Ukraine 2024 Sovereign Restructuring

How can it look like?

April 17, 2024

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Ukraine is going to initiate a new restructuring of sovereign Eurobonds in the coming days. The new deal, according to the IMF, targets a debt service flow relief of up to USD 14.9 bln in 2024-2027, lowering of the public debt to GDP ratio to 65% in 2033, or about USD 22 bln less than the IMF forecasts (and 82% in 2028, USD 21 bln less), and limiting Ukraine's gross financing needs to average 8% of GDP in 2028-2033 (vs.11% forecasted).

Most likely, the restructuring offer will contain a proposal to postpone all the payments on Eurobonds beyond the years 2024-2027. Other possible conditions are relief of accumulated unpaid coupons, cut of future coupons and haircut of par value of the bonds.

Based on our estimates, the current prices of Ukraine's sovereign Eurobonds imply a tough restructuring, with four-year extension of maturities, zero coupons for the next four years, writing off all the accumulated coupons and a 20-25% haircut of the bonds' par value.

Analyzing Ukraine's 2015 debt restructuring, which pursued comparable goals, we conclude that the only helpful condition of that deal was maturity extension for four years. Whereas other targets of that debt operation which "grounded" the haircut (decline of mid-term debt/GDP ratio and lowering of Ukraine's mid- and long-term gross financing needs) were unnecessary. This is primarily because IMF's mid- and long-term forecasts of Ukraine's macro indicators significantly differed from reality.

This time, the IMF's forecasts on Ukraine's macro parameters are much less trustworthy, primarily because they heavily depend on the outcome of russian invasion, size and timing of international financial and military assistance, and post-war recovery path of the nation. In such circumstances, there is little value in the IMF's mid-term debt sustainability analysis and any mid-term forecasts of Ukraine's leverage indicators altogether.

In our view, the upcoming debt operation should be concentrated on shorter goals, namely:

- Secure cash flow relief from Eurobond servicing for the next four years.
- Avoid any short-term increase of Ukraine's public debt.

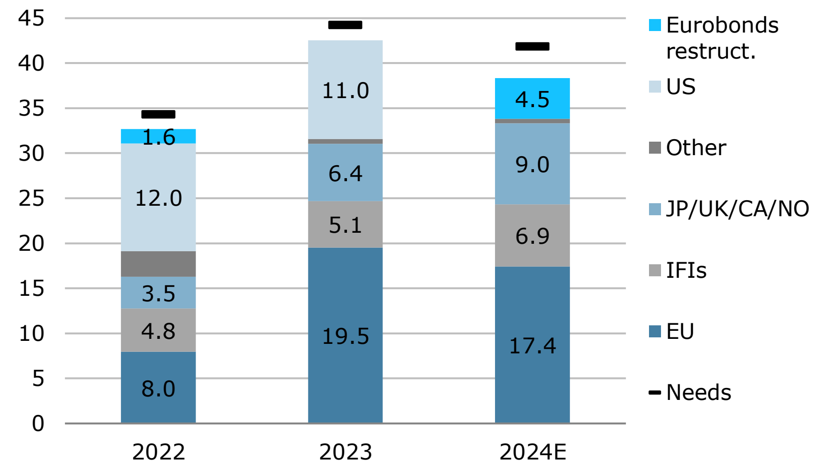
To achieve these goals, we see it would be essential for the government to agree with bond holders on:

- Four-year grace period on coupons and four-year extension of all the bonds,
- Relief of obligations under accumulated (and future) postponed coupons.

Meanwhile, we continue to believe that now it's not the best time to talk about any cut of bonds' par value. Based on future developments, a haircut could be either avoided at all, or its size will have to be much deeper than it can be "estimated" now.

We recommend the bondholders to agree on four-year extension of bonds and forgiveness of accumulated coupons for 2022-2027, with exchange of the arrears into some kind of recovery instruments. At the same time, we recommend avoiding any talks on a face value haircut.

