New UAH sovereign bonds

Ukraine to make UAH 17.7 bln special issuance

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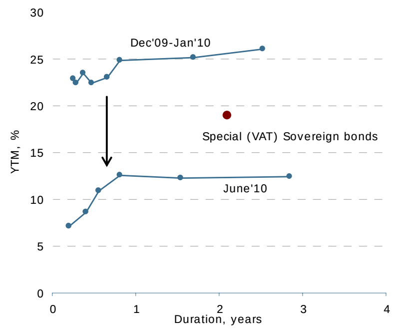
Mykyta Mykhaylychenko
mms@concorde.com.ua
+380 44 391 5577

The large-scale securitization of UAH 17.7 bln in government VAT arrears through sovereign bonds, planned this month, creates a market anomaly. We expect the bonds to be sold by primary corporate recipients at a 17%-21% YTM on the open market. This creates a potentially attractive investment as we deem the issue unique in CEE in terms of expected liquidity, backing by a sovereign government with improving credit quality, low short-term UAH forex risks.

Special (VAT) sovereign bonds

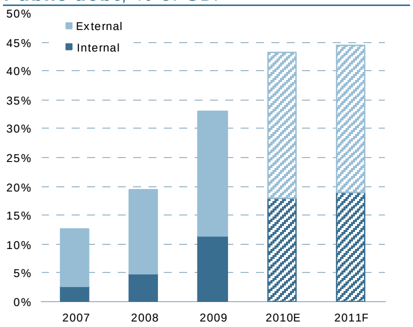
Amount	~UAH 17.7 bln (USD 2.2 bln)
Maturity, years	5 years
Duration, years (at 19% YTM)	2.1 years
Coupon	5.5%, s.a.
Sinkability provision	10% every 1/2 year

UAH sovereign yield curves, primary auctions



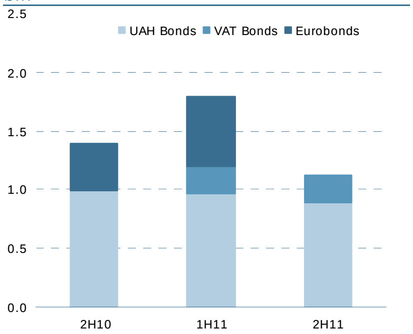
Source: Finance Ministry, Concorde Capital

Public debt, % of GDP



Source: Finance Ministry, Concorde Capital

Public sovereign debt repayment, USD bln



Source: Finance Ministry, Concorde Capital

New UAH sovereign bonds to offer attractive YTM of 17%-21%

Last week the State Tax Administration said it finished taking applications from corporate-exporters to exchange their VAT receivables from the state (accumulated as of May 1, 2010) for sovereign UAH bonds (VAT bonds). The applications equaled UAH 17.7 bln (USD 2.2 bln). In total, the government owed UAH 28.4 bln in VAT arrears as of end-1Q10, UAH 19.5 bln of which it said were eligible to be exchanged for sovereign bonds.

The new bonds will have a 5-year maturity, 5.5% coupon (paid s.a.) and sinkability provision (10% of principal is to be paid every half-year). The latter makes the bonds' duration equal to 2.1 years (at 19% YTM). We also see the primary recipients, which are struggling for cash and closed off from bank lending, as ready to turnaround and sell the bonds at 25%-30% discount to par on the open market, implying 17%-21% YTM (vs. 13%-15% at primary auctions for UAH sovereign bonds – OVDP).

Discount to Par	20%	25%	28%	30%	33%	35%	40%
Implied YTM (s.a.)	15.1%	18.1%	20.0%	21.4%	23.6%	25.1%	29.4%

We expect the bonds to be issued in several tranches starting mid-July and to reach the open market as early as August.

