UKRAINE
Fixed Income

CONCORDE CAPITAL

Oleksandr Klymchuk
ok@concorde.com.ua
+380 44 207 5037

Fixed Income Handbook

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Foreword

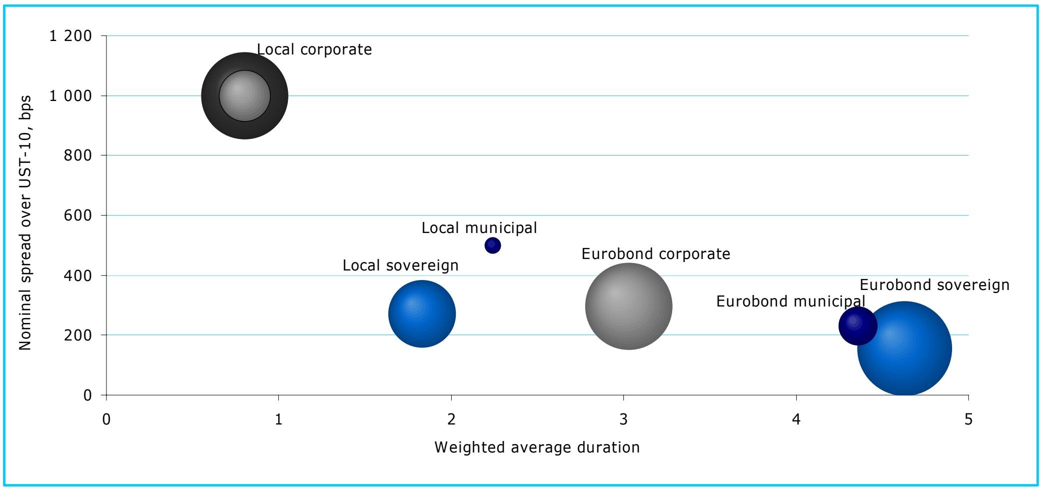
This report is a comprehensive handbook on the Ukrainian fixed income market. It was designed to help investors learn about the market's peculiarities, evaluate the different sectors and provide insight into how to benefit from the opportunities that this market has to offer.

From less than USD 4 bln in outstanding volume in 2003, the Ukrainian fixed income securities market has reached USD 12 bln today. For the next five years we see growth of 30% annually and expect that Ukraine's tradable-debt-to-GDP ratio will increase from current 12% to 25% average for developing countries.

This handbook takes a classical approach and divides the market into Eurobonds and local bonds, and then further into government, municipal and corporate sectors.

Within these pages, we will examine the Ukrainian fixed income securities market as it stands today. The graph below provides a general idea of the market by depicting the six sectors and their total outstanding volumes (represented by the relative size of each bubble), as of 1H06.

Ukrainian fixed income securities sectors



Note: The black outer area on the local corporate bond sector reflects the estimated volume of non-market issues. Please refer to page 53 for discussion
Source: Concorde Capital

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EUROBONDS

Eurobonds - Overview

Eurobonds are the most straightforward way for institutional investors to get exposure to Ukrainian fixed income instruments without FX risks or regulative constraints.

At the end of 1H06, the outstanding amount of Eurobonds for all types of Ukrainian issuers was USD 6.82 bln, which was 17% of the country's gross external debt.

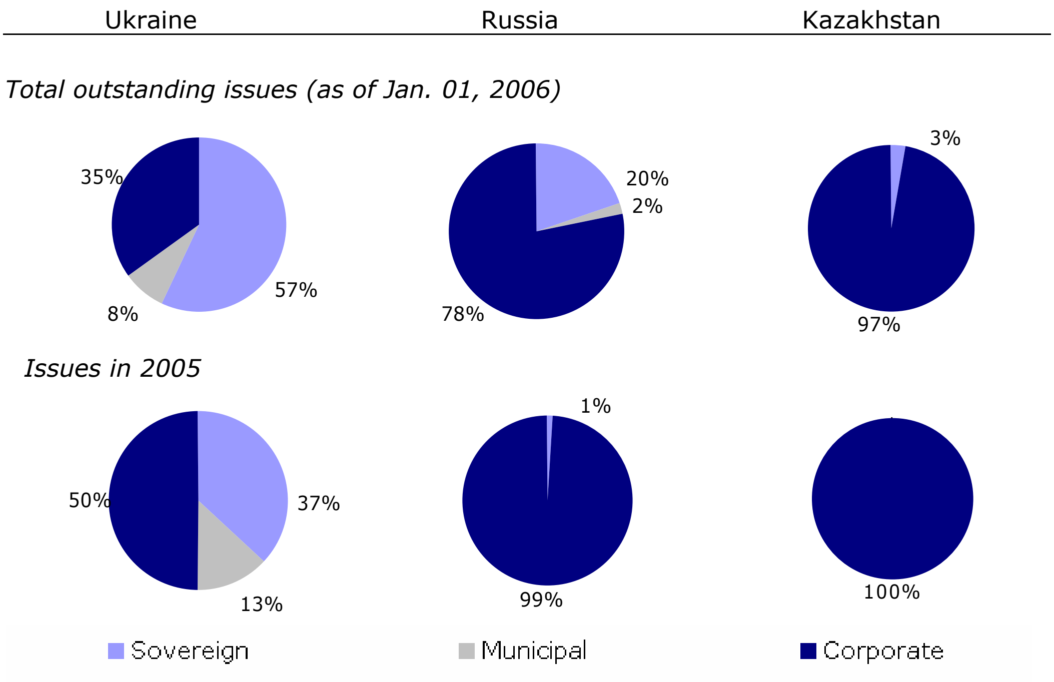
Currently there are seven **sovereign Eurobond issues** on the market with a total amount of USD 3.35 bln and maturities ranging from 2007 to 2018. Four of them are denominated in the US dollar, two are in Euros and one in the Swiss Franc. We expect another USD 1 bln issue in November.

Three **municipal Eurobond issues**, all by the city of Kyiv, remain outstanding for a total amount of USD 600 mln, with maturities in 2008, 2011 and 2015. Their spreads over Ukrainian sovereign Eurobonds are typically about 25 bps, 45 bps and 135 bps respectively.

The **corporate Eurobond market** is made up of 20 issues with a volume of USD 3.58 bln and issues with maturity dates ranging from in late 2006 to 2016. All are denominated in USD. Typical yields among issues by banks range from 6.8% to 8%, while yields for other corporate issues are between 6.8% and 9.5%.

Compared with its CIS peers, Kazakhstan and Russia, where the corporate segment overwhelmingly dominates, Ukraine's Eurobond market is more diversified.

Breakdown of Eurobonds by type of issuer



Source: UBS, Finance Ministry, Cbonds, Concorde Capital

Leading underwriters of Ukrainian Eurobonds

#	Investment Bank	Volume, USD	Issues
1	UBS	527,100,000	Nadra Bank, 2008; Ukraine, EUR 2015; Ukreximbank, 2010; Ukreximbank, 2012; UkrSibbank, 2008
2	Citigroup	452,100,000	Kiev, 2015; Kievstar GSM, 2012; Ukraine, EUR 2015
3	Deutsche Bank AG	302,100,000	Ukraine, EUR 2015; UkrSibbank, 2008
4	Credit Suisse First Boston	250,000,000	Kiev, 2015; Ukreximbank, 2012
5	Dresdner Bank AG	187,500,000	Kievstar GSM, 2012; Nadra Bank, 2008; Ukreximbank, 2010
6	Renaissance Capital	150,000,000	ISD, 2010
7-8	Merrill Lynch & Co., Inc.	100,000,000	Aval Bank, 2007
7-8	ABN AMRO Bank	100,000,000	Ukrsotsbank, 2008
9-10	Moscow Narodny Bank	62,500,000	Stirol, 2008
9-10	ING Group	62,500,000	Stirol, 2008

Source: Cbonds

Until recently, all Ukrainian Eurobonds were underwritten by leading global investment banks. However, last year, two CIS banks entered the market.

Eurobonds - Sovereign

- **Over the last five years, sovereign spreads plummeted from more than 1200 bps to below 200 bps. We see a potential for Ukrainian sovereign spreads to tighten a further 50 basis points in the mid-term.**

- **With the economy growing, the government's debt-to-GDP ratio at 12.7% and the National Bank's FX reserves at USD 19.4 bln, we believe that Ukraine's current sovereign ratings are too conservative. Political and gas price risks are, in our opinion, overestimated – watch for a trigger that would result in a ratings upgrade.**

- **We estimate the Government will borrow USD 2 bln in Eurobonds in 2007 and forecast another USD 2 bln in 2008.**

Legal Aspects

Sovereign Eurobonds are issued by the Cabinet of Ministers of Ukraine on behalf of the state. The Cabinet delegates authority to the Ministry of Finance to issue the bonds. Net proceeds from Eurobond issues are used by the Ukrainian government for state budget purposes.

Ukraine's Budget Code stipulates that the every annual Budget Law must set ceilings for the amounts of external and local debt to be issued during the budget year. However, the Cabinet is allowed to transfer an unused portion of its internal debt quota to increase its external debt quota, or vice versa.

Limitations for Ukrainian residents. Sovereign Eurobonds cannot be offered to investors in Ukraine or residents as part of the initial offer and sale of bonds by lead-managers. However, Ukrainian residents can purchase bonds on the secondary market provided that they obtain an individual license from the National Bank of Ukraine authorizing the transfer of foreign currency to make the purchase. After purchasing the bonds on the secondary market, Ukrainian residents can resell the bonds only if they are licensed as professional securities traders or through a licensed institution.

Taxation. All payments in respect to Eurobonds issued by Ukraine are made free and clear of any withholding of present or future taxes and duties by or on behalf of Ukraine or any political subdivision. If such a withholding or deduction were to be directly required by law in the future, the issuer would be obliged to increase the payment of either the principal or interest, as the case may be, in an amount exactly compensating what the bond holder would have received if no such withholding or deduction was required.

Primary Market

Outstanding issues. Ukraine has six classic outstanding issues of sovereign Eurobonds, two of which are denominated in EUR and four in USD. The Eurobonds maturing in 2011, 2013 and 2015 are bullet bonds. Eurobonds maturing in 2009 have a floating rate linked to LIBOR (6m + 337.5 bps). Both issues maturing in 2007 (which were issued during the government's debt restructuring in 2000-2002) have a sinking fund provision and a mandatory par redemption schedule. In addition to these six issues, Ukraine has USD 46 mln outstanding in special "gazpromovki" bonds (see background, below) and a privately placed issue of CHF 384 mln.

Sovereign Eurobonds in circulation

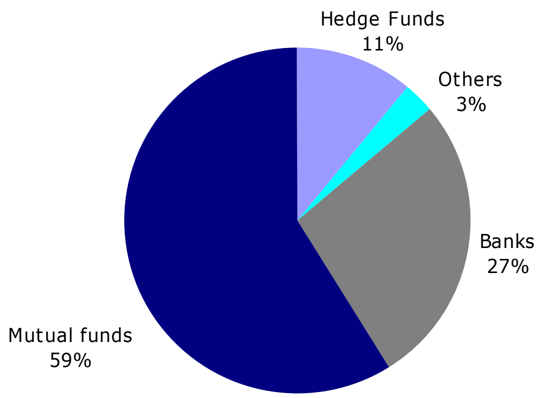
Security	Volume of issue, mln	Amount outstanding, mln	Coupon rate	Date of issue	Maturity
Ukr USD '07	USD 1 588	USD 148	11%	14.04.2000	15.03.2007
Ukr EUR '07	EUR 1 168	EUR 109	10%	14.04.2000	15.03.2007
Ukr USD '09	USD 500	USD 500	Floating*	29.07.2004	05.08.2009
Ukr USD '11	USD 600	USD 600	6.875%	27.02.2004	04.03.2011
Ukr USD '13	USD 1 000	USD 1 000	7.65%	04.06.2003	11.06.2013
Ukr EUR '15	EUR 600	EUR 600	4.95%	06.10.2005	13.10.2015
Ukr CHF '18	CHF 384	CHF 384	3.5%	12.09.2006	15.09.2018

** LIBOR 6m+337.5 bps*
Source: Finance Ministry, Concorde Capital, Bloomberg

Background. Ukraine issued its first Eurobonds in 1995 when the government converted USD 1.4 bln of its debt to Gazprom into sovereign bonds (which are often referred to as "gazpromovki" or Gazprom bonds). The indenture for the USD-denominated bonds stipulated a deferred payment period of two years; a coupon of 8.5% that pays quarterly starting from June 21, 1997 and a maturity date of June 21, 2007. Ukraine launched its first classic Eurobond offers in August and October 1997.

Eurobond investors. Mutual funds are the most active investors for sovereign Eurobond issues and hold the majority of bonds, followed by banks and hedge funds.

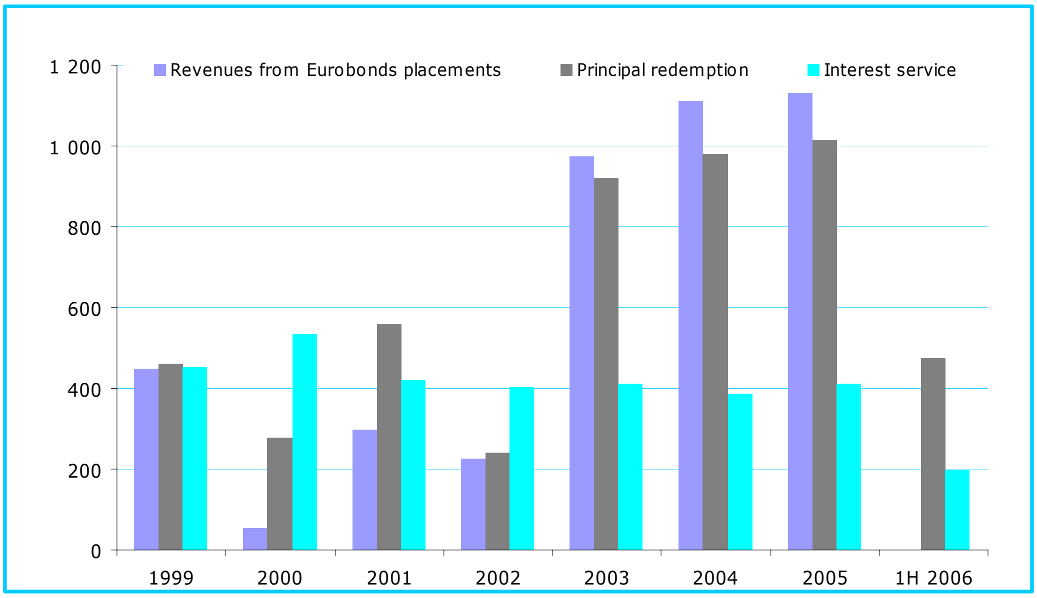
Breakdown of primary investors in Sovereign Eurobonds (Ukr EUR '15)



Source: Cbonds, UBS

Over the last eight years, the Ukrainian government has aimed to reduce its total external debt. However, in 2003-2005, the amount of new Eurobond placements exceeded the amount of principal redemption.

Primary market capital flows, USD mln

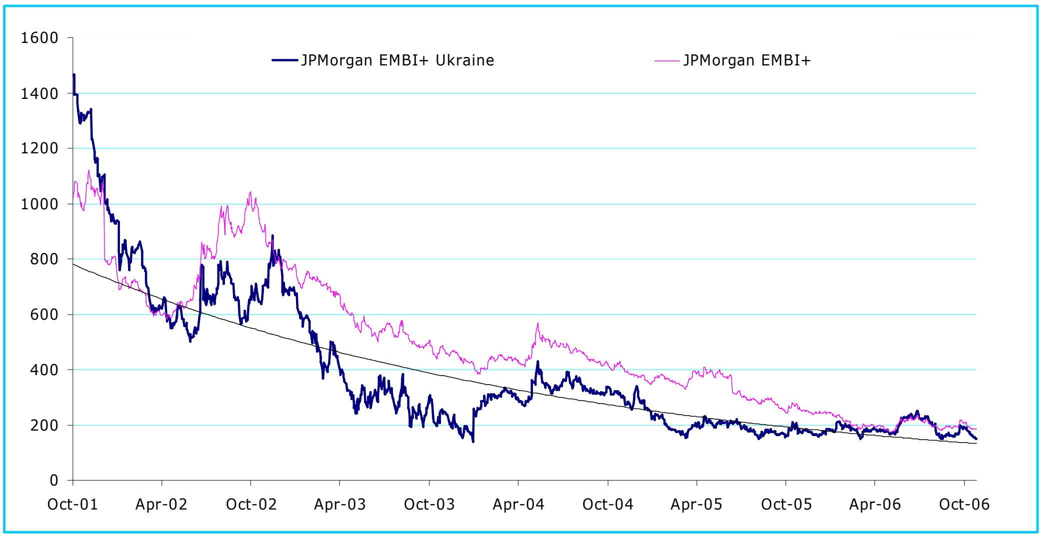


Source: State Treasury of Ukraine

Secondary Market

Over the last five years, we saw a plummet in the spread of Ukrainian Sovereign Eurobonds over the UST benchmark. Moreover, Ukraine performed better than EM countries in general.

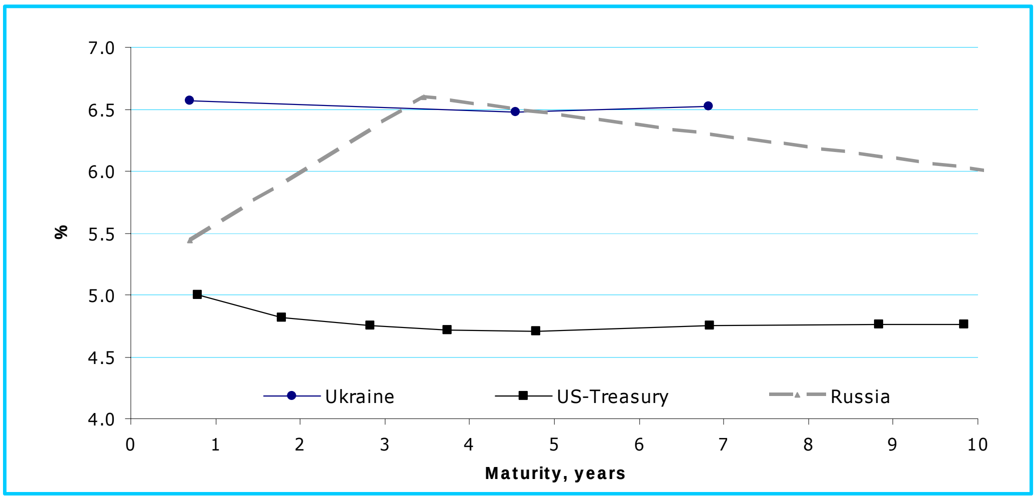
JP Morgan EMBI+ Ukraine Spread, bps



Source: Cbonds, Concorde Capital

There are only three bonds in the USD denominated sovereign Eurobond yield curve with an almost equal spread over the US Treasury curve on its short and long ends. Please note that the shortest sovereign Eurobond is rather volatile and will mature in March 2007.

Sovereign Eurobond yield curves, as of Oct. 17, 2006

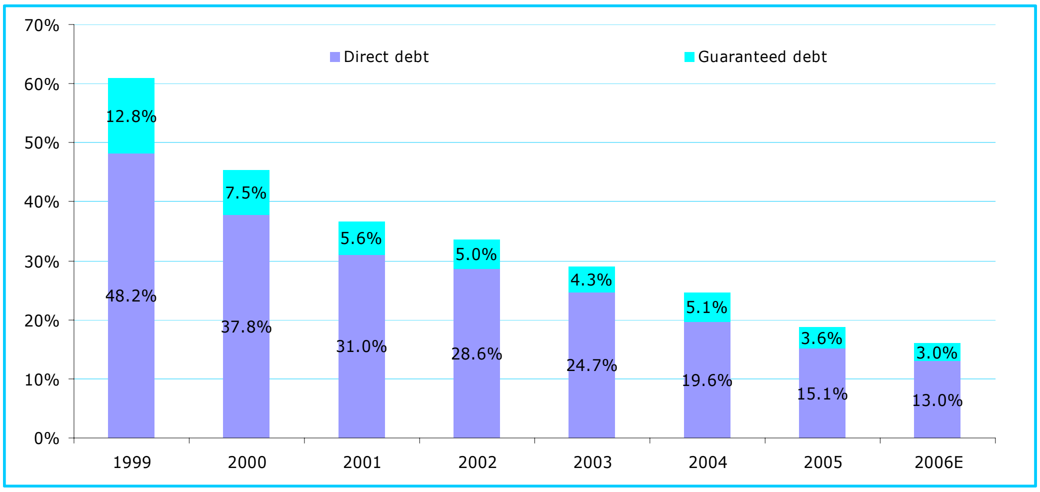


Source: Bloomberg, Concorde Capital

Solvency

After debt restructuring in 2000-2002, the country's payment record for both multilateral and bilateral debt has been irreproachable.

Total sovereign debt to GDP ratio

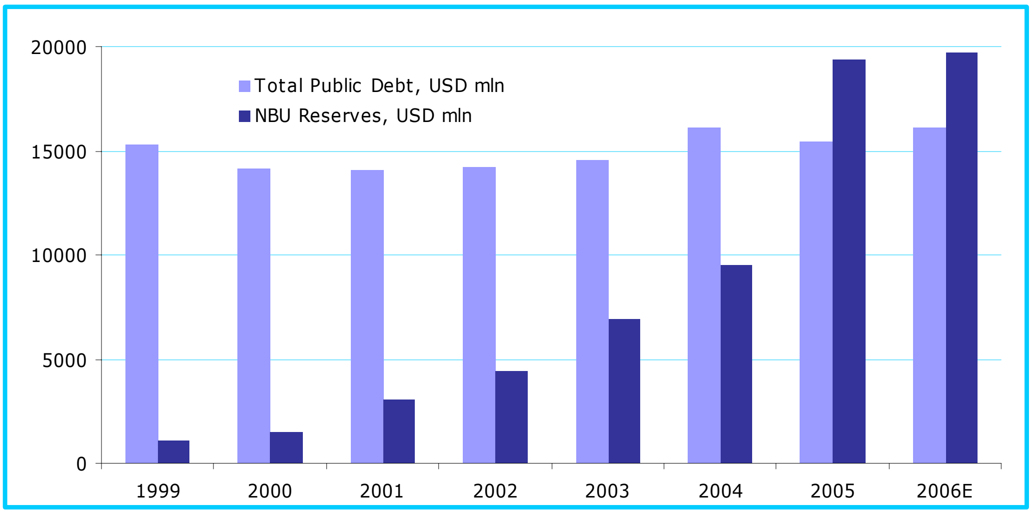


Source: Finance Ministry, Concorde Capital estimates

Since 1999, the ratio of state debt to GDP has declined, moving further from the 60% limit in the Budget Code which coincides with Maastricht criteria for EU candidate countries. The external debt-to-export ratio and maturity structure also improved.

