The Ukraine-EU deal

Political and strategy note

November 22, 2013

CONCORDE CAPITAL

Executive summary

Relations are shifting quickly between Ukraine, EU and Russia, and there is no certainty about what direction Ukraine will ultimately choose.

The November 21 resolution by Ukraine's Cabinet does not rule out the scenario of the Ukraine-EU Association Agreement being signed in Vilnius next week, though it **clearly lessens the chance for a deal**.

The ultimate decision has yet to be made by Ukrainian President Viktor Yanukovych, whom the Ukrainian constitution empowers to determine Ukraine's foreign relations. We expect more clarity after the preannounced meeting of Ukraine's National Security and Defense Council (whose members include the president and prime minister). The date of the meeting is not known at the moment, and our feeling is it will occur closer to the scheduled Vilnius summit (starting November 28).

For those who strongly believe in the scenario that no deal is signed in Vilnius, we recommend looking to short Ukraine's sovereign bonds with a time horizon of two to three weeks, and looking to accumulate the Eurobonds of Naftogaz (NAFTO), the single and most probable winner of warming relations between Ukraine and Russia.

For less aggressive investors, we recommend waiting until the results of meetings of Ukraine's Security and Defense Council and the Vilnius summit. In this report, we offer a tentative action plan, depending on the ultimate outcome of the possible Ukraine-EU deal.

Three possible outcomes

The release of imprisoned former Ukrainian Prime Minister Yulia Tymoshenko, one of the core demands from the European Union (EU) for the smooth signing of the Association Agreement, has been moved backstage. With its November 21 order to postpone preparations for the Eastern Partnership summit in Vilnius on November 28-29, Ukraine's Cabinet of Ministers took the decision-making initiative on whether to integrate with the EU at all, insisting on a pause. Yet the final word still remains with Ukrainian President Viktor Yanukovych, who is the only real decision maker in the country.

In this report, we offer three scenarios for Ukraine-EU relations that are possible at the moment of publishing (given that the scenarios change each day).

The three outcomes can affect Ukrainian securities in different ways, and since we can't estimate with certainty which of the scenarios has the highest probability, we recommend to wait until the summit results before taking any steps.

Based on our analysis of the current political disposition, we stress to investors that an IMF deal is unlikely to be a real option for Ukraine in any scenario, so Ukraine will have to count on the support of the international debt market, the EU, the Russian Federation or the domestic debt market in solving its problem of insufficient ForEx liquidity.

Our three scenarios are:

No deal, moving into Russia's orbit. Either Yanukovych or the EU leadership decides to postpone the deal for an indefinite time (read: until after Ukraine's presidential elections in March 2015). Ukraine will count on Russia's macroeconomic support in this case, which should eventually lead the country to joining the Eurasian Economic Union in 2014-2015.

Last-minute deal. The Association Agreement is signed in Vilnius, whether or not Tymoshenko is released.

Stalling on the deal. EU and Ukrainian leaders will continue their negotiations, in which Ukraine will try to bargain more macro aid while at the same time trying to normalize its relationships with Russia.

None of the these scenarios are advantageous for Yanukovych, whose thoughts are already on the 2015 election. The first one gives him some comfort about financial backing for the next year but no political comfort. The second one looks beneficial from the political standpoint but is more risky on the financing side. The third scenario effectively prolongs the current situation and offers some chance for new dividends from either the EU or Russia (or both), but it is clearly more risky both financially and politically.

Macro and political background: there is no clear win scenario for Ukraine

There is no outcome on Nov. 28-29 that will make Ukraine happy

Whatever the decision at the Eastern Partnership summit on November 28-29, life will get worse in Ukraine.

It's evident that by **signing the Association Agreement, Ukraine** will advance in the eyes of European elite and investment society. But there are no clear short-term monetary benefits from such a deal for Ukraine. Moreover, the deal will jeopardize Ukrainian-Russian business relations and will likely lead to hostile economic sanctions from the Russian side (which accounts for 25% of Ukrainian exports, equal to all the EU countries combined). And there is no clear evidence of whether the EU will help Ukraine solve the macro risks that will be incurred from what will practically be a trade war with Russia.

There is clear perception risk for Ukraine from the international investment society **in case Yanukovych does not sign the EU deal**, and he will likely lose poll ratings in case of failure (though most of the pro-EU electorate never supported him). A likely benefit from the failed EU deal is warmer relations with Russia, which may be beneficial for several months but will create risks for Ukrainian independence as soon as Russia inevitably begins to pressure Ukraine to join the Customs Union, the precursor to the Eurasian Economic Union. Yanukovych will be isolated and on his own in this case, with no support from Western powers, even on a surface level.

