Ukraine Economy and Sovereign Debt

Another restructuring ahead

March 08, 2024

Executive summary

Ukraine's economy remains resilient to its biggest-ever shock, with GDP having recovered by about 5.7% in 2023. The recovery was fueled by strong government expenditures, vast majority of which supported private consumption, as well as strong performance of the agricultural sector. In 2024, economic growth won't be that spectacular (due to more constrained public expenditures), but key drivers could be a recovery in output by some export-focused industries and a catch-up of private investments (providing the government is able to offer acceptable risk insurance conditions).

Despite the unprecedented shocks and risks, Ukraine can be proud of low inflation (below the central bank's target of 5.0%, so far), high liquidity and reliability of the baking sector, relatively stable national currency and a buildup of gross international reserves. Needless to say, Ukraine should be thankful for such a performance to its international partners which have provided net USD 74 bln of financial support in 2022-2023 (or 21% of two-year GDP).

After receiving USD 42.5 bln of gross foreign financial assistance in 2023, Ukraine struggles to secure USD 37 bln of such support for this year. This task looks challenging, as so far, Ukraine can firmly count on about USD 32 bln of international financing, if the US assistance won't be agreed upon. As to our understanding, that gap estimate is based on the assumption that no payments on state Eurobonds will be made in 2024.

In March 2023, Ukraine committed to the IMF that it would complete another restructuring of sovereign Eurobonds in 1H24.

So far, the parameters of MinFin's restructuring offer are not clear, but we guess that the key goal of the debt operation would be to postpone all the payments on Eurobonds and GDP warrants that are scheduled for 2024-2027. At least, the latest available IMF memorandum assumes a USD 14.9 bln of "potential flow relief from debt operations" as a source of financing Ukraine's budget gap. This "flow" more or less coincides with contractual payments on sovereign Eurobonds. Taking into account the dire situation with Ukraine's financing gap, the IMF's "assumption" is not an option, but an unavoidable outcome, irrespective of the position of bond holders.

Our view, suggestions on the bond restructuring

As there is still no clarity about the future ability of Ukraine to service its debt (now the primary goal is to secure new financing), it would be naïve to expect that an ultimate and firm solution on Eurobond payment schedule can be reached this time.

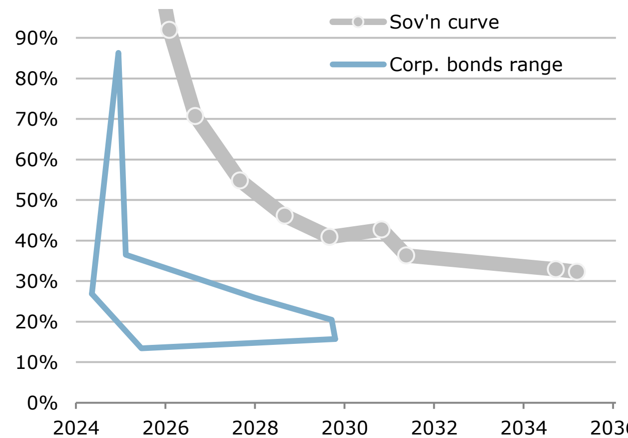
Therefore, we recommend Eurobond holders to avoid any talks with the government on other parameters than the duration of the new payment arrears. Namely, we do not recommend talking about any haircut and interest cuts this time: in the best-case future, the haircut could be avoided at all; while under less favorable outcome, a larger haircut will be renegotiated in the future.

Also, we believe that the market treats Ukraine's GDP warrants too optimistically. In our view, the warrants (with their embedded call option) should not be priced higher than Ukraine's 2027 Eurobond in the best-case scenario. We recommend warrant holders to decline any offers to extend the call option on the warrants during the upcoming restructuring negotiations.

Sovereign and guaranteed Eurobonds

	Price	Amt, USD mln	Maturity	YTM
Sovereign				
UKRAIN 24	33%	912	Sep-2024	534%
UKRAIN 25	33%	1,355	Sep-2025	117%
UKRAIN 26/2	34%	750	Feb-2026	92%
UKRAIN 26/1	33%	1,339	Sep-2026	71%
UKRAIN 27	32%	1,329	Sep-2027	55%
UKRAIN 28 (EUR)	29%	1,090	Jun-2028	52%
UKRAIN 28	31%	1,318	Sep-2028	46%
UKRAIN 29	31%	1,307	Sep-2029	41%
UKRAIN 30	33%	1,600	Nov-2030	43%
UKRAIN 31	28%	1,750	May-2031	36%
UKRAIN 32 (EUR)	26%	1,363	Jan-2032	28%
UKRAIN 34	29%	3,000	Sep-2034	33%
UKRAIN 35	29%	2,600	Mar-2035	33%
Total		**19,713**		
GDP warrants				
UKRAIN 41	48%	2,635	Aug-2041	n/a
State-guaranteed				
Ukrenergo 28	36%	825	Nov-2028	40%
Ukravtodor 30	28%	700	Jun-2030	38%
Total		**1,525**		

Ukraine yield map



Sources: Bloomberg, Concorde Capital calculations

Sovereign Eurobonds:

Restructuring is imminent in 2024

CONCORDE CAPITAL

Ukraine sovereign bonds: IMF deal assumes zero payments in 2024-2027

All the IMF memorandum texts contain an assumption that Ukraine will have about USD 14.9 bln of "external financing" sources from a "potential flow relief from debt operations." In our view, the word "potential" in that expression is a diplomatic concept that in fact means a strict plan that the Ukrainian government should implement.

No doubt, the major "sponsors" of such debt flow relief will be Eurobond holders:

- According to the IMF memorandum, Ukraine is scheduled to finalize a new round of Eurobond by end-June 2024.
- As we show below (slide 8), Ukraine has a shortage of external financing for this year even if it pays nothing to Eurobond holders. In other words, there is no money in Ukraine's state budget for any payments to Eurobond holders this year.
- Annual schedule of the "potential relief" coincides with a scheduled payment on Ukrainian fixed-income Eurobonds and estimated payments on its GDP warrants, as the chart on the right suggests.

The latter implies the IMF "does not want to see" any payments on sovereign Eurobonds in 2024-2027. And this outlines our **base-case scenario for Eurobond restructuring** this year:

Another extension of all payments on bonds for four years

In our view, no other restructuring options for 2024 (e.g. deals involving a haircut or coupon change) look efficient:

- At this stage, we have too little information about future developments in Ukraine to make a solid schedule of payments on bonds.
- If so, the 2024 deal is very unlikely to be the last restructuring talk on sovereign bonds.
- If so, it's too early to talk about any detailed parameters of the deal, except the condition that will allow Ukraine to postpone any payments on bonds in 2024 (and in 2025-2027).

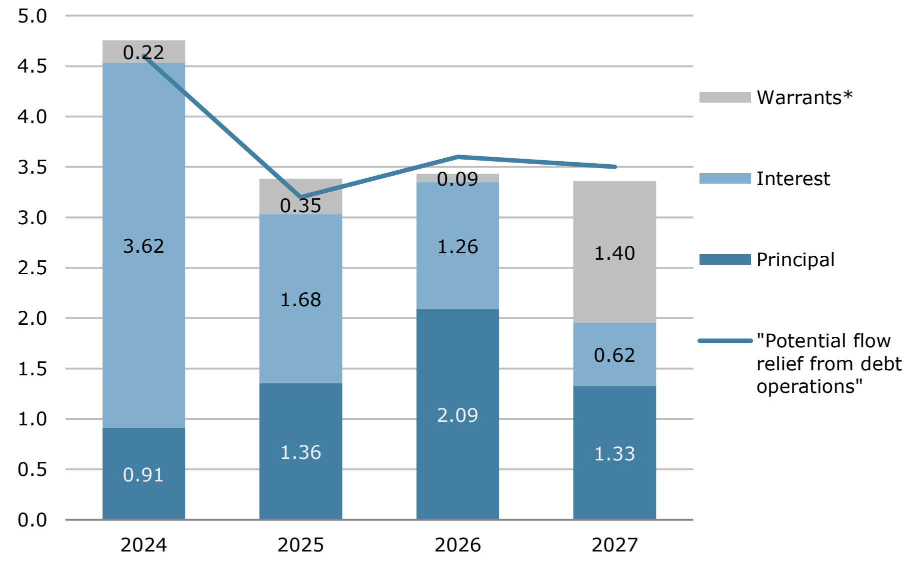
Therefore, we see the best outcome from the 2024 restructuring talks to be the deal comparable to that reached in 2022:

- Four-year extension of maturities of all bonds.
- Postponement of all the scheduled coupons (and GDP warrant payments) for the next four years, with interest on all the delayed payments accrued.

In our view, **the bondholders will have no choice but to accept the conditions of another standstill** (the only topic of negotiations could be the **duration** of the new standstill). If they oppose, there will be simply a de-facto standstill.

At the same time, **we recommend the bondholders to avoid any talks on a haircut this time. If the situation in Ukraine improves, the haircut can be avoided at all; if the situation worsens, the haircut will be deeper, whatever the results of the 2024 deal is.**

Scheduled payments on Eurobonds and IMF's "cash flow relief potential", USD bln



** Calculated based on IMF's GDP forecasts for 2024-2025.*
Sources: IMF, Finance Ministry, Concorde Capital calculations

Ukraine GDP warrants: Look over-priced

Possible payment schedule on GDP warrants has an infinite number of scenarios, some of which (based on official forecasts and some post-forecast assumptions*) are presented on the chart above. If we ignore a high likelihood of restructuring of the warrants for this year, such modelled cash flows imply NPV of warrants (assuming a 30% discount rate) of 59%-120%. However, in our view, this does not make the warrants (priced at about 45% of par now) an attractive investment opportunity:

- The restructuring of warrants (as other government Eurobonds) looks unavoidable this year. The restructuring, as mentioned before, will likely lead to postponement of all the payments beyond the year 2027.
- The presented schedule assumes that the government won't use its call option (allowing it to purchase the warrants at 100% of par by Aug. 1, 2027) as well as expected extension of this call option during the upcoming restructuring.

The presence of the call option simplifies the modelling of flow under the GDP warrants, as is shown below.