The government's VAT arrears were accumulated at end-2008 and 2009, when budget liquidity was squeezed under the slumping real economy (-15.1% in 2009) and jittery financial markets. The Ukrainian government repaid VAT arrears to exporters by issuing bonds back in 2004. Then, it issued UAH 1.9 bln in bonds, with a 14% coupon and sinkablility provision (20% annually). The bonds were repaid on time and in full by 2009. Now the government plans to automate the VAT reimbursement process starting in August and to not accumulate further VAT debt going forward, which is also one of the IMF requirements as part of the new stand-by facility.

Ukraine's sovereign credit quality improving

We view the government as capable and willing to service and repay its debts in the mid-term, as previously. The USD 15 bln stand-by facility from the IMF secured last week also supports this as it will facilitate fiscal consolidation, capping the fiscal deficit at 6.5% of GDP in 2010 and 3.5% in 2011 vs. 7.4% in 2009 (incl. Naftogaz), make it easier to refinance existing debts. The deal also led to a sovereign rating upgrade by Fitch from 'B-' to 'B' (outlook: stable) yesterday.

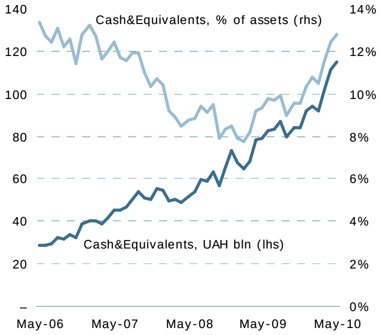
As of end-April, total public debt was at a manageable 34% of GDP (UAH 326.5 bln or USD 41.2 bln). By end-2010, we foresee it reaching 43% of GDP or USD 56.5 bln (accounting for the VAT bonds). This is slightly above the IMF estimate for the emerging market average of 37.2% as of end-2010.

We see debt service expenditures in 2010 amounting to UAH 15-18 bln or 5% of total consolidated budget revenue, 1.5% of GDP, up from 1.1% in 2009.

Scheduled public principal redemptions in 2H10 amount to UAH 7.9 bln (USD 1 bln) in regular local UAH bonds and USD 0.4 bln in Eurobonds. The structure of public debt implies that in 2011 the government will redeem UAH 18.3 bln (USD 2.3 bln) in UAH bonds (incl. UAH 3.5 bln of VAT bonds) and USD 0.6 bln in Eurobonds.

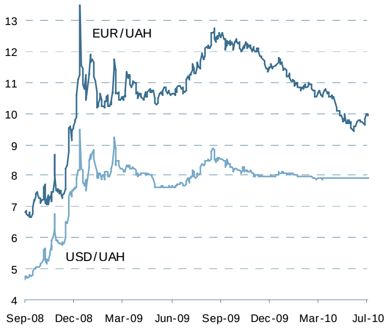
FLASH NOTE

Banking system liquidity, UAH bln



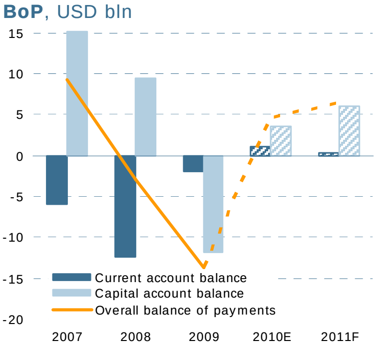
Source: NBU, Concorde Capital

UAH exchange rates



Source: UkrDealing

BoP, USD bln



Source: NBU, Concorde Capital

New bonds to be fairly liquid

We expect the VAT bonds to be fairly liquid due to a large number (few thousand) of primary holders and the high volume of the issue (UAH 17.7 bln, equal to ~1/2 of outstanding regular OVDPs, excluding those owned by the central bank). Having said that, such a jumbo issue, of course, will push the UAH sovereign yield curve up above 15%, at least in the short-term.