Although each of the "clear decision" scenarios (deal or no deal) pose more risks than benefits in the short term, **the worst case will be the "stalling" scenario**. In that case, Ukraine can only theoretically rely on some support from the side of either Russia or the EU (or both). But given the immense scope of the challenges that lie before Ukrainian economy (low ForEx liquidity and high electoral demand for UAH/USD stability), that case raises the likelihood that Ukraine will suffer from currency shock or some default event in 2014.

Political disposition: March 2015 elections in mind

All the Ukrainian government's further actions will be done with an eye on the presidential elections (preliminarily scheduled for March 2015). That's how we are interpreting the current decision-making processes of Yanukovych , the single person that decides anything of importance in Ukraine now.

"Stability" is Yanukovych's only campaign pillar. The key motto of Yanukovych's 2010 presidential campaign was "improvement already today." Soon after his victory, the word "improvement" became lampooned to represent all the trouble that ensued (economic decline, worsened public welfare, tax and other regulatory pressure on local business). For the 2012 parliament election campaign, the slogan of pro-presidential Party of Regions was changed to "stability". Stability is all that Yanukovych has left so it will be his key motto for his next presidential campaign.

The three pillars of "stability" that Yanukovych has left are:

- **Stable UAH/USD rate** and weak local currency, the lack of which during Tymoshenko's 2008-2009 government was the main argument for Yanukovych in alleging his opponent's incompetence.
- **Stable residential tariffs for natural gas and power,** which will be argued as a key achievement of Yanukovych's first presidential term and evidence of a strong commitment to his electorate.
- **Stable prices** (low inflation), perhaps the only manifestation of "stability" that he might have to sacrifice.

The first two points form the backbone of Yanukovych's popularity (as nothing else is left), and these two things cannot be sacrificed unless exchanged for something more compelling. That is why the **IMF** (which is demanding the dismantling of the first two pillars) **is not an option for Ukraine in 2013 and 2014**. But an IMF deal looks indispensable in 2015 so the key question becomes, "How to survive until then?."

The key risk to "stability" is insufficient ForEx reserves. Ukraine's international reserves are at the level of USD 20.5 bln, as of the last reporting date (2.3 month of future imports), and they have all chances to fall to USD 8-10 bln by the end of next year (less than 1.5 months of future imports). That's the main threat to the government's ability to keep the UAH/USD rate stable until the elections.

No clear solution for the key risk. It's cleat that signing the Association Agreement will not help Ukraine to immediately attract new loans abroad to achieve currency stability. Moreover, there is a high risk that the deal will worsen relations with Russia and hurt Ukraine's current account deficit, thus creating even more pressure on the hryvnia.

Political disposition: choices and theories

EU Association offers short-term political, but not economic gains. Signing the agreement can serve as an election boon for Yanukovych. Ukraine's opposition enjoys minimal confidence from the public, and Yanukovych can gain some of the pro-EU electorate by inking the pact. That would somewhat reduce the public backlash from not signing the agreement.

Though we agree with the consensus opinion that the agreement's signing is unlikely, we don't rule out Yanukovych hatching a last-minute surprise in Vilnius. In pursuing this maneuver, Yanukovych reaps all the political dividends while simultaneously depriving credit to the parliament, which has yet to approve the required bills, and the government, which effectively "capitulated" to Russia with its November 21 resolution. In reacting to the resolution, Yanukovych curtly reiterated Ukraine's European choice without offering any specifics.

On a long-term basis, EU Association would improve rule of law and property rights conditions in Ukraine, which would serve to protect the wealth accumulated by Ukraine's oligarchs since the Soviet collapse (including assets Yanukovych accumulated during his presidential term). There's also the pride factor of going down in history as the president who reunited Ukraine's ties with Europe after centuries of Russian domination. But that's not something he's willing to pursue by sacrificing "stability".

EU Association is the best option for the long-term transformation of the Ukrainian economy, but unfortunately, it doesn't solve the key economic problems of the campaign period faced by Yanukovych (specifically, it does not guarantee the stability of the local currency). A possible solution to emerge from the Vilnius summit was offered by European Parliament MP Pawel Zalewski, who proposed an ongoing program of the Ukrainian government periodically implementing economic reforms in exchange for loans from the EU. The lack of available funds was cited by key Cabinet officials, including Prime Minister Mykola Azarov, as their reason for rejecting the agreement.