Warrants vs. fixed income bonds: call option makes them comparable

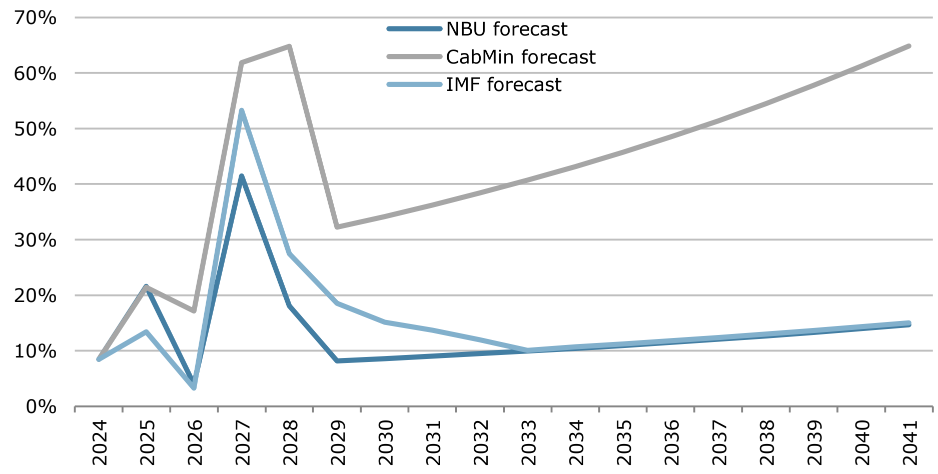
We believe that the market price of Ukraine's GDP warrants should be comparable to the price of Ukraine's 2027 bonds, as their payment schedules are comparable, if we assume a best-case scenario for the future development in Ukraine. Namely:

- If geopolitical risks fade and Ukraine's economy shows some spectacular recovery in 2025 and further, that would make the government pay huge interest on the warrants in 2027 and further.
- But the government could use its call option to limit the 2027 payment to 100% of par and have no future payments. For instance, taking the most optimistic case from above (CabMin forecast), the government is likely to choose paying 100% to fully purchase the warrants in March-April 2027, instead of paying 62% in May 2027, 65% in May 2028 and 32% in May 2029.
- This makes (in the best-case) the warrants comparable to Ukraine's Eurobonds maturing in 2027 - see the lower chart.
- As the chart suggests, even in the best case scenario, the current contractual conditions on the 2027 bonds offer larger payments than on the warrants.

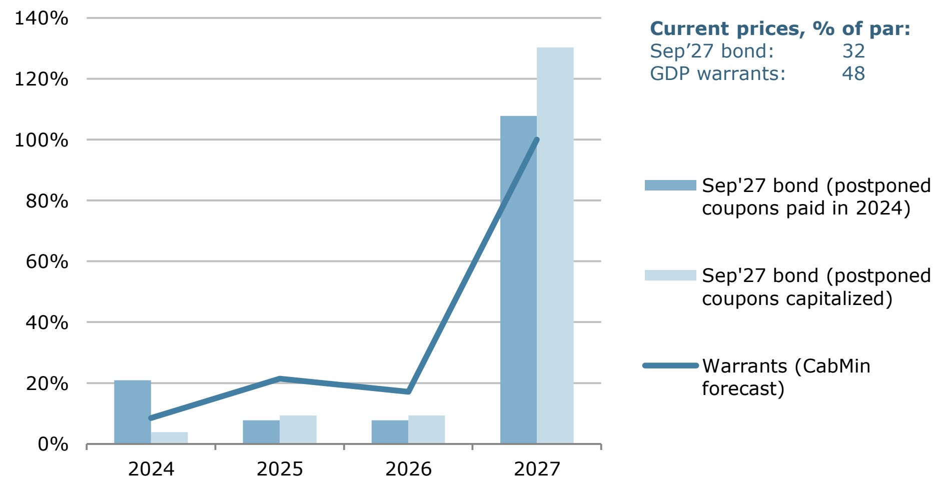
That said, **any price of the warrants that exceeds the price of UKRAIN'27 notes looks unjustly high to us.**

For the holders of warrants, we recommend to oppose any extension of the call option during the upcoming restructuring process. In this way, the holders could take much more value from the warrants in the future.

Payments on warrants depending on macro scenario, % of par*



Estimated scheduled payments under 2027 Eurobond and GDP warrants



** Based on the current terms. NBU (IMF) forecast assumes a 4.0% real growth, 5.0% inflation and 3.0% UAH devaluation vs. dollar since 2027 (2034). CabMin forecast assumes a 5.0% real growth and 5.0% inflation since 2027 and exchange rate from the NBU scenario. Sources: Finance Ministry, NBU, IMF, Concorde Capital calculations*

Public Finances & Debt:

Committed int’l support does not cover 2024 financial gap, so far

State budget: Expenditures cut severely in January, uncertainty in 2024 persists

Ukraine's state budget plan for 2024 assumes monthly average outlays of USD 8.1 bln, which is a sharp decline compared to the actual outlays in 2H23 (USD 11.0 bln). This is because defense expenditures have been budgeted at a much lower level (USD 3.5 bln in 2024 vs. USD 6.8 bln in 2H23). Naturally, with such defense expenditures, Ukraine won't be able to efficiently resist to russian aggression.

In January 2024, Ukraine had to severely cut its total outlays (to USD 5.0 bln) and limit its security & defense expenditures to USD 3.5 bln. In February, budget incomes improved as the government started receiving the lifted banking profit tax for 2023, as well as prepaid 2023 dividends from state companies. Most of 2M24 budget expenditures were financed from the government's own incomes as key donors, the E.U. and the US, were yet to approve their support budgets.

Military expenditures and international assistance

We expect the actual 2024 defense expenditures will be above the plan in 2024 (as it was in 2023) as Ukraine is going to receive international military assistance (partially recognized as "other incomes") and the drafted state budget does not account for such sources.

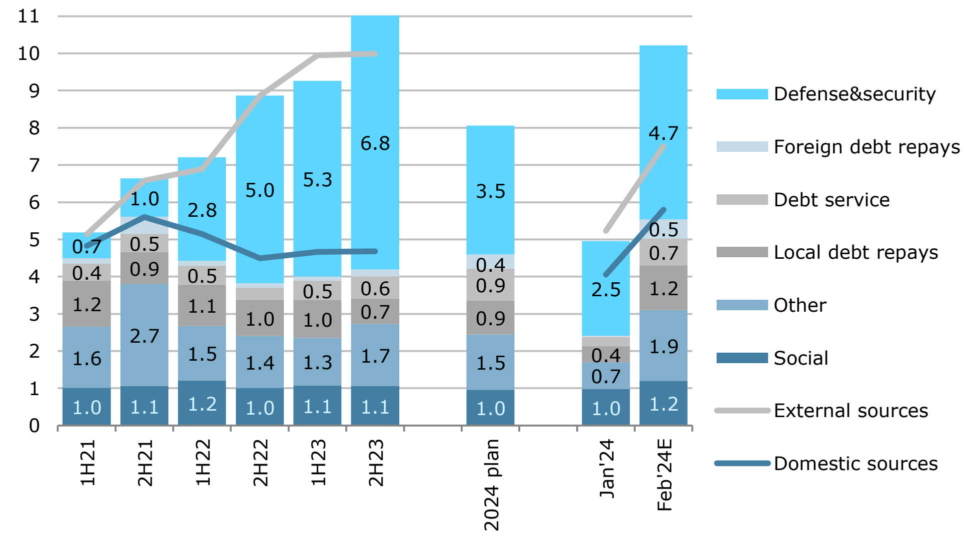
So far, Ukraine's international partners (excluding the U.S.) have committed to provide about USD 25-30 bln of military support in 2024. But this won't be enough to catch up to the expenditure level of 2H23. Therefore, Ukraine critically needs an American military package to be approved. Alas, the uncertainty about the U.S. military package for 2024 persists.

International financial assistance

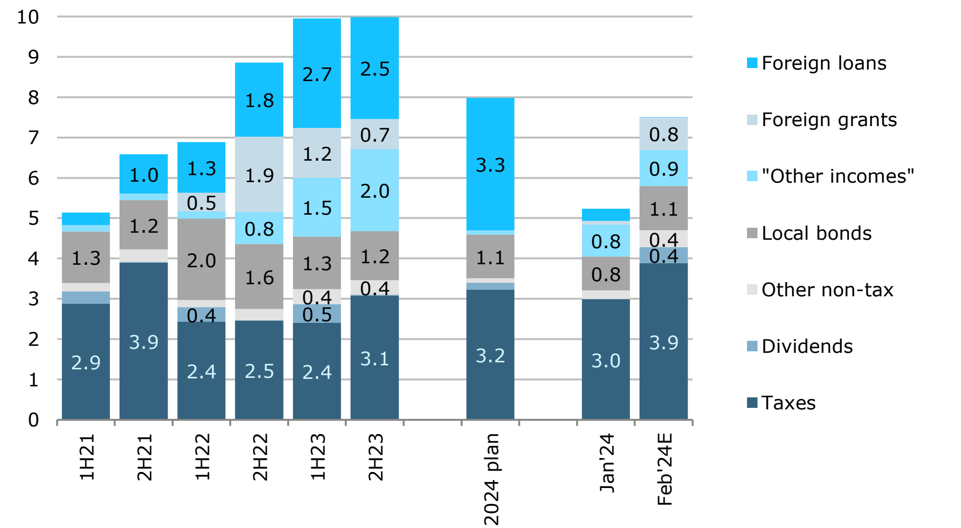
Good news is that the EU leaders were able to approve a EUR 50 bln Ukraine Facility package for 2024-2027, of which Ukraine is reportedly counting on EUR 16-18 bln in 2024. The government expects the first tranche under this program (about EUR 4.5 bln) to arrive in March.

In addition to the first EU tranche, Ukraine is going to receive an IMF tranche for USD 0.9 bln and financial assistance from Japan for about USD 1.3 bln in March. If this plan is realized, Ukraine could receive about USD 7.1 bln of international money in March, which would bring the 1Q24 monthly average level to USD 2.8 bln. That would be enough for that period, as the government will also count on one-off dividend and profits tax payments to boost budget incomes from internal sources.

Monthly average budget outlays and sources, USD bln



Financing of budget outlays, USD bln per month



Sources: MinFin, Concorde Capital research

Financing of state budget is at lowest level since early 2022

Monthly average financing of state expenditures via international debt and grants was USD 3.0 bln in March-December 2022 and USD 3.6 bln in 2023. It covered about 40% of the government expenditures since the start of russian invasion.

In 2024, Ukraine will need about USD 3.1 bln of international financial assistance each month, providing it is able to restructure its Eurobonds (which will allow it to avoid paying of USD 4.5 bln of coupons and principal payments in 2H24).

In January and February 2024, the government raised only USD 0.4 bln and USD 0.8 bln in international loans and grants as the key donors (EU and US) are delaying with their assistance programs. The key international sponsor of Ukraine in 2M24 was Japan which provided USD 0.9 bln.

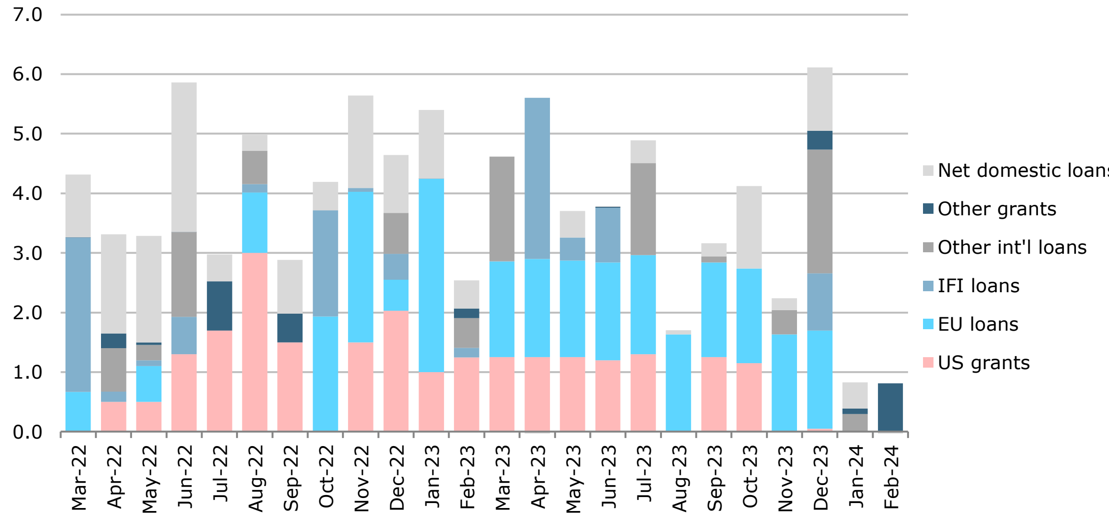
Based on Finance Ministry, Ukraine will need at least USD 37 bln of international financial support in 2024. Theoretically, it can count on the following international sources:

- The U.K., Japan and Canada could collectively provide USD 5.0 bln (after USD 3.4 bln in 2022 and USD 6.4 bln in 2023).
- The IMF foresees USD 5.4 bln financing for this year, while other IFIs could provide up to USD 2.5 bln.
- About USD 17.4 bln (EUR 16 bln) can be provided by the EU.
- Other sources could secure up to USD 1.5 bln in financing.

