Ukraine's liquidity position

How vulnerable is it?

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The general consensus is that the global financial crisis will last for at least another two quarters, and probably until the end of 2009. We look at the structure of Ukraine's debt to determine how the economy is prepared. We revise our projections of Ukraine's key economic indicators, foreseeing less GDP and industrial output growth, a wider C/A deficit and weaker hryvnya over the next year.

Ukraine's considerable debt servicing obligations and expected widening in the C/A deficit next year (due to a hike in the natural gas price and declining steel prices), together with the limited outlook for attracting foreign funds, put the country in an unpleasant financial position in 2009.

Today Fitch downgraded Ukraine's sovereign credit rating one notch to B+, while retaining the rating's negative outlook. Credit default swaps on Ukraine's sovereign debt has shot up to ~1,900 basis points as of today. Many foreign investors consider such high CDS a leading indicator of future default and see Ukraine's current quotations as a warning signal.

Indeed, Ukraine's estimated currency outflows in 4Q08 and 2009 raise concerns:

	4Q08	2009
Outflow, USD bln	**-11.5**	**-62.5**
External debt to be redeemed/refinanced	-8.5	-41.5
Corporate	-8.5	-40.0
Public*	0.0	-1.5
C/A deficit	-3.0	-21.0

** Based on draft of 2008 state budget*
Source: Concorde Capital estimates

On the back of modest sources of currency:

	4Q08	2009
Inflow, USD bln	**1.8**	**10.5**
FDI	1.8	10.0
Portfolio investment	0.0	0.5

Source: Concorde Capital estimates

This creates a gap of USD 9.7 bln in 4Q08 and USD 52 bln in 2009 that requires financing. We next look at the structure of the debt to examine the impact of sums of this magnitude.

4Q08

Out of USD 8.5 bln in external debt due in 4Q09, USD 1.5 bln is bonds and loans, an estimated 2/3 of which has already been refinanced, mostly by commercial banks. The other USD 7 bln represents other short-term debt instruments, mostly in the form of trade credits.

A more serious issue is not visible in these statistics: USD 8 bln - 1/5 of total bank deposits by individuals both in national and foreign currencies – must also be repaid in November-December, posing an additional threat to the banking system. In the atmosphere of distrust in financial institutions, it is difficult to expect these term deposits to be rolled over.

We believe local banks will have to lean on the NBU for support. On the other hand, we estimate that some 1/3 of the total maturing debt is held by banks backed by foreign capital, who will first call on their parent structures.

2009

First, about 40% of the USD 40 bln in corporate external debt maturing through July 2009 is in trade credits.

5Y CDS Ukraine, bps

Source: Bloomberg

Ukraine's sovereign ratings

Agency	Rating	Outlook
Standard & Poor's	B+	Negative
Moody's	Ba3	Positive
Fitch	B+	Negative
R&I	BB	Positive

Source: Rating agencies

Prices for core commodities, as of October 17

	Current	%, YTD	%, yoy
Gas imports, USD/tcm	179.5	0%	38%
Crude oil (URALS), USD/bbl	64.5	-30%	-20%
Winter wheat, USD/mt, FOB**	244.0	-5%	-2%
Steel square billet, USD/mt, FOB**	417.5	-28%	-16%

***Black Sea ports*
Source: Gas of Ukraine, Bloomberg, Metal Courier

Second, another ~20% of the debt is short-term banking debt taken out by foreign-owned subsidiaries, where the parent can be counted on for refinancing. Recent examples: on October 16, Ukrsotsbank received USD 90 mln from Bank Austria Creditanstalt, while on October 15, Raiffeisen Zentralbank extended a USD 180 mln loan to Ukrainian subsidiary Raiffeisen Bank Aval.

Total currency outflow in 2009 adjusted for these two components is USD 38.5 bln, close to the NBU's reserves, which are projected at USD 35.9 bln at the beginning of 2009. Notably, our assumptions imply that short-term debt remains at the current level over 2009, though it is only likely to decrease given the current situation. This means that even in the worst-case scenario Ukraine is relatively well shielded from a default in 2009.