Eurasian Union not an option for Ukrainian oligarchs. Negotiations currently underway on tighter economic integration with Russia might deliver the loans and cheaper natural gas prices to help the Ukrainian economy survive 2014 without macro shocks. Such integration is supported by a major part of Yanukovych's electorate in southeastern Ukraine. Yet Yanukovych must consider what will happen when it comes time to return these loans, and what Ukrainian state assets will Russia demand if the funds aren't available.

It's also worth considering that Russian integration is not a viable option for Yanukovych's personal business interests, and those of Ukraine's oligarchy. Politically, the Russian government will continue to aggressively influence events in Ukraine through satellite parties and politicians. Indeed, any supranational deal with Russia may lead to a complete loss of economic and political independence for Ukraine's wealthiest.

Closed-door arrangements? We believe it's possible that Russian President Vladimir Putin offered some incentives to Yanukovych during their two confidential meetings to encourage the Ukrainian president to abandon EU Association. Besides some loan and gas arrangements, it's possible that he also offered support for Yanuokvych's re-election effort, both locally and internationally.

The Tymoshenko factor. No doubt, Tymoshenko's Imprisonment served as one of the key impediments for the EU to signing the agreement. That being said, the possibility remains that the EU will concede to abandon this demand and sign the agreement anyway, realizing the risk involved of allowing a country as large as Ukraine to fall into the Russian orbit.

The fact that Yanukovych has not released Tymoshenko from prison, allowing that factor to undermine the EU agreement, demonstrates just how seriously he views the threat that she poses to his current monopoly on power.

Economic disposition: ForEx liquidity is the key issue for 2014

Whatever happens in Vilnius, the Ukrainian government will have to deal with a set of severe economic problems that have accumulated during the last few years.

We see some crucial weaknesses that will complicate the life of decision-makers in the near future, but all of them converge at the main bottleneck, which is the economy's increasingly dangerous foreign currency deficit.

Gross reserves need urgent replenishing

A foreign currency shortage is the government's most urgent problem, putting at immediate risk its ability to keep UAH rate stable. If no external financing is found in 2014, Ukraine will have to spend about USD 12.5 bln of its foreign currency reserves next year (which stood at USD 20.6 bln as of end-October). That would reduce Ukraine's reserves to USD 8.1 bln by the end of 2014, or just one month of future imports. To sustain itself smoothly through the next year, the government will have to attract at least USD 6 bln in new ForEx debt.

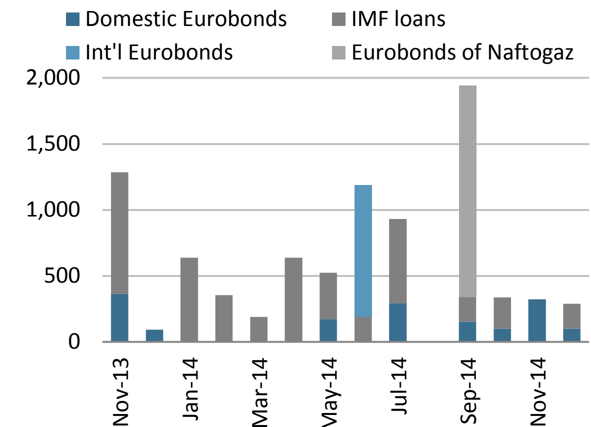
State budget on life support

In 10M13, state revenue increased just 1.9% yoy, far below the fiscal year target of 6.9% yoy. Even such modest growth was solely owing to support from the NBU (UAH 24 bln printed, or 8.6% of total revenue). We anticipate a revenue shortfall of nearly UAH 25 bln and an effective fiscal gap of nearly UAH 75 bln, or 5.1% of GDP in 2013 (excluding state company Naftogaz). There is scarce demand for local state bonds, and only hryvnia printing (either from the NBU directly or through state banks) are helping the Finance Ministry to sell enough state bonds to cover budget gaps. Yet every new tranche of printed money will only add pressure on gross reserves .