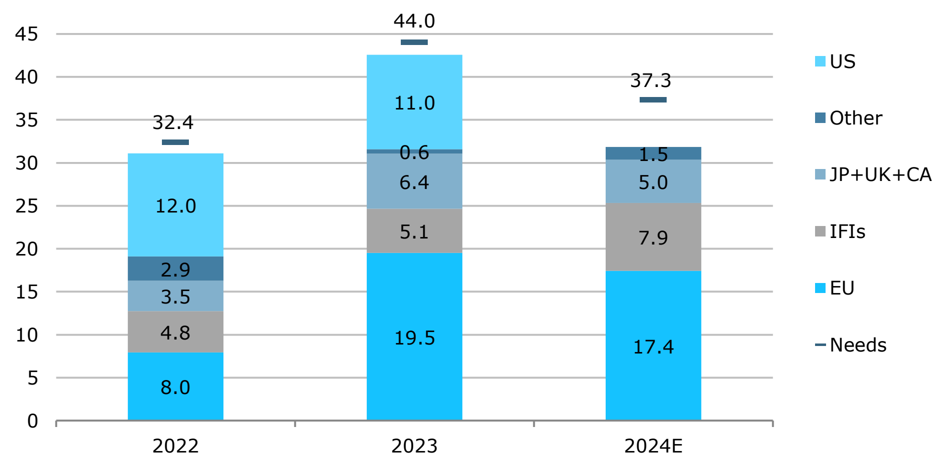
That said, without American financial support, Ukraine is likely to attract no more than USD 32 bln of international financial assistance, implying a potential gap of USD 5 bln.

Among the potential providers of additional financing, there could be Japan, which, according to an unconfirmed statement of Ukraine's Prime Minister, could fill the entire gap with additional financing of up to USD 6 bln.

Financing of budget gap, USD bln



International sources of budget gap financing, USD bln



Sources: Finance Ministry, Concorde Capital calculations

"Sustainability" of Ukrainian state debt: Not much worse than before war

At the end of 2023, Ukraine's state & guaranteed debt reached USD 142 bln*, which is up 50% compared to the pre-war level of end-2021. As compared to GDP, the debt burden reached a "risky" level of 80%. Notably, a major part of the debt increase was due to receiving long-term international loans (amortizing between 5th and 35th years). This allowed the government to increase the weighted average life of its public debt to 10.6 years in 2023, from 6.6 years in 2021.

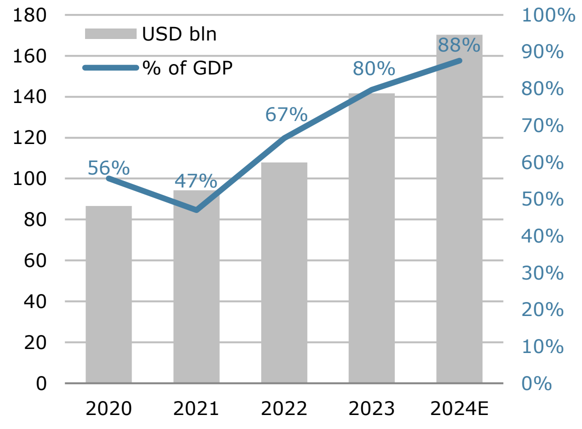
Providing Ukraine is able to restructure its Eurobonds in 2024, with postponement of all the payments for at least four years, its state debt will remain as "sustainable" as it was before the russian invasion:

- Debt repayment schedule for the nearest five years, as percent of GDP, will remain practically the same as in 2021. The only difference of the current situation as compared to the pre-war period is that a longer tail of debt repayment schedule has become "thicker."
- Perhaps a more painful consequence of the increase of state debt is increased interest payments: to 4.0% of GDP in 2024 (in case Eurobonds are restructured with no payments this year), up from 2.8% in 2021. Meanwhile, the key reason for such burden growth is higher interest rates on local debt and liabilities to IFIs.

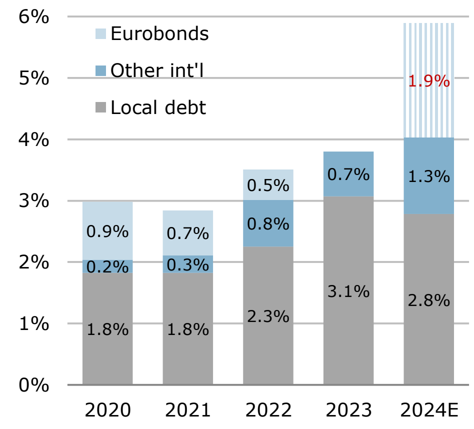
All in all, if the government manages to agree on debt restructuring with Eurobond holders, it will preserve its "debt sustainability" for at least mid-term.

Providing Ukraine won't be able to secure any grant financing of the state budget in 2024 (which is a worst-case scenario), its end-2024 debt to GDP ratio is likely to reach 91%. In our view, such an increase won't harm Ukraine's debt sustainability much, as most of new loans will be attracted at comfortable conditions. Under realistic scenario, Ukraine's state debt to GDP ratio will reach 89% in 2024.

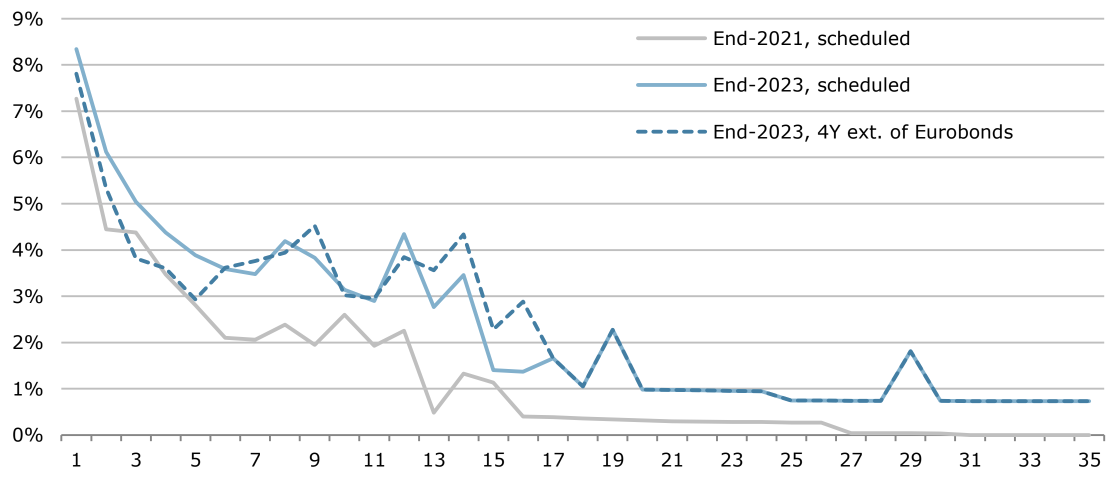
Ukraine's state & guaranteed debt*



State debt service to GDP

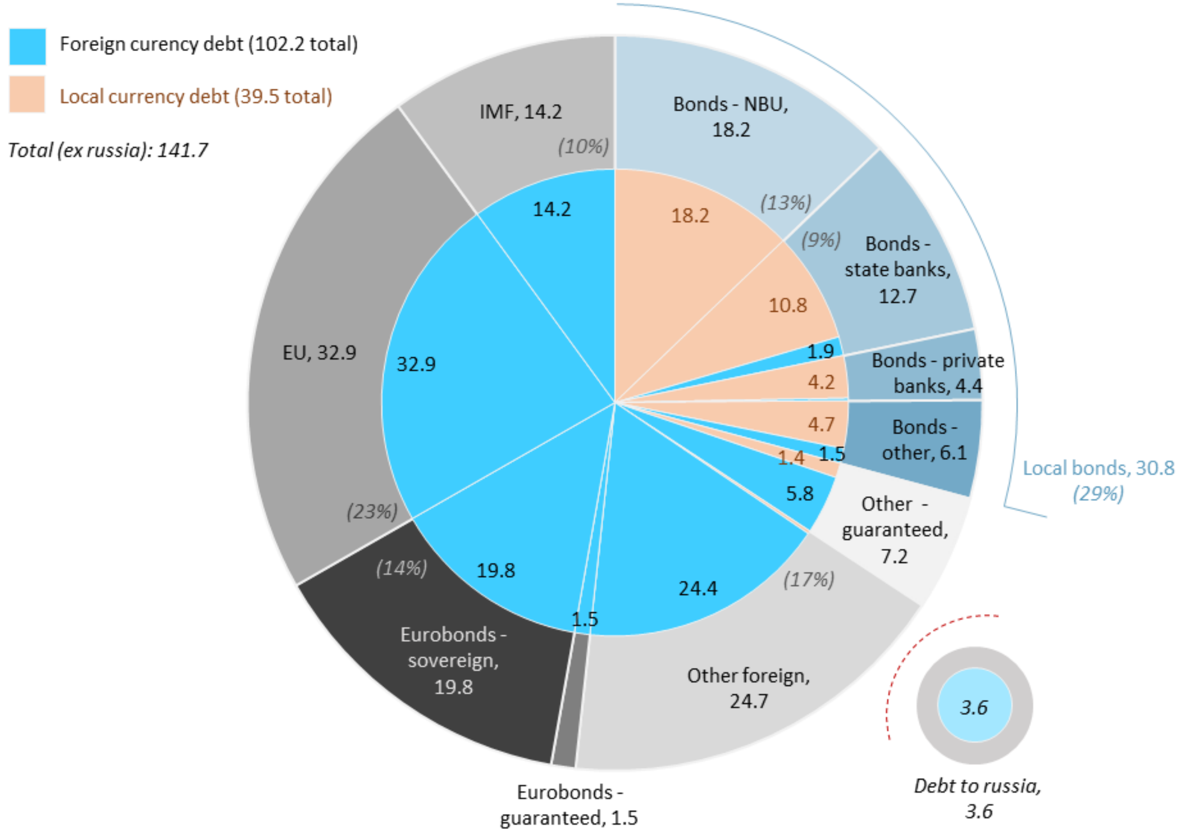


Debt repayment schedule by years as % of GDP of respective end-year



** Note: Statistics exclude debt to the aggressor-state (USD 3.6 bln, or 2.0% of GDP as of end-2023).*
Sources: Finance Ministry, Concorde Capital calculations

Ukraine's state & guaranteed debt, end-2023, USD bln equivalent



Sources: Finance Ministry, NBU. Concorde Capital calculations

War Update

War statistics

Following three successful defense and offense operations in 2022, Ukrainian defenders forced the russians to leave areas of Kyiv, Chernihiv, Sumy, most of the Kharkiv region and the western bank of the Dnipro in Kherson region. Since November 2022, however, Ukraine had no significant territorial gains. Neither had the aggressor after it gained large territories in the first weeks of its invasion.