Substantial NBU FX reserves. The solid current account surplus from 2000 to 2005 helped build up FX reserves (which rose by 37% in 2004 and nearly doubled in 2005) and reduced external vulnerability. The National Bank of Ukraine currently has USD 19.4 bln in international reserves. These resources are sufficient to keep the national currency stable and cover nearly five-months of import volumes, which is much higher than the IMF required level for three months, and an unacceptable one month level like what Ukraine had in 2000.

NBU FX reserves vs. total public debt, EOY



Source: Finance Ministry, NBU, Concorde Capital estimates

Credit ratings

Ukraine is covered by all three leading global ratings agencies and the Japanese agency R&I. Despite several increases over the past few years, all of the leading agencies rate the Ukrainian government's liabilities below investment grade.

Sovereign credit ratings (as of Oct. 25, 2006)

	Foreign currency liabilities		Local currency liabilities		Outlook
	LT	ST	LT	ST	
Fitch Ratings	BB-	B	BB-	B	Positive
Standard and Poor's	BB-	B	BB	B	Stable
Moody's	B1	-	B1	-	Stable

Source: Finance Ministry

The ratings agencies indicated the following opportunities for an upgrade:

- if and when political uncertainties associated with a new government and fractious parliament subside,
- if there are not significant deteriorations in the budget deficit or liquidity ratios (and corresponding increases in lending requirements),
- if key structural reforms accelerate (taxation, energy, banking and legislation affecting corporate governance),
- if economic (and export) diversification of products and markets strengthen to create an economic base more capable of withstanding external shocks, and
- any structural reforms that undermine the large shadow economy and/or strengthen tax administration and collection, thereby boosting government revenues.

The rating agencies also indicated the following downgrade risks:

- political squabbling that renders the current coalition government unworkable, leading to new elections,
- a currency crisis,
- a dramatic deterioration in liquidity ratios, and
- a sharp increase in lending.

In addition, in their opinion, Ukraine is potentially subject to two main types of external shocks: a downturn in global metals prices and a further rise in Russian gas import prices in 2H06.

We believe Ukraine is heading for an upgrade. Ukraine's economic growth is faster and its government debt is much lower than other countries with the same ratings. In our opinion, the current ratings do not adequately reflect Ukraine's credit quality. Ukraine and its government are far from perfect, but the problems are not as great as the ratings suggest.

According to Moody's, Ukraine has the same credit rating as Indonesia, Jamaica, Suriname, Mongolia and the Philippines. Fitch put Ukraine in line with Armenia, Lesotho, Sri Lanka, Nigeria, while S&P grouped Ukraine with Serbia, Venezuela and Turkey.

Moody's default probability

Aaa	0.00%	**A3**	0.54%	**Ba3**	9.79%
Aa1	0.02%	**Baa1**	0.83%	**B1**	13.85%
Aa2	0.05%	**Baa2**	1.20%	**B2**	18.13%
Aa3	0.10%	**Baa3**	2.38%	**B3**	24.04%
A1	0.19%	**Ba1**	4.20%	**Caa1**	32.86%
A2	0.35%	**Ba2**	6.80%	**Caa2**	43.88%
				Caa3	66.24%

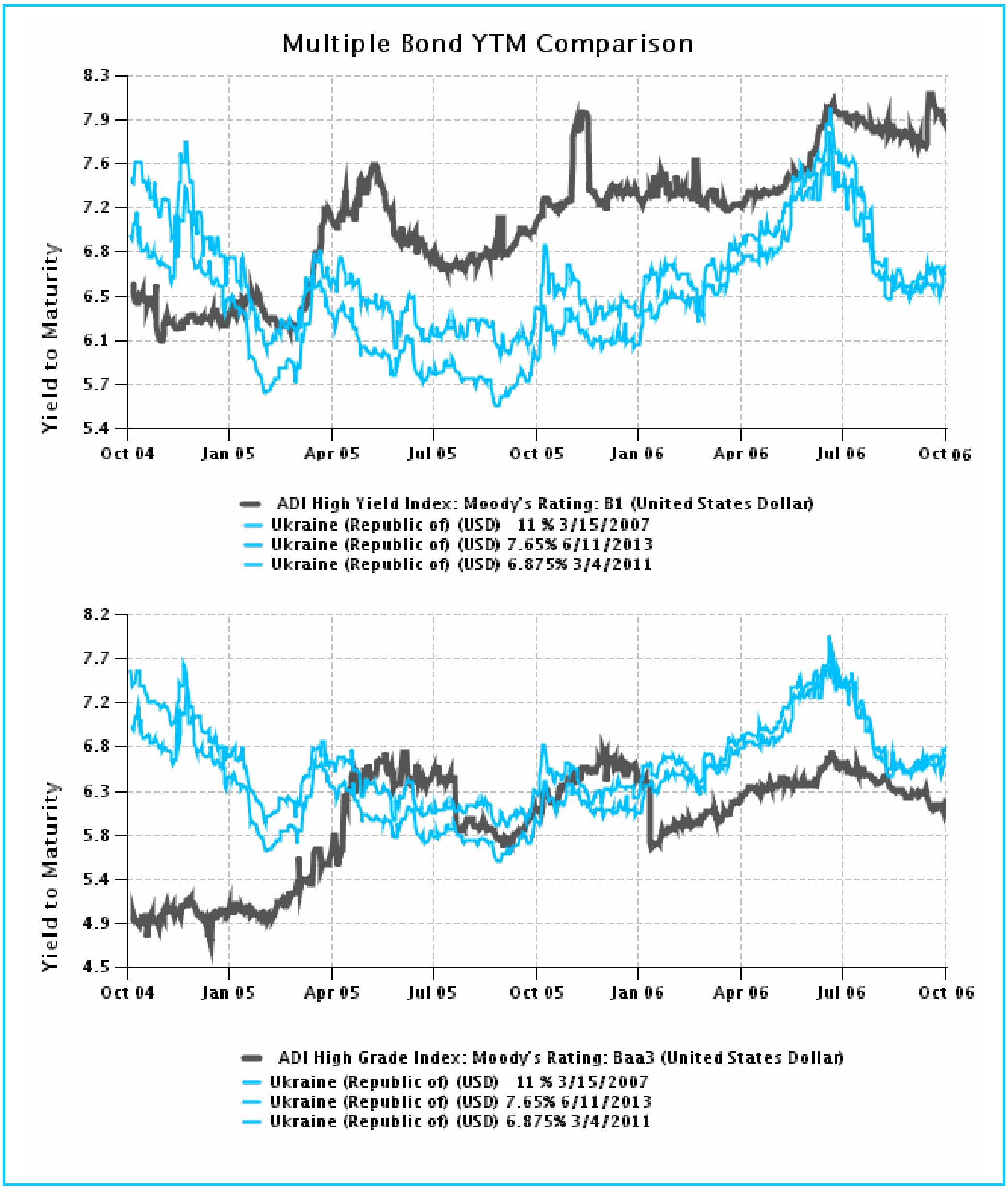
Notes: A default probability table is necessary to implement the methodology; however, only the relative default probabilities – not their absolute values – are relevant to the analysis. For example, the table shows that, for example, A1 credits assumed a default at nearly twice the rate of Aa3 credits, not that the respective expected default rates are 0.19% and 0.10%.

Source: Moody's Rating Methodology

From this perspective, Moody's deems Ukraine's default probability to be two times more than the respective risk for Colombia or Guatemala. We argue that Ukraine offers much lower risk than the leading rating agencies suggest, and even lower than its suggested superiors.

A comparison of the yields of Ukrainian sovereign Eurobonds to indexes of yields on bonds with Moody's B1 (current rating) and Baa3 ratings, as calculated by Advantage Data, shows that Ukrainian bonds are traded closer to the latter, which is four notches higher than Ukraine's rating.

Ukraine vs Moody's High Yield B1 and High Grade Baa3 Indices



Source: Advantage Data

Comparisons of Ukrainian sovereign Eurobonds to indexes of yields on bonds with average yields of Eurobonds with S&P and Fitch ratings of BB- (current rating) and BBB- yielded similar results.

Prospects

The 2006 state budget caps the maximum amount of net external debt that the government is allowed to issue this year at USD 2.1 bln.

The Ukrainian government will not use all of this quota; it has announced plans to obtain a USD 500 mln credit from the World Bank and issue USD 1 bln in Eurobonds in November 2006. The issue will be denominated in USD, and the maturity will be more than 10 years. It also announced plans to tap external markets in 2007. We expect the Finance Ministry to make two issues of about USD 2 bln during the year (the first in 1H07 will most likely be in Japanese Yen, and another in 2H07 in USD or EUR).

In general, despite the former Cabinet's removal, only some specifics in regard to the state's debt policy will be changed while the overall strategic route will be followed. In particular, there are no signs the new government will switch its primary borrowing from external to internal sources in the next two years.

Eurobonds - Municipal

- **Kyiv is the only municipal entity in Ukraine which has issued municipal Eurobonds. Although Kyiv is the largest CIS municipality on the Eurobond market, its total outstanding debt is only 4.2% of expected 2006 City's GDP and 33% of budget revenues.**
- **We expect the fourth Eurobond issue from Kyiv in 2H07 in the USD 300-390 mln range, with a maturity of more than 10 years.**
- **With the recent credit rating upgrade by S&P, Kyiv hit the sovereign ceiling.**
- **Tight legislation currently constrains the ability of other cities and regions to tap the Eurobond market. If these constraints are lifted, we estimate that these municipal entities could attract USD 2-3 bln.**

Legal Aspects

There are four main legal considerations when looking at the Municipal Eurobond segment:

1. Only cities with populations of **at least 800,000** are entitled to borrow externally.
2. There is a legal requirement in the Budget Code, which sets the **limit for the ratio of debt service to budget expenditures** for city councils at 10%.
3. **Finance Ministry approval.** Any borrowing of a city council shall be approved by the Ministry of Finance.
4. **National Bank supervision.** Since 1998, the NBU has warded against possible defaults by Ukrainian municipalities by thoroughly checking their financials and their plans for how foreign borrowing would be used.

Additionally, city councils have to endure long procedures in order to access foreign capital markets, because authorities are cautious of allowing any municipal issuer to enter international markets.

Primary Market

In Ukraine only one municipal issuer, the capital city Kyiv (Kiev), has outstanding Eurobonds. However, unlike in Russia and other CIS countries, Ukrainian municipal issues constitute a notable share of the country's overall Eurobond debt (see page 5).

Kyiv made its first Eurobond issue of USD 150 mln in the summer of 2003. It had a five-year maturity term and was oversubscribed at a yield of 8.75%. Despite the fact that the issue required a substantial premium, 545 bps over the UST benchmark security with a similar maturity, the terms were more beneficial than for borrowing locally.

The second Eurobond issue of 200 mln was issued in July 2004; it had a 7 year maturity, an semiannual coupon of 8.625% and one put option exercisable on July 15, 2007 at 100% par value.

The third issue of USD 250 mln, made in October 2005, is a 10-year bullet bond with a coupon rate of 8% and semiannual payments.

The volume of Kyiv's Eurobonds are in line with other large CIS cities, such as Moscow and St. Petersburg. However, per capita, Kyiv uses external financing more intensively than any other municipality in the region.

CIS municipal Eurobond issues

N	Issue	Currency/Amount (mln)	Status	Maturity
1	Bashkortostan, 2006	USD/20	outstanding	14.12.2006
2	Bashkortostan, 2007	USD/25	outstanding	11.04.2007
3	**Kyiv, 2008**	**USD/150**	**outstanding**	**08.08.2008**
4	**Kyiv, 2011**	**USD/200**	**outstanding**	**15.07.2011**
5	**Kyiv, 2015**	**USD/250**	**outstanding**	**06.11.2015**
6	Moscow, 2000	USD/500	redeemed	31.05.2000
7	Moscow, 2001	DM/500	redeemed	09.04.2001
8	Moscow, 2001	USD/227	redeemed	18.05.2001
9	Moscow, 2004	EUR/350	redeemed	25.10.2004
10	Moscow, 2006	EUR/400	redeemed	28.04.2006
11	Moscow, 2011	EUR/374	outstanding	12.10.2011
12	Nizhny Novgorod oblast	USD/100	redeemed	03.04.2005
13	Saint-Petersburg, 2002	USD/300	redeemed	18.06.2002
14	Yamalo-Nenets AO, 2002	USD/100	redeemed	15.12.2002

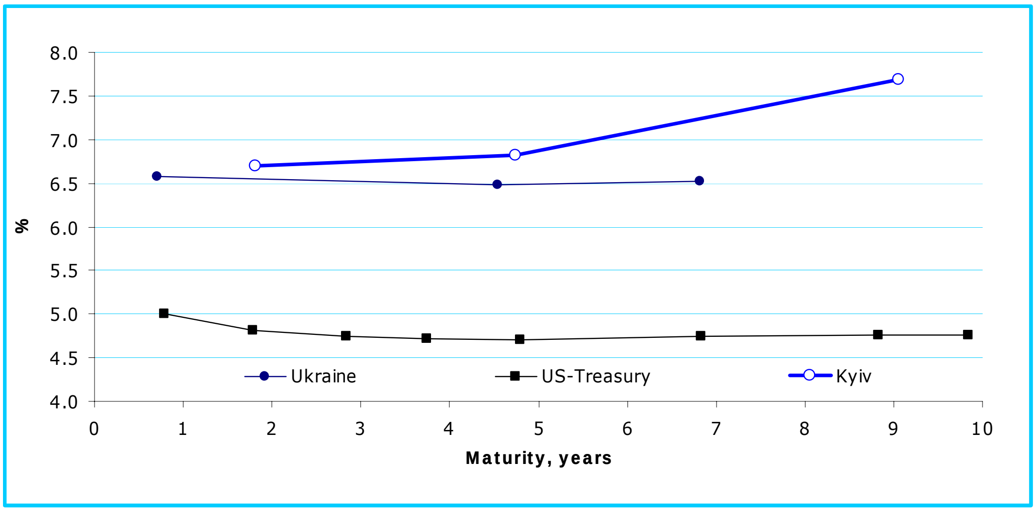
Source: Bloomberg, Cbonds

Secondary Market

Kyiv's first issue was listed on the Luxembourg, Berlin and Frankfurt exchanges, the second on the Luxembourg exchange, and the third on the Frankfurt and Swiss exchanges. These listings are mainly formal in nature, as most trading is OTC.

Several global and CIS investment banks maintain bond quotations and serve as market makers for the securities. The most active are: Merrill Lynch, ING, Credit Suisse, Barclays Bank, HVB, HSBC, BCP Securities.

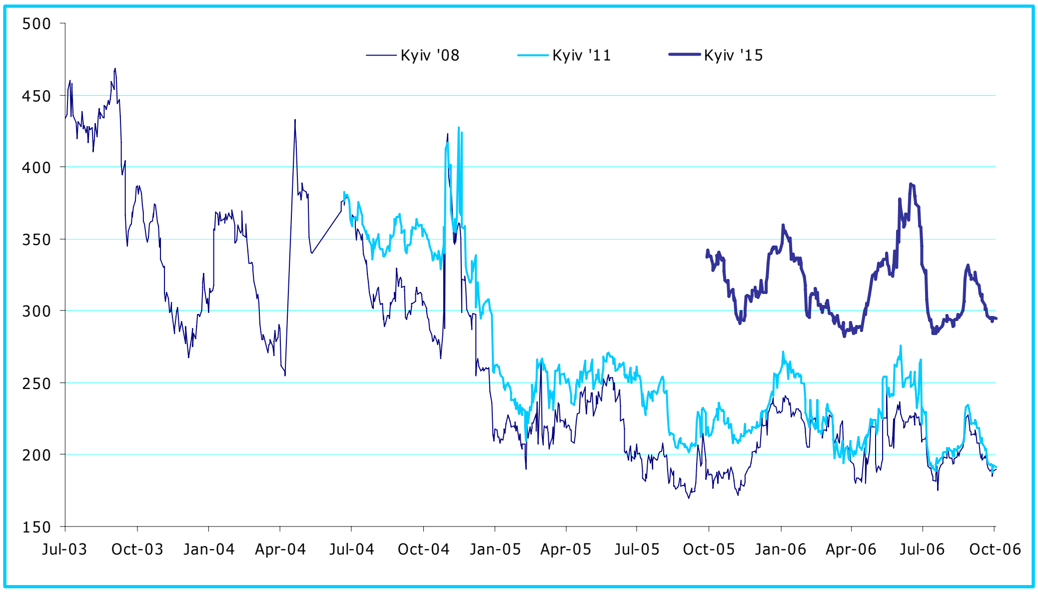
Kyiv Eurobond yield curve, as of Oct. 17, 2006



Source: Bloomberg

Since issuance, the spread of Kyiv '08 bonds over the 10-year UST bond benchmark dropped sharply from about 450 bps to 178 bps. The other two issues followed a general downward trend.

History of municipal Eurobond spreads over the 10-year UST bond, bps

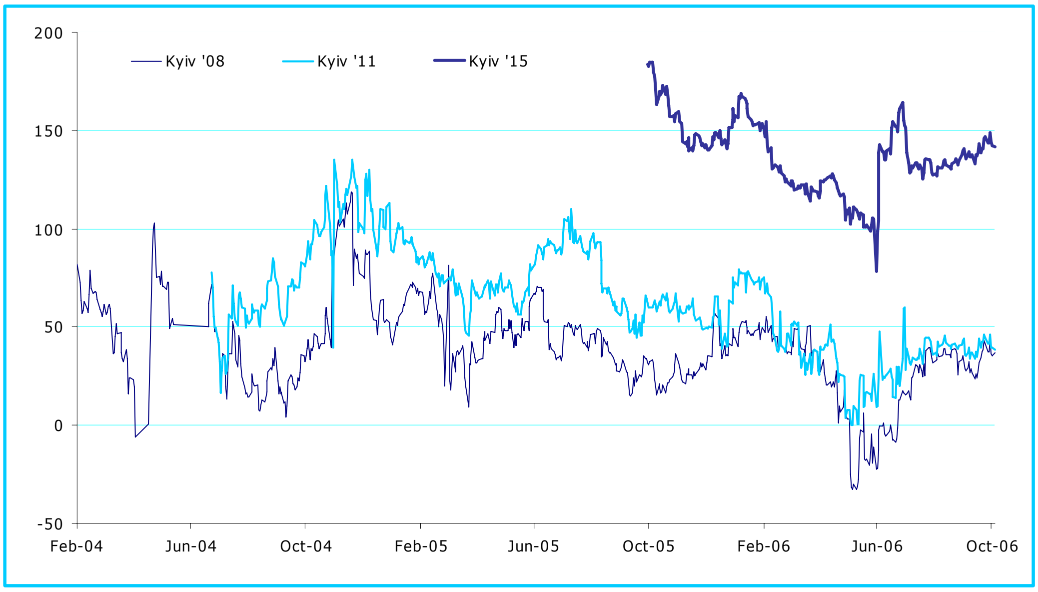


Source: Bloomberg, Concorde Capital

Kyiv '11 is traded at an average of 16-26 bps higher than Kyiv '08. Kyiv '15 is traded, on average, at a much higher premium of 110-117 bps. We expect the spread between the issues will be retained while the spread of Kyiv '08 over the benchmark will decline further to 170 bps by the end of 1Q07.

There is also a trend for municipal spreads to steadily tighten over sovereign Ukrainian Eurobonds. During some periods, Kyiv '08 was traded with a lower yield than the benchmark Ukraine '11 bond. Over the last 12 months, Kyiv '08 was traded at an average premium of 25 bps. The average premiums of Kyiv '11 and Kyiv '15 over the Ukrainian sovereigns are 45 bps and 137 bps respectively.

History of municipal Eurobond spreads (over Ukraine '11), bps



Source: Bloomberg, Concorde Capital

Bond Holdings. According to reports, Kyiv Eurobonds are held predominantly by West European mutual funds.

Kyiv 8.75% '08 bond holdings, as of Aug. 1, 2006

Holder	Amt, USD ths	Share
Fidelity Management	13,840	9.23%
Union Investment	7,100	4.73%
BI Asset Management Fondsmaeglerskap A/S	3,550	2.37%
DWS Investments GmbH	3,000	2.00%
Activest Investmentgesellschaft mbH (Munich)	2,850	1.90%
ING	1,800	1.20%
UBS Global Asset Management (US) Inc	1,350	0.90%
AXA INV Managers	1,200	0.80%
Aberdeen Asset Management Ltd (Sydney)	1,000	0.67%
ERSTE-SPARINVEST Kapitalanlagegesellschaft	500	0.33%
Activinvest INV	250	0.17%
Consultinvest Asset Management S.p.A. S.g.r.	100	0.07%
Total	**36,540**	**24.36%**

Source: Advantage Data, Bloomberg

Credit Ratings

Kyiv's Eurobond issues are rated by Moody's and S&P. Since the ratings were assigned, they have improved; most recently, S&P upgraded its ratings from B+ to BB- in late July.

Municipal credit ratings

	Kyiv 8.75% 2008	Kyiv 8.625% 2011	Kyiv 8% 2015
Standard & Poor's	BB-	BB-	BB-
Moody's	B2	B2	B2

Source: Finance Ministry

Ratings agencies assigned these speculative ratings to Kyiv for mainly two reasons: a low sovereign ceiling and Kyiv's limited revenue independence since the central government controls tax rates and how tax revenues are distributed among the central government and local governments.

However, Kyiv's finances are solid. Its total outstanding debt is only 4.2% of expected 2006 City's GDP and 33% of budget revenues. The city accounts for approximately 15% of the national GDP with only 6% of the country's population, and wage levels are three times the national average.

S&P notes that Kyiv's expenditures are well diversified compared to its CIS peers. The city has financed stable capital expenditures in recent years, mainly from its own revenue base. Since a period of economic decline in the 1990s, Kyiv has enjoyed dynamic growth, which has substantially increased budget revenues. Domestic and foreign investments are growing rapidly.

Kyiv has historically had a substantial portion of its total revenues transferred to the central government, but the share of these transfers is expected to decline in the future.

Kyiv has so far managed its debt appropriately and we do not foresee any repayment problems. According to the Finance Ministry, its ratio of debt service to budget expenditures was never higher than 8.1%, and normally ranges from 1.1% to 4%, which is a good indicator of a stable financial position. These figures meet all the legal requirements of the Budget Code, which sets the respective limit for city councils at 10%.

Upgrade opportunities. The rating agencies indicated the following reasons may lead to an upgraded rating: Greater stability in the interaction between the central and local governments, a conservative approach to debt issuance, and further growth in the city's diversified economy. Additionally, if there is a sovereign rating upgrade, Kyiv's ratings would also improve.

Downgrade risks. RAs cite the following threats which may cause a rating downgrade. First, failure to capture sufficient revenues through tax base expansion that may result in increased dependence on central government transfers. Second, growing debt and foreign exchange risks may result in downward pressure on the ratings.

Prospects

We expect a fourth Eurobond issue from Kyiv in 2H07 in the USD 300-390 mln range, with a maturity of more than 10 years. The issue is more likely to be denominated in EUR than USD.

