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Bahrain's first $ debt issue of 2018, but perhaps not the last…

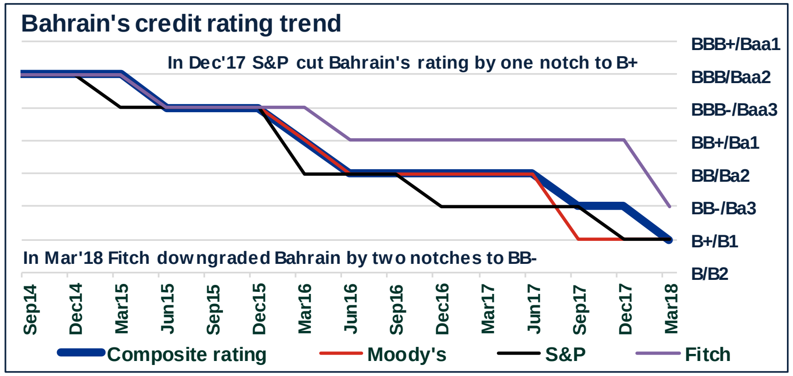
The Kingdom of Bahrain is in the Eurobond market with its first deal of 2018, a 7.5 year US$ benchmark-size Sukuk in the 144A / RegS format. The Sovereign has issued initial price thoughts (IPT) at "7% area" after completing investor meetings in the UK, Asia, the Middle East, and the US.

In our opinion Bahrain has kept the IPTs pretty generous, with substantial new issue premium (NIP) relative to its existing curve and other comparable issues from the emerging markets space, to make the deal attractive enough to investors and hence to ultimately ensure a successful transaction. The IPT of "7% area" for the October 2025 sukuk offers pick up of circa 140bps over its existing March 2025 sukuk. For just six months' extra duration on the same underlying credit this would seem like a very substantial premium indeed. We would estimate the NIP could be tightened to nearer the 100bps mark through the book building process, subject of course to the level of demand that the deal attracts.

The Kingdom of Bahrain has witnessed multiple rating downgrades in past four months. The Sovereign's composite rating (average rating from three major rating agencies) now stands at 'Single-B' level as compared BB level in Sep'17 when it successfully raised $3bn from a 3-tranche deal. At that time, for a 7.5Y sukuk Bahrain offered circa 60bps spread for 1-year extra duration and managed to price it at 5.25% yield, 37.5bps inside the initial guidance.

We believe the issuer is cognisant of the fact that investors would demand a higher NIP considering its deteriorating fiscal position, the challenging global macro backdrop, and fragile investor sentiment towards this region due to ongoing geopolitical issues. However, the kind of NIP currently being proposed by Bahrain (according to the IPT) highlights the fact that the underlying credit quality of the issuer is itself now becoming more of a concern to investors. Moreover, we should note that the NIP offered at the moment is on top of already escalating yields that Bahrain's outstanding bonds and sukuk have witnessed recently as prices fell sharply this year (please see the charts on page 2).

When S&P cut Bahrain's rating to B+ in December 2017, it citied Bahrain's weak external liquidity as the trigger. Fitch downgraded Bahrain by two notches to BB- on 1st March this year saying that the government is yet to identify a clear medium-term strategy to tackle high deficits. Moody's also cited similar concerns last year. The three rating agencies have flagged one common risk – that being the fundamental threat to their respective ratings for the sovereign if they see any stress on its ability to access international capital markets, and of course any further deterioration in ratings would likely lead to a higher debt servicing burden and cost of capital overall.