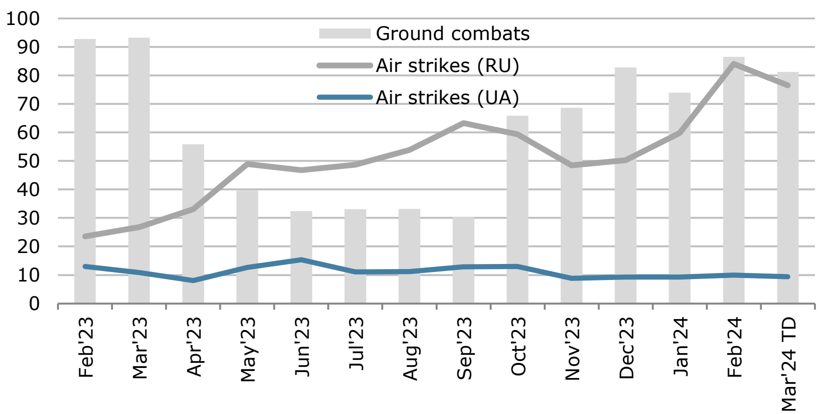
Over the last five months, the aggressor launched a massive offensive operation in western suburbs of Donetsk, managing to capture the ruins of towns of Avdiyivka and Maryinka, as well as some territories in the southern area. Its net territorial gain was around 270 km^2 over the period, while its losses peaked to about 900 soldiers per day (vs. about 500 for the previous periods).

As Ukraine's official statistics suggests:

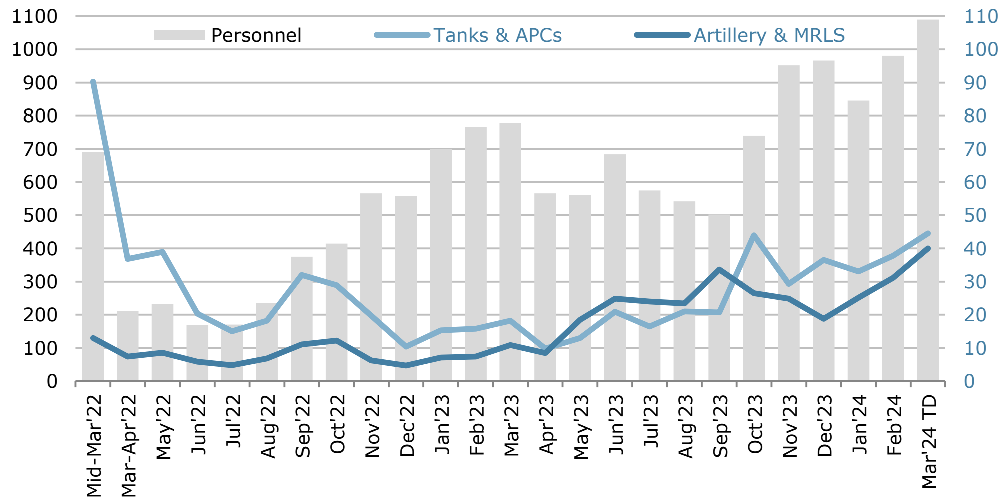
- Over the last couple of months, Ukraine's armed forces were not as efficient in damaging russian artillery as before, which confirms a deficit of ammunition. Meanwhile, supply of ammunition is gradually improving, and Ukraine is awaiting a soon arrival of a large batch of shells on the initiative of the Czech government.
- The aggressor intensified the use of aviation against Ukrainian positions, and the defenders had nothing to respond. Massive bombing of the front line has become the biggest problem. Hopefully, the situation will improve in mid-2024, providing Ukraine's western partners supply fighter jets and more air defense systems.

Meanwhile, so far, there is lack of clarity on whether Ukraine will be able to de-occupy some of its territories in 2024. Among possible positive developments, Ukraine could be successful in damaging the bridge connecting occupied Crimea and a russian territory, which would worsen the occupant's military logistics.

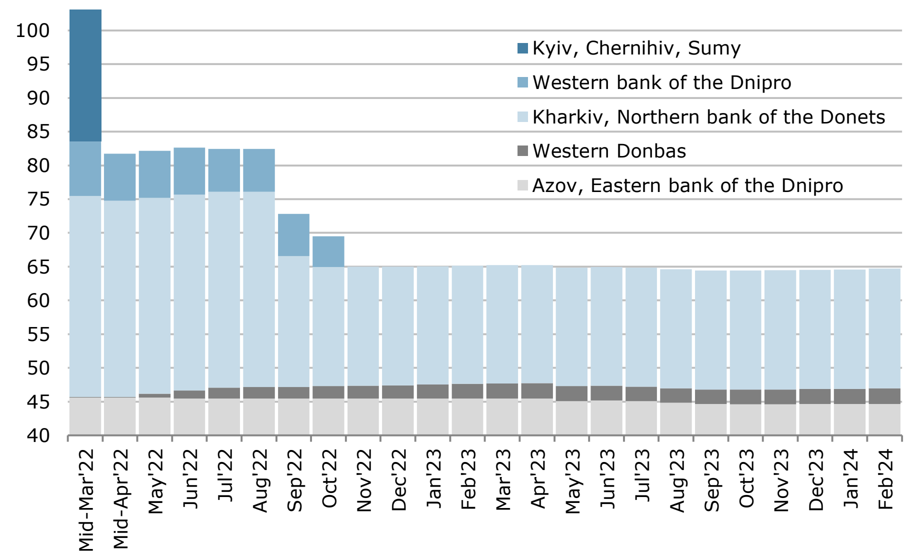
Military actions, daily average



Aggressor's losses, daily average

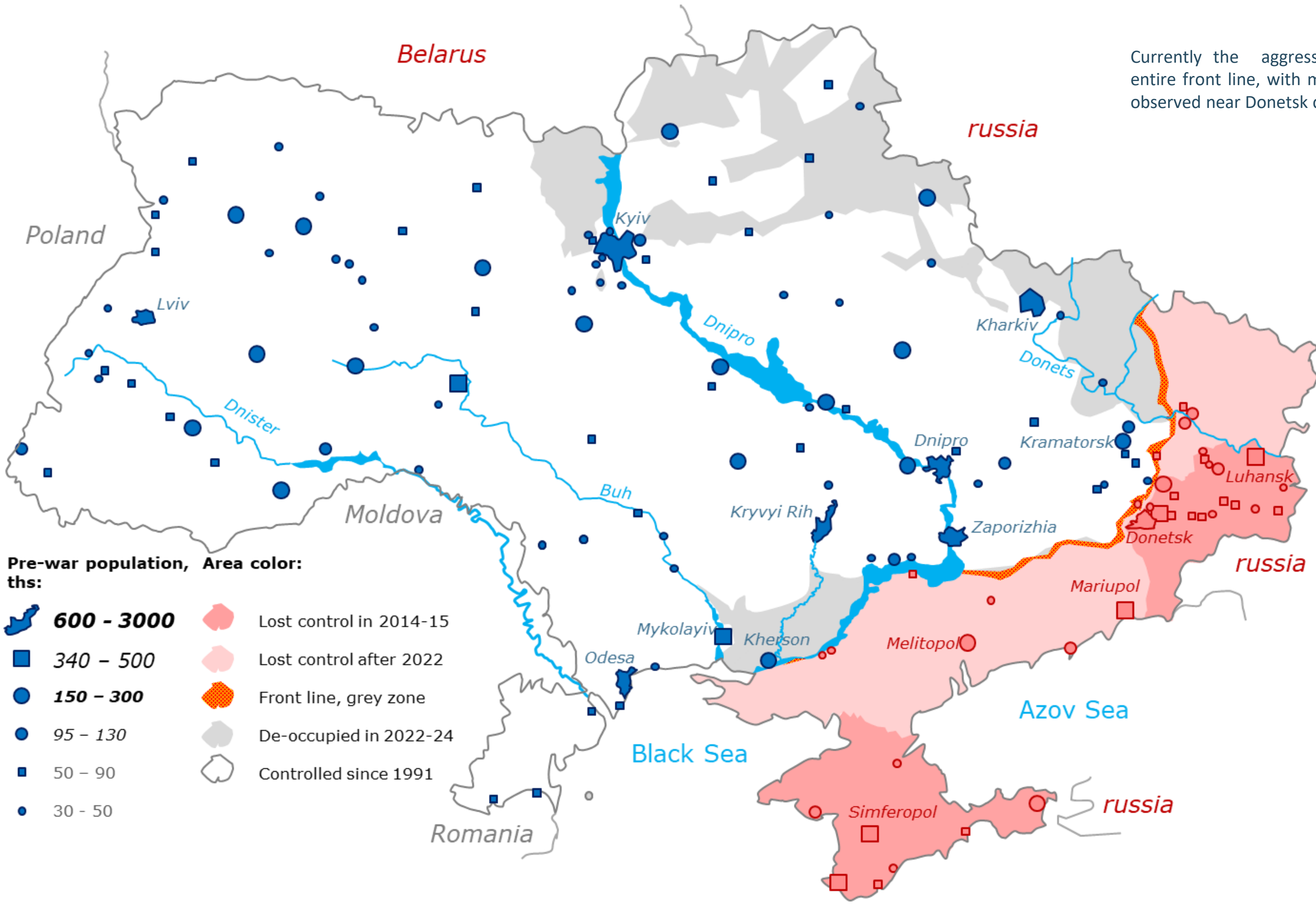


Occupied area*, eop, ths km^2



** Includes only area captured by russia in 2022-2023. Does not include occupied Crimea (26.9 ths km^2) and part of Donbas occupied in 2014 (about 16.8 ths km^2)*
Sources: General Staff of Armed Forces, Deepstatemap.live, Concorde Capital research

Currently the aggressor is pressing across the entire front line, with most massive assaults being observed near Donetsk city.