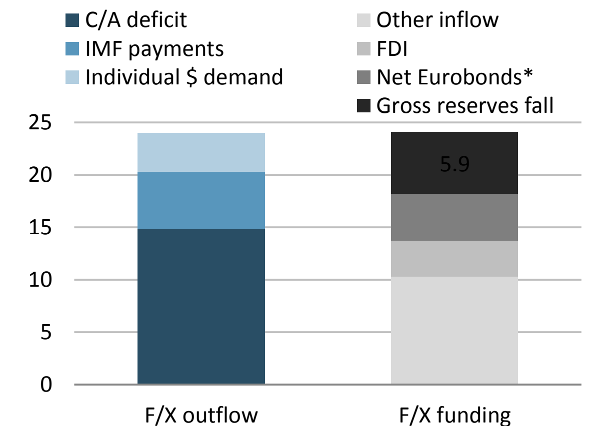
Balance of payments in chronic deficit

The permanent current account (C/A) deficit of Ukraine is a structural weakness that can hardly disappear without fundamental reforms. We expect the 2014 C/A deficit to remain as high as the current year (nearly USD 14.8 bln, or 8.4% of GDP). Capital inflow will narrow, whatever the result of the summit. The key reason is the high risk of instability posed by the approaching presidential election, the result of which is as much unpredictable as it is determinative.

Repayment schedule for sovereign and guaranteed debt, USD mln



Foreign currency balance in 2013, USD bln



** Both, local and international Eurobonds*
Source: NBU, Concorde Capital estimates

Economic disposition: Options to solve the ForEx deficit in 2014

Regardless of the outcome of the EU Association Agreement and the historical and geopolitical implications it will have, the key question facing the Yanukovych administration during the post-Vilnius period will actually be very simple: from where do we get the foreign cash to maintain a stable local currency in 2014?

We estimate the total BoP gap at USD 12.5 bln in the next 14 months. Out of this amount, we estimate that:

- No more than USD 5.6 bln can be funded by further plundering NBU reserves (to USD 16.0 bln, or two months of future imports as of end-2014)
- About USD 2.0 bln can be painlessly attracted on the local market (via placement of domestic Eurobonds)

The remaining amount, about USD 5-6 bln, should be attracted either from the sources that aren't guaranteed now, or with painful steps. We've outlined the possible options.

- **EU macro loans** are possible if the EU deal is signed in Vilnius, but they won't cover all ForEx needs.
- **International Eurobonds** are a good option after Ukraine signs the EU deal and is rewarded by international investors (at least in the very short term), but they're still unlikely to fully cover the gap.
- **Macro loans from Russian banks** are an option should Ukraine not sign the EU deal and start new bargains with Russia. By itself, the Russian loans can be sufficient for Ukraine to cover its needs. Still, this option looks risky as the political price for them can be too high.
- **Russian aid in the form of discounted gas prices** is an option if Yanukovych agrees to the Eurasian Union.
- **"Intensive" internal sources** are available, such as over-intensive placement of local Eurobonds with some aggressive state levers to make banks buy them. Among such levers are blatant ways to squeeze foreign currency from local businesses and households, including forced conversion of ForEx deposits, excessive taxes on foreign currency operations, and a 100% obligatory sale of foreign currency for exporters and investors. That's perhaps the most painful option for the Ukrainian banking system, but today it still looks preferable to the IMF choice.

An IMF deal is not an option for the pre-election year of 2014. Again, the Ukrainian government is not ready to take cash in exchange for painful reforms (like boosted household gas prices and letting the hryvnia devalue). At the same time, there is a clear consensus that **IMF-demanded reforms and IMF funding will be the only option that will keep the economic situation under control in 2015.**

Below are our projected outcomes for the Vilnius summit and possible methods the government may use in 2014 to finance its ForEx liquidity shortfall.

Possible outcomes of the Ukraine-EU deal

Arguments for each scenario

No EU deal, moving into Russia's orbit: The EU leadership or Yanukovych states explicitly that the deal will not be signed in Vilnius.

Why it's probable: This scenario is based on the notion that Yanukovych and Putin have reached some closed-door deal and as a consequence, the Ukrainian side is fulfilling Russia's requirements. It opens the door to possible macro aid from Russian banks and gas discounts from Gazprom, precisely what the Yanukovych administration needs to solve its short-term problems. Such a scenario, however, looks risky for Yanukovych, who will gradually lose his ability (in the next few years) to preserve economic and political independence from Russia. Nevertheless, it's entirely realistic he will choose to solve the short-term challenges at the expense of the country's European future.

Last-minute deal : Yanukovych pulls a surprise and decides to sign the deal at the summit itself.

Why it's probable: For Yanukovych personally, implementing EU Association institutions such as rule of law and private property rights protects the accumulated wealth of his family, and secures him a special role in Ukraine's history. There is a fair chance that the EU would offer macro financing to cope with economic problems, and there is some chance that the EU would convince the IMF to soften its demands for Ukraine to restart cooperation. There's a high chance that the fixed income market would react positively in the very short term, which would open a new window for Ukrainian Eurobonds. There's also a high chance that the EU would persuade Slovakia to supply up to 5 bcm of gas to Ukraine (cheaper than what Gazprom offered).