Demand for VAT bonds will come from three sources:

- Domestic banks, which are currently sitting on up to UAH 20-25 bln UAH in excess liquidity. Given the issue's long duration and maturity vs. the short-to-medium term of the excess liquidity in banking sector, though, we expect banks to only cautiously convert free UAH liquidity into VAT papers. A conservative estimate with 30% of excess liquidity going into VAT bonds creates UAH 6-7.5 bln in demand from the banking sector
- Non-resident portfolio investors (hedge funds, bank prop books, etc.). In 2005 to early 2008, foreigners were key players on the Ukrainian domestic fixed income market, holding almost 1/3 of all outstanding OVDPs. We expect foreign investors to act opportunistically, buying at discounts to secure an attractive return
- Ukrainian corporates. The government has already expressed a tentative intention to allow companies to use VAT bonds to repay debts to other corporate, specifically Naftogaz (est. UAH 6 bln or 1/3 of the issuance could be used in this way)

FX risks are low

Since last November, the USD/UAH exchange rate has remained stable at 7.9-8.1. Fundamentally, we do not see devaluation pressure on the hryvnya mounting in the nearest future:

- Balance of payments has been improving recently. In 5M10, the BoP posted a double surplus of USD 1.6 bln combined. In 2010, in total, we foresee a current account surplus of some 0.8% of GDP (USD 1.1 bln), and the finance account equaling 2.6% of GDP (USD 3.5 bln). To keep the hryvnya from appreciating in this circumstance, the NBU bought net USD 4.2 bln in excessive forex in March-June
- Ukraine secured a USD 14.9 bln (50% of current central bank's reserves), 2.5 year of new stand-by facility from the IMF. We see access to the additional forex liquidity keeping UAH risks low and supporting market confidence in the hryvnya
- Public confidence in the hryvnya has also improved: in 5M10 retail deposits in UAH rose 17.4% vs. only 4.8% for retail deposits in foreign currency. On the local retail market over 5M10 demand exceeded supply by USD 1.9 bln vs. USD 2.7 bln in 5M09
- Domestic inflation eased substantially over the last two years. In June, consumer prices grew only 6.9% yoy vs. 12.3% in December 2009; the most recent peak was 31.1% back in May'08. By end-2010, we expect consumer inflation of 9-10%

We also do not expect excessive UAH appreciation, as the NBU will keep the hryvnya from strengthening, if necessary, so as not to harm the export-driven real economy recovery.

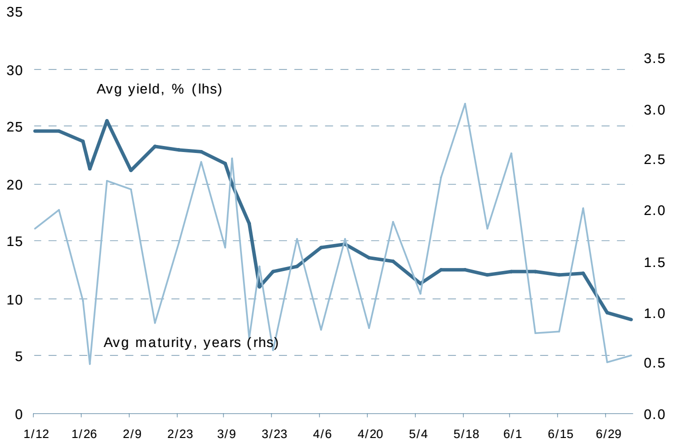
We expect 400-600 bps yield contraction in the months ahead

The 25%-30% discounts we expect the primary VAT bondholders to sell the papers at, imply 17% - 21% (s.a.) YTM. This is well above current OVDP yields of 13%-15%, vs. 20%+ at the beginning of the year (2, 3-year papers).

As we expect further fiscal consolidation (supported by the new IMF program) and public debt stabilization at around 45% of GDP at end-2011, yields on regular OVDP and VAT bonds should converge to 10%-15% in the next 1-2 years. Hence, potential yield contraction for the new VAT bonds could shrink 400-600 bps, implying 9%-14% price appreciation.