Ukraine's international financing, USD bln



Sources: MinFin, Concorde Capital research

Lessons from 2015 restructuring: Only maturity extension was really helpful

MinFin restructured privately-held state and guaranteed debt of USD 15.5 bln par value in 2015, having exchanged its old debt into USD 12.7 bln of new Eurobonds maturing in 2019-2027 and value recovery instruments (GDP warrants) with par value of USD 3.1 bln. Also, it exchanged Eurobonds of Kyiv city (USD 0.45 bln) into a set of new government bonds and warrants. As a result of the deal, par value of new bonds was USD 13.0 bln and of the warrants USD 3.2 bln.

The goals of the 2015 debt operation, as had presented by the IMF, were:

1. Avoid payments **of USD 15.3 bln** on state and quasi-state debt servicing in 2015-2018 in order to accumulate hard currency within Ukraine.
2. Decrease the ratio of state and guaranteed debt to GDP to **71%** as of end-2020, from the forecasted level of 80%.
3. Create conditions for keeping the government's gross financing needs (GFN) at an average level of **10%** of GDP in 2019-2025, and decrease GFN ratio to an average **12%** in 2015-2018 (from forecasted level of 18%).

Analyzing the outcomes of debt operation, we conclude that:

1) Ukraine managed to **reach the first goal** as the government and state companies decreased the payments to external creditors by USD 15.2 bln over 2015-2018 via a shift of debt maturity by four years. This included a decline of payments under state debt by USD 8.6 bln and payments of state companies by USD 3.5 bln. On top of that, Ukraine granted a "permission" from the IMF to not pay a russian state entity USD 3.1 bln under the so-called "Yanukovych bonds".
2) Talking about the decrease of the state debt to GDP ratio, Ukraine managed to **outperform the plan**. As of end-2020, the ratio was 60.4%, or 9.6 pp below the post-restructuring plan, even though Ukraine had to radically increase its leverage in 2020 to cope with COVID-19 crisis (as of end-2019, the ratio was 27.1 pp below the plan). That said, the debt haircut (decline of notional value of state debt by USD 2.8 bln in 2015) was not necessarily to achieve the goal. Moreover, to reach the target (assuming IMF's forecasts were true), Ukraine had had to decrease its debt by about USD 8.7 bln in 2015, which was not reached by the debt operation.
3) The third goal was **over-reached for the 2015-2018** period (GFN was 11% of GDP for that period), which suggests again that the haircut was not necessary. For objective reasons, the 2019-2025 GFN target was not reached.

The key reason for Ukraine to perform better (in terms of leverage and GFN) after the 2015 restructuring was much higher actual GDP as compared to the 2015 IMF forecasts. This suggests the IMF's mid- to long-term macro forecasts are not very accurate for Ukraine. As we show below, in the current circumstances, the IMF's mid-term (and even short-term) forecasting power is even weaker.

In the nutshell, the postponement of debt maturity by an average four years in 2015 was efficient (as it saved hard currency for the country during the hardest days), while the effectiveness of the debt cut for the sake of reaching mid- and long-term macroeconomic parameters was low.

Goals of Ukraine's 2015 debt operation: plan vs. fact, USD bln

	Target	Fact	Comments
Cash flow relief, 2015-2018	15.3	15.2	The goal was met, if we include also quasi-sovereign debt and "russian bond"
State debt in 2020, % of GDP	71.0%	60.4%	The goal was overshoot due to much higher than forecasted GDP, and despite the COVID crisis that spoiled the results of 2020.
Implied state debt cut in 2015	8.7	2.8	The fact includes 3.13 state debt haircut, less assumption of Kyiv city debt (0.35).
Average gross financing needs, % of GDP, 2019-2025	10.0%	>17.4%	The goal was not met in any year (the ratio was 12.2% in pre-war years 2019-2021).
Average gross financing needs, % of GDP, 2015-2018	12.0%	11.0%	The goal was overshot due to much higher than forecasted GDP. (The ratio was 12.8% if 2017 debt operation with NBU included).

