clear the mind of the readers in general and various commentators in particular. The key element to understand is the objectives for going to the international bond market. Our objective was not to borrow money from the market. As clarified, our objective was of strategic nature, that is, to re-establish our relations with international investor's community; put Pakistan's name on the radar screen of the international capital market and establish a pricing benchmark. As discussed above, both developed and developing countries always try to remain in touch with investor's community irrespective of their foreign exchange reserves. Pakistan succeeded in achieving widest market visibility through a focused marketing strategy targeted at the widest investor audience in Singapore, Hong Kong, Frankfurt, Middle East and London. Pakistan also succeeded in attracting high quality and a well-diversified investors, resulting in oversubscription of the order book. Most importantly, Pakistan achieved a tightest possible pricing of its bond – a point which was widely quoted in international press.

Pakistan's Eurobond was a resounding success. It provided a platform through which Pakistan's new image and economy was conveyed to global investors. This will not be a one-off affair. Pakistan will continue to remain in touch with global investors and as such will be going to the market at least once a year. The proceeds of the Eurobond *($ 500 million)* will be used to retire high cost external debt *(mostly suppliers credit)*. As stated by the Finance Minister, Pakistan will be pre-paying yet another $ 1.0 billion high cost debt before the end of the current calendar year.

Pakistan today is different from the past in so far as its economic and political strength is concerned. It is no longer vulnerable to external shocks. It has regained its financial sovereignty. The country's future *(our tomorrow)* is bright as reflected in the investor confidence. Private sector of Pakistan has regained confidence and is investing to sustain future growth. Industrial growth is accelerating and the overall economic growth target is likely to be surpassed. In a difficult external trading environment our exports and imports are growing at higher double-digit level. Low inflation and low interest rate environment have provided stability which is absolutely vital for investment and growth. Pakistan will be graduating shortly from a low income to middle income country. No one can stop the fruits of development to trickle down to the masses. It is just a matter of time.