Ukraine's Cabinet of Ministers resolution on November 21, which effectively postpones the country's preparation for the Vilnius summit, does not preclude this scenario. Instead, it has offered a glimmer of renewed hope that it may happen considering that the country's ultimate decision-maker, Yanukovych, has yet to offer his final word. Local political observers have speculated the president may decide to cancel the Cabinet resolution and even release Tymoshenko. In doing so, Yanukovych would score political points with the public and deprive credit for the EU deal from his rivals. With this maneuver, he would try to demonstrate that he is the only person who has the ability to pursue Euro-integration, while both the Cabinet and parliament are ineffectual.

Stalling on the deal: The EU leadership and Yanukovych declare clearly their wish to come back to the deal in the near future, as soon as all the issues and risks are addressed. We believe it's highly unlikely the deal will be signed in 2014 if it's postponed in Vilnius.

Why it's probable: With this scenario, the EU preserves its strict position on the Tymoshenko/rule of law issue, but will not lose Ukraine completely. For the Ukrainian side, this outcome preserves the status quo in Ukraine-EU relations and offers a chance to continue bargaining for better trade and financing conditions with both the EU and Russia. (Improved loan and gas import conditions are possible, but not ensured).

“No deal” scenario: possible outcomes and action plan

Investment summary. The markets will very likely hate this scenario, while from the analytical point of view it may create the most solid ground for the economy to move smoothly through 2014 without severe damage, but with escalated risk of some macro shocks in the end if Russian influence becomes too high.

- If this scenario occurs, we recommend looking at an opportunity to the long sovereign bonds, with a time horizon of no more than six months.
- For those who strongly believe in this scenario, we recommend going short immediately, with a time horizon of a couple of weeks.

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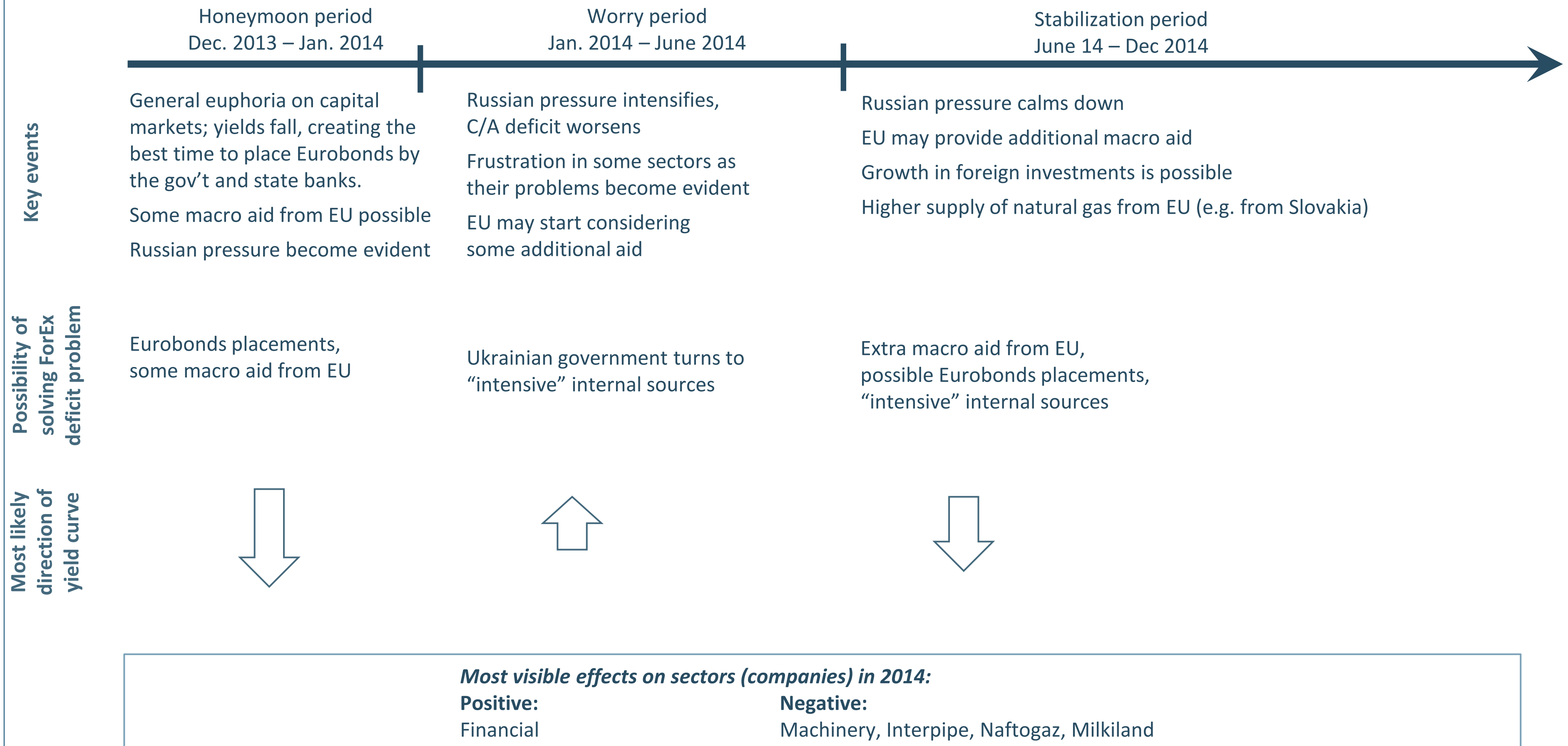
“Last-minute deal” scenario: possible outcomes and action plan