Sources: UkrStat, General Staff of Armed Forces, Deepstatemap.live, Concorde Capital research

Economy Update

Ukraine macro indicators

USD bln, unless other indicated

	2020	2021	2022	2023E	2024E
Nominal GDP	155.8	200.6	162.0	178.0	191.8
Real GDP chg	-3.8%	3.4%	-28.8%	5.7%	2.6%
State & guaranteed debt, eoy*	86.7	94.4	107.9	141.7	170.2
% of GDP	56%	47%	67%	80%	89%
CPI, eoy	5.0%	10.0%	26.6%	5.1%	7.3%
CPI, average	2.7%	9.4%	20.2%	12.9%	6.0%
UAH/USD rate, eoy	28.3	27.3	36.6	38.0	41.5
UAH/USD rate, avg	27.0	27.3	32.3	36.6	39.0
Goods & services trade balance	-2.4	-2.7	-25.9	-37.8	-35.4
C/A balance	5.3	-3.9	8.0	-6.6	-11.9
BoP	2.0	0.5	-2.9	9.5	4.6
Budget expenditures	47.8	54.6	81.6	109.8	103.0
% of GDP	31%	27%	50%	62%	54%
Defense/security expenditures	10.3	11.1	47.8	73.1	64.4
% of GDP	7%	6%	30%	41%	34%
Budget deficit, ex grants	7.9	7.1	42.2	48.3	37.3
% of GDP	5%	4%	26%	27%	19%
Budget deficit, with grants	7.9	7.1	27.7	36.8	31.3
% of GDP	5%	4%	17%	21%	16%
Debt financing of budget, net	6.7	6.5	25.9	34.7	31.1
- External	5.1	4.1	17.1	29.7	27.0
- Domestic	1.6	2.4	8.9	5.0	4.1
Total resources for the defense	10.7	11.7	79.0	100.3	n/a
% of GDP	7%	6%	49%	56%	n/a
Total foreign support of Ukraine	5.5	4.7	72.1	89.3	n/a
% of GDP	4%	2%	44%	50%	n/a
- Military support	0.4	0.7	40.5	48.1	n/a
- Financial grants	0.0	0.0	14.5	11.5	6.0
- Net loans	5.1	4.1	17.1	29.7	27.0
Gross foreign loans	5.3	7.6	18.9	31.5	30.5

**Without debt to russia (USD 3.6 bln)*
Sources: UkrStat, NBU, Finance Ministry, Concorde Capital research

Economic recovery to slow down in 2024

Ukraine's real GDP increased 5.7% yoy in 2023, based on the estimate of the National Bank. This implies Ukraine's real economy advanced by about 11% yoy in real terms in 2H23.

Key drivers of economic recovery in 2023 (after a 29% plunge in 2022) were large government consumption (mostly due to war-related expenditures) which was possible because of a generous international financial support of Ukraine, increased private consumption (due to increased budget outlays and because of low comparison base) and exceptional performance of the country's agriculture sector (supported, among other, by favorable weather).

As Ukraine's economy has adjusted fast to the new reality in late 2022 and 2023, there is limited room for further spectacular growth in the coming years, unless the russian aggression is stopped.

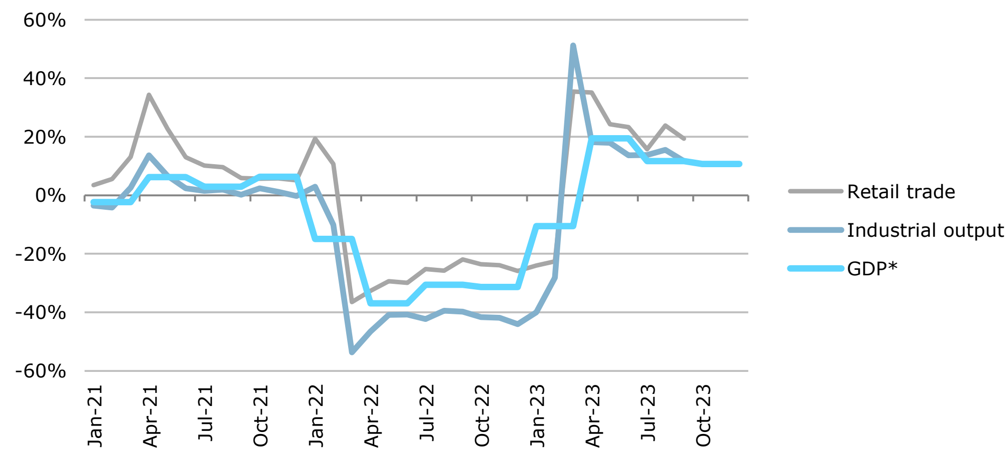
The most reliable sources see Ukraine's real GDP will grow by 3.1% to 3.9% this year (the Ukrainian government sees a 4.6% expansion, but this estimate is rather political than rational).

Among the key growth drivers for 2024, we see output recovery in some of the export-focused industries that had been affected heavily by the breach of logistics chains in 2022-2023. Also, there is a good chance that private investments will become a key driver (due to low comparison base, postponed demand and a better access to risk insurance instruments).

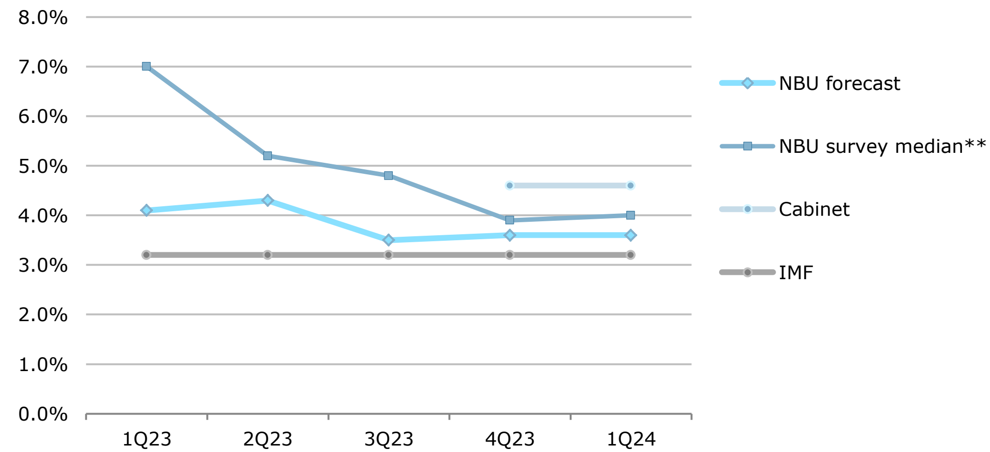
Meanwhile, government consumption is unlikely to drive the economy as budget expenditures (and international sources of their financing) do not promise any expansion. Also, it is not likely that Ukraine's agriculture sector will be able to demonstrate another exceptionally strong year.

All in all, we see that Ukraine's real GDP will grow between 2% and 3% in 2024.

Real growth, yoy



2024 real GDP forecast: change in time



** For Oct-Dec 2023 – estimate. ** Survey of financial analysts conducted by the NBU (13-17 forecasts in each survey)*
Sources: UkrStat, Economy Ministry, NBU, Concorde Capital calculations

Industrial output: Visible recovery from shock, still way below pre-war numbers

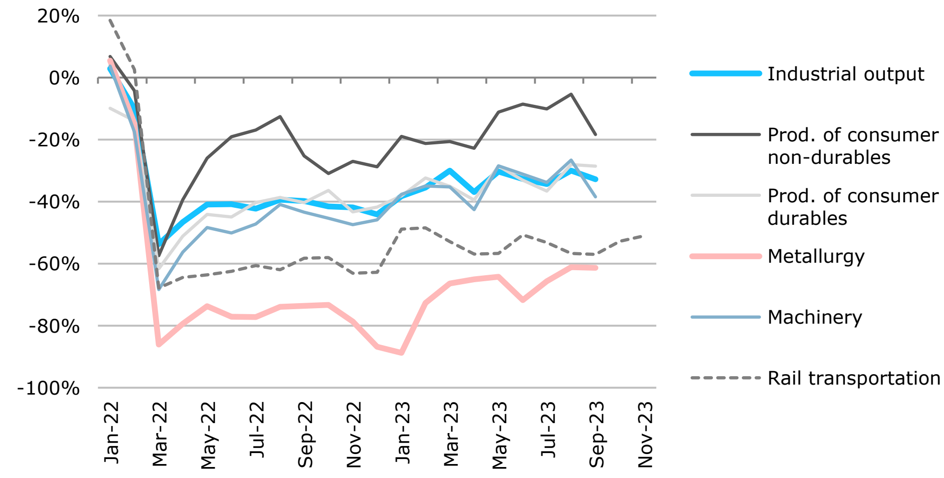
Industrial sector, the biggest victim of russia's aggression against Ukraine, demonstrated a 51% yoy real recovery in February and mid-teen growth in April-June, mainly due to weak comparison base. In 1H23, the industry declined 2.9% yoy and 33.9% compared to 1H21.

Among the best performing sub-sectors is production of non-durable consumer goods (about 20% decline compared to pre-war levels). This segment promises to recover further, to be fueled by relatively stable consumer demand and encouraging results of 2023 grain harvest.

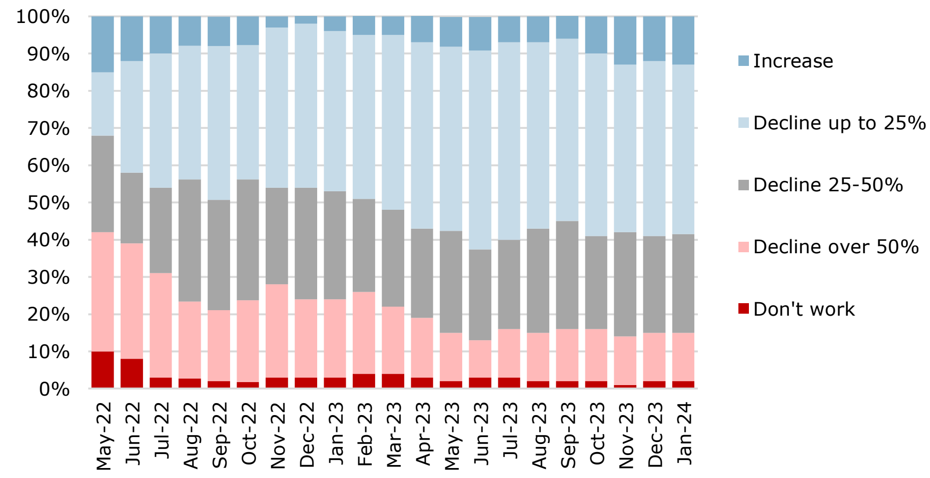
Metallurgy remains among the biggest victims of the invasion, which suffered directly (from damaging and occupation of key industrial premises) and indirectly (via the blockade of sea routes, the main channel of goods exports). Some recovery in iron ore and steel production is expected in 2024 to make these sectors among top performers this year.

Ukraine's machinery sector is likely to improve its results in 2024, benefitting from increasing military orders.