2015 Eurobond restructuring outcome:

Total 15 issues of state and guaranteed Eurobonds with a USD 15.0 bln par value, average life of 3.5 years, average interest rate of 7.67%, were exchanged into:

- 9 issues of state Eurobonds with USD 12.3 bln total par value, average life of 7.5 years, uniform interest rate of 7.75%, and
- GDP warrants of USD 3.0 bln par value, paying interest in 2021-2040, depending on performance of Ukraine's economy.

Sources: IMF, MinFin, UkrStat, NBU, Concorde Capital research

Lessons from 2015 restructuring: IMF mid-term forecasts are not much accurate

As can be seen from the charts here, IMF's forecasting power of Ukraine's macro indicators is not good enough to refer to it for the purpose of debt operation:

- The IMF was broadly correct in forecasting Ukraine's state debt and gross financing needs (GFN) in 2015.
- Meanwhile, its 2015 forecasts of Ukraine's GDP differed by over 1.25x for 2019, and the discrepancy slightly corrected in 2020 due to the COVID-19 crisis.
- For that reason, IMF's 2015 forecasts of Ukraine's state debt to GDP ratio (one of the basic goals of the 2015 debt operation) significantly differed from the fact: Ukraine managed to decrease the ratio much faster than the fund expected. That suggests the haircut of state debt in 2015 did not play important role for Ukraine's government.

That said, the IMF's forecasting power of Ukraine's mid-term GDP development was weak in 2015. High uncertainty was a key reason for that.

Notably, the uncertainty is even bigger these days, which can be illustrated by:

- The radical change of IMF's forecasts of Ukraine's GDP in its latest report as compared to the report issued 12 months ago (estimated Ukraine's 2028 dollar GDP was upgraded by 15%, see the last chart on the slide).
- The fact that Ukraine's actual 2023 GDP was 8.1% above the IMF's March 2023 forecast (and 20% above it in dollar terms), and even 0.7% above its March 2024 estimate.

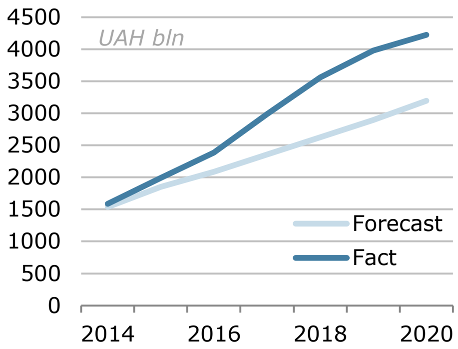
Our conclusion is that it's impossible to accurately forecast Ukraine's macroeconomic parameters for a period longer than one year. And even for one year, changing forecasts by 10% in any direction is "normal" in Ukraine's current reality.

In such circumstances, any debt operation that pursues mid- and long-term goals based on macroeconomic parameters makes little sense.

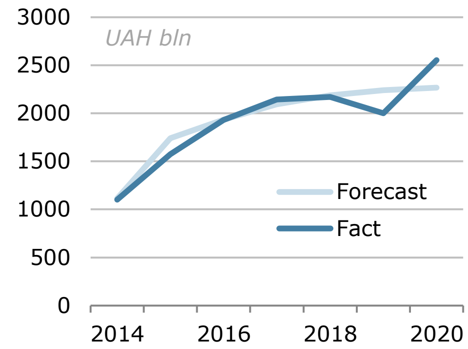
Therefore, in the upcoming debt operation, Ukraine and its creditors should focus on shorter goals:

1) **Secure maximum cash flow relief for the next 2-4 years, when Ukraine is very likely to have an enormous budget deficit and is likely to face scarce financing.**
2) **Secure minimum effect of the deal on Ukraine's state debt.**