Investment summary. Our talks with funds lead us to expect that the markets will be overly enthusiastic if the deal happens in this way, but as we state below, there is little fundamental support for such high optimism.

- If this scenario occurs, we recommend looking at an option to short sovereign bonds, with a time horizon of three-six months
- For those who strongly believe in this scenario, we recommend going long right now, with a time horizon of a couple of weeks.



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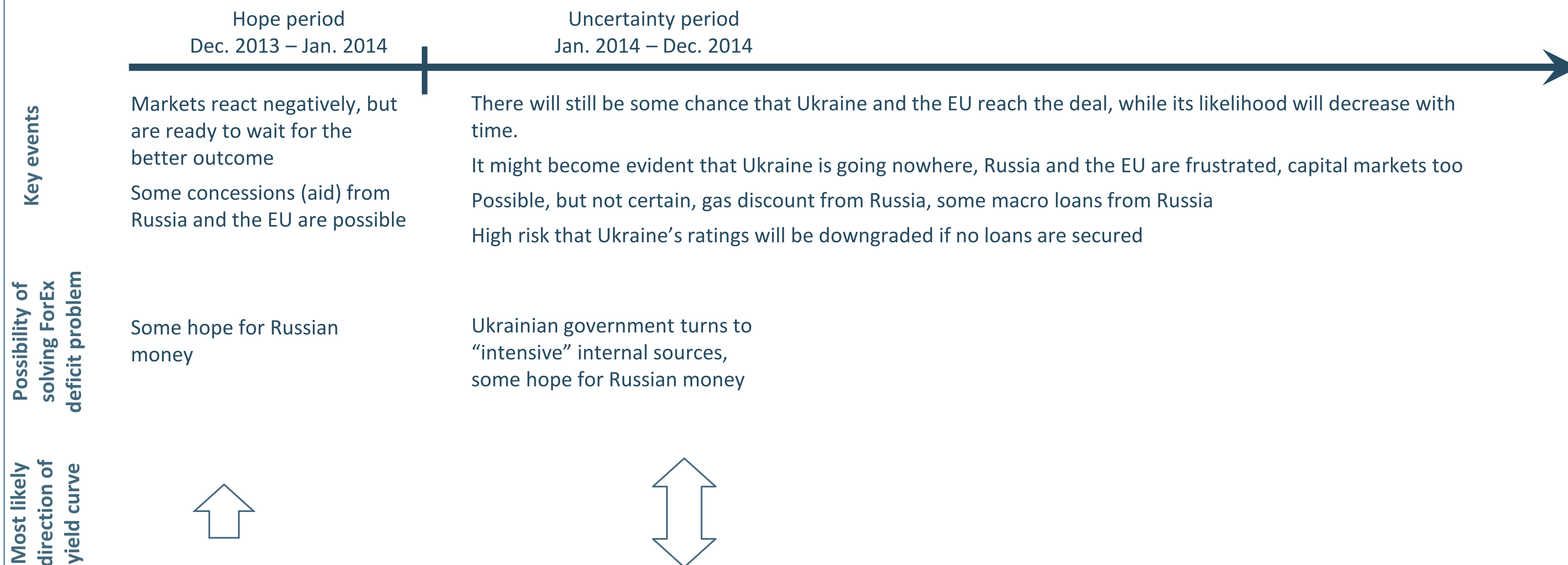
“Stalling the deal” scenario: possible outcomes and action plan

Investment summary. Since this scenario does not give an answer to where Ukraine is going geopolitically, and it creates frustration among believers in a EU deal, Ukraine’s sovereign curve is very likely to move upward. Afterwards, the direction of yield curve is high to predict.