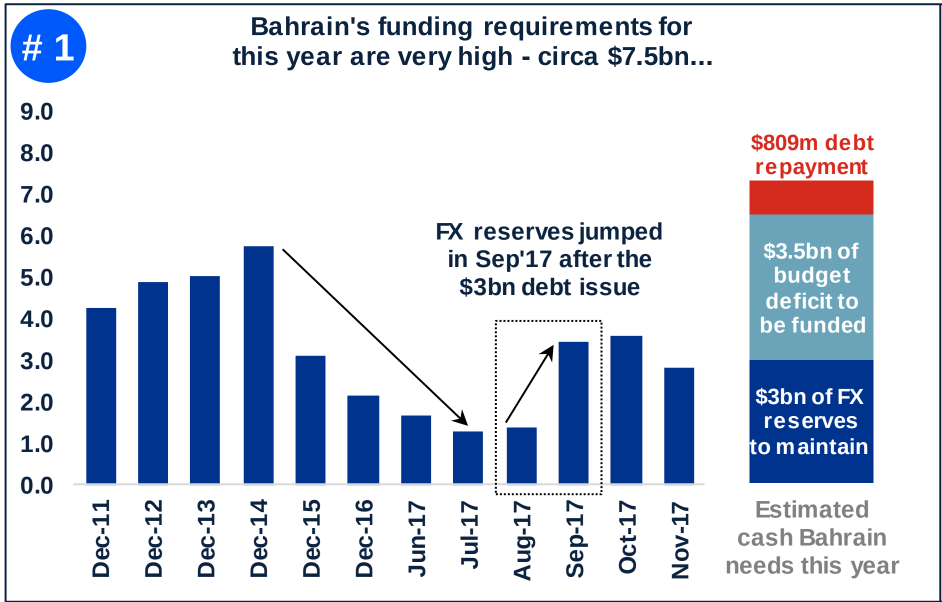


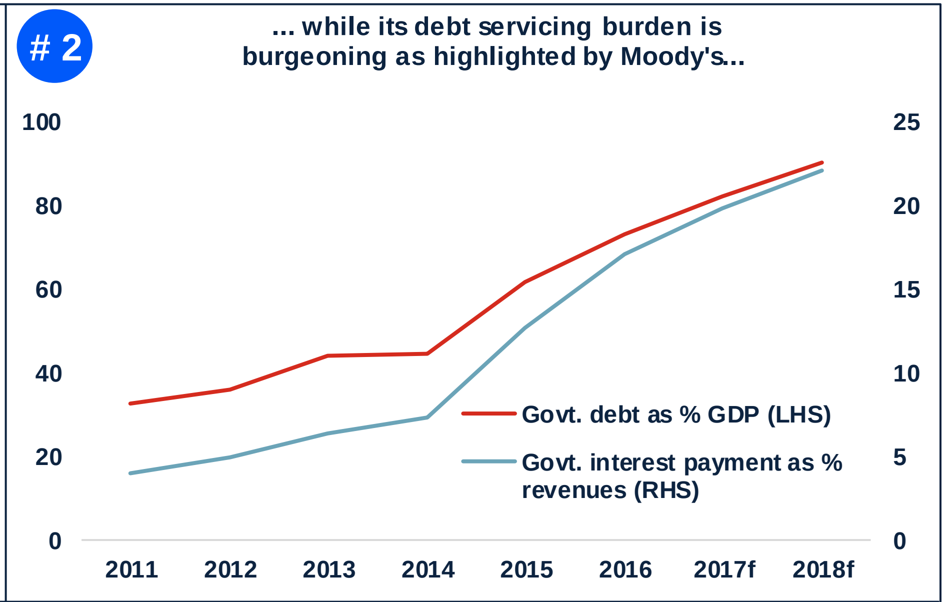
Source: FAB/Bloomberg

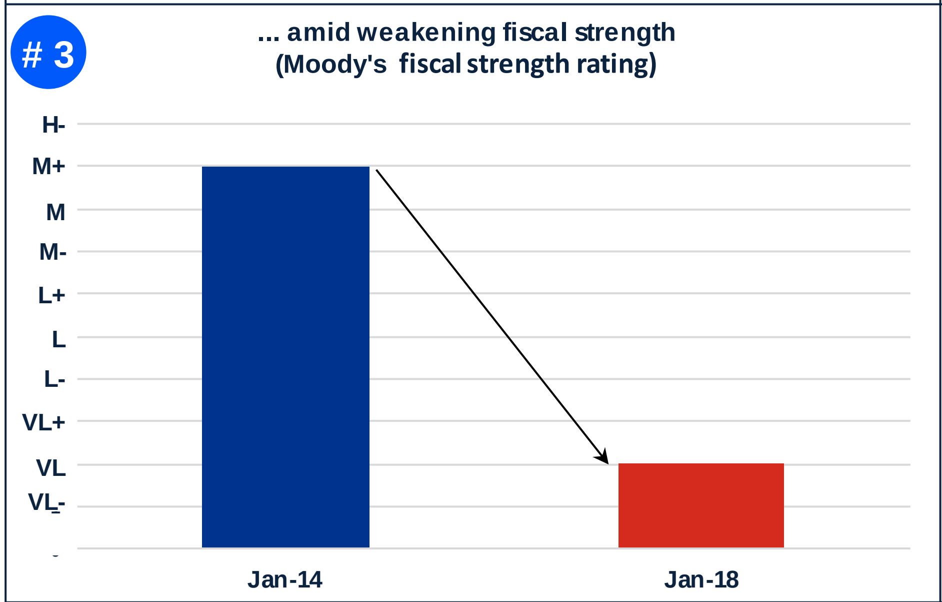
In our opinion even if Bahrain successfully prints this 7.5 year sukuk deal, the premium paid and the fact that the transaction was "scaled back" from the initial talk of a multi-tranche deal, may lead the rating agencies to take a somewhat negative view of the Sovereign's access to funding. However, as a mitigating factor, we should also take note of the Stable outlook Bahrain has from S&P and Fitch as both factor in implicit support from the Kingdom of Saudi Arabia if Bahrain is to experience any significant financial distress.

