November 7, 2013

Naftogaz Eurobonds

State guarantee to grease the skids

We recommend that bondholders treat Naftogaz 2014 notes the same as Ukrainian government Eurobonds, since they bear the same default risk as government papers. Going further, we suggest adopting the simple notion that Naftogaz is not a financially capable entity. Therefore, the main question becomes whether the government has enough incentive to repay Naftogaz debt. We claim: yes. From that standpoint, the current negative news flow on the failures of Naftogaz to repay its debt is white noise that actually creates a unique opportunity to bottom-fish for Naftogaz bonds.

The current spread of NAFTO YTM to the Ukraine-2014 bond is close to 300bps, which is significantly above its historical mean of 140bps. Such a large spread isn't justified, we believe, since Naftogaz bonds bear the same rating as sovereign bonds do (Fitch rates both at B) and holders of NAFTO bonds effectively have the same rights as government Eurobond holders. We deem the current NAFTO price an attractive entry point.

Presidential guarantees. While Naftogaz has no internal capacity to repay its 2014 Eurobond, as well as its other obligations, allowing it to default on its Eurobonds isn't an option for the government. The bond has a state guarantee, defaulting on which that will set a negative precedent for Ukraine. The breach of an unconditional and irrevocable state guarantee will drastically impair the state's ability to raise new debt or refinance what exists. The breach will also put into question the redemption of other debt guaranteed by Ukraine's government, worth USD 11 bln out of the country's total indebtedness of USD 69.1 bln as of end-September. Moreover, such a default will be clearly negative for a president launching a re-election campaign just after NAFTO-14 matures.

Budget provision for bond repayment. It can happen that Naftogaz will receive a direct subsidy from the budget to repay its Eurobond next year. The government plans to pump UAH 14.8 bln into Naftogaz equity next year aimed at facilitating the smooth repayment of its 2014 Eurobond, according to Halyna Pakhachuk, a Finance Ministry official. This provision was reportedly included into the draft of the 2014 state budget. We have to admit that Naftogaz will need an additional injection to cover its working capital needs (to smoothly pay its bills for imported gas) of UAH 10-15 bln next year. For instance, it received UAH 16 bln in 2011, UAH 12 bln in 2012 and is expected to get UAH 18 bln this year to cover its own budget gap. So far, no information about any additional state contributions to finance Naftogaz working capital in 2014 has been disclosed. Given the previous numbers, the 2014 capital injection into Naftogaz may be a record high.

The NBU may also help. Ukraine's parliament approved on October 10 the first reading of a bill that will allow the government to issue 5%, 5-year promissory notes to compensate the difference between utility company costs and their (low) tariffs. This law was specially designed for heating companies to repay their debt for gas (which amounted to UAH 6.7 bln just in 8M13 and amounts to almost UAH 16.0 bln, as of today). The key question is whether the National Bank of Ukraine (NBU) will be ready to buy out these notes from Naftogaz, or provide refinancing to those banks that will be ready to buy them out. If the law is passed and refinancing/buyout issues are resolved, Naftogaz will receive another powerful source of financing its working capital needs.

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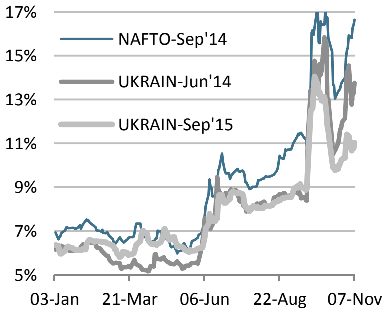
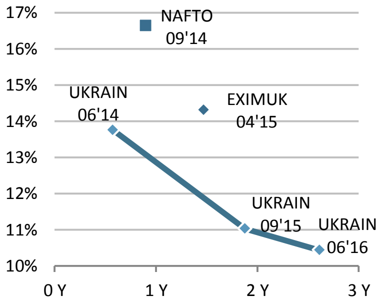
Bloomberg ticker	**NAFTO**
Outstanding, USD mln	1,595
Maturity	30 Sep. 2014
Coupon	8.25% , S/A
Fitch / Moody's / S&P	B / na / na

YTM in 2013



Source: Bloomberg

Yield map: NAFTO vs. closest peers



Source: Bloomberg

Restructured Russian loan. In October 2013, Naftogaz managed to carry over a USD 2 bln loan from Gazprombank into a long-term, state-guaranteed facility. The government's obvious desire to keep the state guarantee in effect is another reason to prevent default now, since the tool can be used to secure the other future obligations of state-controlled entities.