- For those who strongly believe in this scenario, we recommend going short right now, with a time horizon of a couple of weeks.



Most visible effects on sectors (companies) in 2014:
Positive:
Naftogaz

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Only “no deal” provides certainty to move smoothly through 2014

Based on our core assumption that the main task for the government is to get through smoothly in 2014 (without devaluation and other macro shocks), below we provide a rough analysis on the available sources of Ukraine’s financing of its ForEx liquidity needs. Our core conclusion is:

- **only by moving closer to Russia does Ukraine secure the needed financing in the least politically harmful way.**

Recall, we assume that USD 5 or 6 bln of external financing will be enough to get through the next year smoothly. **The adequacy and political effect of the options look as such:**

	Political effect	Last-minute EU deal	EU deal stalled	No EU deal
Eurobonds	**Neutral**	**Very likely (USD 2-3 bln)**	-	-
Loans from EU	**Neutral**	**Very likely (USD 1-2 bln)**	Some chance for it	-
Russian money	Risky	-	Some chance for it	Very likely ($ 5-6 bln)
"Intensive" internal sources	Negative	Might be a need for USD 1-2 bln	The most likely outcome (need up to USD 6 bln)	-
IMF money	Very negative		Might be a need	**Could become less painful**

Comments:

If Yanukovych clearly states there is no EU deal, **Russian money** (in the way of bank loans, and, less likely, gas discounts) is nearly secured and should be sufficient to cover the deficit. An important outcome of Russian exposure is a high risk for geopolitical or economic concessions that Russia might demand in exchange. One of the other probable positives can be a significant discount for Russian gas, which would remove at least one of two core impediments for Ukraine in dealing with the IMF (there would be no need to raise gas tariffs). At least at this moment, **such a scenario looks most certain in terms of securing enough ForEx financing.**

If Yanukovych signs the EU deal, Eurobonds and macro aid from the EU look like the most straightforward ways to finance the 2014 deficit. But these sources are not guaranteed, so eventually it may happen that Ukraine will have to revert to internal sources by squeeze dollars from the economy or population. This scenario is the second-best choice, but its “value” for the government can increase in the process of negotiations with the EU.

If Yanukovych stalls the deal (to continue discussions with both the EU and Russia), there is a good chance to secure macro financing from at least one side. Needless to say, there is little surety that Ukraine will succeed in such bargaining. Therefore, there is a high risk that Ukraine will have to squeeze dollars from the domestic market via unpopular moves, or even do the least popular step of an IMF deal.

Vilnius effects on sectors and companies

Winners and losers of the EU deal

Banks: positive in the short term. We see that in the first month after the deal's signing, some activity may occur in Ukraine's financial sector that may benefit the banking system. Access to cheaper EU financing and activation of investment activity from the EU should benefit Ukrainian banks in the mid term as well.

Poultry and egg producers: slightly positive. The EU deal enables Ukrainian producers of poultry and shell eggs to start deliveries to European markets (again, after EU standards are adopted by Ukraine's food regulators). The positive effect, however, should not be overestimated: the allowed quota for chicken is 36-40 kt p.a., or just 6% of **MHP's** planned capacity for 2015. The quota for shell eggs will be 25-40 mln units p.a., or less than 1% of aggregate **Avangard's** and **Ovostar's** production capacity.

Crop farmers: slightly positive in the long term. The key positive effect on crop farmers will be Ukraine's commitment to gradually decrease and cancel the 10% export duty for sunflower seeds. Ukraine will be allowed to keep the duty at the level of 10% in the next 10 years, after which it would be gradually reduced and then fully canceled in the 15th year. While being slightly **beneficial for** domestic crop producers (especially those focusing on sunflower, such as **KSG Agro** and **Agroton**), the duty's cancellation will **undermine the core business of Kernel,** which currently effectively earns 88% of its operating profit on oil production (and most of the profit comes from the difference between domestic prices of sunflower seeds, which are subject to export duties, and duty-free exports of sunflower oil). Given that there's a long wait until the full cancellation of duties, its effect on companies' value will be small for the time being.

