

UAH sovereign bonds

Yields to stay low for some time

Ukrtelecom privatization to cover 1Q11 cash needs

It appears that the Ukrainian government has covered its funding needs not only for the remainder of 2010, but for the first quarter of 2011 as well. Consequently, the government can afford to keep short-term yields low at primary UAH bond auctions during the next few months (6.5% for 6M, 7.8% for 1Y), and look toward the longer end of the curve, where yields are likely to see some decline.

With the Ukrtelecom privatization going forward and approximately UAH 10.5-12 bln anticipated from the sale in 1Q11, the government should have enough cash to cover 73%-84% of the UAH 14.3 bln in debt coming due in the first quarter. As it still has to cover UAH 5.1 bln of debt redemptions in 2Q11 and a total of UAH 10.4 bln in the second half, we expect the government to continue issuing UAH debt as well as a Eurobond down the road, although without increasing yields.

Yield curve to flatten with decline at the longer end

Consequently, we are now bullish on sovereign UAH debt over the next few months, based on the successful privatization of Ukrtelecom and continuing cooperation with the IMF.

- We suggest moving toward the longer end of the curve (above 1Y), where there is larger upside potential (yields may decline from 11%-12% to closer to 10%) due to higher duration;
- We see 1Y yields moving to 8%-9% (from the current level of about 10% - see chart 6), but the bonds have smaller upside price potential given the shorter duration;
- In our opinion, VAT Bond prices have risen about as high as they are likely to go, with yields plummeting from 17.6% to 12.5% since issue at the end of August (Chart 2). At least 50% of the bonds have already reached the secondary market. Given the dearth of historical data from 2006-2008, when two and three-year bonds were sold at 6%-9%, we now expect VAT bonds (2.1 year duration, 4.5 years to maturity) to eventually yield 10.5%-11%, implying 3% upside potential to the current price.

Liquidity improves

Liquidity in the UAH debt market has been improving as daily average trading volumes (excluding VAT Bonds) now stand at more than UAH 500 mln (USD 63 mln) vs. UAH 200-300 mln earlier in 2010, while volume for VAT Bonds is above UAH 700 mln (see Chart 3). The demand for UAH sovereign debt should also remain high:

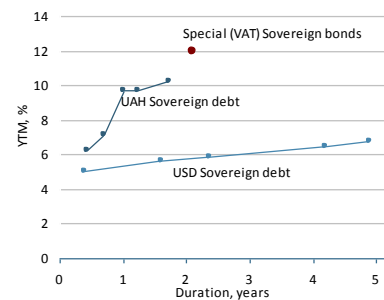
- International fixed income investors have demonstrated increased interest in UAH debt as they have already bought nearly 25% of the VAT bonds issued (see Chart 4), while their share of total outstanding UAH bonds surged from 1% at the beginning of 2010 to 7% now;
- Local banks will also invest in UAH sovereign debt given the high liquidity and still cautious approach to corporate lending. Their UAH correspondent accounts now stand at UAH 20-25 bln, implying UAH 8-13 bln in cash above obligatory reserves, while total cash is at 12% of aggregate assets compared to less than 10% in mid-2008;

Declining sovereign UAH debt rates, coupled with low UAH forex risk, will also support further recovery in the local corporate bond segment, pushing yields down.