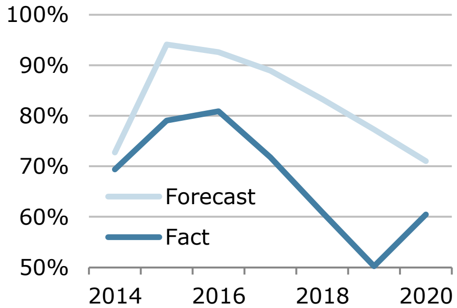
GDP: fact vs. IMF's Mar'15 forecast



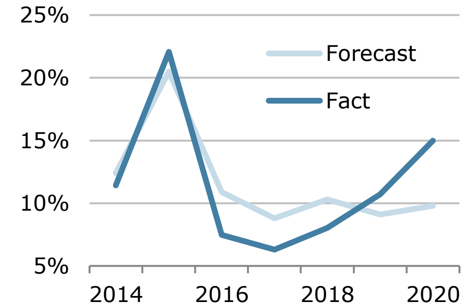
State debt: fact vs. IMF's Mar'15 forecast*



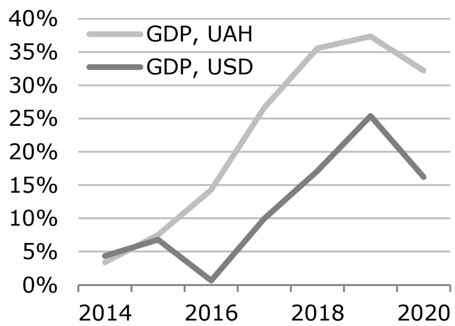
Debt / GDP: fact vs. IMF's Mar'15 forecast*



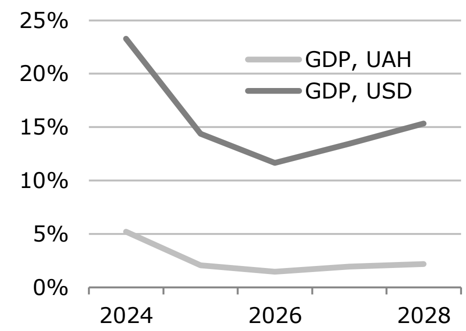
GFN / GDP: fact vs. IMF's Mar'15 forecast*



GDP: Fact / IMF's Mar'15 forecast



GDP: IMF's Mar'24 forecast / Mar'23 forecast



** IMF forecasts assumed completion of debt restructuring*
Sources: IMF, MinFin, UkrStat, NBU, Concorde Capital research

Goals of 2024 debt operation

According to the recent IMF memorandum, the upcoming Eurobond restructuring should help the government to:

Secure reduction of state debt to GDP ratio in 2033 (2028), facilitate reduction of gross financing needs in 2028-2033.

Taking into account weak forecasting power of any mid-term economic projections for Ukraine now (as well as little effect of the 2015 debt operations on the same indicators) there is no need to take such goals seriously.

A decline of short- and mid-terms gross financing needs of the Ukrainian government is an important task, irrespective of what long-term models suggest. It can be reached by multi-year postponement of any Eurobond payments (which is unlikely to be agreed upon this time), or a write-off of Eurobond liabilities (which is partially possible).

Save up to USD 14.9 bln of cash flow in 2024-2027

Taking into account large war-related expenditures of the Ukrainian government and irregularity of international financial support for Ukraine, relief from any amount for debt servicing will be helpful.

Of that amount, scheduled for this period Eurobond payments are USD 13.6 bln.

To pursue this goal, Ukraine's government will likely offer another postponement of all the payments on Eurobonds, this time for 4 (and no less than 3) years.

What to do with delayed coupons

In August 2022, the government offered a two-year postponement of all coupons and maturities and agreed to pay coupon rates on all the delayed coupons. After the end of the grace period, it will have to pay (or capitalize) about USD 4.0 bln of delayed coupons.