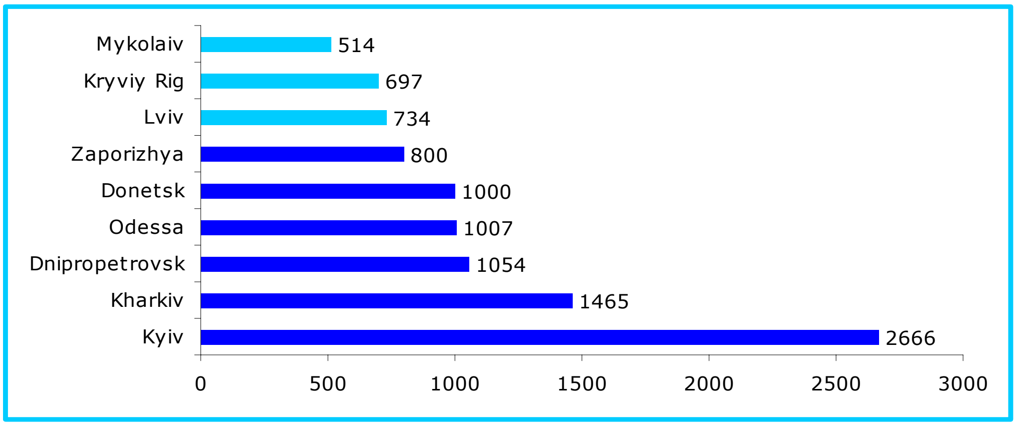
The future of the broad Ukrainian municipal Eurobond market will be determined by three key factors: (1) regulative improvements; (2) economic growth; and (3) the pace of the European integration progress.

Current legislation constrains market development in three main ways:

1. Because subordinate legislation for issuing bonds denominated in foreign currency is undeveloped, Eurobonds are currently issued through a loan participation note scheme using a two-step procedure. First a bank or a group of banks issue loan participation notes and sell them to investors, and then the bank or banks loan the funds to municipalities. This complicated process increases the cost of borrowing.

2. There is currently a limit that only allows municipalities with a population of 800,000 to borrow externally. Only six Ukrainian cities meet this requirement.

Population of Ukraine's largest cities, ths



Note: Population as of 2005
Source: State Statistics Committee of Ukraine

3. Regional entities (including the Autonomous Republic of Crimea and Oblasts, the smallest of which has a population exceeding 900,000) are banned from external borrowing.

Population of all Ukrainian oblasts

Oblast	Population, ths	Oblast	Population, ths
Donetsk Obl	4 841	Zhytomyr Obl	1 390
Dnipropetrovs'k Obl	3 568	Sumy Obl	1 300
Kharkiv Obl	2 914	Mykolaiv Obl	1 265
L'viv Obl	2 627	Zakarpattia Obl	1 258
Luhans'k Obl	2 546	Chernihiv Obl	1 245
Odesa Obl	2 469	Kherson Obl	1 175
AR of Crimea	2 034	Rivne Obl	1 173
Zaporizhzhia Obl	1 929	Vinnytsia Obl	1 172
Kyiv Obl	1 828	Ternopil' Obl	1 142
Poltava Obl	1 630	Kirovohrad Obl	1 133
Khmel'nyts'kyi Obl	1 431	Volyn' Obl	1 061
Ivano-Frankivs'k Obl	1 410	Chernivtsi Obl	923
Cherkasy Obl	1 403		

Notes: Included settlements that are administratively subordinated to town councils
Source: State Statistics Committee of Ukraine

Ukrainian officials are actively considering lifting the first two restraints. The third restraint might also be lifted as part of the government's plans for municipal reform, which include granting increased independence to the oblasts, but at the moment we don't see the government moving in that direction.

If more Ukrainian municipalities are allowed to borrow abroad, we forecast the total outstanding volume of the municipal Eurobonds to exceed USD 3 bln in the next three years.

The municipalities with experience borrowing locally and with exposure to international business and foreign investment will be most likely to attract foreign capital at favorable terms.

Eurobonds – Corporate

- **12 out of 20 outstanding Corporate Eurobonds issues are made by banks.**
- **Banking Eurobonds trade at spreads ranging from 140 to 320 bps over the 10-year UST, the spreads of telecoms and machine building are 230-280 bps, and the spreads of metallurgy, oil & gas and chemicals are in the 400-600 bps territory.**
- **All ratings are below the investment grade, and Ukraine's low sovereign ceiling is the main constraining factor.**
- **We expect about 5 new issues to increase the sector's outstanding volume to more than USD 4 bln by the end of the year.**

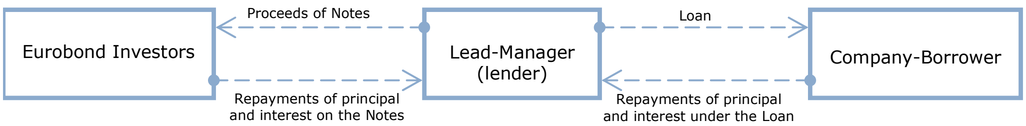
Legal Aspects

Ukrainian legislation still does not allow for bonds to be issued in a foreign currency. There was a limitation in the previous Law of Ukraine "On Securities and the Stock Exchange," according to which corporate bonds could only be denominated in local currency. The new law (already in effect) allows for bonds to be denominated in foreign currencies, but the SSEC still needs to develop subordinate legislation for this to take force. In addition, according to Ukrainian legislation in effect until 2008, bond volumes are also prohibited from exceeding 100% of the issuer's charter capital. The issue of bonds in liquid amounts is significantly constrained by this charter limit.

Thus, Ukrainian corporate Eurobond issuances are made so that they are not governed by legislation and are not registered with the State Securities and Exchange Commission (SSEC).

As a rule, Corporate Eurobonds are issued according to a **loan participation note (LPN) scheme**. A lead-manager issues notes and forwards income from the issue to the Ukrainian company in accordance with a loan agreement. The loan agreement is registered with the National Bank of Ukraine.

LPN organizational structure



Source: Concorde Capital

Eurobond payments are secured so that the lead-manager is obligated to pay the principal amount and interest on the Eurobonds to investors **only to the extent that the lead-manager receives payments from the borrower** under the loan agreement.

A lead-manager is usually located in a European country that has concluded a double tax treaty with Ukraine, which allows the parties **to optimize tax consequences** from the bond issue. Under Ukrainian law, a 15% withholding tax applies to interest paid to a non-resident, unless otherwise noted in an applicable double tax treaty. For example, in accordance with the treaty with the Government of the United Kingdom on Feb. 10, 1993; interest paid by a borrower located in Ukraine to a bank located in Great Britain are exempt from the 15% withholding tax (see more on p. 75).

Primary Market

At the end of 1H06, there were 17 corporate Eurobond issues on the market with a total par value of USD 2.87 bln. Unlike sovereign bonds, all the corporate issues are denominated in USD, despite lower borrowing rates in EUR. This is because of the greater importance of the dollar in Ukraine's economy and the more developed USD FX market in Ukraine. Ukrainian corporations are reluctant to expose themselves to additional FX risks as the majority (about 75%) of their transactions with foreign partners are denominated in USD.

Outstanding corporate Eurobonds, as of end of 1H06

Security	Currency / Amount (mln)	Maturity date
Aval Bank, 2007	USD/100	23.05.2007
Azovstal, 2011	USD/175	28.02.2011
ISD, 2010	USD/150	23.09.2010
Kievstar GSM, 2009	USD/266.42	17.08.2009
Kievstar GSM, 2012	USD/175	15.04.2012
Nadra Bank, 2008	USD/100	04.11.2008
Naftogaz, 2009	USD/500	30.09.2009
PrivatBank, 2006	USD/100	19.12.2006
PrivatBank, 2016	USD/150	09.02.2016
Stirol, 2008	USD/125	19.08.2008
Ukreximbank, 2009	USD/250	23.09.2009
Ukreximbank, 2012	USD/250	04.10.2012
Ukreximbank, 2016	USD/95	09.02.2016
UkrSibbank, 2007	USD/100	05.04.2007
UkrSibbank, 2008	USD/125	14.07.2008
Ukrsotsbank, 2008	USD/100	06.06.2008
Yuzhmash, 2009	USD/107.5	21.01.2009

Source: Cbonds

One of the main trends for the Ukrainian corporate Eurobond market is a **move toward longer maturities.** The weighted average maturity of corporate Eurobonds was close to 3 years in 2002 and 2003 and increased to more than 4.8 years in 2004 before declining slightly to under 4 years in 2005. A dramatic increase in the weighted average maturity to 8 years occurred in 1H06, which is more than two times longer than local corporate bonds.

Another important trend is the **gradual decline in interest rates** at which Ukrainian issuers have been able to attract funds. In 2002, the weighted average cost of Eurobond borrowing was 12.75%, in 2003 it was 10.89%, in 2004 it dropped to 8.72% and in 2005 it declined again to 8.19%. These declines made Eurobond borrowing much more attractive relative to local borrowing.

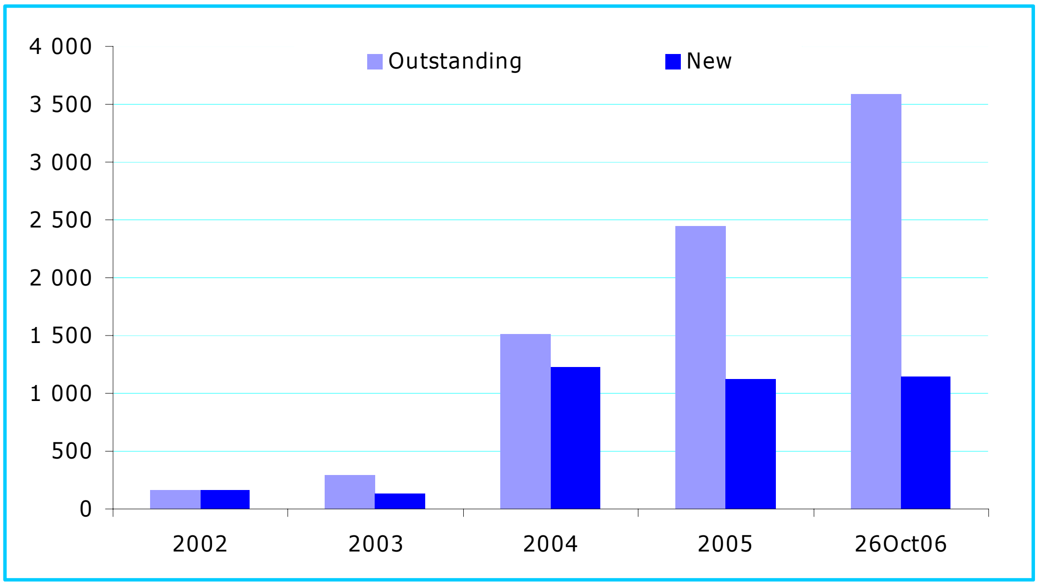
The weighted average cost of borrowing in 1H06 was equal to 8.83%, a nominal increase of 64 basis points compared with 2005. The increase was caused by two factors: longer maturities and a general rise in interest rates internationally.

It also should be noted that in Ukraine **corporate Eurobonds are structured differently than corporate bonds on the local market**. Eurobonds are bullet debentures and typically have no put options.

The typical **volumes of corporate Eurobonds by far exceed those of local issues**. The average volume of corporate Eurobond issues is USD 168 mln (median USD 125 mln) while the average volume of local corporate issues is the hryvnya equivalent of USD 5.3 mln (median USD 2 mln).

Economic Growth Whets the Appetite for Borrowing. The total par value of outstanding issues has grown rapidly since Ukrainian corporations started issuing Eurobonds in 2002. The volume of 2005 issues exceeded the volume of 2002 issues by 7 times.

Corporate issues by total par value, USD mln



Source: Bloomberg, Cbonds, Concorde Capital

Who buys Ukrainian corporate Eurobonds?

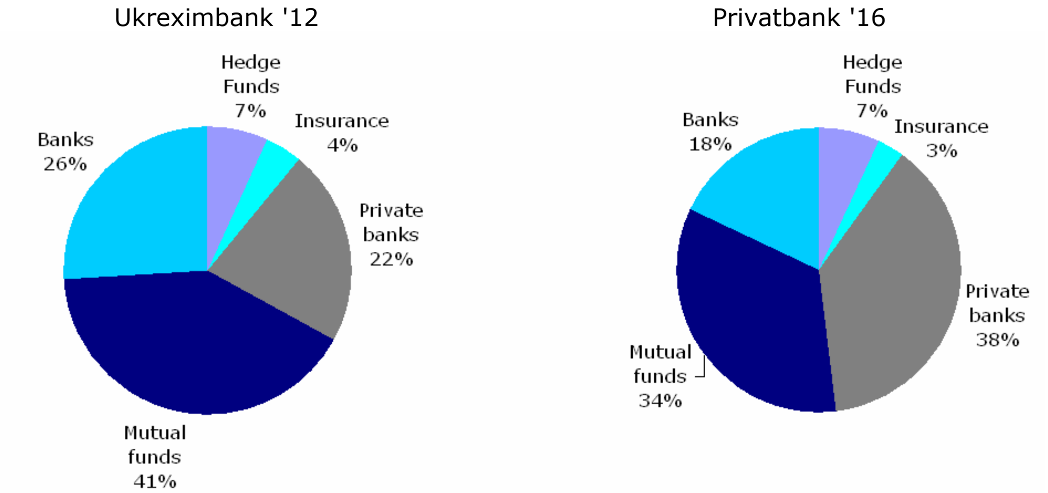
Although information is not available for all issues, it is possible to determine trends in the distribution of corporate Eurobond investors based on information released by underwriters and the issuers themselves.

The main investors in Ukrainian corporate Eurobonds are mutual funds, banks and private banks. Hedge funds, insurance companies and pension funds are smaller players. Most investors are located in Europe, and some from the U.S., Asia and Russia.

In the case of Kyivstar's placement it was reported that the **geographical distribution** was as follows: U.K. 47%, U.S.A. 30%, France 5%, Netherlands 5%, Asia 4%, other 9%. Ukrsibbank's placement had a wider geographic distribution: U.K. 24%, Austria 12%, Switzerland 11%, France 10%, Scandinavian countries 10%, Asia 9%, Russia 7%, U.S. offshore 3% and the rest of Europe 13%.

A breakdown of the primary investors in Ukreximbank and Privatbank shows that the leading **investor types**, mutual funds, bought more than one third of the bonds. In second place, private banks accounted for 22-38% of the issues. A notable share of about 20% were bought by banks. Hedge funds took 7% of each of the issues, and the share of other investor types was negligible.

Corporate Eurobonds breakdown by investor type



Source: Cbonds, UBS

The breakdown of investor types for the Kyivstar and Ukrsibbank issues were similar. The bulk of demand for Kyivstar came from mutual funds (68%), while banks took 17%, insurance companies and pension funds 8%, and other investors 7%. Funds and asset managers took 48% of Ukrsibbank bonds, private banks 23% and banks 29%.

Secondary Market

Almost all corporate Eurobonds are listed on one or more stock exchanges (usually Luxembourg, Switzerland or London).

However, OTC trading is more prevalent, which hampers transparency. Ukrainian corporate Eurobonds are not subject to any OTC trade reporting systems such as TRACE in the U.S. As very little information on trade volumes is available, we used a bid-ask spread analysis and broker activity to evaluate how actively Ukrainian bonds are traded.

The most liquid issues are those of Ukreximbank, Ukrsibbank, Kyivstar and Naftogaz. The most active brokers are Barclays Bank, Credit Suisse and ING. The following brokers maintain liquidity for Ukrainian corporate Eurobonds.

Table of Ukrainian Eurobond brokers

	Ukrsibbank	Ukreximbank	Naftogaz	Kyivstar	Ukrsocbank	Privatbank	Stirol	ISD	Nadra Bank	Yuzhmash	Azovstal	**TOTAL**
Barclays Bank	+	+	+	+	+	+	+	+	+	+		10
Credit Suisse	+	+	+	+	+	+			+			7
ING Bank		+	+	+			+				+	5
Walter Ludwig GmbH	+	+	+									3
RZB Austria	+	+			+							3
HSBC			+	+								2
BNP-Paribas	+			+								2
Renaissance								+				1
HVB	+											1
BCP Securities LLC		+										1
TOTAL	6	6	5	5	3	2	2	2	2	1	1	35

Source: Bloomberg

The bid-ask spreads of corporate issues are in line with Ukrainian sovereign bonds, ranging from 0.2 to 1%, with extraordinary and temporary exceptions, such as Stirol's 3%. The spreads are much tighter than for domestic corporate bonds and just a little wider than spreads typical of Russian corporate Eurobond issues.

Bid-ask spreads, %

Security	**as of May 18, 2006**	**as of Oct. 17, 2006**
Stirol, 2008	3.0	1.1
Naftogaz, 2009	1.1	1.0
Yuzhmash, 2009	1.1	1.1
Nadra Bank, 2008	1.0	0.9
PrivatBank, 2016	1.0	0.9
Azovstal, 2011	0.9	1.0
Ukreximbank, 2012	0.9	0.8
Kyivstar GSM, 2009	0.7	0.4
ISD*, 2010	0.5	-
Ukreximbank, 2009	0.5	0.6
UkrSibbank, 2007	0.5	0.2
UkrSibbank, 2008	0.4	0.4
Kyivstar GSM, 2012	0.2	0.7
PrivatBank, 2006	0.2	-
Ukrsotsbank, 2008	0.2	0.4

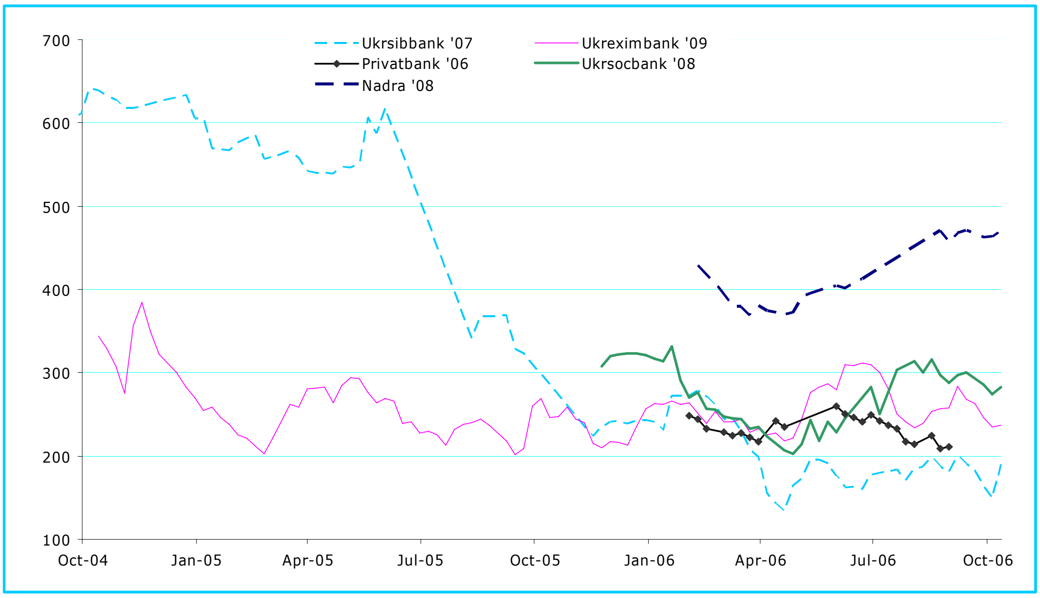
*Notes: *ISD – Industrial Union of Donbass*
Source: Bloomberg price providers

Historical Yields

The main trend was a decline in yields till the end of 3Q05, before the trend reversed. The reversal was caused by two factors: UST bond yields increased, and a widening of the spreads of Ukrainian sovereign bonds over UST bonds. The latter was caused by political instability (parliamentary elections and protracted coalition talks), the increase in gas prices in January 2006 and growing investor concern about emerging markets (see Corporate Eurobonds: trading history p. 69).

Banking Eurobonds. Both externally and locally, the banking sector is considered to be less risky. Foreign capital inflows to the sector are growing quickly, and we expect the spreads of the best performing Ukrainian banks' Eurobond issues to converge with sovereign spreads in the mid-term.

History of banking Eurobonds spreads (over 10-year UST), bps

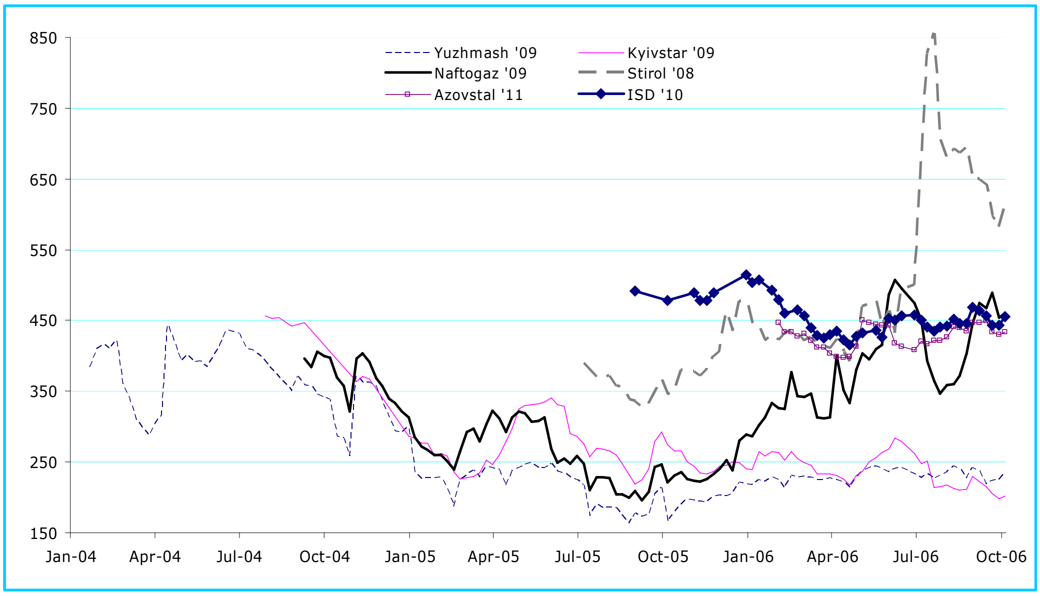


Source: Concorde Capital, Bloomberg

Banking Eurobonds are traded with a spread ranging from -20 to 158 bps over Ukrainian sovereign Eurobonds and from 140 to 320 bps over the UST bond benchmark. The lone exception is the much smaller Nadra Bank issue, which is traded with higher spreads of 300 bps and 460 bps respectively.

Non-Banking Corporate Eurobond yields are higher and are traded at spreads ranging between 230 bps and 600 bps over the UST bond benchmark.

Non-Banking corporate Eurobond spreads (over 10-year UST), bps



Source: Bloomberg, Concorde Capital

The gas crisis had the most harmful effect on bonds from issuers in the metallurgical, chemical and oil & gas sectors. The risk of **gas price increases sharply divided non-banking Eurobonds into two groups** depending on the share of gas in company's expenditures. Yields of less gas dependent Kyivstar and Yuzhmash were not significantly affected, while yields of others increased.

Credit Ratings

All Eurobond issuers except ISD were assigned credit ratings from leading global agencies. **All ratings are below investment grade**, with Ukraine's low sovereign ceiling as the main constraining factor.

