ThinkAdvisor

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AUGUST 17, 2015

Investors Leery of Upcoming Iraqi Bond Despite New Credit Rating

Increased output from the Organization of the Petroleum Exporting Countries (OPEC) over the summer has lowered the price of oil yet again, and if this dynamic continues, things don't bode too well for Iraq, which is gearing up to issue a $5 billion sovereign bond—its first in nine years.

The cash-strapped country is desperately in need of funds. Lower oil prices, combined with higher military spending and increased costs stemming from the ongoing civil conflict have all greatly eroded Iraq's savings buffers, says Fitch Ratings, which has just assigned the country its first single B-minus credit rating.

Iraq is highly dependent on oil revenues, Fitch said, and has some of the world's largest reserves, which for the moment, are away from the areas of domestic insecurity. Nevertheless, security is a huge concern for Iraq, with ISIS militants currently controlling three of its 18 provinces, Fitch said.

The upcoming Eurobond will provide some help in financing the country's deficit. But even with a credit rating from Fitch to back it, frontier market investors like Alison Graham, founder and chief investment officer at Voltan Capital Management, are not sure about Iraq or the bond. Low oil prices are one thing (Iraq is highly dependent on oil revenues), but “our main concern about the Iraqi bond relates to the government’s fiscal management, even more so than to oil prices,” Graham said.

“The bond proceeds will be used mainly to finance the country's large budget deficit, which we don't see improving substantially absent better political governance and an amelioration in the security situation. If the bond’s tenor is too short, if oil prices don't recover substantially or southern export bottlenecks are slow to resolve, Iraq might find itself facing the need to restructure or to rely on International Monetary Fund (IMF) support for repayment.”

Graham also has concerns about repayment.

When the autonomous Iraqi province of Kurdistan had the choice between paying civil servants and the armed forces, or paying international oil companies to which it owed money, “it logically chose to support its own citizens first,” she said. “In the absence of a strong private sector, Iraq’s federal government employs a large portion of the working age population and already is experiencing liquidity constraints in meeting wage and other expenditures, since the dinar’s peg to the dollar makes it difficult to simply print money. While the bond’s coupon payments should be manageable, the government might make a similar choice to support the army and civil servants over principle repayment to foreigners, although likely IMF support mitigates this risk.”

On the oil front, Iraq has the potential to produce a great deal more oil, said Jonathan Waghorn, co-fund manager for Guinness Atkinson’s Global Energy Fund in London. However, since they first went into Iraq about five years ago, most international oil companies have found production to be very hard as the infrastructure is extremely poor. Since the ISIS problem has escalated, the level of activity has dwindled as companies have been removing their personnel, even as Iraq’s oil export infrastructure has improved.

“Iraq is targeting eight million barrels a day but we don’t think they will get there, because even if they were to add four million barrels a day and produce that, we would need to see between $200 billion and $500 billion of investment into Iraq, but with oil at $50 a barrel, the industry just can’t afford the amount of reinvestment that needs to go into Iraq,” Waghorn said.

He said he expects better oil prices in the second half of the year and perhaps a rise in prices next year to around $65 to $70 per barrel. This would bode well for Iraq, he said, since Iraq and Saudi Arabia are currently the greatest producers in OPEC. Among all Fitch-rated sovereigns, Iraq has the greatest commodity dependence, the agency said. Oil accounts for around 40% of Iraq's GDP and over 90% of fiscal and current external receipts.

The mitigating factors to rising oil prices, though, are fear over new supply coming from Iran after its recent negotiations with the U.S., Waghorn said, and output from the U.S. is also strong.

"There are a number of factors that are pulling and leading us to this oversupplied market today, but still, the market is not as oversupplied as it was," Waghorn said. "Demand for oil is also robust, which is good, but right now, there isn't enough to make prices, so we are not yet at the turning point. As such, oil prices are likely to remain volatile for some time as we try to find a bottom, but we do think that an estimate of between $65 and $70 per barrel for next year is good."

In the longer term and barring an oil price recovery, Graham believes that Iraq has great potential as a regional industrial hub and consumer economy. The country was beginning to see a revival in construction – including, among others, a new shopping mall in Baghdad—before the fiscal situation deteriorated. If that dynamic continues, and Iraq makes better progress in terms of governance, then investors could become more interested in Iraq even without a recovery in oil prices, she said.