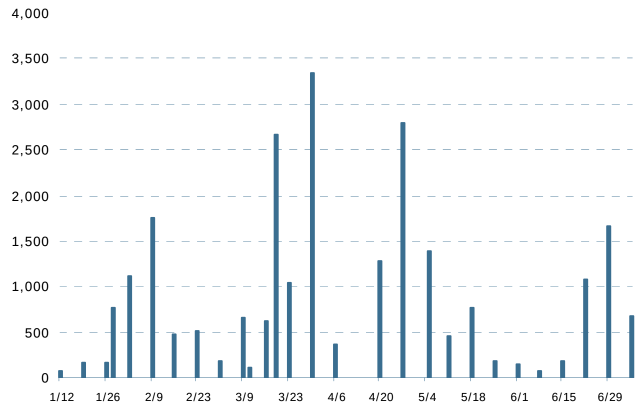
We believe the VAT issue to be unique in the CEE in terms of liquidity, backing by a sovereign government, issued in a currency yet to win back ground lost in the crisis (the UAH plunged 60% in 2008), and yielding 17-21%.

Sovereign UAH bond avg YTM, time to maturity at primary auctions in 2010



Source: Ministry of Finance, Concorde Capital

Sovereign UAH bond primary auction placement volumes in 2010, UAH mln



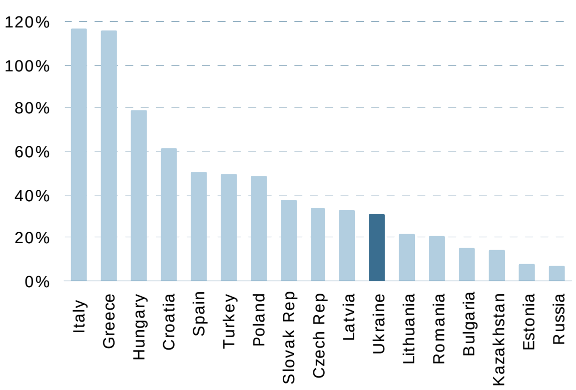
Source: Ministry of Finance

Sovereign UAH bond (OVDP) placements at primary auctions

Auction date	Volume, UAH mln	Avg yield, %	Avg. maturity, years
Short-term placements			
1/26/10	169	23.67	1.11
1/28/10	761	21.30	0.49
2/16/10	484	23.20	0.88
3/16/10	626	16.50	0.73
3/19/10	2,662	11.00	1.45
3/23/10	1,041	12.40	0.62
4/6/10	367	14.46	0.83
4/20/10	1,270	13.50	0.84
5/5/10	1,395	11.31	1.17
6/8/10	67	12.41	0.79
6/15/10	177	12.00	0.81
6/29/10	1,659	8.74	0.50
7/6/10	668	8.25	0.58
Medium-term placements			
1/12/10	79	24.64	1.81
1/19/10	157	24.55	2.00
2/2/10	1,116	25.44	2.29
2/9/10	1,761	21.17	2.20
2/23/10	504	22.98	1.69
3/2/10	177	22.85	2.47
3/9/10	658	21.77	1.62
3/11/10	109	20.00	2.51
3/30/10	3,337	12.84	1.71
4/27/10	2,786	13.27	1.89
5/11/10	453	12.58	2.31
5/18/10	772	12.46	3.04
5/25/10	183	12.12	1.81
6/1/10	139	12.42	2.56
6/22/10	1,083	12.26	2.01