Long-term debt ratings for Ukrainian issuers, July 2006

	Moody's	S&P	Fitch
Azovstal	B3	B-	-
ISD*	-	-	-
Kyivstar	B1	BB-	-
Nadra Bank	B1	-	B-
Naftogaz	Ba2	-	B+
Privatbank	-	-	B
Stirol	B3	-	B
Ukreximbank	Ba2	-	BB-
Ukrsibbank	Ba2	-	BB-
Ukrsocbank	Ba3	B-	B-
Yuzhmash	B1	BB-	-

Notes: ISD – Industrial Union of Donbass
Source: Bloomberg

There were two important factors that contributed to recent changes in corporate Eurobond ratings: **problems related to rising gas prices,** and **foreign acquisitions**.

Upgrade case. In April Moody's upgraded the long-term debt ratings of Ukrsibbank's two issues loan participation notes to Ba2 from Ba3. The upgrade in the bank's debt rating resulted from a review that followed the acquisition of a 51% stake in Ukrsibbank by BNP Paribas, the third-largest European bank by assets.

In Moody's view, BNP Paribas (rated Aa2) with its solid experience in European markets is more likely than the previous owners to support Ukrsibbank if needed.

Downgrade case. In April Fitch downgraded Naftogaz's local and foreign currency ratings to B+ from BB- because of the company's deteriorating financial condition. The senior unsecured rating on Naftogaz's USD 500 mln Eurobond maturing in 2007 was also downgraded to B+ from BB-. The outlook for both ratings remains negative.

Fitch said it was concerned about Naftogaz's cash flows in light of the gas price increase and delays passing on the price increase to consumers. The downgrade put pressure not only on Naftogaz's Eurobond but also on all other Ukrainian Eurobonds.

Prospects

In the long-term, there are several fundamental factors that will drive the growth of Ukraine's external corporate debt market.

- **Thirst for long money.** Local capital markets do not seem to be capable of providing it anytime soon.
- **Large fixed capital investment needs**. According to the NBU, more than 60% of fixed assets in Ukrainian enterprises are technologically outdated or have been fully depreciated. The lack of local investment funds and the lower cost of external capital will bring large industrial companies to the external debt market.
- **Most Ukrainian companies are extremely underleveraged.** Sooner or later, corporations will change their capital structure and increase their leverage.

In the short-term, the number of 2006 issues will be determined by conditions on external capital markets. Optimistically, if rates on international capital markets in 4Q06 are favorable and the new Ukrainian government's actions are perceived as stable, we expect approximately five new issues that would increase the outstanding corporate Eurobond volume to more than USD 4 bln. Pessimistically, two or three issues will increase the outstanding volume by USD 250-350 mln, which leaves the outstanding corporate Eurobond volume just a little below USD 4 bln.

Among the string of companies that are planning to enter Eurobond market, those in the banking sector are the most promising in terms of growth, expansion, solvency and management quality.

Corporate Eurobond issues announced for 2006

	Company
1	Nadra Bank
2	"AVentures Group" (retail trade)
3	Azovstal
4	Pravex Bank
5	AvtoKrAZ
6	Pivdenniy Bank
7	Ukrsibbank (BNP-Paribas Group)
8	ZAZ Ukraine (UkrAuto)
9	Ukrsotsbank (Banca Intesa)
10	Khreschatyk Bank
11	Privatbank
12	Kreditprombank*
13	VaBank
14	Finance and Credit Bank*
15	Alfa-Bank Ukraine

**In the pipeline*
Source: Concorde Capital, Companies data

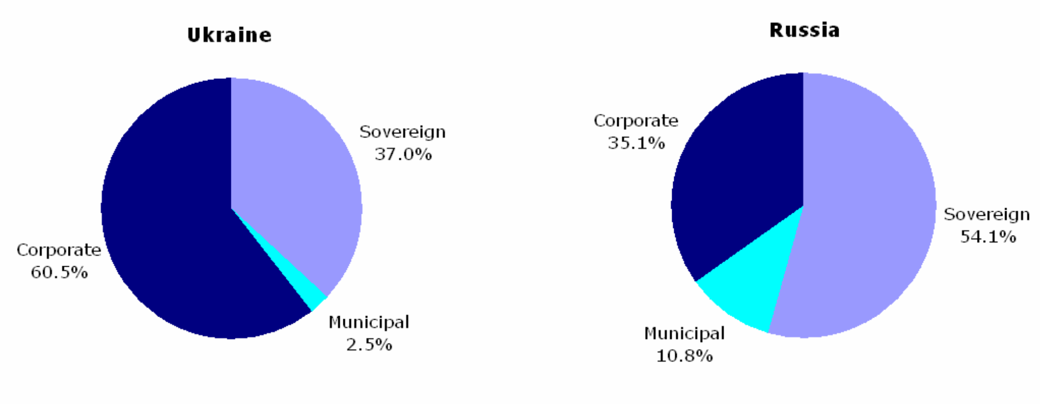
LOCAL DEBT MARKET

Local Bonds - Overview

At the end of 1H06, the outstanding debt for all types of local bonds was an estimated USD 4.76 bln, which was 5.7% of GDP and 41% of Ukraine's total (local and external) bond debt. Local tradable debt is much lower than bank debt, that amounts to 34% of GDP.

Unlike Eurobonds, most local tradable debt is in corporate bonds, which account for 60.5% of the total and is growing. This ratio is higher than in developed economies and other CIS countries (for example, in Russia corporate bonds account for 35.1% of local debt). Corporate debt accounts for a large share of Ukraine's local debt for three reasons: local sovereign borrowing was suspended from July 2005 to September 2006, the local municipal bond market has developed slowly, and private businesses have been more effective and aggressive on capital markets.

Outstanding local bond market debt



Source: Concorde Capital, Bond Market Association

The **sovereign local bond** market is made up of 35 issues (as of the end of 1H06) for a total amount of USD 1.76 bln, with maturities ranging up to 2010. The secondary market for government securities currently offers yields of 8-10%. The Finance Ministry's activity on the primary market till the end of the year will be limited to three midterm issues with 2-year, 3-year and 5-year maturities.

Seventeen **municipal local bond** issues are outstanding for a total of USD 116 mln, a mere 2.5% of the local bond market as of 1H06. The municipal bond market was frozen in 1998-2002 and only recently revived. Typical yields in this sector are from 10.5% to 12.5%. We believe the sector has a good chance to grow significantly and decrease yields in the mid-term.

There are more than 500 **corporate local bond** issues with a total outstanding amount of USD 2.88 bln as of 1H06. New issue volumes registered with the State Securities and Exchange Commission (SSEC) tripled in 2005 (compared to 2004) and in 1H06 (compared to 1H05). This sector has the widest range of yields, from 10% to more than 20%. However, the local corporate debt market is small compared with other countries. The Russian local corporate debt market is nine times bigger and the American market is almost two thousand times bigger. Nevertheless, in Russia the ratio of outstanding domestic corporate bond debt to GDP is lower (2.7%) compared with Ukraine (3.5%).

Local Bonds - Sovereign

- **Foreign investors hold 40-60% of outstanding local sovereigns. The government is not welcoming "hot money" as it did in the late nineties and is reluctant to borrow at a high cost. The NBU is able to limit volumes that can be owned by non-residents.**
- **Organized market turnover of local sovereign bonds averages 96%, which is in line with government securities in other European countries.**
- **Three mid-term issues are planned by the Finance Ministry to be reopened at its auctions until the end of the year with the following maturities and stop yields - 2Y: 9%, 3Y: 9.4% 5Y: 9.5%.**

Sovereign local bonds are issued by the Finance Ministry and are fully backed by the Cabinet of Ministers. The Finance Ministry is Ukraine's largest debt issuer, its securities account for 37% of domestic tradable debt. The amount of outstanding local sovereign bonds as of 1H06 was UAH 8.87 bln, or 49% of the state's total domestic debt and 12% of the state's total debt.

Legal Aspects

The government's internal debt is guaranteed against all state-owned property, according to the Law "On the Sovereign Internal Debt of Ukraine."

Non-resident restrictions

The government has developed instruments that in case of necessity will limit sovereign bond volumes that can be owned by non-residents.

In June 2005 Ukrainian authorities also introduced a regulation restricting non-residents from buying local securities with maturities less than one year. However, the Finance Ministry has not issued any such bills since before the restriction was implemented and did not announce any plans for future issues. The regulation sent the message that the government is not welcoming "hot money" as it did in the late nineties.

Types of securities

Sovereign local bonds are often referred to as OVDPs, their Ukrainian acronym. All are issued in book-entry form, and the National Bank of Ukraine serves as the exclusive depositary for all issues.

Sovereign local bonds can be divided into two groups:

1) **Regular bonds**, issued at auctions. The Finance Ministry can choose to issue any of the types (listed below), which have been set by the Cabinet of Ministers of Ukraine; and

2) **Special bonds**, which are issued for special purposes and have an irregular structure.

There are five categories of regular sovereign local bonds:

1) **Short-term bills** – short-term government securities maturing in less than one year and bearing no interest. They have a par value of UAH 1,000 and are the government's only discount bonds.

2) **Medium-term bonds** – bonds with coupons paying interest quarterly and with maturities ranging from one to five years. They are bullet issues with no option features. The par value is UAH 1,000.

3) **Long-term bonds** - bonds with maturities longer than five years. All coupon payments are made quarterly. The standard variant of long-term bonds are bullet issues with no option features and a par value of UAH 1,000.

   The Finance Ministry can stipulate one put option. If there is such an option, the government will redeem the bonds at par value by the request of the holder on the stipulated put date, which must coincide with a future coupon payment.

4) **Long-term puttable bonds** – long-term bonds with a put option available to holders after the fifth coupon payment; if exercised, the government must redeem them at face value, which is typically UAH 1,000, at the time the next coupon payment is due.

5) **Long-term amortizing bonds** – long-term bonds, which amortize par value in equal parts at the time of coupon payments starting from the sixth coupon payment.

There are two types of special government bonds:

1) **VAT bonds** – bonds issued in 2004 to restructure overdue VAT refunds that were owed to exporters. These bonds have a floating coupon rate equal to 120% of the weighted average of NBU interest rates. They are amortizing bonds, with 20% of par value paid together with each annual coupon payment due on. Two series of bonds were issued: the total par value of the first issue was UAH 1.2 bln (USD 238 mln), while the second's par value was UAH 0.75 bln (USD 149 mln). Their maturity dates are Dec. 31, 2008 and June 30, 2009 respectively.

   Percentage bonds (POVDP) – inflation-linked 10-year bonds issued in 2000 to restructure the Finance Ministry's debt to the NBU. The coupon rate was adjusted annually based on the consumer price index. Coupon payments and par redemption were to be made monthly. The total par value of the issue was UAH 10.5 bln.

   Even though the Finance Ministry redeemed the bonds by 2006, this structure is likely to be used in the future in order to provide pension funds with inflation-protected instruments.

Primary Market

The Finance Ministry and NBU recently renewed auctions of sovereign local bonds after a break of more than a year. The Finance Ministry has been holding auctions almost every Monday and Thursday, beginning on Sept. 4 and they were preliminarily announced to end on Dec. 18.

The ministry plans to make only three mid-term issues with two, three and five-year maturities and then to reopen them till the end of the year.

The 2006 state budget law sets the maximum allowable amount of outstanding sovereign local debt at USD 4.78 bln. That means the Finance Ministry can borrow up to USD 1.2 bln on local markets in 2H06.

The government's stated goal is to raise USD 900 mln (UAH 4.55 bln) by the end of the year. However, there has so far been little interest from investors at the yield levels that the government is offering (2-year yield: 9%, 3-year: 9.4%, 5-year: 9.5%). As of Oct. 17, the government held 22 auctions and raised only UAH 236 mln (USD 46.7 mln).

The Auction Process

Auctions are regulated by the NBU and held jointly by the NBU and the Finance Ministry. There are two types of auctions:

1) **single-yield auctions** - only noncompetitive bids are accepted, and bids are based only on quantity, not yield. If the total amount of the bids is higher than the offered amount, the bonds are awarded on a pro rata basis.

2) **multiple-yield auctions** - competitive and noncompetitive bids are accepted. These auctions can have one or two stages.

   In a one-stage auction, participants submit a competitive bid indicating the yield and volume, or alternatively submit a noncompetitive bid indicating the volume and a readiness to accept the weighted average yield of the auction.

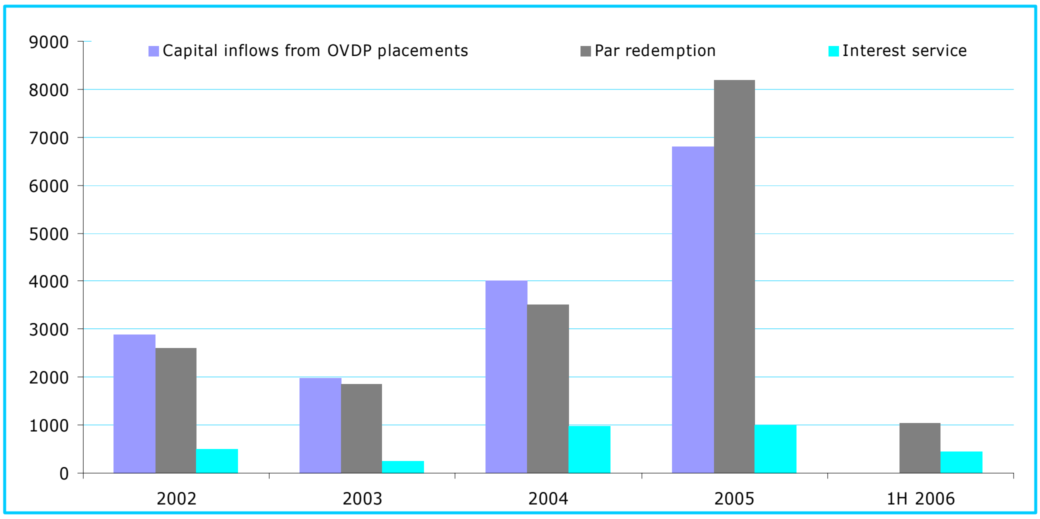
   In a two-staged auction, during the first stage, participants can submit competitive or noncompetitive bids. In the second stage, competitive bidders have an option to increase the volumes or decrease the yields of their bids, and can also submit an additional noncompetitive bid; while noncompetitive bidders can submit additional competitive or noncompetitive bids. Bidders are not allowed to withdraw or decrease the volumes of their initial bids.

Only authorized dealers, with a special license from the NBU, can participate in local sovereign bond auctions. The bidders are obliged to reveal the identity of the ultimate buyers of the bonds to the NBU.

No guarantee deposit is required, but sanctions can be applied to dealers that fail to settle by the announced date after the winning bid is placed.

The Finance Ministry's debt-management program is not publicly disclosed. However, the name of the program, "**A Future Without Debt**," says it all. Capital outflows (amounts paid to investors including redemption and interest) have increasingly exceeded inflows since 2002. In 2005, redemptions alone exceeded capital inflows, as the government sought to reduce state debt.

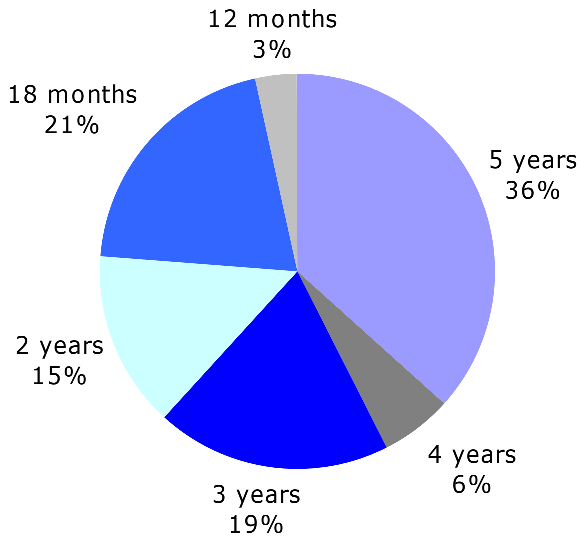
Primary market capital flow dynamics, UAH mln



Source: State Treasury

One of the main changes in the local government securities primary market was the Finance Ministry's decision to decrease and then stop issuing short-term securities. Previously short-term bills made up a large share of local government issues. This caused problems for the government in late 90s. In 2003, the Finance Ministry issued a substantial amount of short-term bills (48% of all local sovereign bonds) for the last time and by 2005 the government stopped issuing them all together.

Maturity structure of outstanding OVDPs, end of 1H06



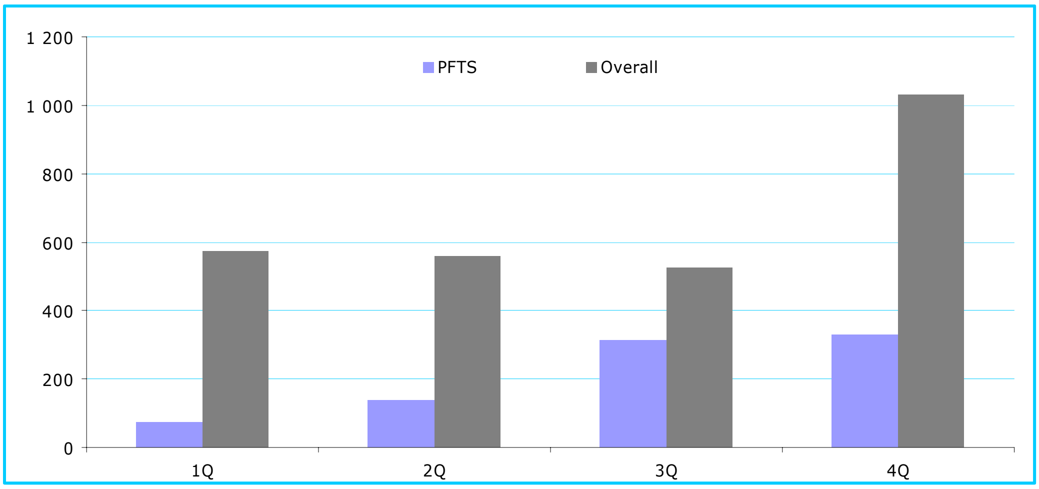
Source: Finance Ministry

Secondary Market

Foreign investors and local commercial banks are the main players on the secondary market in local government bonds. Local investment companies play a small role. According to Finance Ministry data, foreign investors owned about 60% of all local government securities as of the beginning of this year. However, the NBU reported that the share declined during 1H06 as foreign investors acquired less than they sold, causing a net capital outflow of USD 419 mln (whereas in 1H05 the respective net inflow was USD 962 mln).

Trading in sovereign local bonds is conducted both over-the-counter and on the organized market (through the PFTS electronic trading system).

OVDP trading volumes in 2005, USD mln



Source: PFTS, SSEC

OTC Trading

The majority of deals including most B2C transactions are made OTC and are negotiated entirely by phone. Most of the time OTC trading exceeds trading activity on the organized market.

PFTS Trading

The PFTS is a B2B venue. All PFTS trades in government bonds in 2005 were concluded via commercial banks, according to the PFTS's annual report. Banks with foreign ownership (all or part) accounted for 66% of the total volume of PFTS trades in government bonds.

Currently, about a half-dozen traders, most of which are still commercial banks, maintain quotations for OVDPs on the PFTS.

Trading activity is growing rapidly. The volume of government bonds traded on the PFTS in 2005 reached USD 768 mln (595% of the 2004 level). Over 9M06, the trading volume was USD 1.53 bln (347% of the first 9m05 level).

PFTS Trading Model

The PFTS has two platforms for government bonds: order-driven (PFTS-OVDP) and quote-driven. On both platforms bonds are priced at their *full prices* in hryvnyas. The order-driven platform allows for trades with the NBU. The majority of deals are made on the quote-driven platform.

One of the main features of the quote-driven trading model is the ability to "correct the price" by calling the party that submitted an offer and agreeing to execute a trade within the limits of the spread (or even beyond it). This ability is important for trading in low-liquid securities that might have large bid/ask spreads. Knowing the other party in the trade helps to come to an agreement, possibly including non-standard settlement conditions. However, if standard settlement conditions and the quoted price are fully acceptable, a participant can execute a transaction electronically.

As of Oct. 18, 2006, 11 of the 33 local government bond issues in circulation are listed on the PFTS. The most actively traded bonds are those that mature on 15.11.2006, 30.12.2009, 30.06.2009 and 01.01.2009.

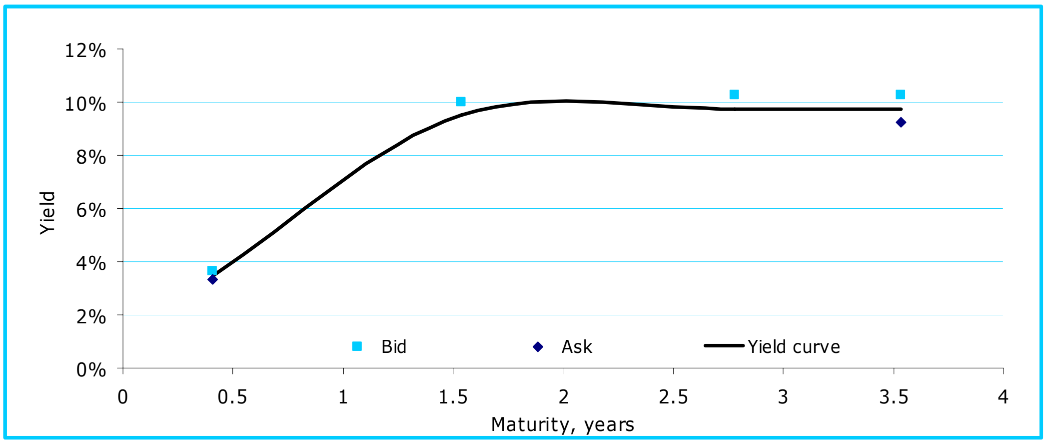
PFTS listed government bonds, as of Oct. 18, 2006

PFTS identifier	ISIN	Coupon rate	Maturity
21501	UA3B00021501	5.62%	25.10.2006
21105	UA3B00021105	5.29%	15.11.2006
20701	UA3B00020701	11.23%	03.01.2007
21204	UA3B00021204	5.59%	16.05.2007
20800	UA3B00020800	11.68%	02.01.2008
22301*	UA3B00022301	9.00%	02.09.2009
16206	UA3R00016206	10.73%	01.01.2009
21006	UA3B00021006	6.48%	01.04.2009
20406	UA3R00020406	10.20%	30.06.2009
22400*	UA3B00022400	9.40%	03.09.2009
20909	UA3B00020909	11.94%	30.12.2009

**The securities which the Finance Ministry will reopen at its auctions till the end of the year*
Source: Concorde Capital, PFTS, Bloomberg

The majority of trades on the PFTS are made via quote-driven system, where posted quotations mainly serve as an invitation to negotiate terms of the deal via phone. The quotation can fail to depict actual volume and price that market participants are ready to pay. Often deals are concluded at a price beyond the bid-ask range. Bid volumes typically do not exceed 1,000 bonds (approx. USD 200,000), although the average deal exceeds 10,000 bonds (approx. USD 2 mln). Moreover, bid-ask spreads for governmental securities typically range from 0.5% to 2.3%. These factors make it more difficult to draw a 100% accurate yield curve.