Report date

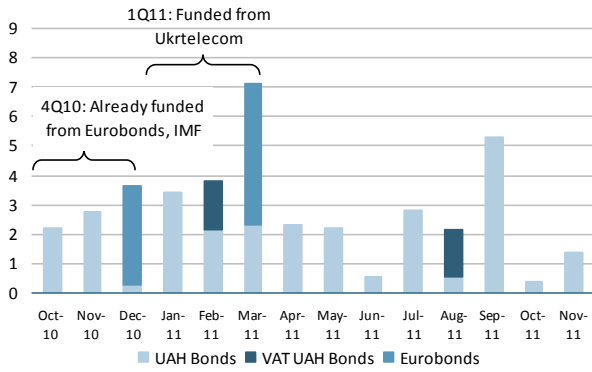
13 Oct 2010

Yield curves, as of 12/10/2010



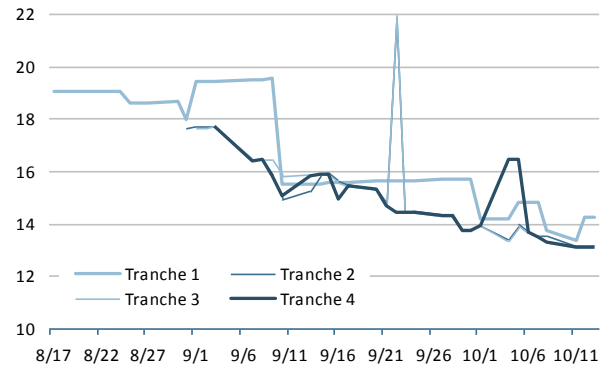
Source: Bloomberg, Concorde Capital

Chart 1. Public debt redemption schedule, UAH bln



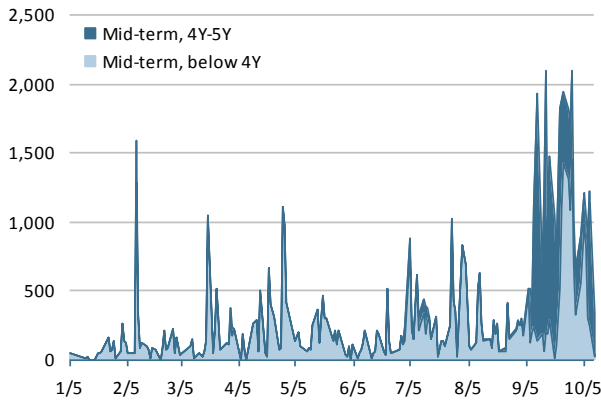
Source: Finance Ministry, Concorde Capital estimates

Chart 2. VAT Bonds YTM, %



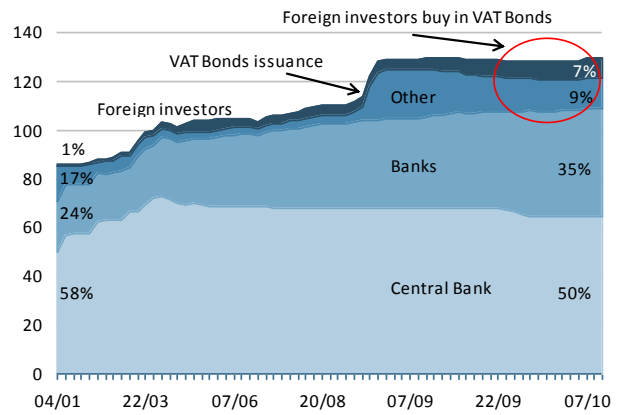
Source: Bloomberg

Chart 3. UAH mid-term sovereign bond trading volumes on the secondary market in 2010, UAH mln