Real output as compared to 2021



Enterprises' output vs. pre-war level, IER surveys*



* *http://www.ier.com.ua/files/Projects/2023/TDF/2023_NRES_Septembert_FINAL_UA.pdf*

Sources: UkrStat, IER, Rail Insider, Concorde Capital calculations

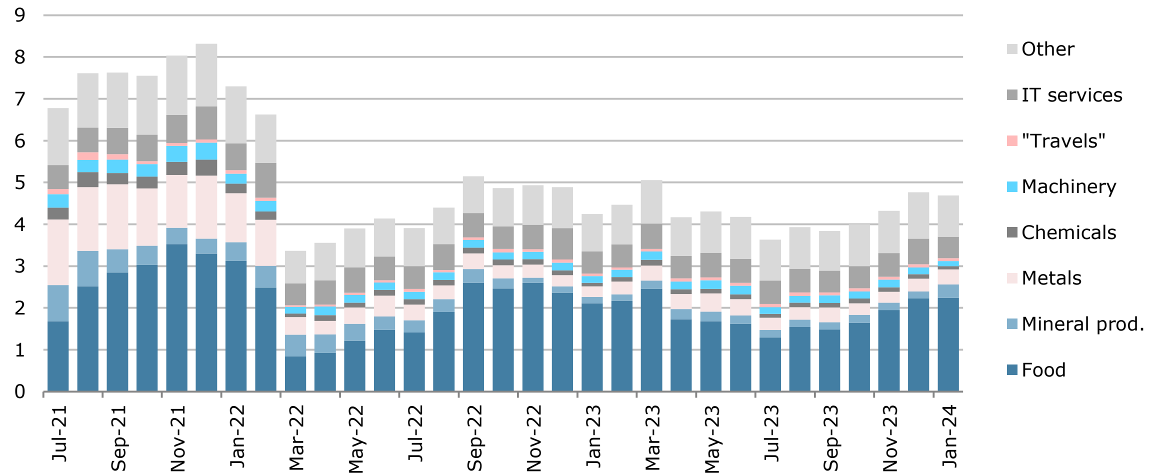
Trade balance: Deficit reaches all-time high in 2023

The most important trends of Ukraine's trade in 2023 are:

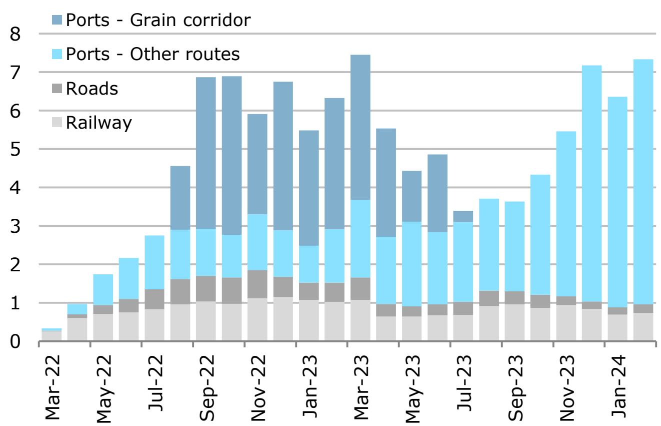
- The biggest import item of 2022, "travel services" (expenditures of temporary refugees outside Ukraine) slightly decreased in 2023, but stood broadly fixed at around USD 1.33 bln per month in April-December.
- Since June 2023, machinery has become the biggest import item, which we relate to increased supplies of goods for Ukraine's defense.
- The biggest export category, food, was declining between March and July of 2023 due to interruptions of the work of the sea corridor, which had been established in mid-2022 under supervision of russia. In September 2023, Ukraine was able to establish its own grain corridor, which allowed it to expand its food exports. As a result, in volume terms, Ukraine's December-February grain export volumes exceeded those seen in mid-2022.
- Metallurgical and mineral exports (mainly steel and ore) remain depressed due to limited access of the exporters to seaports. It is likely that we will see significant improvement in such goods export in 2024.

Ukraine's goods and services trade deficit expanded to USD 37.7 bln in 2024, after USD 25.7 bln in 2022 and USD 2.7 bln in the pre-war year of 2021. Most likely, the deficit will remain stable yoy in 2024.

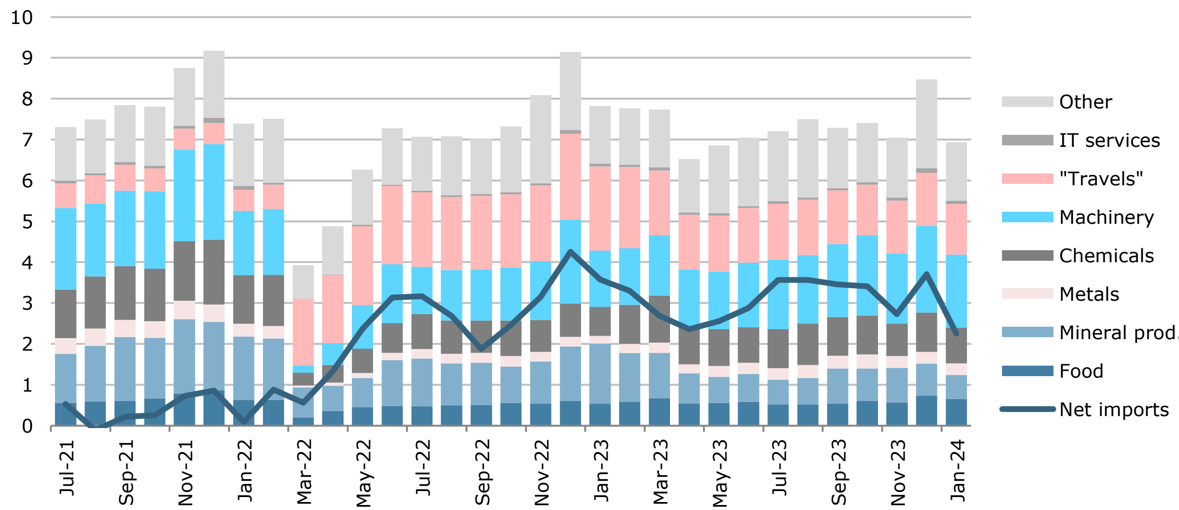
Exports of goods and services, USD bln



Agricultural exports by routes, mmt



Imports of goods and services, USD bln



Sources: NBU, Agrarian Ministry, Concorde Capital calculations

Gross NBU reserves: Weak growth forecast implies further ForEx liberalization

Ukraine's gross international reserves increased by USD 12.0 bln in 2023 to reach a record-high level of USD 40.5 bln (5.6 months of future imports) as of the year's end. Key driver of such a build-up was USD 40.7 bln of net international financing of Ukraine's budget gap, which exceeded NBU's USD 28.6 bln interventions at the ForEx market (aimed at supporting relatively fixed rate of the local currency).

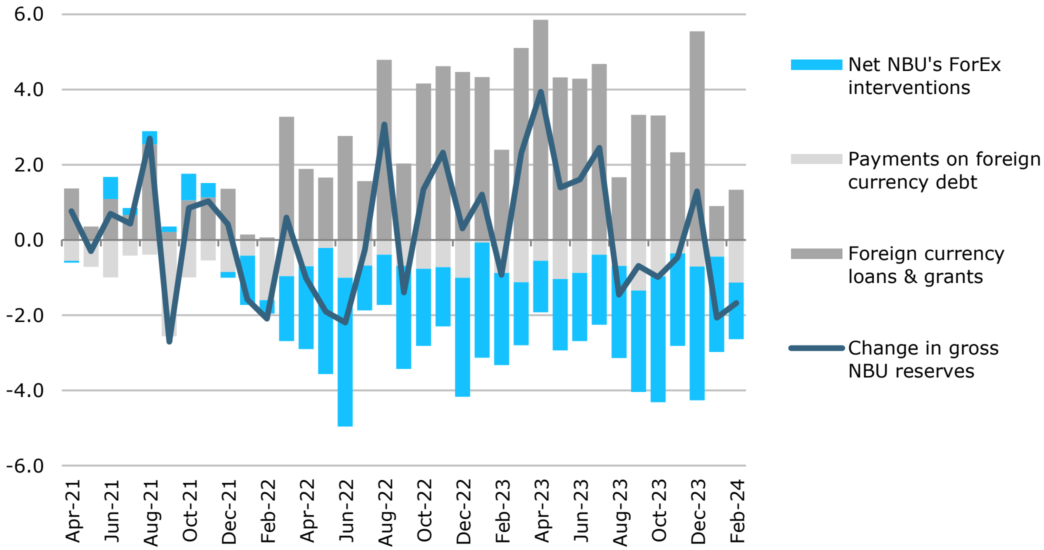
In January-February 2024, due to a record-weak external financing of budget deficit, Ukraine's gross reserves underwent a decline to USD 37.1 bln, even though the NBU was able to slightly cut its ForEx interventions. Nevertheless, the reserves stay at a safe level of 5.0 months of future imports.

As Ukraine's financial assistance is going to radically improve in March, its gross reserves are likely to come back to its historical highs at the end of March.

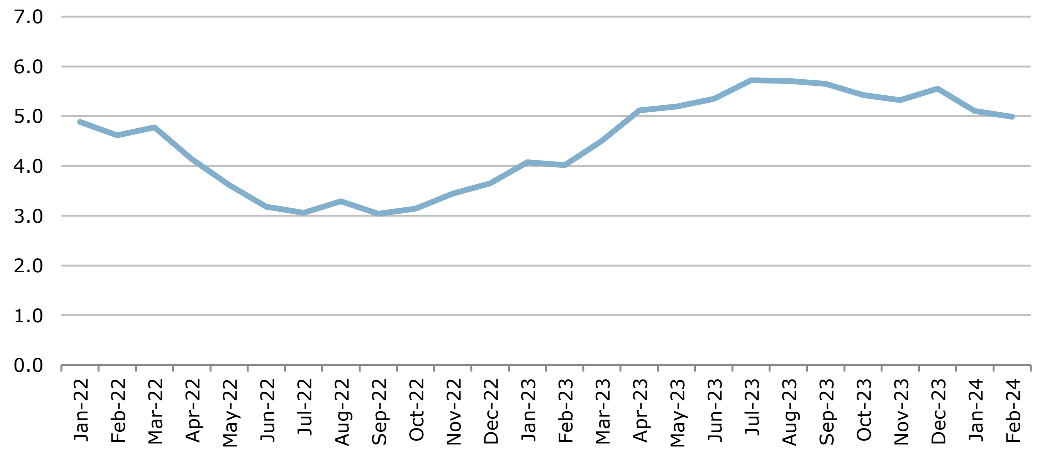
The most important step to curtail demand for foreign currency since russian invasion was NBU's introduction of tight control on capital flows. The postponed demand for hard currency withdrawal related to loan servicing and repatriation of dividends by business is increasing, which threatens enormous foreign currency outflow (up to 1/3 of the current level of gross reserves) once the restrictions are lifted.

The National Bank sees its gross reserves will be at USD 40.4 bln level as of end-2024, which is flat yoy. Taking into account that gross reserves increased by USD 12.0 bln in 2023, the no-growth forecast for 2024 (amid no expected widening of trade deficit and a planned devaluation of hryvnia) looks rather conservative. We relate such a conservatism to an NBU's intention to start ForEx market liberalization for business already this year.

Key drivers of NBU reserves change, USD bln



Gross NBU reserves, months of future imports



Sources: NBU, Concorde Capital calculations

Hryvnia: NBU to allow for devaluation within its "currency stability" range

In October 2023, the National Bank decided to shift from the policy of fixing the UAH/USD rate that it implemented in the first hours of russian invasion. Instead, it introduced a policy of "managed flexibility" of the UAH/USD rate. In the environment of structural deficit of foreign currency, this policy still assumes heavy interventions of the NBU to keep the ForEx market balanced.

With this shift, the National Bank has officially committed to a "currency stability" strategy meaning the devaluation of hryvnia will be low enough to keep UAH deposits in the banks (yielding 10%-12% after tax for 12M) more profitable than investments into cash dollars.