Sovereign yield curve, as of Oct. 18, 2006



Source: Concorde Capital, PFTS

For the trading history of the most liquid local sovereign bonds, please see page 71.

Turnover and Liquidity

On an annualized basis, the turnover of sovereign bonds on the PFTS in 1H06 was equal to 96%. This turnover is in line with turnovers of government securities in other European countries, according to data from the inter-dealer (B2B) market of Europe's electronic exchange (MTS).

PFTS trading turnover (1H06)

	Annualized turnover
Benchmark	122%
*UA3B000**21105***	*216%*
*UA3B000**20909***	*76%*
*UA3B000**20800***	*63%*
*UA3B000**21006***	*39%*
Other	31%
Total	**96%**

Source: PFTS, Concorde Capital

MTS trading turnover for selected European countries

	Amount outstanding, EUR mln	MTS monthly turnover	Annualized MTS turnover
Greece			
Benchmark	130,184	8.02%	96%
Non-Benchmark	18,116	2.95%	35%
Total	**148,300**	**7.40%**	**89%**
France			
Benchmark	82,928	1.85%	22%
Non-Benchmark	704,772	2.55%	31%
Total	**787,700**	**2.48%**	**30%**
Germany			
Benchmark	68,000	2.03%	24%
Non-Benchmark	705,800	3.94%	47%
Total	**773,800**	**3.77%**	**45%**
Italy			
Benchmark	218,166	15.70%	188%
Non-Benchmark	938,934	10.51%	126%
Total	**1,157,100**	**11.49%**	**138%**
Portugal			
Benchmark	44,873	23.56%	283%
Non-Benchmark	33,527	5.60%	67%
Total	**78,400**	**15.88%**	**191%**

Source: Peter Dunne, Michael Moore and Richard Portes: *European Government Bond Markets: transparency, liquidity, efficiency,* City of London, May 2006.

Solvency

Ukraine's sovereign credit rating and solvency have already been considered in this report in the sovereign Eurobonds section (see page 11).

For your convenience, we repeat the table on Ukraine's sovereign credit ratings here.

Sovereign credit ratings

	Foreign currency liabilities		Local currency liabilities		Outlook
	LT	ST	LT	ST	
Fitch Ratings	BB-	B	BB-	B	Positive
Standard and Poor's	BB-	B	BB	B	Stable
Moody's	B1	-	B1	-	Stable

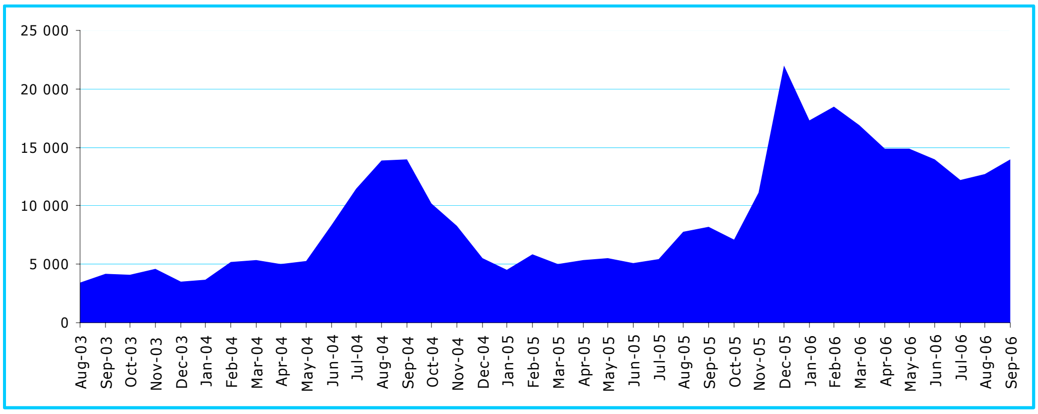
Source: Finance Ministry

Prospects

Despite attracting only 5% of the announced goal for 2006 (UAH 4.55 bln), the government is reluctant to increase yields (2y: 9% 3y: 9.4% 5y: 9.5%). The government's reluctance is backed by external borrowing plans and this year's state budget performance.

State budget revenues in 1H06 were higher than expected and expenditures lower, making the budget deficit only USD 656 mln (the limit for the year is USD 2.62 bln). Also, as of Oct. 8, the government has about UAH 13 bln (USD 2.57 bln) in its aggregated account (which is enough to cover the budget deficit for the rest of 2006 by 130%). If not for the gas price increase and higher social expenditures in 2H06, the government would have had no need to borrow substantially.

Aggregated state treasury account, UAH mln



Source: State Treasury of Ukraine

It is possible that a new long-term strategy for issuing internal state bonds will be created and one of the state-owned banks (Ukreximbank or Oshchadbank) will act as the liquidity provider for government securities. We welcome these plans because they will help the government improve liquidity on the secondary market and provide market participants with reliable benchmarks.

Government Agencies to Issue Securities?

The idea of Ukrainian government agencies issuing debt has been floated, but currently only one agency, the Government Mortgage Institution, is working on a definite plan.

Similar to the U.S.'s Fannie Mae, the Government Mortgage Institution was created by the government to facilitate mortgage lending and provide mortgage security liquidity. The Government Mortgage Institution will raise funds by issuing bonds under government guarantees, and will receive a smaller amount of financing from the State Budget. The first issue of UAH 1 bln (approx. USD 200 mln) of such bonds has been planned, but is awaiting authorization from the Verkhovna Rada. A consortium of BNP-Paribas and Ukrsibbank has agreed to place all of the issue.

Local Bonds – Municipal

- **This USD 129 mln sector offers the longest maturities on the local market, with spreads ranging over local sovereigns from 30 bps to 300 bps.**
- **The municipal sector has a special regulative framework, which was implemented in the aftermath of the first and only default in 1998.**
- **In the mid-term, we expect administrative reforms and legislative changes to give municipalities more financial and administrative independence. Without reforms, the sector's share of the local market will not be higher than 2-4%.**

Legal Aspects

All cities regardless of their population are allowed to issue local bonds, as is the Autonomous Republic of Crimea. Other regional authorities such as Oblasts (Regions) were allowed to issue local bonds in the past but are currently restricted.

Payments on municipal bonds are not exempt from taxation.

The municipal local debt sector has a special regulative framework, which was implemented in 1998-2002 in the aftermath of the first and only default (see Background, page 45). During this period, municipalities were banned from making issues. The framework includes presidential decrees, regulatory acts of the State Securities and Exchange Commission (SSEC) and the Budget Code, which includes a series of requirements including a borrowing limit, mandatory independent credit ratings, a specified borrowing purpose and approval of municipal issues by the Finance Ministry.

The regulations allow the Finance Ministry to prevent any local government borrowing that could potentially lead to a default. However, the many regulations also limit the potential of the municipal bond market, as city councils must undergo arduous procedures and oblasts are forbidden from making issues.

Primary Market

All municipal bonds in Ukraine are general obligation bonds. Municipal authorities do not issue revenue bonds, in which bond issuers finance a project or enterprise by pledging its future revenues to the bondholders.

Unlike local corporate bonds, municipal bonds have longer maturities; they rarely have put options and most have unchangeable coupon rates. The earliest outstanding municipal bond issue, made by the city of Kyiv in 2003, has an atypical structure. The issue has a changeable coupon rate equal to 150% of the NBU discount rate (floor: 10% cap: 14%) and put options exercisable on 27.11.06, 26.11.07 and 26.05.08. No other issue has a changeable coupon rate and only three other issues (two by Donetsk and Zaporizhya's first issue) offer put options.

Outstanding issues, as of Oct. 17, 2006

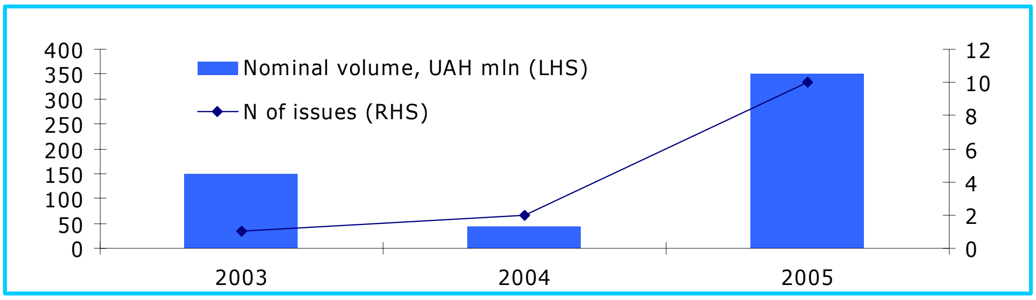
Issue	Coupon, %	Maturity
Cherkasy, (A series)	12	27.12.2010
Donetsk (A series)	14	15.08.2007
Donetsk (B series)	11.75	11.07.2010
Donetsk (C series)*	12	05.09.2011
Ivano-Frankivsk, (A series)	12	28.02.2011
Kharkiv (A series)	10.75	26.06.2008
Kyiv (A series)	changeable	25.11.2008
Komsomolsk (A series)*	12	03.08.2009
Odessa (A series)	12	31.12.2007
Odessa (B series)	13	31.12.2008
Odessa (C series)	14	31.12.2010
Vinnytsya (A series)	11.95	30.12.2007
Vinnytsya (B series)*	12	30.12.2008
Zaporizhya (A series)	15.35	28.12.2006
Zaporizhya (B series)	10.5	10.07.2007
Zaporizhya (C series)	11	08.07.2008
Zaporizhya (D series)	11.5	07.07.2009
Zaporizhya (E series)	12	06.07.2010

**Bonds issued in 2H06*
Source: Concorde Capital, Cbonds

The outstanding volume of the municipal bond market is USD 129 mln; as of 1H06 it was USD 116 mln (UAH 583.5 mln). The median issue volume was USD 4.95 mln (UAH 25 mln) and the average was USD 7.7 mln (UAH 38.9 mln). Coupon rates range from 10.5% to 15.35%. The largest issues are those of Kyiv (approx. USD 30 mln), Kharkiv (USD 19.8 mln) and Odessa (USD 13.9 mln).

The Ukrainian municipal bond market grew dramatically in 2005. Economic growth and favorable market conditions spurred new municipal issues. Overall, there were 10 new issues with a total volume of UAH 350 mln (USD 66 mln). In 1H06 Vinnytsya and Ivano-Frankivsk entered the market with relatively small issues. In 2H06 Komsomolsk, Donetsk and Vinnytsya issued bonds, we expect new issues to appear, but the overall volume is unlikely to surpass the volume of issues in 2005.

New municipal issues



Source: SSEC

Background

In total, there have been less than four dozen Ukrainian municipal bond issues. In 1995-1998, 16 municipal issues were made with a total volume of about USD 150 mln, none of which are still in circulation. The largest issues were those of the Autonomous Republic of Crimea, Odessa, Kyiv and Dnipropetrovsk. All, except for one Odessa issue, were redeemed on schedule.

There was insufficient regulation of the municipal bond market before 1998, and some municipalities were governed by ex-Soviet officials who were incompetent in managing debt. Interest rates were very high, maturity terms were very short, and the volumes of issues were predominantly small.

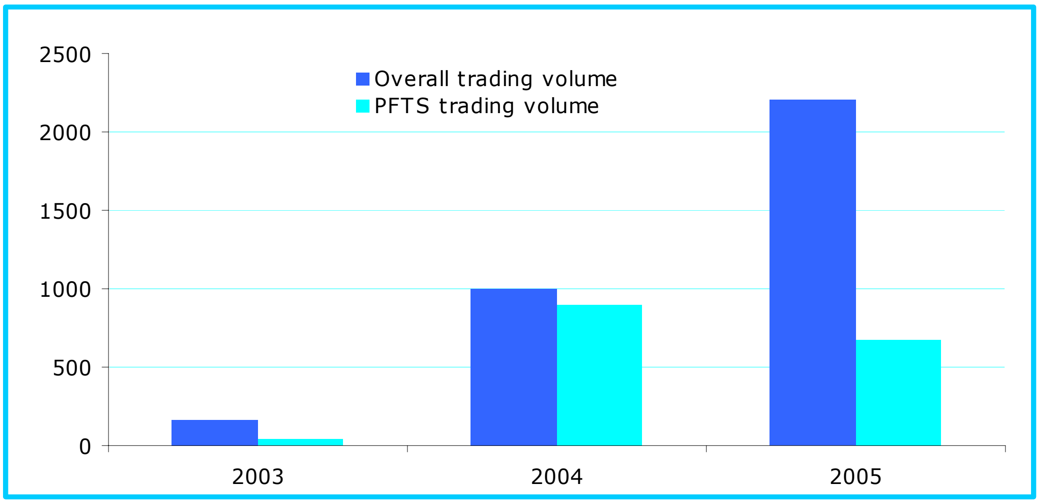
Default case. In 1998, the market suffered a blow after a default on a municipal bond issued by the city of Odessa. The issue was made in 1997 for UAH 61 mln (par value, which was then about USD 33 mln), and had a yield of 50 percent, which was to be paid in a year, together with the principal redemption. The issue received a B+ credit rating from Fitch. It was reported that the investors included individuals, municipal enterprises, local banks and foreign investors such as the Bank of New York, Credit Suisse First Boston, Goldman Sachs.

Authorities planned to refinance the debt from the proceeds of a planned Eurobond issue, which they believed would have a lower coupon and higher volume. However, the plan failed and the central government refused to bail out Odessa.

Secondary Market

Trading in municipal local bonds is conducted through the PFTS electronic trading system and over-the-counter. Trading on the PFTS dominated during 2004, but OTC trading has dominated since 2005.

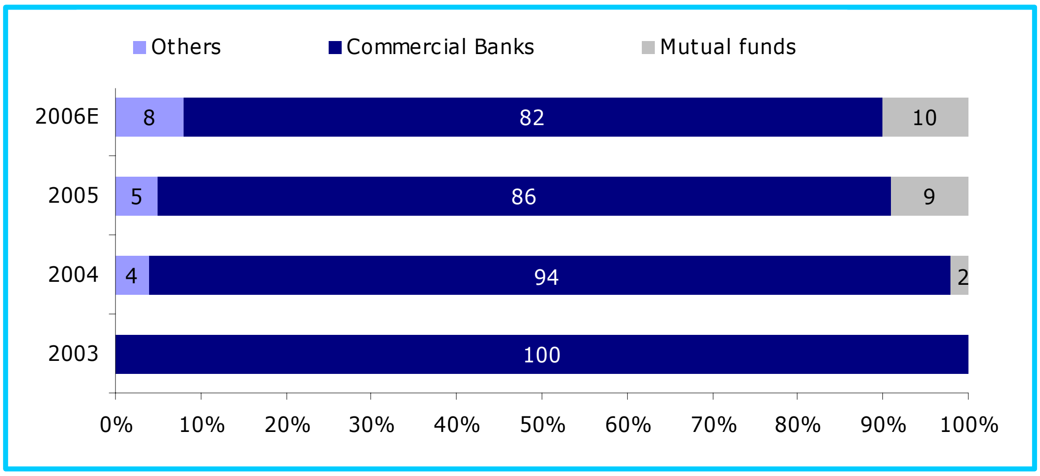
Secondary market trading volume, UAH mln



Source: SSEC

Local commercial banks are the leading players in the municipal bond market. However, in recent years local mutual funds and investment companies have been taking increasing shares.

Secondary market participants (PFTS+OTC)



Source: Concorde Capital, SSEC

All outstanding municipal bonds are listed on the PFTS. The PFTS' Index Committee divides municipal bonds into three tiers.

Among the first tier, the most traded municipal bonds on the PFTS in 2005 were Kyiv City Council (Series A) and Kharkiv City Council (Series A). Among the second tier, the most traded bonds were Donetsk City Council (Series B), Zaporizhya City Council (Series D) and Donetsk City Council (Series C). Currently, there are no municipal bond issues listed on the third tier.

PFTS listed municipal bonds, as of Oct. 17, 2006

Issue	PFTS ticker	Issue volume, UAH
Cherkasy, (A series)	OCHERA	5 000 000
Donetsk (A series)	ODONC	20 000 000
Donetsk (B series)	ODONCB	45 000 000
Donetsk (C series)*	ODON2C	50 000 000
Ivano-Frankivsk, (A series)	OIVFRA	5 500 000
Kharkiv (A series)	OHARA	100 000 000
Komsomolsk (A series)*	OKOMSA	8 000 000
Kyiv (A series)	OKYIV	150 000 000
Odessa (A series)	OODESA	50 000 000
Odessa (B series)	OODESB	70 000 000
Odessa (C series)	OODESC	30 000 000
Vinnytsya (A series)	OVINRA	8 000 000
Vinnytsya (B series)*	OVINRB	8 000 000
Zaporizhya (A series)	OZAPR	25 000 000
Zaporizhya (B series)	OZAPRB	25 000 000
Zaporizhya (C series)	OZAPRC	20 000 000
Zaporizhya (D series)	OZAPRD	20 000 000
Zaporizhya (E series)	OZAPRE	10 000 000

**bonds issued in the 2H06*
Source: PFTS

Municipal bonds were the only type of securities whose PFTS trading volumes decreased in 2005 to UAH 0.67 bln, which was 75.3% of the level in 2004 (4.61% of the total volume of the PFTS in 2005). The decrease was caused by commercial banks reducing the number of so-called "technical trades" compared to the previous year (see more on technical trades on page 58).

Commercial banks accounted for 99% of trading in municipal bonds on the PFTS in 2005. Commercial banks with foreign ownership (all or part) accounted for 30% of trading, while local investment companies accounted for only 1% of the total volume.

Turnover and Liquidity

Municipal bonds are traded by about a dozen brokers (mostly commercial banks), around half of which trade on a regular basis. The average trade volume concluded on the PFTS is UAH 5 mln (approximately USD 1 mln). Bid-ask spreads of municipal bonds are not significantly wider than those of sovereign bonds. However, the spreads and turnovers range significantly depending on the individual security.

Trading turnovers and bid-ask spreads, as of Oct. 31, 2006

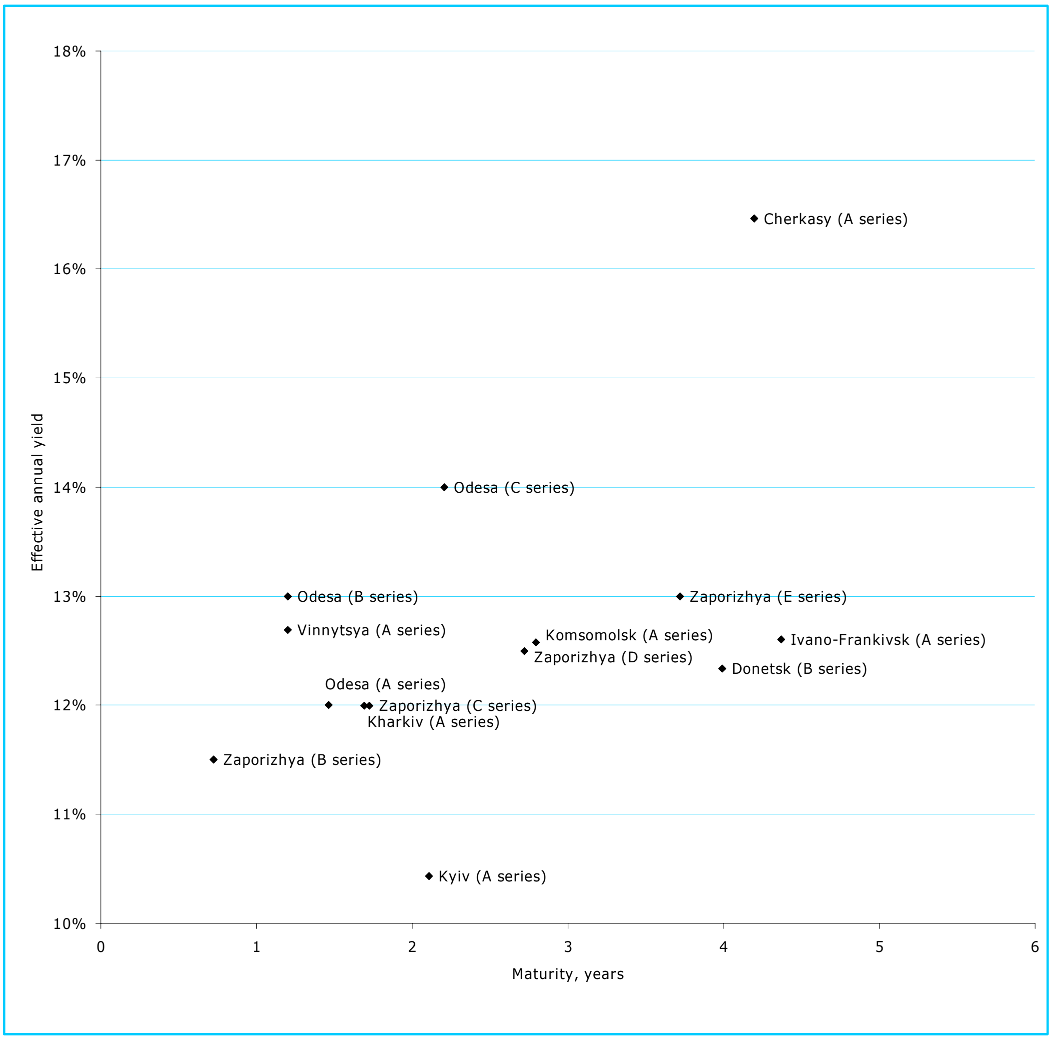
	Bid-ask spread	Annualized turnover
Zaporizhya (D series)	2.5%	325%
Odessa (B series)	0.4%	319%
Kharkiv (A series)	1.7%	308%
Odessa (A series)	0.2%	241%
Zaporizhya (C series)	1.7%	215%
Zaporizhya (B series)	0.7%	213%
Donetsk (B series)	6.9%	106%
Zaporizhya (E series)	3.3%	100%
Kyiv (A series)	0.5%	31%
Donetsk (A series)	7.5%	24%
Odessa (C series)	n/a	19%
Zaporizhya (A series)	n/a	6%
Cherkasy, (A series)	7.1%	2%
Ivano-Frankivsk, (A series)	11.6%	1%
Vinnytsya (A series)	4.9%	0%

Notes: Issues made in the 2H06 are not included.
Source: PFTS, Concorde Capital

Yield Map

The spreads of municipal bonds over sovereign bonds normally range from 30 bps to 300 bps. The closest to the sovereign curve is the Kyiv issue, while other issues are often traded with much wider spreads.

Municipal yield map, as of Oct. 17 (based on PFTS bid quotes)



Source: PFTS, Concorde Capital

Credit Ratings

Current legislation requires municipalities to have independent credit ratings before they can issue bonds. All local issues have ratings assigned either by the local agency Credit-Rating or by a globally recognized agency. The credit quality of Ukrainian municipalities is also regulated by the Budget Code, which limits debt servicing at 10% of local budget expenditures.