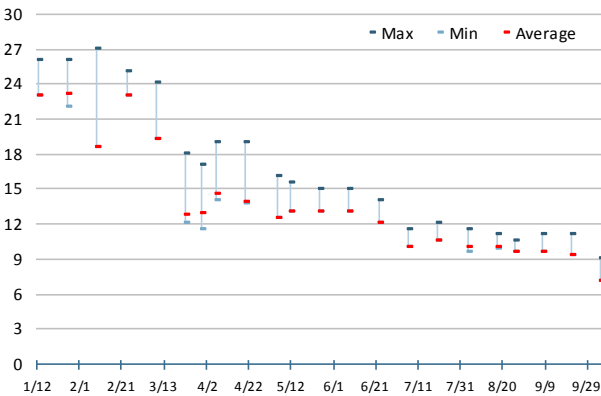
Source: NBU, Concorde Capital estimates

Chart 4. UAH sovereign bonds holders in 2010, UAH bln



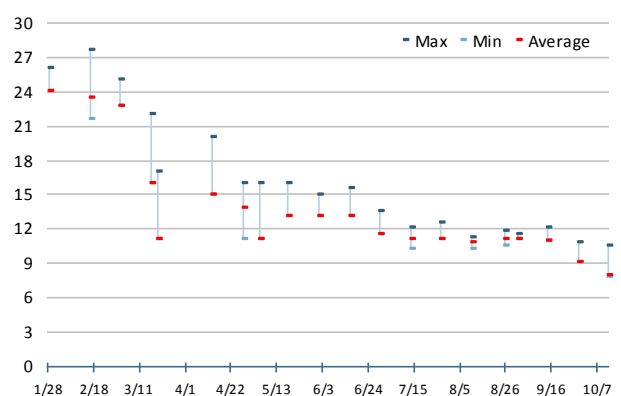
Source: NBU, Concorde Capital estimates

Chart 5. Yields on 8M-9M UAH sovereign bonds at primary auctions in 2010, %



Source: Finance Ministry, Concorde Capital estimates

Chart 6. Yields on 11M-1Y UAH sovereign bonds at primary auctions in 2010, %



Source: Finance Ministry, Concorde Capital estimates

Math: 2010-1Q11 cash needs look covered

“Back of the envelope” calculations suggest that the government has already covered the majority of its funding needs through year-end, with the total shortfall now at approximately UAH 1 bln:

2010 budget needs

Fiscal deficit	UAH 60 bln	
UAH debt redemption (public)	UAH 21 bln	(incl UAH 5.2 bln in Oct-Dec)
FX Debt redemption (public)	<u>UAH 3.4 bln</u>	(USD 0.43 bln Yen Eurobond, December)
TOTAL	UAH 84.4 bln	

2010 sources of financing 2010

Loan from VTB	UAH 15.8 bln	(USD 2 bln)
IMF (directly to the gov't)	UAH 15.8 bln	(USD 2 bln)
Eurobonds	UAH 15.8 bln	(USD 2 bln)
UAH debt placed (YTD)	<u>UAH 36.1 bln</u>	
TOTAL	UAH 83.5 bln	

Total current shortfall for 2010 UAH 0.9 bln

Importantly, this conclusion rests on the following assumptions/risks:

- The VTB USD 2 bln loan, maturing in December 2010, will be extended
- The IMF USD 1.5 bln second tranche (with USD 1 bln to go directly to the government) will be disbursed in November-December 2010
- Officially, the government is saying that VAT reimbursement arrears now stand at UAH 3 bln, in line with IMF requirements. However, the government reimbursed VAT for only UAH 12 bln in 8M10 in cash vs. UAH 21.9 bln in 8M09, despite improving economic conditions. This is somewhat troubling and the IMF reaction when considering the second tranche could be negative if it discovers that the MinFin is continuing to accumulate VAT reimbursement debt.

For the beginning of 2011, we expect UAH 10-12 bln from the Ukrtelecom privatization will cover 75%-90% of debt redemptions in 1Q11 (there is typically a fiscal surplus in the first half of the year):

Public debt redemptions in 1Q11

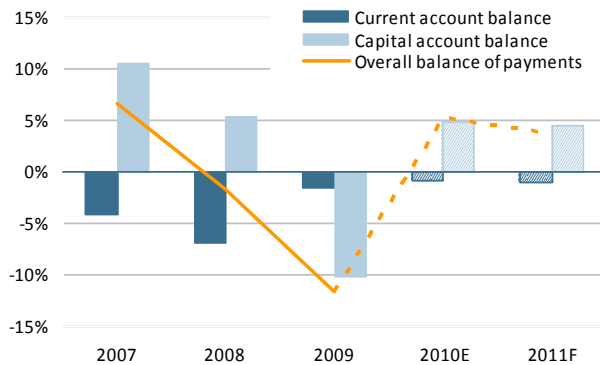
UAH debt redemption (public)	UAH 7.9 bln	
VAT Bonds principal payment	UAH 1.6 bln	
FX Debt redemption (public)	<u>UAH 4.8 bln</u>	(USD 0.6 bln Eurobond in March)
TOTAL	UAH 14.3 bln	