Food producers (cheese, confectionery): challenging in the short term, neutral in the long term. The last cheese and candy wars showed how dependent these sectors are on Russian demand. An opened EU market for Ukrainian dairy looks like a mid-term opportunity, but it will still demand the adoption of EU standards by Ukraine's food regulators, which might take some time. On the other hand, Ukrainian cheese markets opened to EU products is a challenge for those focused on the domestic market, but not insurmountable. As **Milkiland** stated in its update, Ukraine's opened borders will allow the company to boost cheese supplies from its EU-located dairy.

Machinery: challenging in the short term, uncertain in the long term. The most apparent loser is considered to be the machinery sector, which heavily depends on Russian demand. On the other hand, importing certain machinery products (such as power machinery and aerospace) are critical for Russia, and there is little risk that they will suffer in the short term (in the longer term, there is some risk that Russia will do its best to substitute Ukrainian producers). The already dammed subsectors (like railcar producers) have little prospects in Russia, no matter what happens. The key challenge for the machinery sector is to adopt EU standards and requirements, which will demand enormous investment. On the other hand, cancelling EU duties for imported machinery will make modernization cheaper, thus enabling Ukrainian producers to become more competitive on the global scene.

Winners and losers of the EU deal (continued)

Steel & mining sector: risky in the short term, negative in the long term. There is a range of problems that producers may face with a signed EU deal.

- The first is an accelerated closure of Customs Union markets with antidumping barriers. The first threat already materialized recently: the Eurasian Economic Commission (EEC) initiated an antidumping investigation against Ukrainian-made rods on November 20, which may impact **Metinvest** and **ArcelorMittal Kryviy Rih**. Further investigations and barriers against Ukrainian steel products are yet to come. The exposure of Metinvest to the Customs Union market is 15% of total sales. Specifically, **Azovstal** sells 13% of its products to Russia, Belarus and Kazakhstan, **Yenakiieve Steel** -16%, and **Alchevsk Steel** - 18%. These steelmakers will have to find new markets, and the EU market isn't likely to absorb all the surplus steel left.
- The second threat is that a deficit of scrap steel, which is already very strong in Ukraine, will become even more acute. According to the EU deal, **Ukraine will have to decrease its export duty on scrap steel to nil** in the next seven years, from EUR 11.6 per ton in 2013. Moreover, Kazakhstan, from where Ukraine mainly imports its scrap, is likely to close its exports to countries that are not Customs Union members.

Pipes: negative. With the EU deal, Ukraine's largest pipe producer, **Interpipe**, will have to abandon its hopes to regain its exclusive, duty-free status on the Customs Union market, where the company has been selling up to 30% of its products. Duties at the level of 19% will be restrictive for the company. On the other hand, an antidumping duty of 13.8% for **Interpipe's** seamless pipes will remain effective in the EU, despite the signing of the Association deal.

Naftogaz: challenging. Some hopes related to **Naftogaz's** business are related to a possible increased supply of cheaper natural gas from the EU. In particular, the EU may facilitate gas imports from Slovakia of up to 5 bcm per year, which will help much to decrease Ukraine's dependence on Russian gas (this year, Ukraine plans to import 26 bcm of gas from Russia). At the same time, an EU deal is inferior to the "no deal, mover closer to Russia" scenario, in which **Naftogaz** can count on deeper discounts for gas.

Winners and losers of “no deal” scenario

Naftogaz: perhaps the main winner. There’s a high probability that Ukraine will be granted some discounts for Russian gas, which raises the chance that Naftogaz will be able to narrow its financial gap. In case of the “no deal” scenario, we expect the spread of the NAFTO bond to the sovereign curve will decrease.

Steel sector: slightly positive. Ukraine may preserve some chance that Russia will postpone imposing its trade barriers for some time, as a membership bonus for joining the Customs Union. On the European side, sales from Ukrainian steelmakers are secured through vertical integration, which foresees production of semi-products in Ukrainian plants and subsequent reprocessing at European subsidiaries – rolling mills. Azovstal supplies 36% of its products to the EU as semis to related enterprises within **Metinvest**, out of its 41% total sales to Europe. **Alchevsk Steel** supplies 25% out of total 30% of European sales to related enterprises.

Railcars and pipes : little chance for a turnaround. We do not believe that Russia will reopen its market for Ukrainian railcar producers, even in the event that Ukraine fails to sign the EU deal. Nor do we expect **Interpipe** will be granted its exclusive status on the Russian market, as it used to have as of mid-2013. We believe that only Customs Union membership would set the prerequisites for restoring these companies’ positions in Russia. In the meantime, **Interpipe** will have to find a market for 30% of its pipes (currently exported to Customs Union states) in the Middle East and Europe, while Ukraine’s railcar producers will have to find a market for 60%-90% of the freight railcars they produce.

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