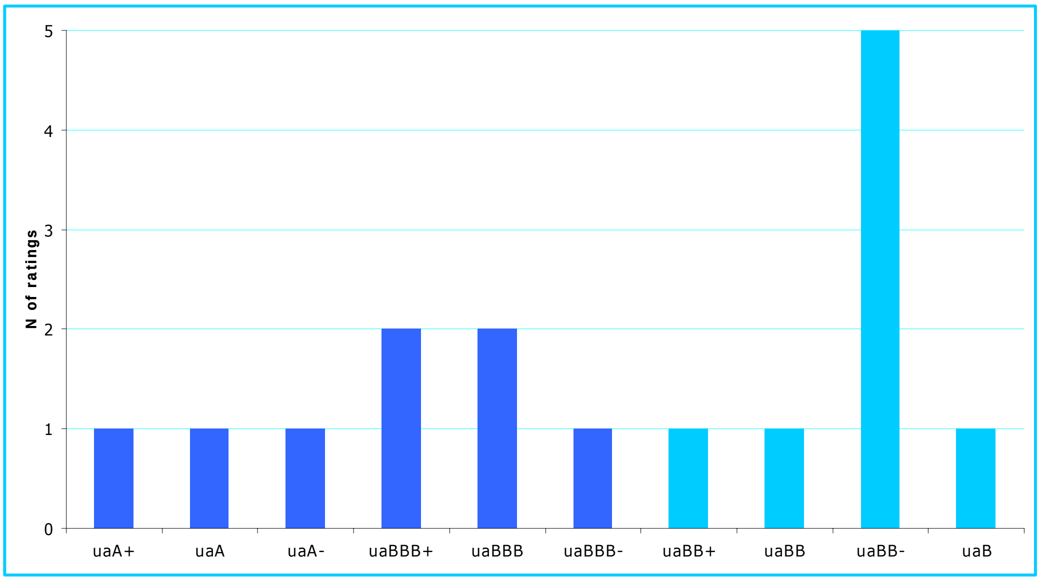
Municipal credit ratings

	S&P		Moody's		Fitch		Credit-Rating
	GRS	NRS	GRS	NRS	GRS	NRS	NRS
AR of Crimea	B+	uaA+					
Brovary							uaBBB-
Cherkasy							*uaBBB*
Dnipropetrovsk	B+	uaA+					
Donetsk							uaA-
Ivano-Frankivsk	*B+*	*uaA*					*uaBBB*
Kamenets-Podilsky							uaBB+
Kharkiv			B2		B+		uaA
Komsomolsk							uaA-
Kyiv	BB-		B2				
Odessa					B+		uaBBB-
Sevastopol							uaBB+
Vinnytsya							*uaBB*
Zaporizhya							*uaA-*
Ukraine	BB-	uaAA	Ba3		BB-	AA+(ukr)	

Notes: (1) The table includes municipalities that don't have outstanding issues; (2) ratings in italics are of bond issues, ratings in plain text are of the issuers; (3) GRS is the Global Rating Scale; NRS is the Ukrainian National Rating Scale.
Source: Credit-Rating, Bloomberg, Cbonds, S&P, Moody's

The majority of ratings for Ukrainian municipalities were assigned by the local ratings agency, Credit-Rating. According to its national rating scale, 50% of municipality issues received an investment grade rating. Ukrainian legislation bans insurance companies and pension funds from investing in securities that do not have investment grade ratings on the national scale by an authorized agency (Credit-Rating, S&P, Moody's and Fitch).

Proportion of high grade and high yield municipal issues



Source: Credit-Rating

Prospects

We expect a few more cities and medium-sized towns to make municipal bond issues by the end of the year. The most interesting planned issues are one from Odesa (UAH 100-200 mln) and a debut issue by Dnipropetrovsk (UAH 100 mln).

There are also plans for smaller cities and towns such as Vinnytsya, Luhansk, Brovary and Berdyansk. Due to the low volumes of these issues, they are unlikely to attract broad interest and are more suitable to commercial banks and investors adhering to a buy-and-hold strategy.

In the medium-term, we expect administrative reforms giving municipalities more financial and administrative independence. It is also possible that municipal issues' interest payments will be exempted from taxation in the future and amendments to the Budget Code will be made establishing a limit for outstanding debt to local budget expenditures. If the majority of these reforms are implemented including lifting the restrictions on oblasts (regions), then we expect the outstanding volume of municipal bonds to exceed USD 1 bln by the end of 2008.

Local Bonds – Corporate

- **Unlike all other Ukrainian fixed income market sectors, local corporate bonds are distinguished by the enormous presence of non-market issues – at an estimated 2/3 of all bonds.**
- **The market universe is characterized by high, double digit yields and predominantly short durations (under one year).**
- **Typical features of local corporate bonds are put options and an annual revision of coupon rates.**
- **Until recently all outstanding corporate issues had speculative grades according to global ratings scales. With only one default, Ukrainian speculative bonds prove to be one of the least risky globally.**

Types of Securities

There are three basic types of corporate bonds defined in Ukrainian legislation: coupon bonds, discount bonds and Ukrainian commodity bonds.

> **Ukrainian Commodity Bonds.** These bonds are structured differently from bonds in other markets. At maturity they do not yield cash to their holders, but instead give the right to receive commodities or services from the issuer, as stipulated in the indenture. These bonds do not pay any interest as a rule.

While the most popular type of corporate bonds are coupon bonds, discount bonds are not popular in Ukraine. There have been less than two dozen discount bond issues, almost all issued by financial and construction companies. Ukrainian commodity bonds are commonly issued by construction companies as an instrument to sell real estate on the primary market, both to individuals and businesses.

Ukrainian corporate bonds are mainly debenture bonds, which are not secured by any specific property or collateral.

We expect new types of debt instruments to appear on the market by the end of 1H07. A recently adopted law, "On Securities and the Stock Market," allows issues of mortgage-related securities and convertible bonds. However, the SSEC is still in the process of developing subordinate regulations needed to fully implement the new debt instruments.

Due to an overall policy of legal liberalization, we also expect the SSEC and the NBU to develop regulations permitting bond issues with principal and coupon payments in foreign currencies.

Market and non-market issues. Corporate bond issues can be divided into two categories: market and non-market. Non-market bond issues are those issued to related parties and not to the broad market.

The information agency Cbonds divides the market into these two categories, which we will use in our research. However, since Cbonds is not the only entity that breaks down the bond market; other breakdowns will vary slightly depending on the methodology. According to Cbonds, as of the beginning of this year 33% of local corporate bonds were market issues and 67% were non-market.

Maturities. Ukrainian corporate bonds have short maturity dates of about 3 years. Non-market issues generally have longer maturity dates and distort the picture of the market's maturity structure.

Maturity structure of the corporate bond market, years

	All	*Market*	*Non-market*
Weighted average	4.87	3.29	7.30
Standard deviation	4.71	1.64	5.34
Median	3.00	2.99	2.99
Maximum	32.02	11.01	32.02

Source: Concorde Capital

Coupon payments frequency. Ukrainian companies make coupon payments more frequently than in developed countries. The overwhelming majority of Ukrainian corporate bonds pay coupons quarterly, and other frequencies are rare.

Foreign currency linkage. Some bonds have a coupon that is set in a foreign currency but payable in the hryvnya equivalent: Grisan (series 1-A), Arkada-Fond (series 2-J) and Otdih (series 1-A).

Embedded options. Almost every corporate bond has put options. Typically put options are exercisable at twelve-month intervals (after four coupon periods). There are usually no conditions in order to exercise put option (such as a change in the interest rate or credit rating) and no limitations on how much of the issue can be put.

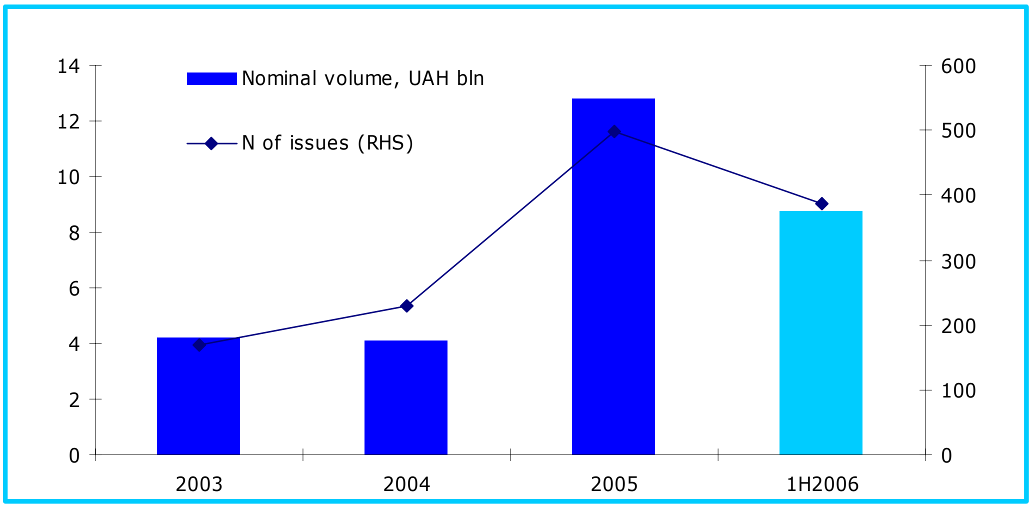
Ukrainian companies commonly issue bonds that allow them to reset the coupon rate annually. This structure helps balance the interest of issuers and bond holders. Issuers hedge against a possible fall in interest rates by giving themselves the ability to lower coupons on their issued bonds, while shielding investors from the possibility of an unfavorable change by providing annual put options at 100% of par value, which are available after the coupon rate for the next year has been announced.

Yield calculation. Most often market participants use the effective yield. Since almost all corporate bonds have put options and changeable coupon periods, market participants calculate the yield for corporate bonds in terms of the yield to the first event, either put or maturity.

Primary Market

Over the past three years, Ukrainian businesses have increasingly realized the advantages of bond debt. The volume of new registered corporate issues more than tripled in 2005 and continued with rapid growth in 1H06, when the total volume of issued bonds reached UAH 8.76 bln versus UAH 3.1 bln in 1H05.

New corporate bond issues registered by the SSEC



Source: SSEC

The number of new corporate issues has also increased rapidly from around two dozen in 2001 to 169 in 2003 and more than five hundred in 2005.

Leading underwriters, 2005

№	Underwriter	Volume of bond issues, UAH	Number of issues
1	Ukrsibbank	1,620,000,000	24
2	Ukrsotsbank	305,250,000	8
3	Khreshchatyk Bank	232,000,000	6
4	VABank	168,307,900	9
5	Raiffeisen Bank Ukraine	167,750,000	5
6	First Ukrainian International Bank	150,000,000	2
7	ING Bank Ukraine	130,000,000	4

Source: Cbonds

The local market leaders account for a relatively small share of the total volume. In 2005, the top seven underwriters of Ukrainian corporate bonds accounted for only 22% of the total volume of new issues (whereas in the U.S., the top seven underwriters had 65% of the market in 2005).

Industry Breakdown

Construction and financial companies account for 58% of all outstanding corporate bonds, 14 percentage points more than in 2004. The shares of all other industries declined in 2005 compared with the previous year.

Outstanding corporate bonds by industry at the end of 2005

Industry	Number of issues	Volume (par value) UAH, ths	Share
Construction	208	5 245 691	38.00%
Financials	99	2 778 711	20.13%
Retail & Wholesale trade	54	1 373 880	9.95%
Metals & Mining	21	1 036 000	7.50%
Transport	17	918 305	6.65%
Food & Beverage	52	825 800	5.98%
Telecoms	9	505 450	3.66%
Energy	5	456 900	3.31%
Machine building	8	330 000	2.39%
Chemicals	22	193 536	1.40%
Oil & Gas	6	140 000	1.01%
Total	**501**	**13 804 274**	**100%**

Source: Concorde Capital, Cbonds

However, when non-market issues are excluded, the breakdown is very different. Issues by financial companies dominate with a 40% share (35% in 2004), followed by issues by trading companies with 13.9% (13.8% in 2004), food & beverage with 12.8% (18.8% in 2004), metals & mining with 10.8% (5.8% in 2004), transport with 7.15% (1% in 2004) and machine building with 6.7% (9.42% in 2004). Notably, construction companies, which account for the bulk of outstanding corporate bonds, account for only 2% of market issues.

Outstanding market issues by industry at the end of 2005

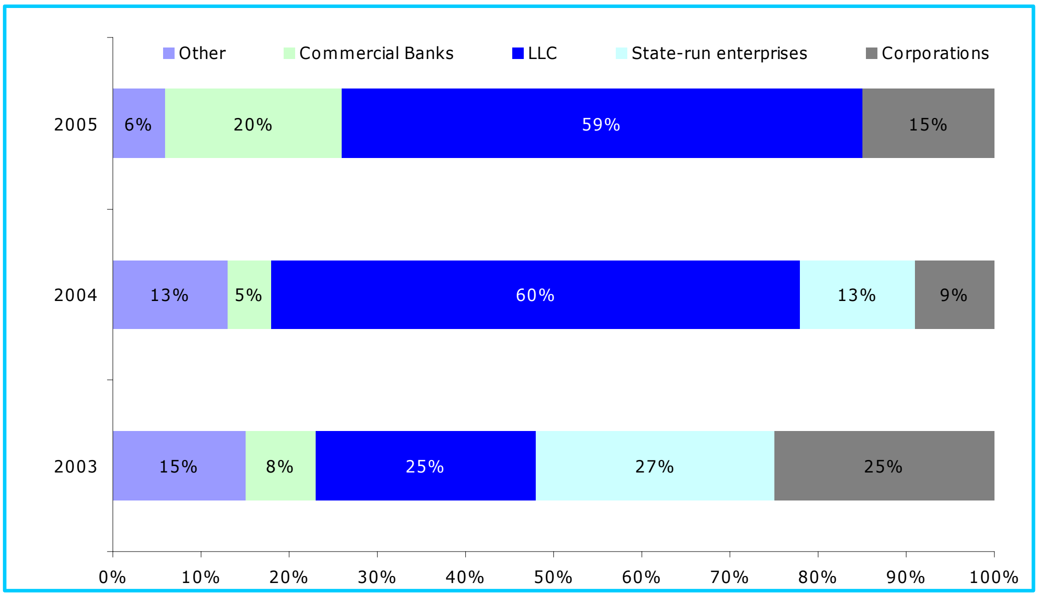
Industry	*Market issues*	*Volume (Face value) UAH, ths*	*Share*
Financials	40	1 795 500	40.00%
Retail & Wholesale trade	34	623 900	13.90%
Food & Beverage	35	576 000	12.83%
Metals & Mining	11	483 800	10.77%
Transport	3	321 000	7.15%
Machine building	5	300 000	6.68%
Oil & Gas	6	140 000	3.12%
Construction	8	111 200	2.48%
Chemicals	9	76 500	1.70%
Telecoms	3	40 000	0.89%
Energy	3	21 000	0.47%
Total	**157**	**4 488 900**	**100%**

Source: Concorde Capital, Cbonds

Breakdown of Issuer Types

One of the most notable trends in 2003-2005 has been a decline in the share of corporate bonds issued by state-run enterprises. Steady tightening of governmental supervision finally materialized in the regulation that required state-run enterprises to receive approval from the Finance Ministry in order to issue bonds. This process has made it more difficult for state-run enterprises to issue bonds, while allowing the Finance Ministry to limit the possibility of abuse by the managers of state-run enterprises.

Market breakdown by legal type of issuer



** Corporations include open and closed joint-stock companies*
Source: SSEC

The breakdown by issuer types shows that limited liability companies (LLCs, in Ukrainian: TOVs) dominated the market with a 59% share in 2005.

However, the true leading players are joint-stock companies (OJSCs and CJSCs), which sometimes create LLCs as SPVs to issue bonds. Some of these LLC issues are guaranteed by the parent corporations. According to Ukrainian legislation, corporations (open and closed joint stock companies) are forbidden from making issues with volumes exceeding 100% of their charter capital.

However, in 2008 Article 8.3 of the law “On Securities and the Stock Market” takes effect allowing corporate enterprises to issue bonds with volumes of up to 300% of their charter capital, which will cause a significant change in the issuer breakdown.

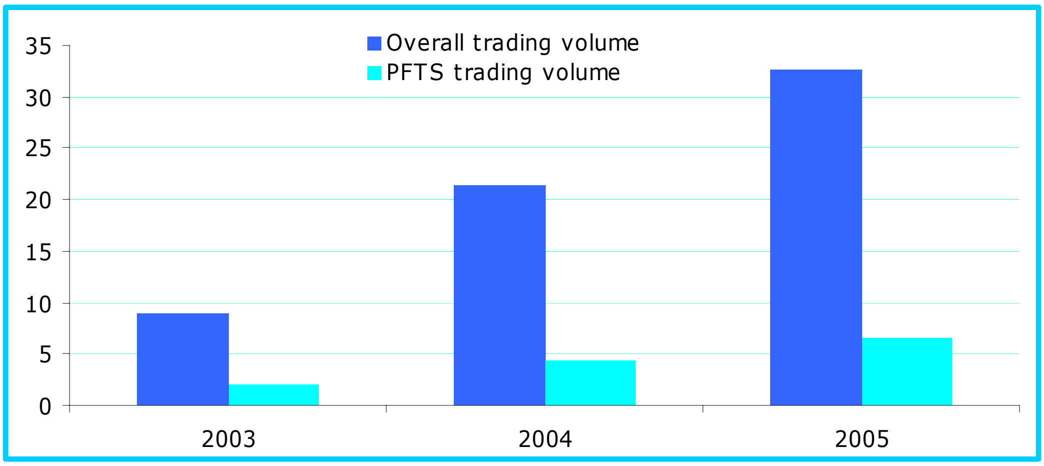
Secondary Market

The principal secondary market for Ukrainian corporate bonds is over-the-counter. The important issue is transparency because there are no electronic reporting systems for trades and quotes like TRACE and market participants are not provided with reliable data on all the activities on the secondary market.

According to the SSEC, the share of corporate bond trading conducted on the organized market has gradually declined in recent years: it was 22.2% in 2003, 20.2% in 2004 and 19.9% in 2005. Almost all organized trading in local corporate bonds is done on the PFTS. The PFTS also plays an important role because it is still the main transparent source of information on market activity.

Secondary market trades steadily increase. According to SSEC calculations (which are based on their own methodology), the overall trading volume (PFTS+OTC) in 2003 was UAH 9 bln (USD 1.7 bln). By the end of 2004, the volume more than doubled (USD 4.2 bln). In 2005, it continued to grow, reaching UAH 32.6 bln (USD 6.45 mln).

Corporate bonds trading volume, UAH bln



Source: SSEC

The trading volume of corporate bonds on the PFTS was UAH 2 bln in 2003, UAH 4.3 bln in 2004 and UAH 6.45 bln in 2005. The growth rate of PFTS trading volumes was a little lower than the overall market: 116% in 2004 (137% overall) and 50% in 2005 (53% overall).

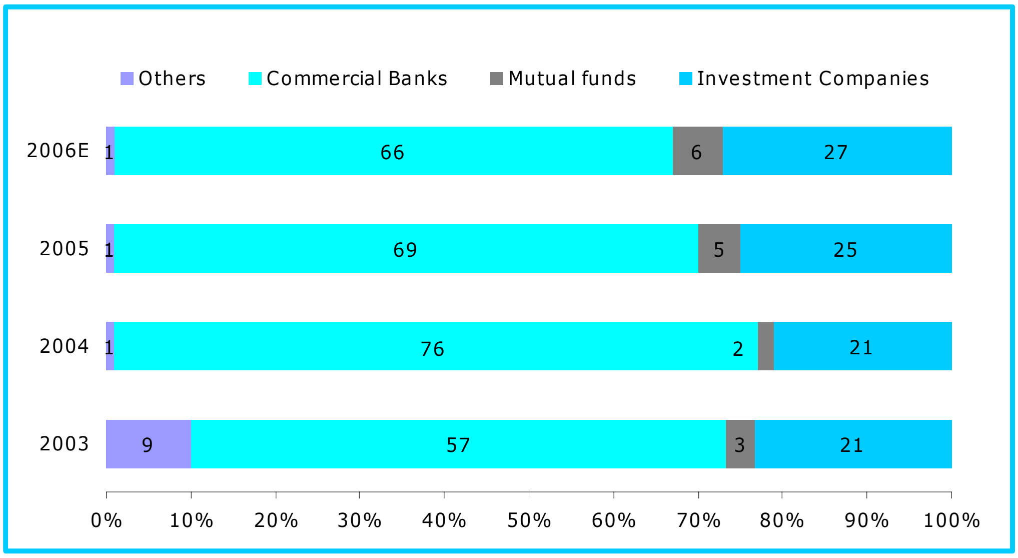
By industry, the most actively traded issues on the PFTS were in food & beverage, machine building, financial, metallurgical and trading companies.

The most actively traded corporate bond in 2005 among those listed in the PFTS's first tier were Khreshchatyk Bank (series E). Among those listed in the PFTS's second tier, the most active were ZAZ (series A), ZAZ (series B) and MCS (series A). In the PFTS's third tier, the most active corporate bonds were Metalen (series A), Newest Starch Technologies (series A) and Boryspil Airport (series A).

List of Collateral the NBU Accepts for Refinancing
In a way, a guide to the liquidity and quality of local corporate bonds has been provided by the NBU in a regulative letter adopted in July 2006, which define a list of the most liquid issues that the NBU might accept as collateral for refinancing commercial banks (see more on page 73). Please keep in mind that the issues selected by the NBU were chosen based on the PFTS trading volumes, which might include a large amount of technical non-market deals.

The bulk of trades on the secondary market (OTC+PFTS) are made by and through commercial banks. Their share of the total market has been between 57% and 76% in recent years. The share taken by local investment companies grew from 21% in 2003 to 25% in 2005. Mutual funds have also increased their share of the market, but in 2005 it was still only 5%.

Secondary market participants (PFTS+OTC)



Source: SSEC

In PFTS trading, commercial banks are much more dominant, with 98% of PFTS corporate bond trades in 2005 (banks with foreign ownership accounted for 16%). Investment companies made up only 2% of the total PFTS corporate bond trading volume.

One of the reasons that commercial banks account for a larger share of PFTS trading than in overall trading is that they make large amounts of technical trades on the PFTS.

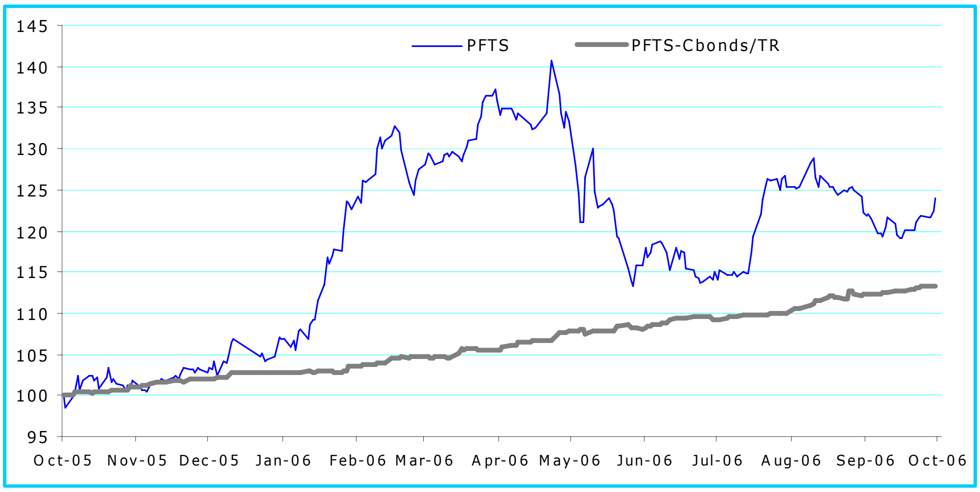
These **technical trades** are used by commercial banks to avoid transferring funds for regulatory capital purposes in accordance with NBU requirements.