FX risks are low

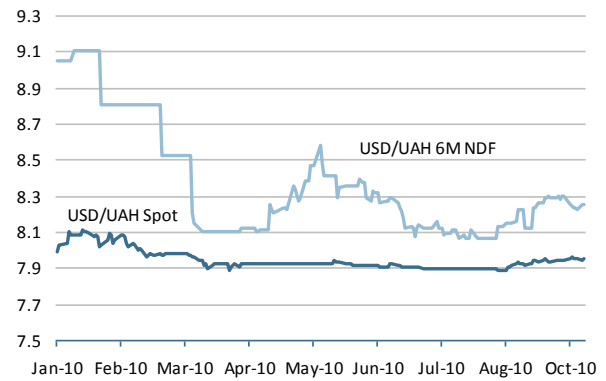
Since last November, the USD/UAH exchange rate has remained stable at 7.9-8.1. Fundamentally, we do not see significant devaluation pressure in the nearest future, although seasonal short-term volatility in the fall is possible.

- The balance of payments has been improving this year. In 8M10, the current account was USD 562 mln in the red (vs. a deficit of USD 1.1 bln over the same period last year), while the financial account saw a surplus of USD 5.8 bln (as opposed to a deficit of USD 9.7 bln in 8M09), with FDI accounting for almost half of this amount. For 2010 in total, we expect the current account to be around zero or at a marginal deficit of up to 1% of GDP, while the financial account should post a surplus of 4.8% of GDP.
- With the Ukrtelecom privatization a buyer (particularly a foreign buyer) could sell foreign exchange on the domestic market to generate the UAH liquidity necessary to make a payment to the government. This will boost NBU foreign exchange reserves by as much as USD 1.5 bln at the beginning of 2011.
- Ukraine secured a USD 15 bln (50% of current central bank reserves), 2.5-year new stand-by facility from the IMF, USD 1.9 bln of which has already been received. We see access to the additional forex liquidity keeping UAH risk low and supporting market confidence in the hryvnya.

- Public confidence in the hryvnya has also improved: in 9M10 retail deposits in UAH rose 32.5% vs. only 12.4% for retail deposits in foreign currency. On the local retail market over 9M10, demand exceeded supply by USD 4.2 bln vs. USD 5.7 bln in 9M09.

Balance of Payments, % of GDP


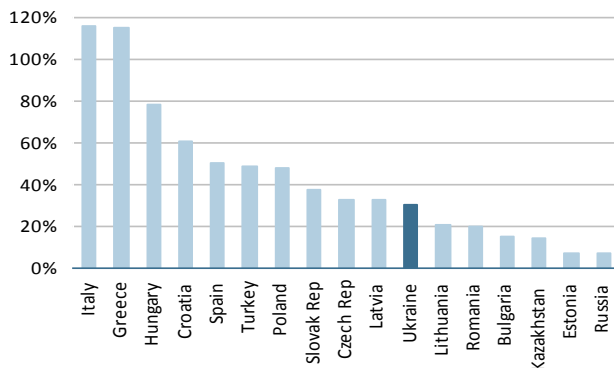
Source: NBU, Concorde Capital estimates

UAH spot exchange rate, 6M NDF*


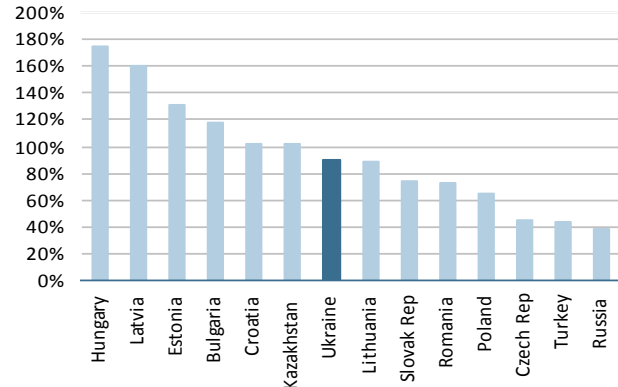
* Bloomberg composite

Source: UkrDealing, Bloomberg

Seasonal volatility in the exchange rate could be possible this fall as we have seen 0.8% UAH depreciation since the beginning of September, while local elections scheduled for October 31 could trigger some volatility as well. Eventually, accelerating inflation might also translate into depreciation pressure on the hryvnya, although for now we see this possibility as remote given the current strong net currency inflow through the BoP.