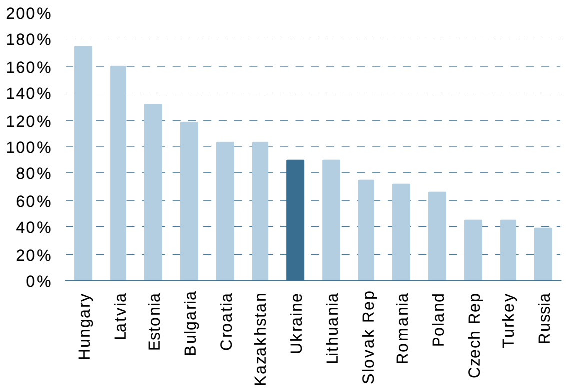
Source: Ministry of Finance

Public debt in 2009, % of GDP



Source: Concorde Capital, CIA

Total external debt in 2009, % of GDP



Source: Concorde Capital, IMF

Yearly economic indicators and Concorde Capital forecasts

	2002	2003	2004	2005	2006	2007	2008	2009	2010E	2011F
Business cycle indicators										
Real GDP, % chg yoy	5.2	9.6	12.1	2.7	7.3	7.9	2.3	-15.1	4.0	4.9
Nominal GDP, UAH bln	226	267	345	441	544	721	948	915	1056	1207
Nominal GDP, USD bln	42.4	50.1	65.0	86.1	107.8	142.7	179.9	117.4	133.7	152.8
GDP per capita, UAH	4685	5591	7273	9372	11630	15372	20495	19901	23079	26495
GDP per capita, USD	880	1048	1371	1829	2303	3044	3890	2555	2921	3354
Consumption, % chg yoy	9.5	11.5	13.1	20.6	15.9	17.1	11.8	-14.1	3.0	5.0
Investment, % chg yoy	-1.5	24.3	5.5	14.0	18.5	22.1	5.1	-52.9	6.8	7.5
Industrial output, % chg yoy	7.0	15.8	12.5	3.1	6.2	10.2	-3.1	-21.9	6.8	7.7
CPI (eop), % chg yoy	-0.6	8.2	12.3	10.3	11.6	16.6	22.3	12.3	10.0	8.0
PPI (eop), % chg yoy	5.7	11.1	24.1	9.5	14.1	23.3	23.0	14.4	10.0	15.0
External indicators										
Current account balance, USD bln	3.2	2.9	6.9	2.5	-1.6	-5.9	-12.5	-1.9	1.1	0.4
Current account balance, % GDP	7.5	5.8	10.6	2.9	-1.5	-4.1	-7.0	-1.6	0.8	0.3
Trade balance, USD bln	1.9	1.3	5.0	0.7	-3.1	-7.9	-13.7	-2.7	1.0	0.5
Trade balance, % GDP	4.4	2.6	7.7	0.8	-2.8	-5.5	-7.6	-2.3	0.7	0.3
Exports, USD bln	23.4	29.0	41.3	44.4	50.2	64.0	85.7	54.1	62.9	70.1
Exports, % chg yoy	10.7	24.0	42.6	7.5	13.2	27.4	34.0	-36.9	16.2	11.5
Imports, USD bln	21.5	27.7	36.3	43.7	53.3	71.9	99.4	56.1	61.2	68.6
Imports, % chg yoy	5.0	28.7	31.3	20.4	22.0	34.8	38.3	-43.5	9.1	12.0
Capital account balance, USD bln	-1.2	0.1	-4.3	8.0	4.1	15.1	9.5	-11.9	3.5	6.0
Capital account balance, % GDP	-2.9	0.2	-6.7	9.3	3.8	10.6	5.3	-10.2	2.6	3.9
FDI net, USD bln	0.7	1.4	1.7	7.5	5.7	9.2	9.9	4.5	5.0	6.0
NBU reserves (eop), USD bln	4.4	5.1	9.5	19.4	22.3	32.5	31.5	26.5	35.1	41.5
Debt indicators										
Public debt, USD bln	13.8	14.5	16.0	15.5	15.9	17.6	24.6	37.8	54.8	65.4
Public debt, % GDP	32.5	29.0	24.7	18.0	14.8	12.3	13.7	33.0	43.1	44.4
Corporate external debt, USD bln	n/a	13.0	17.8	25.5	42.7	67.6	85.0	80.0	85.5	90.5
Corporate external debt, % GDP	n/a	25.9	27.3	29.6	39.6	47.4	47.2	68.1	63.9	59.2
Gross external debt, USD bln	n/a	23.8	30.6	38.9	54.5	80.0	101.7	104.0	115.5	125.5
Gross external debt, % GDP	n/a	47.5	47.1	45.2	50.6	56.0	56.5	88.5	86.4	82.1
Monetary indicators										
Monetary base, UAH bln	30.7	40.1	53.8	82.8	97.2	141.9	186.7	195.0	225.8	259.6
Monetary base, % chg yoy	33.6	30.5	34.1	53.9	17.5	46.0	31.6	4.4	15.8	15.0
Money supply (M3), UAH bln	64.9	95.0	125.8	194.1	261.1	396.2	514.7	487.3	575.7	688.0
Money supply, % chg yoy	41.8	46.5	32.4	54.3	34.5	51.7	29.9	-5.3	18.1	19.5
Monetary multiplier (eop MB/M3)	2.1	2.4	2.3	2.3	2.7	2.8	2.8	2.5	2.6	2.7
Monetization (avg M3/GDP), %	24.9	30.3	32.0	36.7	42.3	46.4	46.0	55.0	50.3	52.3
Exchange rate										
Interbank UAH/USD (avg)	5.33	5.33	5.32	5.10	5.04	5.03	5.30	8.11	7.90	7.90
State budget										
Revenues, UAH bln	n/a	55.1	70.3	105.2	133.5	165.9	231.7	210.3	267.5	301.8
Expenses, UAH bln	n/a	55.8	79.5	112.8	137.1	174.2	241.5	242.4	323.6	338.1
Balance, % GDP	n/a	-0.4	-3.0	-1.8	-0.7	-1.4	-1.3	-3.5	-5.3	-3.0
Social indicators										
Population, mln (eop)	48.0	47.6	47.3	46.9	46.6	46.4	46.3	46.0	45.8	45.6
Unemployment (ILO methodology, avg), %	9.6	9.1	8.6	7.2	6.8	6.4	6.4	8.0	7.5	7.0
Average monthly salary, UAH	376	463	591	806	1,043	1,351	1,806	1,909	2,163	2,523
Real disposable income, % chg yoy	18.0	5.8	16.8	20.1	16.1	12.8	10.3	-9.4	3.0	8.0