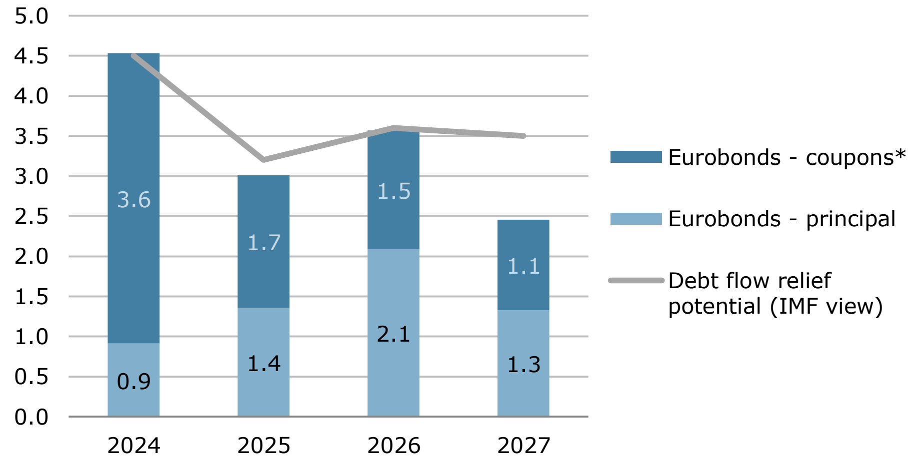
If MinFin offers the same conditions this time, it will accumulate USD 12.2 bln of delayed coupons after the next four-year period (and USD 9.9 bln, if the extension will be for three years).

For the Ukrainian government, it will be challenging to both, making the delayed payments and capitalizing them, which will lead to a significant spike of the state debt. Taking into account that "forgiveness" of delayed coupons is "priced in" by the market (see the next slide), it might be wise for the government to offer their write-off in the nearest restructuring process, possibly in exchange of some recovery instruments.

Goals of Ukraine's 2024 debt operation, IMF's view (USD bln)

	Pre-deal estimate	Target	Diff	Diff, USD	Comments
Cash flow relief, 2024-2027		up to 14.9			This is a vital task, taking into account scarce external financing of Ukraine's deficit.
- Of which, Eurobonds		up to 13.4			
State debt / GDP, 2033	72.5%	65.0%	-7.5%	-22.3	Following the 2015 deal, such a target was overshot. It's impossible to calculate 2033 parameters now.
Implied debt cut in 2024		11.3			
State debt / GDP, 2028	91.2%	82.0%	-9.2%	-20.9	Following the 2015 deal, such a target was overshot. It's impossible to calculate 2028 parameters now.
Implied debt cut in 2024		15.1			
Average GFN / GDP, 2028-2033	11.0%	8.0%	-3.0%	-7.8	Average GFN was 9.7% of GDP in 2016-2021. It's impossible to calculate 2028-2033 parameters now.

Eurobonds payment schedule & "flow relief potential" from debt operation, USD bln



** Assuming all the accumulated coupons for 2022-2024 are paid in 2H24-1H25 (not capitalized).*
Sources: IMF, MinFin, UkrStat, NBU, Concorde Capital research

Market seems to be “ready” for massive haircut

Ukrainian sovereign dollar Eurobonds trade now at 29%-38% of par, which implies the market is pricing in a tough restructuring this year.