As the market becomes more mature, commercial banks will account for a diminishing share of both the organized and OTC markets, while the shares of mutual funds and investment companies will increase.

The PFTS-Cbonds Total Return Index

The PFTS calculates a total return index for corporate bonds. The index represents the relative value of a fully-invested index portfolio, i.e. all coupon payments are immediately reinvested in the same index portfolio. The index was launched on October 1, 2004 with a base value of 100. For the index calculation formula see Appendix (page 72).

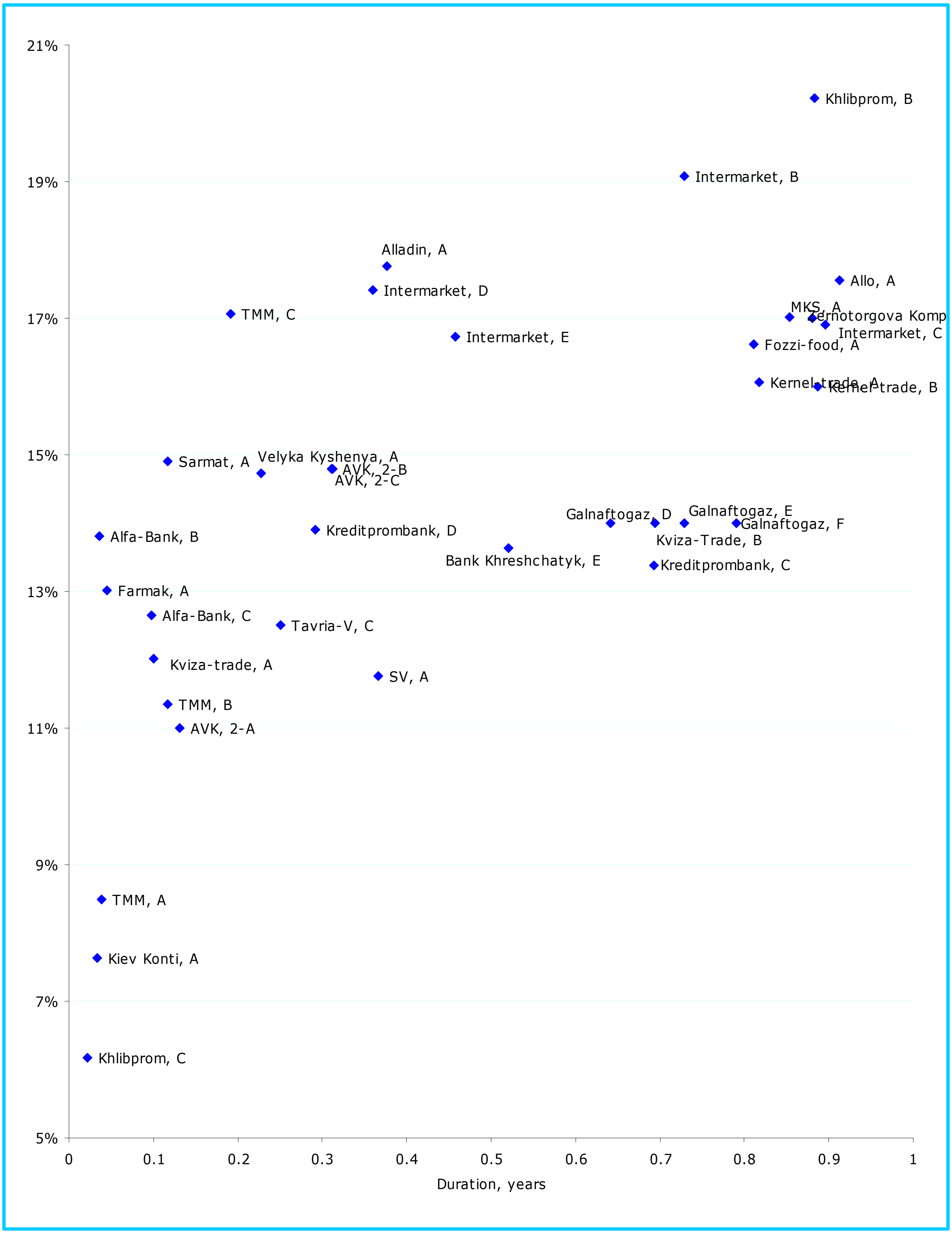
Equity (PFTS) versus Bonds (PFTS-Cbonds/TR)



Rebased as follows: PFTS (20.10.05 330.24=100); PFTS-Cbonds/TR (20.10.05 114.43=100)
Source: PFTS, Concorde Capital calculations

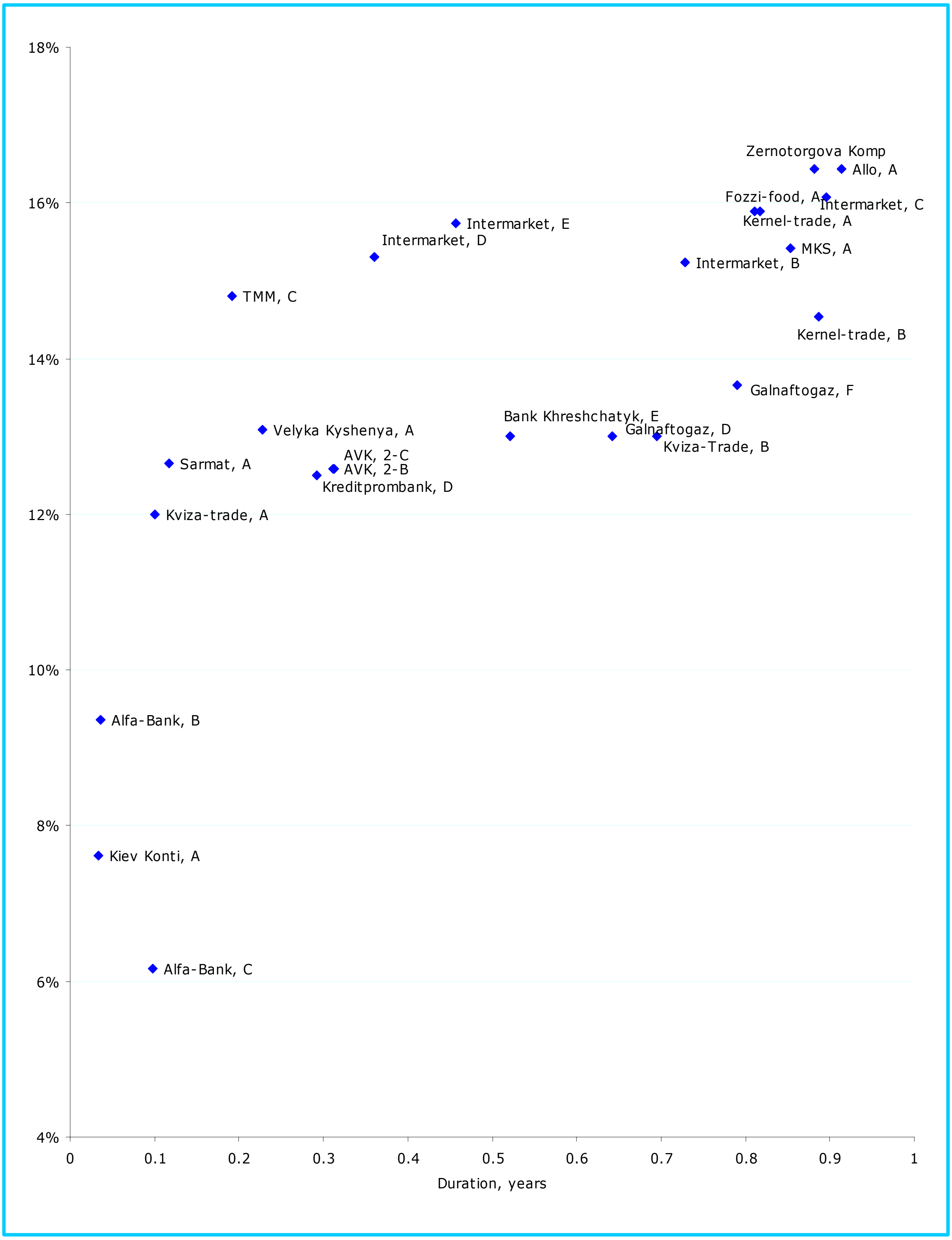
Over the last twelve months (Oct. 20, 2005 – Oct. 20, 2006), local corporate bonds yielded 13.3%, as displayed by the PFTS-Cbonds portfolio, which was quite attractive reward for the risk assumed. The PFTS equity index struggled with dramatically higher volatility to an unimpressive 23.9%.

Corporate yield map (PFTS bid quotes as of Oct. 30, 2006)



Source: PFTS, Concorde Capital

Corporate yield map (PFTS ask quotes as of Oct. 30, 2006)



Source: PFTS, Concorde Capital

Credit Ratings

According to global rating scales all outstanding corporate issues have speculative grades.

Most Ukrainian corporate bond issues are rated by the local ratings agency Credit-Rating, which has assigned more than 200 corporate ratings. Only a few dozen so far have been rated by one of the three major global ratings agencies (S&P, Moody's and Fitch).

However, the global agencies are seeking to expand their local presence. All three recently introduced National Rating Scales.

> Credit ratings within a **National Rating Scale (NRS)** indicate the relative creditworthiness of issuers and issues within one country and thus provide for better credit differentiation than a global rating scale.
>
> Each national rating scale has its own common rating symbols modified by a respective country marker (e.g. for Moody's: Aaa.ua for the Ukrainian NRS or Aaa.ru for the Russian NRS; S&P: uaAAA, ruAAA; Fitch: AAA(ukr), AAA(rus)). They are not designed to be compared across countries. Investors requiring internationally comparable ratings should use a global rating scale (GRS).
>
> The national ratings of uaAA and AA+(ukr) with stable outlooks were assigned to Ukraine by S&P and Fitch respectively. These ratings have been set as the benchmarks to evaluate the credit quality of other local issuers.

Despite the fact that Credit-Rating has more experience in Ukraine after assigning more than 200 corporate ratings, Credit-Rating lacks the reputation and credibility of international agencies. Foreign agencies also have disadvantages: they are not present locally, making it harder to evaluate the real credit quality of Ukrainian companies; and on average their services are four times as expensive. The expense involved is one reason why so few ratings have been assigned by international agencies.

Credit Ratings of Ukrainian Issuers from Leading Global RAs

	S&P		Moody's		Fitch		Credit-Rating*
	GRS	NRS	GRS	NRS	GRS	NRS	NRS
Financial							
Aval			B2 /Stable				uaAA- /Stable
Bank Finance and Credit, Ltd			B2 /Stable				
Bank-NRB			B2 /Stable				
Calyon Bank			B2 /Stable				
KredoBank	B /Stable	uaBBB /Stable					
First Ukrainian International Bank					B- Stable	BBB(ukr) /stable	
Forum Bank			B2 /Stable	A1.ua			
Garant-Auto			B3/ Stable				
Index Bank			B2 /Stable				
Industrialbank					CCC Stable		
Khreshchatyk					B Stable		uaA /Stable
Kreditprombank			B2 /Stable				
Mriya Bank					BB- /Positive		
Nadra Bank			B2 /Stable		B- /Stable		uaBBB+ /Stable
Pivdenny Bank			B2 /Stable		CCC+ /Stable		uaBBB+ /Stable
Pravex Bank			B2 /Stable				
Privatbank			B2 /Stable		B /Stable		uaBBB+
ProCredit Bank					BB- /Stable		
TAS-Commercebank			B2 /Stable		B- /Stable	BBB-(ukr)/Stable	uaBBB+ /Stable
Ukreximbank			B2 /Stable		BB- /Stable	AA(ukr)/Stable	
Ukrgazbank			B2 /Stable				uaBBB /Stable
Ukrsibbank			B2 /Stable		BB- /Stable		
Ukrsotsbank	B- /Positive		B2 /Positive		B- /Positive		
VABank			B2 /Stable				
Non-financial							
Kyivstar	BB- /Stable		B1 /Positive				
Naftogaz			Ba3 /Stable		B+ /Negative		Withdrawn
Zaporizhstal			B3 /Stable				

**Notes: Credit-Rating's NRS has been added for comparison. GRS is the Global Rating Scale; NRS – Ukrainian National Rating Scale*
Source: Credit-Rating, Bloomberg, Cbonds, S&P, Moody's, Fitch

Almost all ratings by the leading global ratings agencies have been appointed to commercial banks and other financial institutions, while non-financial companies have tended to choose Credit-Rating.

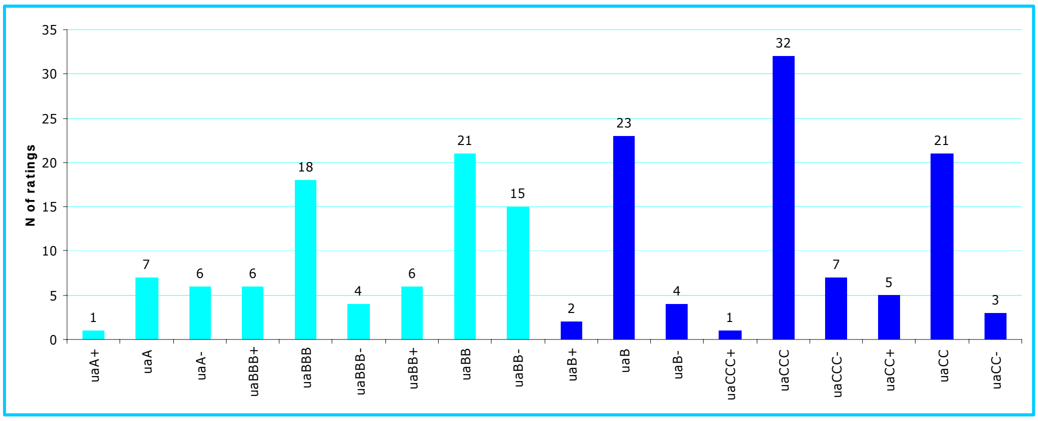
Breakdown by Rating Grades

Global Rating Scales. All outstanding Ukrainian corporate issues have speculative grades with the exception of the issue of Calyon Bank Ukraine (M: Baa3).

National Rating Scales. Although the investment grade bar is lower in national rating scales, the majority of issues still have speculative grades.

Because international agencies have not assigned significant numbers of ratings, we rely on Credit-Rating's ratings for our breakdown of the high grade and speculative grade sections of the market. According to its national scale, 22% of issues by non-financial companies have investment grade ratings and 78% are speculative grade.

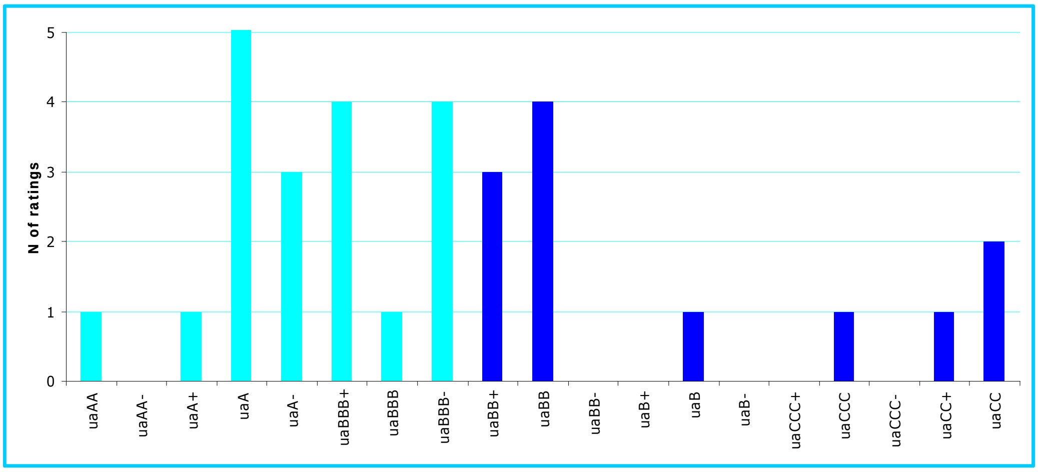
Proportion of high grade and high yield ratings of non-financial companies



Source: Credit-Rating

In contrast, 63% of issues by financial companies (mainly commercial banks) have investment grade ratings and only 37% are speculative grade.

Proportion of high grade and high yield ratings of financial companies



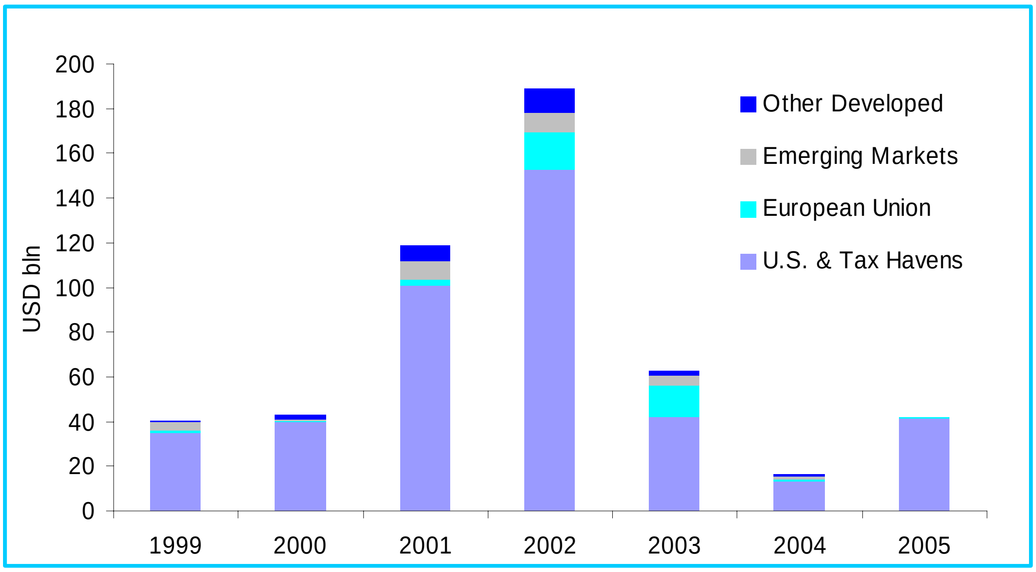
Source: Credit-Rating

Default Rates

There has been **only one default** on the Ukrainian corporate bond market. The default last year by Agroproduct (uaB+) raised the corporate default rate of Ukrainian corporations from zero to 0.36%. If only market issues are considered, the default rate is 1.11%. However, even that rate is lower than the global default rate and much lower than in many developed economies.

The defaulted amount was equal to USD 10 mln. According to S&P, it constituted only 0.02% of the global amount of defaulted bonds (USD 42.1 bln) in 2005.

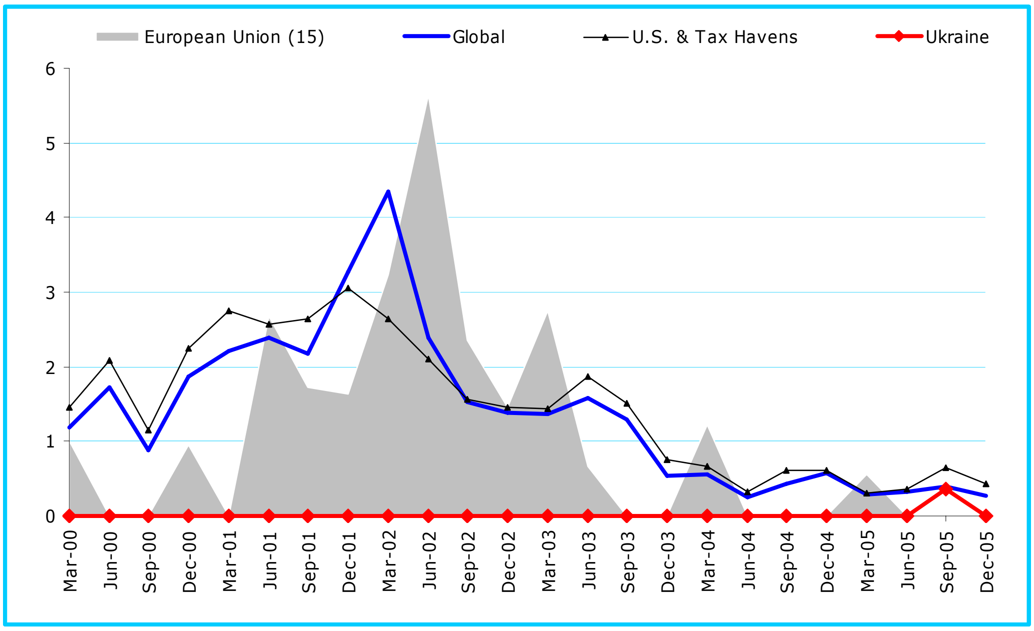
Total global corporate defaulted debt



Notes: Tax Havens: Bermuda and the Cayman Islands.
Source: S&P

Ukrainian high yield bonds prove to be one of the least risky globally. For the last six years (2000-2005), the average of quarterly default rates for speculative grade bonds globally was 1.38%. The average was 1.47% for the U.S. and 1.08% for EU-15 countries. For Ukraine, the rate stands at a comparatively low level of 0.02%.

Speculative grade quarterly default rates, %



Notes: Tax Havens: Bermuda and the Cayman Islands.
Source: S&P, Concorde Capital

The Agroproduct-Agroexport Default Case

The first series (A) of defaulted bonds were issued in April 2003 and a second series (B) in May 2005. Agroproduct LLC's bonds were guaranteed by its mother corporation OJSC Agroexport and underwritten by Alfa Bank. The indentures stipulated a semiannual put option; the first issue initially had a coupon rate of 18%, but when the second issue was made with a 17.5% coupon, the first issue's coupon was lowered to 17.5%.

There were many red flags concerning the company's financial situation before the second issue. However, it was successfully placed and Credit-Rating assigned a *uaB+* rating with a positive outlook.