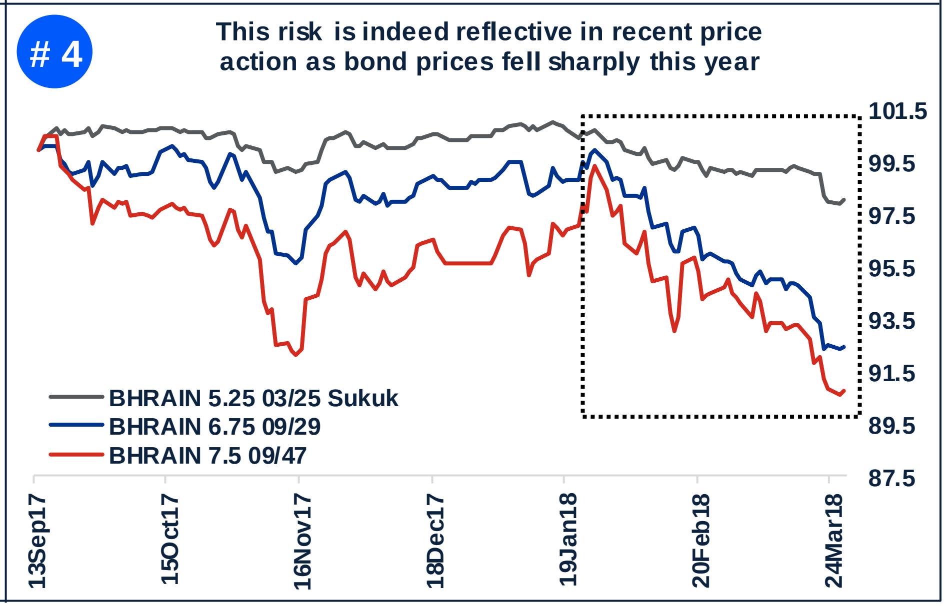
We feel that the ultimate size of the deal, the final premium Bahrain agrees to pay to investors, and of course the secondary market performance of this paper once issued, will be key in terms of ascertaining how investors now perceive this credit. The geographic allocation of the sukuk will also be an important criteria on which to judge the success of the deal given that Bahrain met investors across Europe Asia and indeed the US.

One surprising element missing from the deal is the potential 12-year and 30-year conventional bond that the issuer had intimated to investors before and during the roadshow. Absent those tranches, we would expect the Kingdom of Bahrain to be back in the market to issue more paper in 2018 as we estimate the sovereign's funding needs for this year at circa $7.5bn. Hence definitely a case of 'watch this space'.