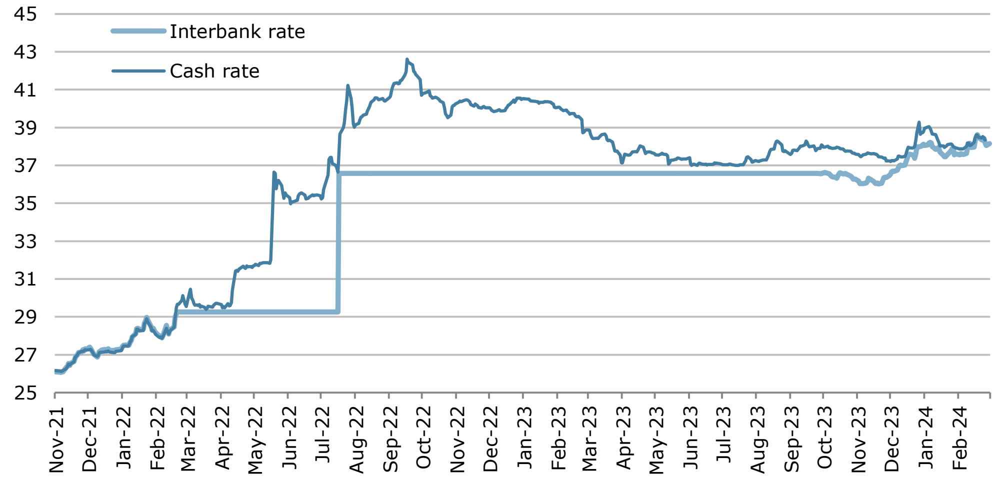
- In December, when demand for cash dollars is peaking seasonally, the NBU allowed for a 4.3% devaluation of hryvnia, to UAH 38.0/USD.
- In January, when demand for dollars decreased significantly, the NBU did not let Ukrainian currency to revalue.
- In February, the NBU further cut its ForEx interventions to let hryvnia further devalue (by 0.9% m/m).
- Notably, in February, the cash (unofficial) rate of dollars has converged to the interbank (official) rate for the first time since the russian invasion.

The National Bank's tactics to gradually step out of ForEx market coincides with our view that the regulator will allow for a moderate devaluation of the national currency in 2024.

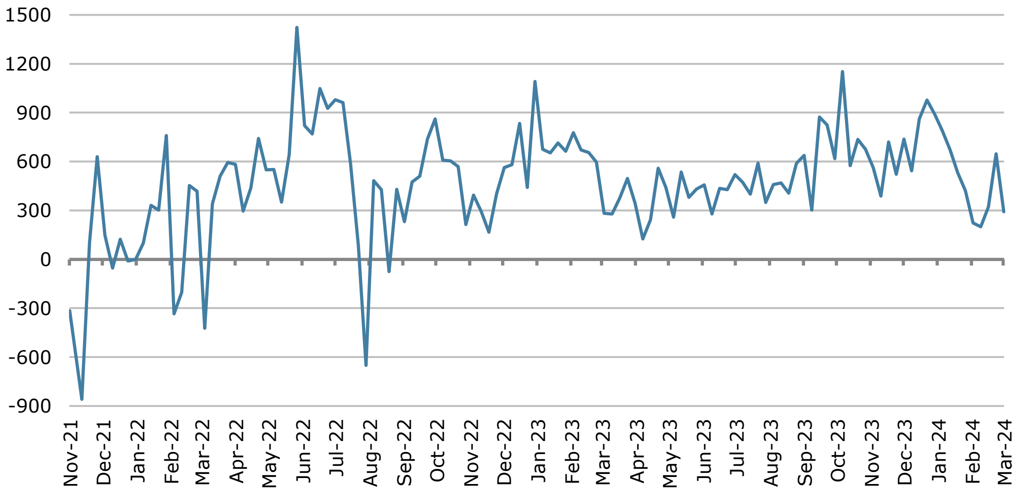
In particular, we estimate the NBU assumes the average UAH/USD rate of 39x in 2024 (up 6.6% compared to the average rate of 36.6 in 2023). We estimate the NBU sees the average dollar rate to reach 41.9 UAH (up 7.5% yoy) in 2025 and 48.1 UAH (up 10.0% yoy in 2026). Our estimates are based on the data provided by the January's inflation report of the NBU.

That said, we see the NBU is expecting average appreciation of dollar vs. hryvnia at 8.7% p.a. in the next three years. This suggests the NBU's monetary policy (which aims at keeping hryvnia interest rates attractive for Ukrainians) will remain tight in the mid-term.

UAH/USD rate



Weekly NBU ForEx interventions, USD mln*



** Positive numbers are for the net sale of foreign currency.*
Sources: NBU, Concorde Capital calculations

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Prices: Tight monetary policy, stable USD rate, weak food prices curb inflation

After peaking at 26% yoy in October 2022, consumer inflation lost momentum and started slowing down fast. In January 2024, annual CPI was 4.7%, the lowest level since late 2020.

Inflation of food, the biggest component of the consumer basket, has been slowing down since November 2022, which is mostly a result of weaker global soft commodity prices and a strong 2023 harvest in Ukraine. Other important factors of the fast disinflation were tight monetary policy and optimistic expectations on stability of Ukrainian currency.

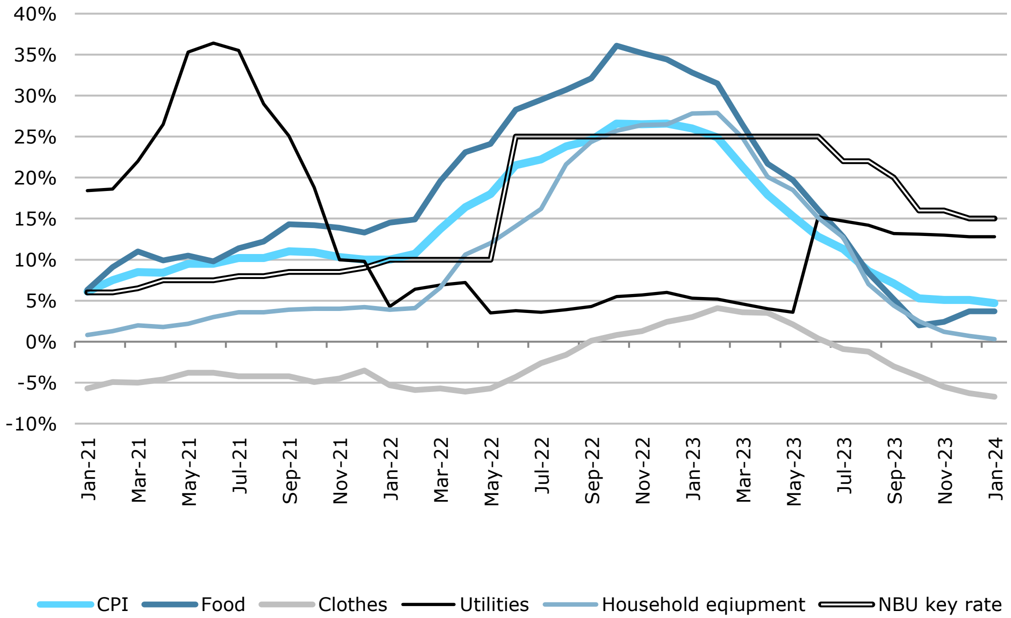
Meanwhile, a one-off increase of electricity rates for households by 70% since July 2023 was among the biggest inflation drivers in late 2023. Notably, regulated residential prices of other utility items (natural gas, heating, water) have been fixed since the beginning of russian invasion. Such capped regulated prices, therefore, are accumulating their inflation potential.

In 2024, consumer inflation is expected to speed up slightly. Among the expected inflation drivers, there are:

- Increased hryvnia devaluation expectations due to the National Bank's departure from the policy of fixed UAH/USD rate.
- Speed up of production costs, primarily labor. This will be driven by a limited supply of qualified labor (due to emigration and military draft), as well as a regulatory increase of minimum wages (by 19% since April 2024, as compared to end-2023, vs. no increase in 2022-2023).
- Likely weaker yoy agricultural production after weather-driven bumper harvest in 2023.

The NBU is expecting that CPI will reach 8.6% in end-2024, while we see the inflation to be slightly weaker.

Key drivers of consumer inflation



Sources: NBU, UkrStat, Concorde Capital calculations

Money Market & Banking Sector

Hryvnia rates: NBU's tight monetary policy is not much efficient

In June 2022, the National Bank introduced a tight monetary policy to address war-related challenges on the market. It increased its key rate to 25% from 10%, in the hope that market rates will be adjusted correspondingly. However, "monetary transmission" turned out to be too slow. The only visible increase in rates was observed in corporate loans as the banks took advantage of NBU's rate adjustment. At the same time, the banks were reluctant to increase their deposit rates significantly in 2022: in December, corporate and individual deposit rates increased by 6.2 pp and 4.9pp as compared to May, respectively. Yields of sovereign bonds only increased by 7.5pp as the government did not count on the open bond market as a source of budget deficit financing.

The NBU had to significantly adjust its policy in early 2023 to facilitate the monetary transmission. Its primary focus was to make individual deposit rates increased in order to demotivate Ukrainians from running into dollars:

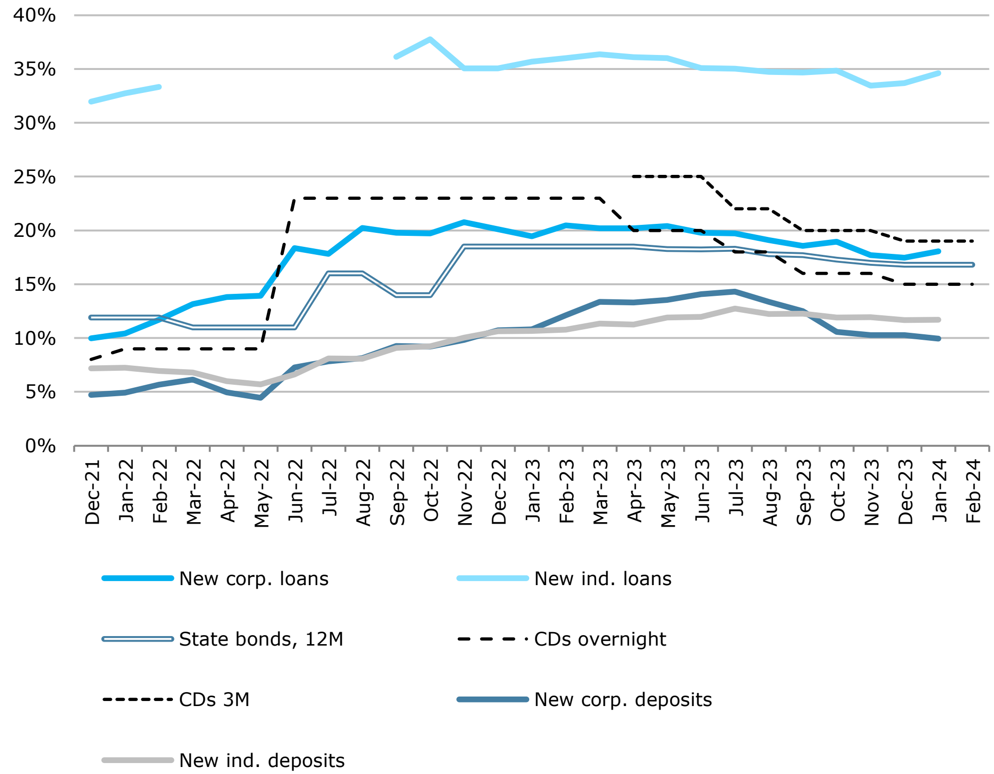
- In February-March, it raised to 20% the reservation ratio for banking short-term retail accounts (from 5% as of early January).
- In April, it introduced high-yield 3-month certificates of deposits (offering a 25% rate). The banks were eligible to invest in such CDs depending on their track record of attracting of 3M+ individual deposits.