Source: State Statistics Committee, National Bank of Ukraine, Ministry of Finance, Bloomberg, Concorde Capital estimates

Concorde Capital, Head office
2 Mechnikova Street, 16th Floor
Parus Business Centre
Kyiv 01601, Ukraine
Tel.: +380 44 391 5577
Fax: +380 44 391 5571

www.concorde.ua

Concorde Capital
4 Fourth Lesnoy Pereulok, 5th Floor
Capital Plaza
Moscow 125047, Russia
Tel.: +7 495 642 87 15
Fax: +7 495 225 85 00

office@concorde.com.ua

CEO
Igor Mazepa im@concorde.com.ua

Head of Sales & Trading
Alexander Shnir ash@concorde.com.ua

International Sales & Trading
Anastasiya Nazarenko an@concorde.com.ua
Marina Martirosyan mm@concorde.com.ua
Rostyslav Shmanenko rs@concorde.com.ua
Marina Damaskina md@concorde.com.ua

Domestic Sales & Trading
Yuriy Pilipenko up@concorde.com.ua
Alisa Tikhomirova at@concorde.com.ua

Director of Research
Andriy Gostik, CFA ag@concorde.com.ua

Director of Domestic Fixed Income
Roland Vizner rv@concorde.com.ua

RESEARCH

Strategy
Andriy Gostik, CFA ag@concorde.com.ua

Metals & Mining
Andriy Gerus ga@concorde.com.ua

Utilities (Telecom, Energy), Machinery
Yegor Samusenko syg@concorde.com.ua

Oil & Gas
Andriy Gerus ga@concorde.com.ua
Ruslan Patlavskyy rp@concorde.com.ua

Real Estate
Andriy Gostik, CFA ag@concorde.com.ua

Agriculture, Consumer-related
Andriy Gostik, CFA ag@concorde.com.ua
Ruslan Patlavskyy rp@concorde.com.ua

Economics, Financial services
Mykyta Mykhaylychenko mms@concorde.com.ua

Fixed Income
Andriy Gerus ga@concorde.com.ua
Mykyta Mykhaylychenko mms@concorde.com.ua

Politics
Brad Wells bw@concorde.com.ua

Editor
Brad Wells bw@concorde.com.ua

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