Worst-case scenario: postponing Eurobond repayment till November 2014. In case Naftogaz will not be able to repay smoothly its Eurobond, we see that the Ukrainian government will have no other choice but to repay on the guarantee. Our analysis of documents on state guarantees and conversations with respective officials does not enable us to clarify the technical procedure of how the state's Naftogaz guarantee will work. Based on our understanding of the issue, Ukraine's guarantee will take effect no later than ten days after Naftogaz's repayment date. As the guarantor, the Finance Ministry will have to take the NAFTO bond "at least *pari passu* with all of its other unsecured and unsubordinated obligations" (e.g. its Eurobonds). Therefore, the government will have no more than 30 days to repay. Thus, in the worst-case scenario, NAFTO-14 will be repaid on November 9, 2014, or 40 days after its maturity. Again, recall that the later the payment, the closer it will be to the official start of Ukraine's presidential election campaign (to commence in very late 2014).

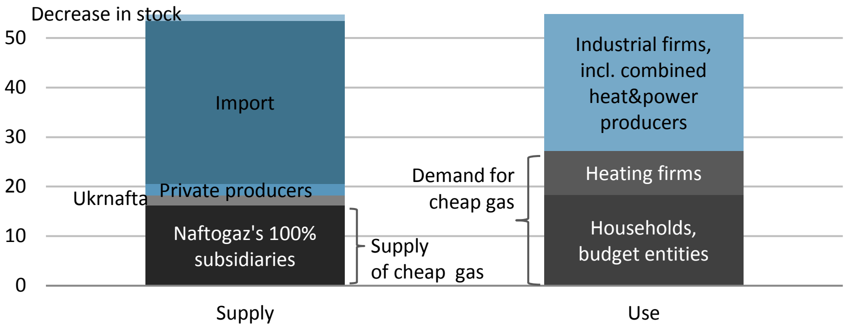
Don't treat Naftogaz as a going concern

We recommend treating Naftogaz not as a business entity, but as a subsidiary (financing vehicle) of the government. Naftogaz's business model is not sustainable, as it relies on state support to cover the difference in the price of natural gas purchased from Russia and sold to domestic heating companies (and households as well, but the official position of the government is that Ukraine sells domestically extracted gas to households).

In fact, Naftogaz can only rely on its two 100% subsidiaries as a source of cheap gas that is consumed by households (paying on average USD 93/tcm) and heating companies (paying USD 136/tcm). It even cannot rely on Ukrnafta, where Naftogaz owns 50%+1 stake, as the company's smaller shareholder directs most of the produced gas to related industrial enterprises.

Heating firms and households consume more gas than Naftogaz is producing. So they use some portion of expensive Russian gas, and this is the main source of the state monopoly's headache. The good news is Naftogaz is increasing its production while heating companies are declining their gas consumption, which should lead to a reduced Naftogaz deficit in the future.

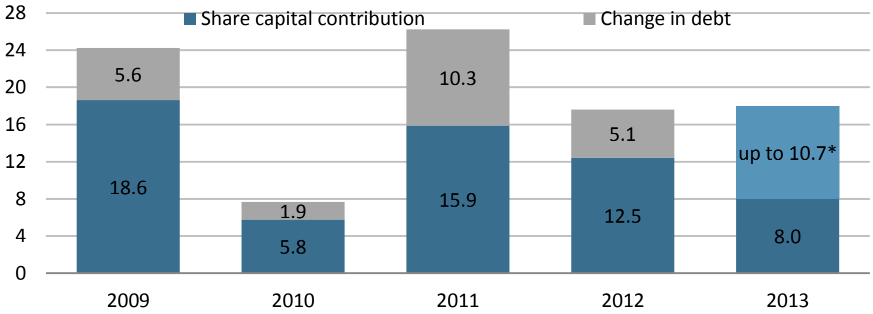
Gas market balance in Ukraine in 2012, bcm



Source: Energy Ministry, Energobiznes, Concorde Capital research

Each year, Naftogaz has to finance its gap via equity injections from the state that are paid in local state bonds, which Naftogaz sells later to the market, if necessary. The remaining deficit is covered by new loans attracted by Naftogaz.

External financing of Naftogaz, UAH bln



** May be provided from state budget as a compensation for tariff differences or as a capital contribution. That's yet to be decided by Cabinet/Parliament. Source: MinFin, Company data, Concorde Capital research*

Such a scheme is not Naftogaz's decision, but the government's policy of postponing subsidies that otherwise should have been paid directly to households and heating enterprises. To be more precise, the government has another method to support heating enterprises, which also suffer from low tariffs: in 2012, Ukraine spent UAH 7.7 bln from the state budget to support heat producers (enabling them to pay for gas) and it is scheduled to spend another UAH 5.0 bn this year.

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