These measures did not work much as the banks increased average individual deposit rates by about 1.9pp in July 2023, as compared to January. Meanwhile, the average deposit rates for corporate clients (which were not stimulated by the NBU) increased 3.5pp over the same period. However, the NBU was able to report about its success as the banks were able to break a downward trend in individual term deposits: after a 7% yoy decline in 2022, term deposits increased by 24% YTD as of end-August 2023 and were steadily increasing further.

In July 2023, the NBU decreased the key rate from 25% to 22%, while in late October it decided to align the key rate to a rate of overnight CDs (16%). Since December, both rates are at the level of 15%.

Taking into account that Ukraine's headline CPI was 4.7% in January 2024 and the NBU expects it to reach 8.6% by December, the National Bank's monetary policy remains tight. The declared reason for the tight policy is NBU's intention to make sure that local currency deposits offer a better return for households than their potential investments into cash dollars. In this way, the NBU believes there will be limited speculative demand for foreign currency in Ukraine.

Interest rates on hryvnia instruments



Sources: NBU, Concorde Capital calculations

Local currency liquidity of banks is increasing as the build up of their deposit base (+70% since February 2022, +35% in 2023) outpaces their lending activity (net loans decreased by 1% since February 2022 and increased by mere 1% in 2023).

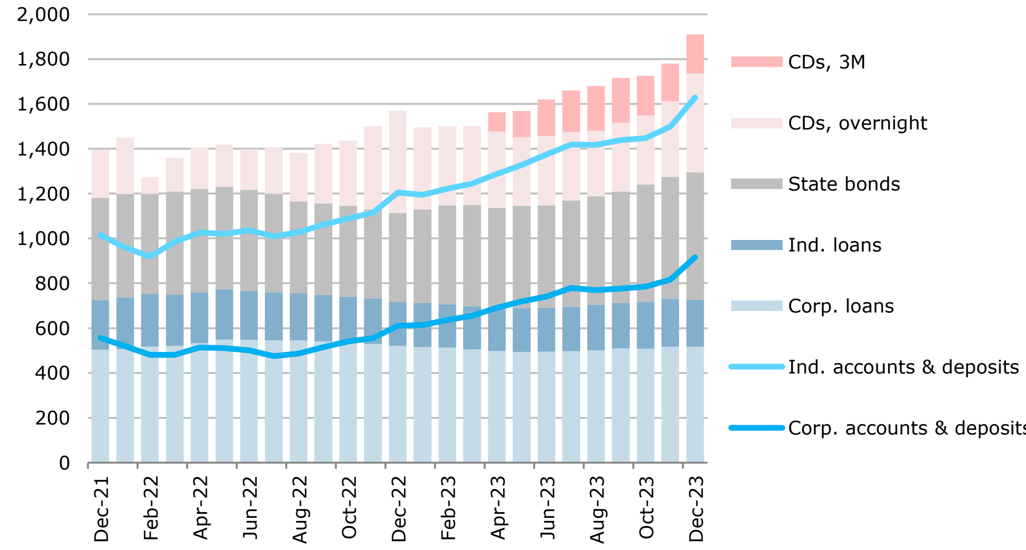
The National Bank's tight monetary policy allowed the banks to "invest" with a high return into the certificates of deposits (CDs): their exposure into such instruments increased 144% since February 2022 and by 35% in 2023. In fact, CDs have become not just an instrument of NBU's monetary policy but rather the main risk-free investment instrument for the banks. Also, in 2023, the banks were actively investing into local government bonds (exposure increased 43% yoy), which are also considered as low-risk instruments.

Starting November 2022, the banks' exposure to bonds and CDs exceeded their net loan portfolio. Starting December 2022, their interest income from securities is exceeding interest incomes from their clients.

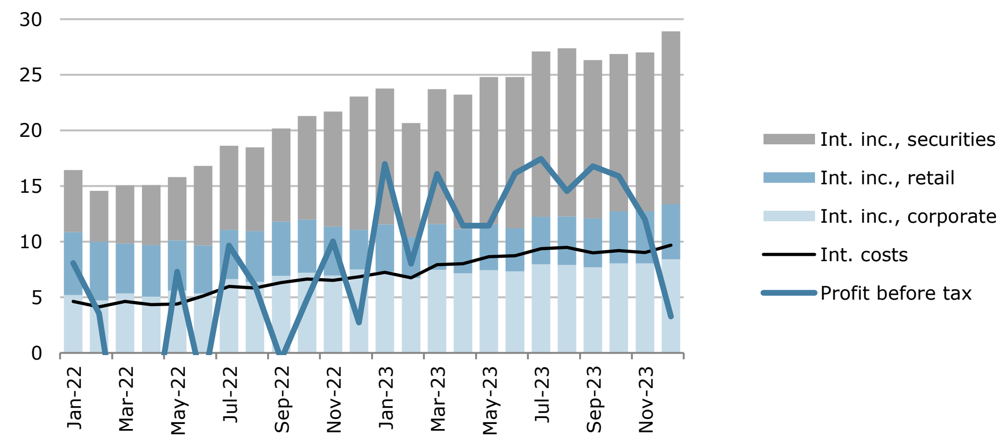
Availability of high-yielding instruments discourage the banks from seeking new borrowers. As the NBU is expecting to keep a tight monetary policy at least in 2024, the banks' motivation to finance the Ukrainian business is likely to remain weak.

Exposure of the banks into "low-risk" and high-yielding securities allowed the banks to generate super profits last year: in 11M23, the sector's ROE was 53% (vs. 15%-35% in 2018-2021). This result was corrected in 12M23 to 32% as the parliament adopted a special 50% profit tax rate for the banks for 2023. Starting 2024, the banks' profit tax will be 25% (vs. 18% rate for other businesses in Ukraine).

Key banking local currency accounts, UAH bln, eop



Banking interest incomes and costs, UAH bln



Sources: NBU, Concorde Capital calculations

Dollar rates in Ukraine: Low & stable despite volatility in the U.S.

Due to currency control measures, Ukraine's dollar money market remains isolated from the global agenda.

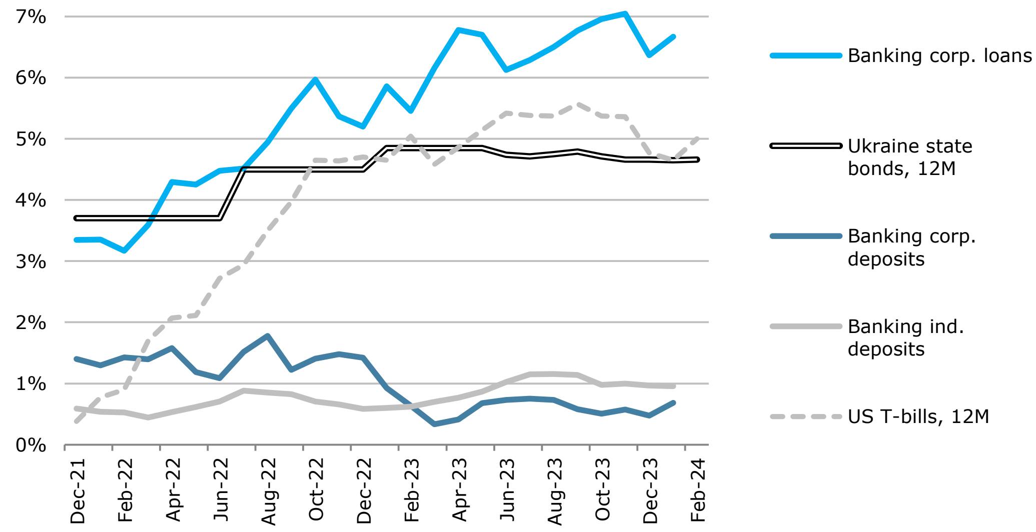
Banks are lending in foreign currency only to the companies which have sufficient export revenue, otherwise they have to provision at least 50% of the newly issued loan. For this reason, foreign currency loans are rare in Ukraine: net foreign currency loans decreased by 36% since February 2022.

At the same time, the banking foreign currency deposit base is increasing despite low deposit rates (foreign currency accounts of clients increased 10% since February 2022). The banks, therefore, allocate most of their foreign currency liquidity at the correspondent accounts with foreign banks. Since October 2022, the banks' correspondent accounts abroad have exceeded their net loan portfolio in foreign currency.

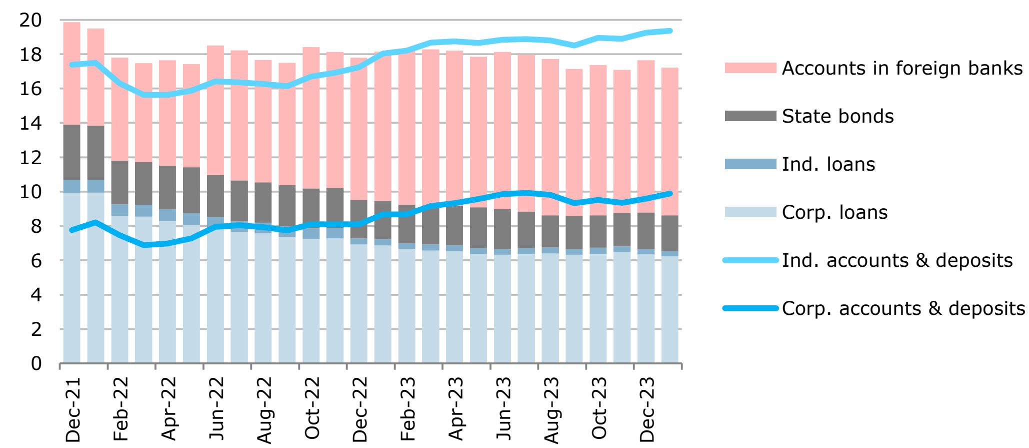
Low deposit rates and limited ability to lend in foreign currency, coupled with abundant liquidity, has resulted in uniquely low lending rates in dollars inside the country:

- Local banks are lending to exporters at rates which are comparable to the IMF's financing rate for the Ukrainian government.
- Yields of short-term local government bonds denominated in dollars are currently comparable to the yields of U.S. treasury bills.

Interest rates on dollar instruments



Key banking foreign currency accounts, USD bln equivalent, eop



Sources: NBU, Bloomberg, Concorde Capital calculations

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Contacts

2 Mechnikova Street, 16th Floor
Parus Business Centre
Kyiv 01601, Ukraine

Tel.: +380 44 391 5577
Fax: +380 44 391 5571

www.concorde.ua

CEO
Igor Mazepa im@concorde.com.ua

SALES & TRADING
Alisa Tykhomirova at@concorde.com.ua

RESEARCH
Alexander Paraschiy ap@concorde.com.ua