Agroexport financials

	2002	2003	2004
EBITDA, USD mln	25.4	8.1	32.7
EBIT, USD mln	23.5	4.0	24.1
EBITDA/ Interest, times	10.1	0.6	1.4
EBIT /Interest, times	9.4	0.3	1.0

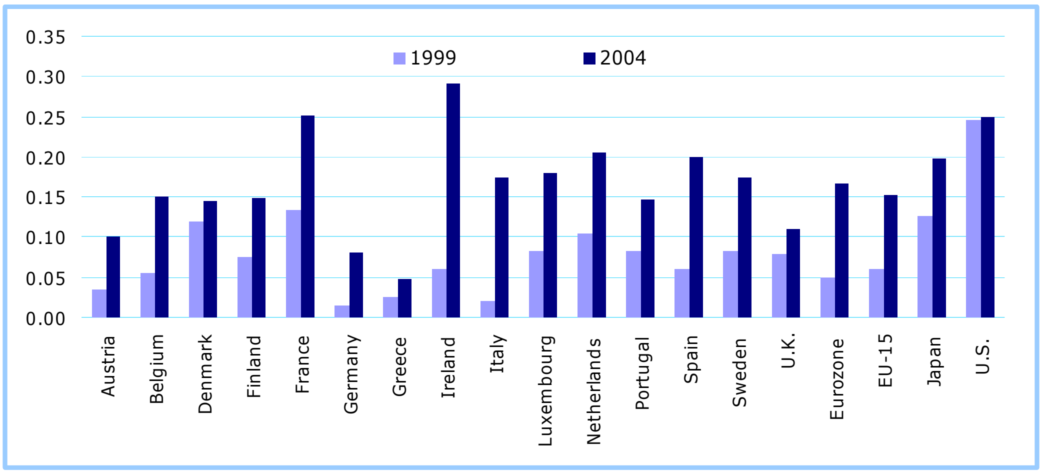
Source: Agroproduct investment memorandum

Agroproduct failed to make the first coupon payment for its second issue in August 2005. Initially Agroexport Group management convinced investors to enter negotiations, which postponed the announcement of the default until early 2006.

Prospects

The ratio of outstanding corporate bond debt to GDP has increased from 2001 to 2006 from 0.3% to 3.3%, while the nominal outstanding volume increased more than 20 times. The ratio in Ukraine is higher than the respective ratio in Russia (2.7%) but is still much lower than in other developing and developed countries.

Corporate bond debt relative to GDP

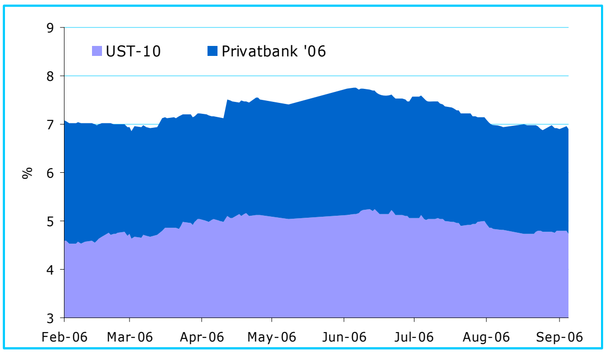


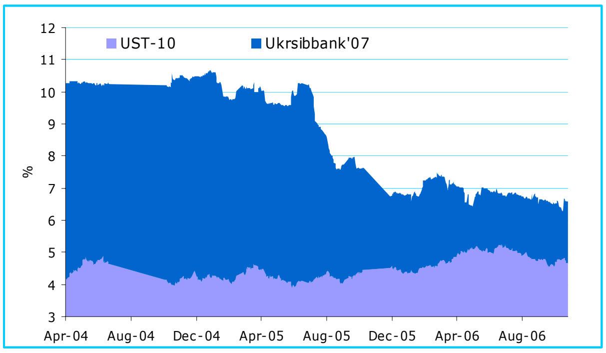
Source: Jean-Pierre Casey, Karel Lannoo. Evolution, Architecture and Regulation of the European Bond Market, Centre for European Policy Studies, Brussels, 2005

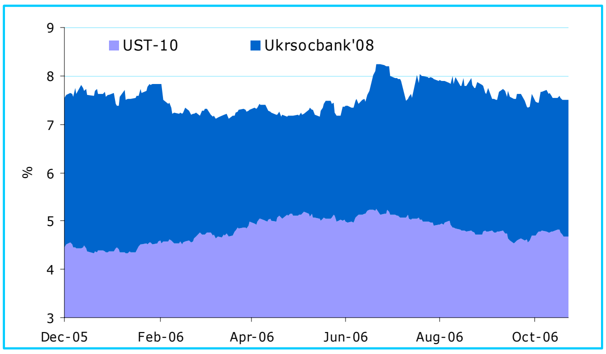
In recent years, almost all European countries dramatically increased their ratios of corporate bond debt to GDP. We expect Ukraine to follow this trend and forecast the total outstanding corporate bond debt to GDP ratio to exceed 10% by the end of 2010. We also expect the share of non-market issues to be negligible by that time.

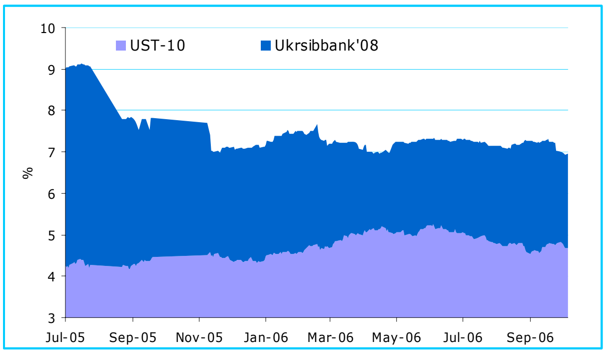
APPENDIX

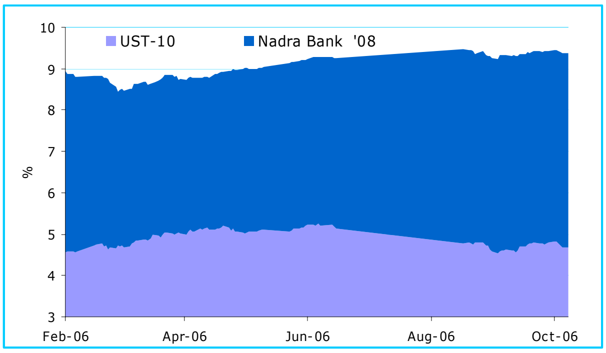
Corporate Eurobonds: Trading History

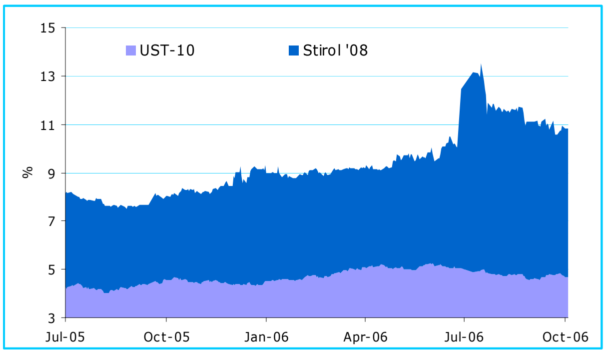


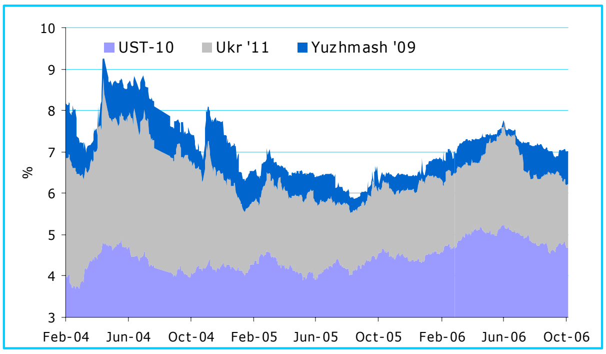


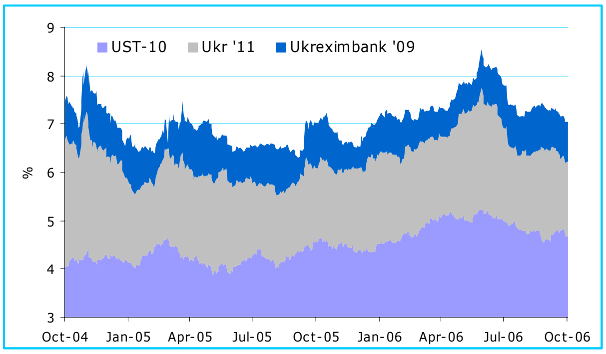






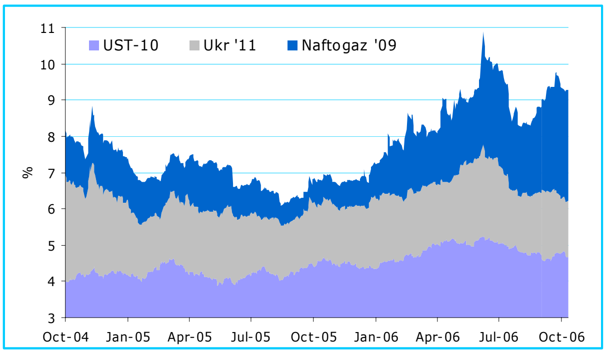


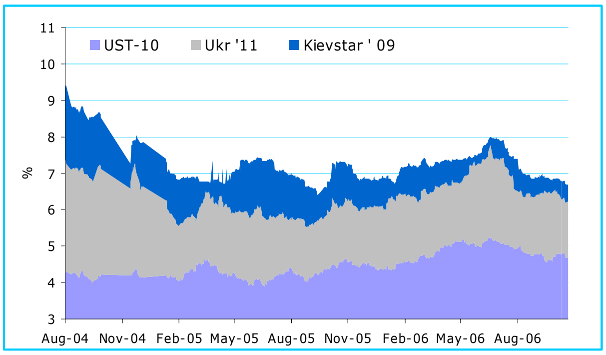


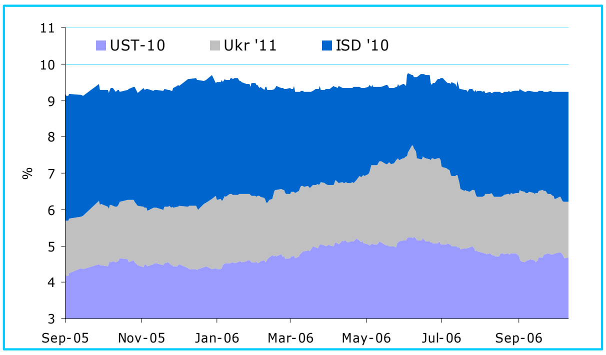


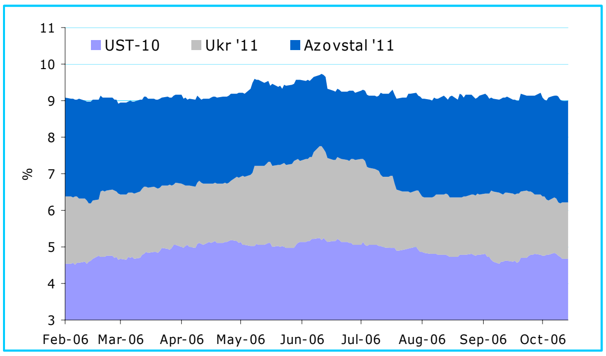
Source: Bloomberg, Concorde Capital

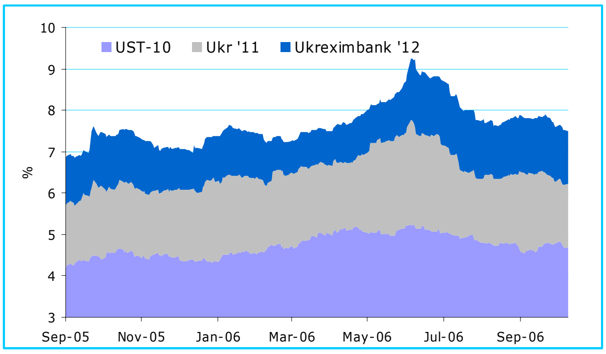
Corporate Eurobonds: Trading History

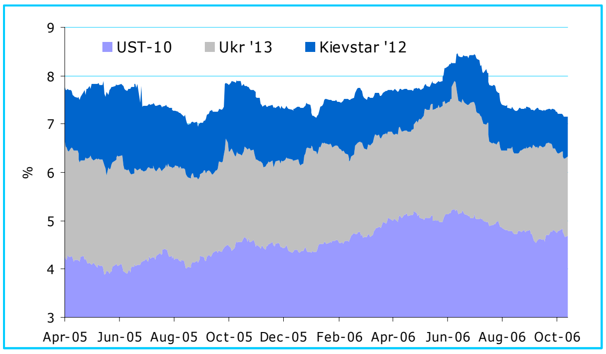


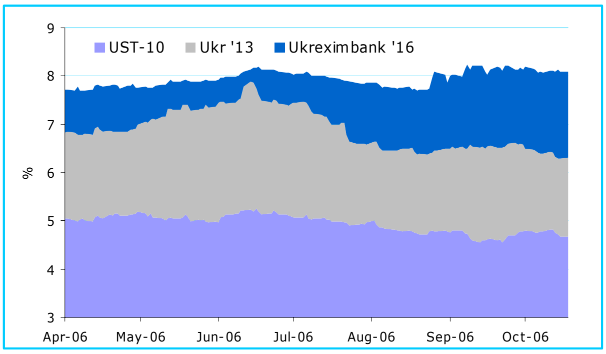


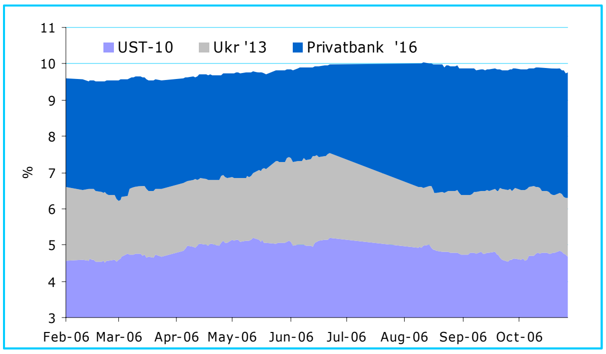






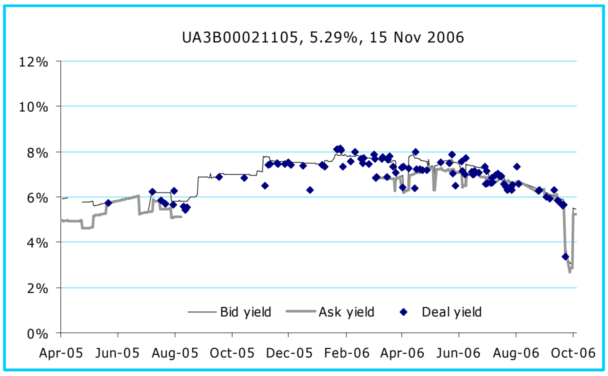


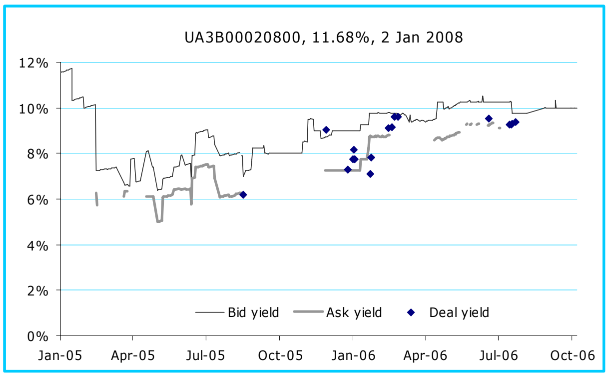


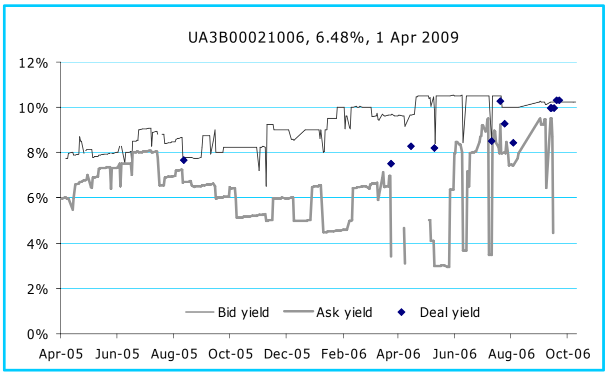


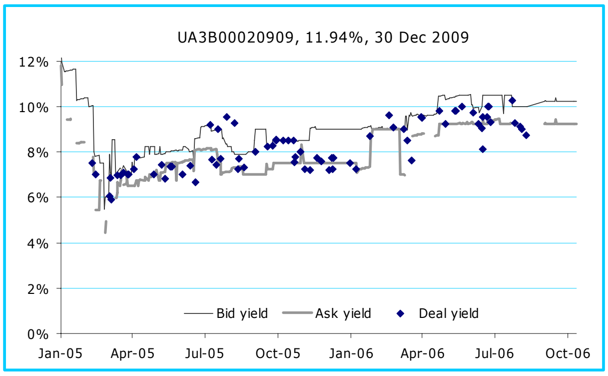
Source: Bloomberg, Concorde Capital

Local Sovereigns: Trading History









Source: PFTS, Concorde Capital

The PFTS-Cbonds/TR Index

The PFTS calculates a total return index for corporate bonds. The index represents the relative value of a fully-invested index portfolio, i.e. all coupon payments are immediately reinvested in the same index portfolio. The index was launched on Oct. 1, 2004 with a base value of 100.

The index is calculated according to the following formula:

$$TRI_t = TRI_{t-1} \times \sum_{i=1}^{n} \frac{(P_{i,t} + A_{i,t} + G_{i,t}) \times V_i}{(P_{i,t-1} + A_{i,t-1}) \times \sum_{i=1}^{n} V_i} \qquad (1)$$

$$P_{i,t} = \frac{BID_{i,t} + ASK_{i,t}}{2} - A_{i,t} \qquad (2)$$

where:

t	Current period
$t-1$	Previous period
i	i-bond issue of the portfolio
$BID_{i,t}$	Best bid
$ASK_{i,t}$	Best ask
V_i	Total par value of i-bond issue
n	Number of issues in the index portfolio
$A_{i,t}$	Accrued interest
$G_{i,t}$	Coupon payment in t-day of an i-bond

If either $BID_{i,t}$ or $ASK_{i,t}$ is not available, then: $P_{i,t}=P_{i,t-1}$

NBU Liquid Corporate Bond Universe

The National Bank of Ukraine has compiled a list of the most liquid corporate bonds (Letter of *17.07.2006 N 14-011/1671-7457),* which it might consider as collateral for refinancing commercial banks.

1. Metalen (series A)
2. Airport Boryspil
3. LuAZ (series A)
4. Zolotiy Rig (series A)
5. AVK (series A)
6. AVK (series B)
7. Odesa Champaign plant
8. Fozzi-Food (series A)
9. Kiev-Konty (series A)
10. Kernel Trade (series A)
11. Kviza Trade (series A)
12. Lugansk gofrotarniy kombinat (серія A) (series A)
13. MKS (series A)
14. Syndikat (series C)
15. T.M.M. (series A)
16. Ukrainian patoka (series A)
17. Ukrainian insurance group (series A)
18. Velyka-Kyshenya Finance (series A)
19. ZAZ (series A)
20. ZAZ (series C)
21. Cukrovik Poltanshchiny (series A)

Tax Issues for Foreign Investors

Withholding Tax

Whenever bond interest is paid, the paying agent shall levy a withholding tax of 15% unless the investor is a resident of a country which has signed a double taxation treaty with Ukraine, in this case the investor's revenues and capital gains shall be taxed at the rate indicated in the treaty. The list of the countries which have signed a double taxation treaty with Ukraine is shown in the table on below.

In order to evaluate tax at the rate in the appropriate double taxation treaty, an investor must provide a Tax Residence Certificate (Tax Exemption Certificate).

The certificate, which is valid for one year, is issued by the authorized body of the foreign country, as specified in the international treaty or in accordance with that country's legislation. The certificate must be translated and legalized, in compliance with Ukrainian legislation, and must contain the following information:

- Full name of the foreign investor's company;
- Confirmation that the foreign investor is acting in accordance with the relevant international double taxation treaty and that they are legally subject to taxation under legislation in the foreign investor's country of residence;
- Name of authorities; name, surname and signature of the authorized person within the authorities, which authenticated the confirmation;
- Date of issue of the certificate.

Countries that have signed a double taxation treaty with Ukraine

Country	Tax rate	Country	Tax rate
Algeria	10%	Italy	10%
Austria	2%(1) 5%(2)	Kazakhstan	10%
Azerbaijan	10%	Kyrgyzstan	10%
Belgium	2%(1) 5%(2)	Korean Republic	5%
Belorus	10%	Latvia	10%
Bulgaria	10%	Lithuania	10%
Canada	10%	Moldova	10%
China	10%	Netherlands	2%(1) 10%(2)
Croatia	10%	Norway	10%
Cyprus	0%	Poland	10%
Czech Republic	5%	Portugal	10%
Denmark	10%	Russia	10%
Egypt	12%	Romania	10%
Estonia	10%	Syria	10%
Finland	5%(1) 10%(2)	Slovakia	10%
France	2%(1) 10%(2)	Switzerland	0%(1) 10%(2)
Germany	2%(1) 5%(2)	Sweden	10%
Georgia	10%	Tajikistan	10%
Great Britain	0%	Tailand	10%(1) 15%(2)
Greece	10%	Turkey	10%
Hungary	10%	Turkmenistan	10%
Indonesia	10%	USA	0%
India	10%	Uzbekistan	10%
Iran	10%	Vietnam	10%

Note: (1) tax rate for financial institutions; (2) tax rate for other legal persons and individual. Please see the corresponding treaty for the tax rate applicable to specific cases.
Source: Concorde Capital

Pension Fund Tax

To buy foreign currency and repatriate it, an agent of the foreign investor, as a participant in the interbank foreign currency market and a state tax agent, is authorized to deduct a tax of **1.3%** of the purchased currency (hryvnya equivalent) for the Pension Fund of Ukraine. Please note that the tax is scheduled to be lowered to 1% in 2007, according the current draft of the State Budget.

Concorde Capital
3V Sportyvna Square
2nd entrance, 3rd floor
Kyiv 01023, UKRAINE

Tel +380 44 205 5030
Fax: +380 44 206 8366
www.concorde.com.ua
office@concorde.com.ua

CEO	
Igor Mazepa	im@concorde.com.ua
Equity Sales	
Marina Martirosyan	mm@concorde.com.ua
Lucas Romriel	lr@concorde.com.ua
Anastasiya Nazarenko	an@concorde.com.ua
Director of Research	
Konstantin Fisun, CFA	kf@concorde.com.ua
Chief Strategist	
Tom Warner	tw@concorde.com.ua
Utilities (Telecom, Energy)	
Alexander Paraschiy	ap@concorde.com.ua
Metals & Mining	
Andriy Gostik	ag@concorde.com.ua
Eugene Cherviachenko	ec@concorde.com.ua
Machine Building, Construction, Consumer Goods	op@concorde.com.ua
Olha Pankiv	
Financial Services & Macroeconomics	av@concorde.com.ua
Alexander Viktorov	
Oil & Gas, Chemicals	vn@concorde.com.ua
Vladimir Nesterenko	
Fixed Income	ok@concorde.com.ua
Oleksandr Klymchuk	
News/Production	np@concorde.com.ua
Nick Piazza	pk@concorde.com.ua
Polina Khomenko	
Editor	bw@concorde.com.ua
Brad Wells	