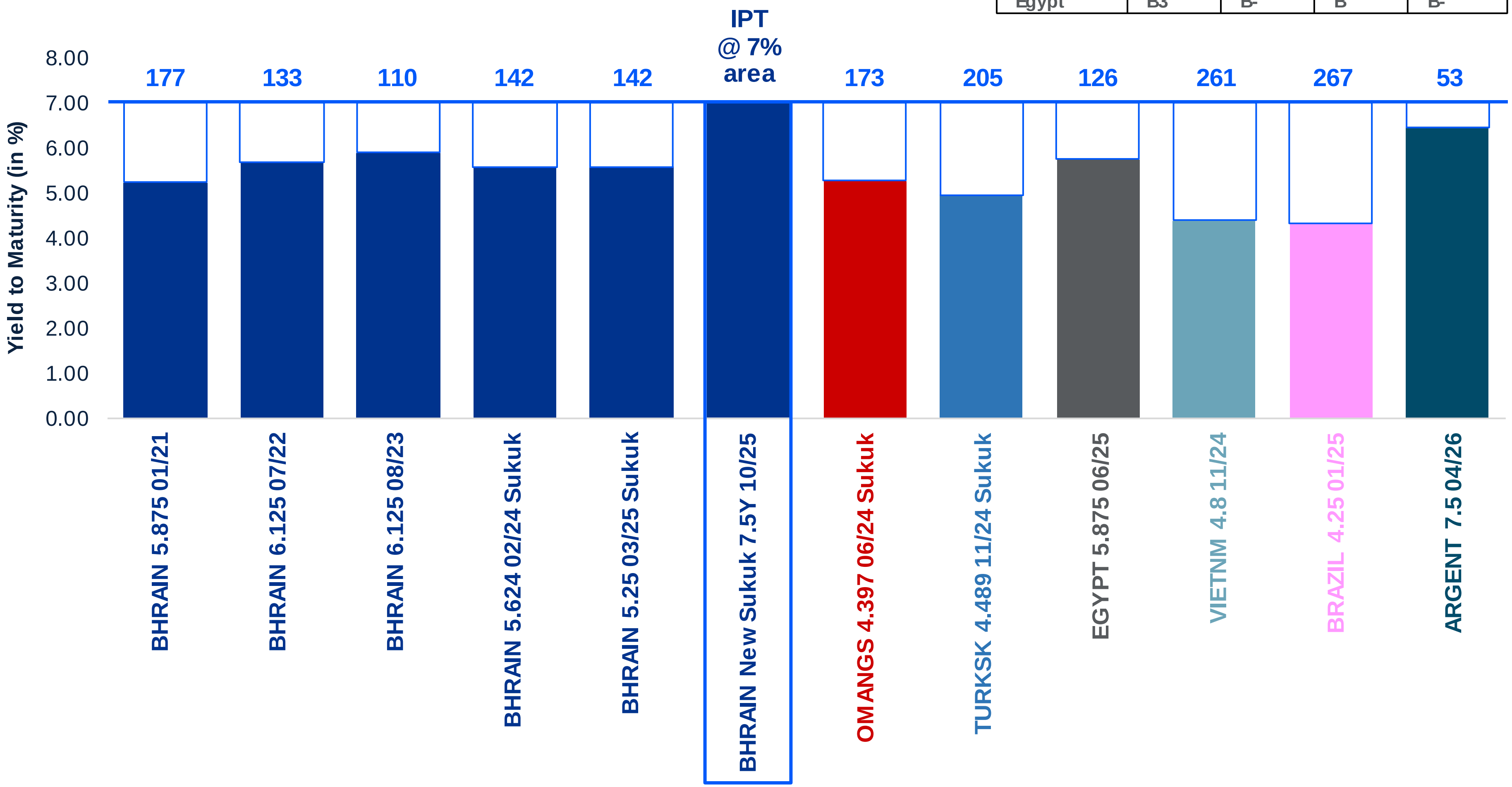


Source: Central Bank of Bahrain; Moody's; Bloomberg; FAB; Notes: Government debt as % of GDP, Govt. interest payment as % revenues and fiscal strength data are based on Moody's estimates; Moody's fiscal strength rating parameters range from Very High (VH) to Very Low (VW) and within this range 'H' stands for High, 'M' is Medium, and 'L' stands for Low.

Relative Value (Yield to maturity based on IPT)

Yield spreads in basis points vs peers based on initial price thoughts

Credit Rating	Moody's	S&P	Fitch	Composite
Oman	Baa3	BB	BBB-	BB+
Turkey	Ba2	BB	BB+	BB
Brazil	Ba2	BB-	BB-	BB-
Vietnam	B1	BB-	BB-	BB-
Bahrain	B1	B+	BB-	B+
Argentina	B2	B+	B	B
Egypt	B3	B-	B	B-



Source: FAB/Bloomberg; Note: Peer bond/sukuk yields are as per the closing price on 27th March 2018.

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