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	4.3	4.9
Nominal GDP, UAH bln	226	267	345	441	544	721	948	915	1059	1211
Nominal GDP, USD bln	42.4	50.1	65.0	86.1	107.8	142.7	179.9	117.4	134.1	153.3
GDP per capita, UAH	4685	5591	7273	9372	11630	15372	20495	19901	23146	26572
GDP per capita, USD	880	1048	1371	1829	2303	3044	3890	2555	2930	3364
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	7.8	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	-1.8	-1.1	-1.5
Current account balance, % GDP	7.5	5.8	10.6	2.9	-1.5	-4.1	-7.0	-1.5	-0.8	-1.0
Trade balance, USD bln	1.9	1.3	5.0	0.7	-3.1	-7.9	-13.7	-2.0	-1.5	-1.0
Trade balance, % GDP	4.4	2.6	7.7	0.8	-2.8	-5.5	-7.6	-1.7	-1.1	-0.7
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	64.4	72.1
Imports, % chg yoy	5.0	28.7	31.3	20.4	22.0	34.8	38.3	-43.5	14.7	12.0
Capital account balance, USD bln	-1.2	0.1	-4.3	8.0	4.1	15.1	9.5	-11.9	6.5	7.0
Capital account balance, % GDP	-2.9	0.2	-6.7	9.3	3.8	10.6	5.3	-10.2	4.8	4.6
FDI net, USD bln	0.7	1.4	1.7	7.5	5.7	9.2	9.9	4.5	4.0	6.0
NBU reserves (eop), USD bln	4.4	5.1	9.5	19.4	22.3	32.5	31.5	26.5	34.9	40.4
Debt indicators										
Public debt, USD bln	13.8	14.5	16.0	15.5	15.9	17.6	24.6	39.7	52.2	63.5
Public debt, % GDP	32.5	29.0	24.7	18.0	14.8	12.3	13.7	34.8	38.9	41.4
Corporate external debt, USD bln	n/a	13.0	17.8	25.5	42.7	67.6	85.0	79.3	85.3	91.3
Corporate external debt, % GDP	n/a	25.9	27.3	29.6	39.6	47.4	47.2	67.5	63.6	59.6
Gross external debt, USD bln	n/a	23.8	30.6	38.9	54.5	80.0	101.7	103.3	115.3	126.3
Gross external debt, % GDP	n/a	47.5	47.1	45.2	50.6	56.0	56.5	88.0	86.0	82.4
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	50.2	52.2
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	302.7
Expenses, UAH bln	n/a	55.8	79.5	112.8	137.1	174.2	241.5	242.4	323.6	339.0
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

Contacts

CONCORDE CAPITAL

2 Mechnikova Street, 16th Floor
 Parus Business Centre
 Kyiv 01601, Ukraine
 Tel.: +380 44 391 5577
 Fax: +380 44 391 5571
 www.concorde.ua
 Bloomberg: TYPE CONR <GO>

CEO

Igor Mazepa im@concorde.com.ua

SALES

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
 Dasha Vasilieva vd@concorde.com.ua

Domestic Sales & Trading

Yuriy Pilipenko up@concorde.com.ua
 Alisa Tikhomirova at@concorde.com.ua

Director of Domestic Fixed Income

Roland Vizner rv@concorde.com.ua

RESEARCH

Director of Investment Research

Rebecca Baldrige, CFA rb@concorde.com.ua

Metals & Mining

Andriy Gerus ga@concorde.com.ua

Utilities, Machinery

Yegor Samusenko syg@concorde.com.ua

Oil & Gas

Andriy Gerus ga@concorde.com.ua
 Ruslan Patlavskyy rp@concorde.com.ua

Agriculture, Consumer-related

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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