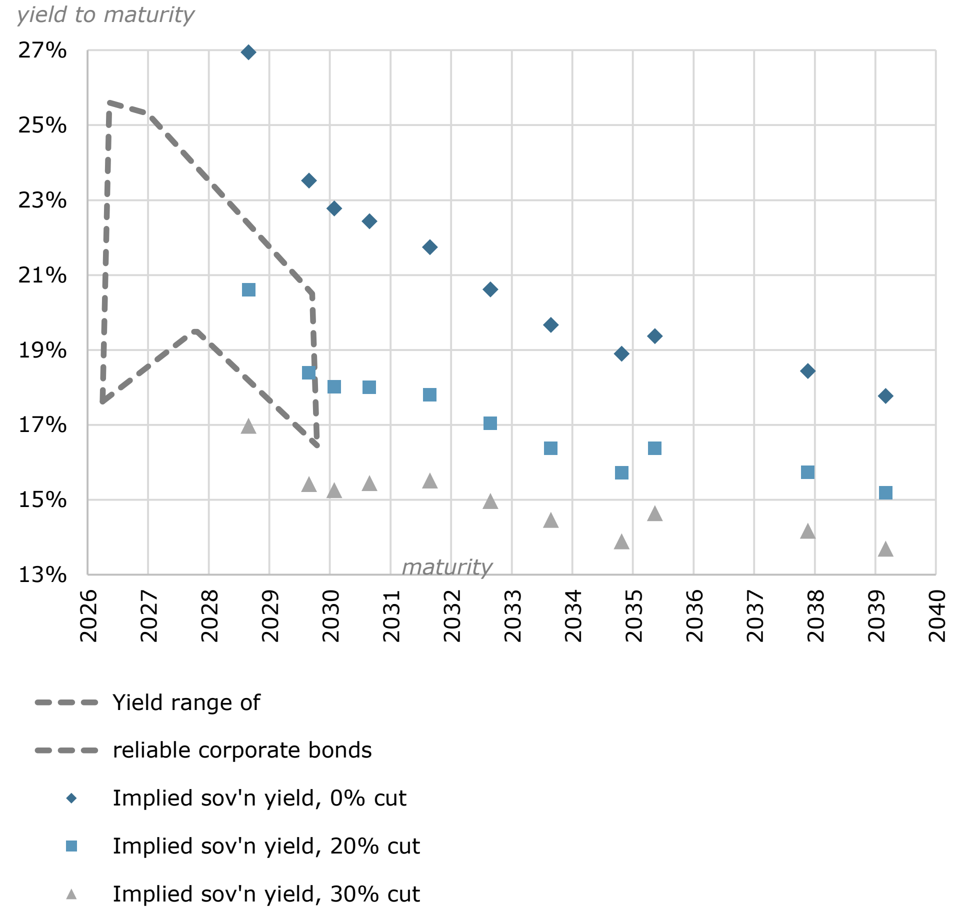
Our analysis suggests that the “fair yields” of Ukrainian sovereign bonds are between 22% and 15%, or within the range of Eurobonds of “reliable” (capable to service their debt) corporate Ukrainian issuers. Assuming that after the restructuring, sovereign bonds will trade within the corporate bonds’ range, we calculated which possible conditions of the upcoming sovereign restructuring do the bonds “price in”.

First, we assume that new restructuring conditions will contain a four-year extension of bonds’ maturity with zero coupon rate for the period. Second, we assume that the accumulated coupons on the bonds (USD 4.0 bln payable in 2H24-1H25) will be written off. Such parameters imply the yields of the nearest three state bonds at 23%-27%, which is way above the range of Ukrainian corporate bonds of the same maturity.

Therefore, we see the market “assumes” even more aggressive restructuring: as can be seen on the chart, bond prices seem to imply also a face value cut of at least 20%.

In our view, today it’s not the best time to talk with Ukrainian authorities on any face value haircut, but it would be wise to talk about some kind of relief from accumulated coupon obligations. Meanwhile, there is still a chance that any cut of the face value won’t be necessary for Ukraine’s mid-term debt sustainability.

Ukraine corporate Eurobond map vs. sov’n bonds with haircut scenarios*



** All scenarios assume four-year extension of sovereign bonds in 2024, zero coupons for 2022-2027*
Sources: Bloomberg, Concorde Capital research

What conditions of debt operation might be efficient

We believe following restructuring conditions will be efficient for the government and acceptable for bondholders:

- **Another four-year delay of all coupon payments** and another **four-year maturity extension** of the bonds. This will allow Ukraine to save USD 13.4 bln of external payments in 2024-2027.
- **Another four-year delay of all the payments under GDP warrants**. Based on the IMF macro forecasts, this will save Ukraine about USD 2.2 bln in 2024-2027.
- A consent from bond/warrant holders **to apply no interest** for the grace period (2022-2027). In such case, Ukraine's debt servicing obligations would be lowered by about USD 12.5 bln (as compared to the scenario of interest capitalization at original coupon rates).
- It would be also wise to **exchange** the accumulated/capitalized coupon arrears for some kind of **recovery instruments** that will be linked to future payments at the cost of russia (either by use of confiscated assets, or any kind of future compensations). Moreover, if a secondary market for such instruments is established, Ukraine could consider exchange of its other (including future) debt obligations into them.

Sources: IMF, MinFin, UkrStat, NBU, Concorde Capital research

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