We suggest that in 2009 NBU reserves will only be used to smooth deterioration in the balance of payments, while Ukraine will fund its external debt servicing via foreign financing. On October 16, Ukraine announced that it could be granted from USD 3 to 14 bln from the IMF. Furthermore, sovereign Eurobonds have, in our opinion, a chance to be placed at tolerable rates, with conclusion of the Ukraine-IMF deal (Ukrainian authorities said they expected to sign the pact in the next 2-3 weeks).

C/A: Crucial variable in currency outflow

We forecast that in 2009 the current account deficit will widen to USD 21.0 bln, mostly as a result of an increase in the natural gas price (11% of Ukraine’s imports) and declining steel prices (45% of Ukraine’s exports).

On a positive note, the gas price can, with rather high probability, be set below our projection (USD 320/ths mcm): if Russia and Ukraine approve the gas price formula discussed at their meeting earlier this month, the price would be about USD 260/ths mcm. This price would improve the C/A imbalance by USD 3.1 bln.

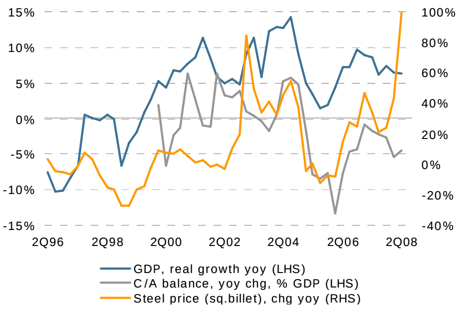
Steel prices, as the most important determinant of C/A deficit dynamics, are estimated by us to abate next year. We forecast the average annual steel price to decline by 7% yoy (steel square billet, FOB Black Sea), down 38% from its peak in July 2008 – though, at USD 750/mt, will be more than the current ~USD 450/mt. The rebound in prices may be supported by pressure of consolidated raw materials suppliers on steel smelters.

At the same time, grain exports, can potentially add up to USD 1-2 bln to the current account. Prices are likely to increase next year, as this year’s record global harvest is sure to go unmatched. The 2009 Ukrainian harvest could well remain at this year’s high, thanks to the plentiful flow of capital into the sector over the last year.

Forecast revision

We revise our forecasts of Ukraine's key economic indicators in 2008 and 2009. We decreased our expectations for GDP and industrial output growth in 2008, to 5.3% yoy and 3.0% yoy, respectively. We also reviewed anticipated C/A deficit from 4.3% of GDP at yearend to 5.8%, growing to 9.1% in 2009. At the same time, so far, we do not change our CPI and PPI performance forecasts for either year.

Impact of steel prices on GDP and C/A



Source: Bloomberg, National Bank of Ukraine, State Statistics Committee

Comparison of old and new economic forecasts

	2007	2008E		2009F	
		old	new	old	new
Business cycle					
Real GDP, % yoy	7.6	6.8	5.3	6.5	4.3
Nominal GDP, USD bln	141.2	202.4	197.0	246.8	231.2
Industrial output, % yoy	10.2	7.0	3.0	7.5	5.9
CPI (eop), % yoy	16.6	21.0	21.0	15.0	15.0
PPI (eop), % yoy	23.3	40.0	40.0	18.0	18.0
External sector					
FDI net, USD bln	9.2	10.4	10.4	13.5	10.0
C/A balance, % GDP	-4.2	-4.3	-5.8	-5.3	-9.1
Trade balance, % GDP	-5.6	-4.9	-6.5	-5.8	-9.5
Debt indicators					
External debt, % of GDP	59.9	56.8	56.4	57.9	60.3
NBU reserves, USD bln	32.5	42.0	35.9	42.0	25.4
Exchange rate					
Interbank UAH/USD (avg)	5.03	4.87	4.90	4.90	U/R

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