

Ukraine economy update

Examining recovery prospects for a bottomed out economy

Summary

The Ukrainian economy had stabilized by the middle of this year:

- Declining rates of key macro indicators slowed down to single-digits;
- The hryvnia has calmed since April and even strengthened on the back of improved external trade and continued cooperation with IFIs;
- Debt restructuring has nearly concluded, which will lead to fast gross international reserves accumulation;
- The C/A deficit has been at 5Y lows as of mid-2015, and the dependence of Ukraine's trade accounts on Russia has significantly decreased. At the same time, trade volume with EU countries has also lagged behind previous years' stats, mainly due to the collapse of economy in Donbas;
- The budget is benefiting from high inflation and impressive surpluses, which will secure easy implementation of the 4.2% of GDP deficit target in 2015, as outlined by the IMF.

At the same time, we do not see any signs of fast recovery for the nearest future:

- The regional economy is cooling down on Russia's aggravating economic problems and weak prices for global commodities. Against this backdrop, we see quite a tough recovery path for the Ukrainian economy with near zero growth in 2016;
- Since Ukraine has addressed last year's challenge of empty gross international reserves, the new upcoming challenge is fiscal consolidation in 2016:
 - In the next year, the Finance Ministry will lose some significant sources of revenue, like central bank profits, interim import duties, an interim hike in gas production royalties;
 - At the same time, it will have to narrow its deficit-to-GDP target in the next year and conduct a tax reform aimed at decreasing the burden on the economy, on the back of high social liabilities.

Key macro indicators

	2014	2015E	2016E
Real GDP, yoy	-6.8%	-10.4%	0.6%
Nominal GDP, USD bln	132.8	90.0	95.8
C/A balance, USD bln	-4.6	-2.2	-3.7
Gross int'l reserves, USD bln	7.5	16.9	22.7
External public debt, USD bln	38.8	49.3	52.8
Total public debt, USD bln	69.8	74.0	77.5
Cons. budget balance, % of GDP	-4.2%	-4.2%	-3.7%
CPI, average	12.1%	49.1%	13.7%
UAH/USD, average	11.9	21.8	23.8
UAH/USD, eop	15.6	23.0	25.0

Economic recovery delays

The real sector bottomed out in the beginning of 2015 and started gradually improving after that. In 2Q15, GDP decline slowed down to -14.6% yoy vs. -17.2% yoy in 1Q15.

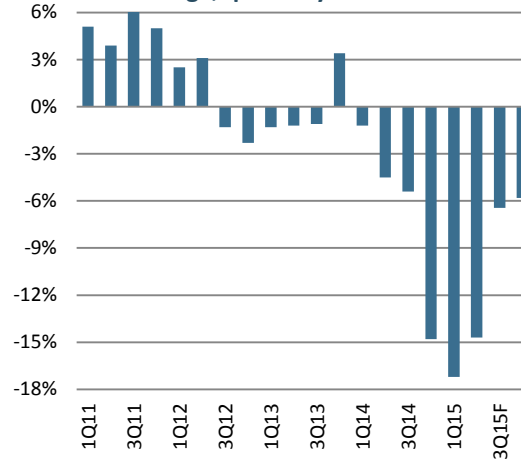
So far, the low comparative base effect (due to the factor of the Donbas occupation that was in place as of Sept. 2014) is the main reason for the improving statistics. We see little evidence that economic activity is indeed recovering:

- Falling resource prices at the global markets, as well as cooling regional activity on the back of Russian economic decline, are the main reasons for the delayed recovery;
- Private consumption, which was the key driver of economic growth in 2010-2013, is subdued due to decreasing real incomes;
- The investment climate in Ukraine (which should have been fueled by deregulation, tax reform, and a judicial system overhaul) is improving too slowly, disappointing expectations of a year ago.

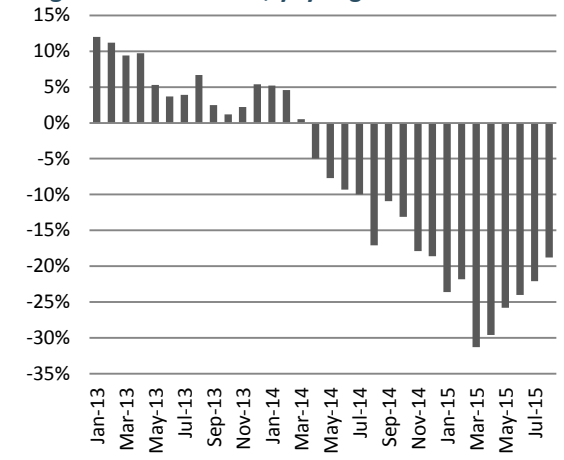
Against this backdrop, we are quite skeptical on whether there will be a noticeable improvement of economic activity until at least the middle of 2016.

For 2015, we project real GDP falling 10.4% yoy while for 2016, we expect near zero (+0.6% yoy) GDP growth.

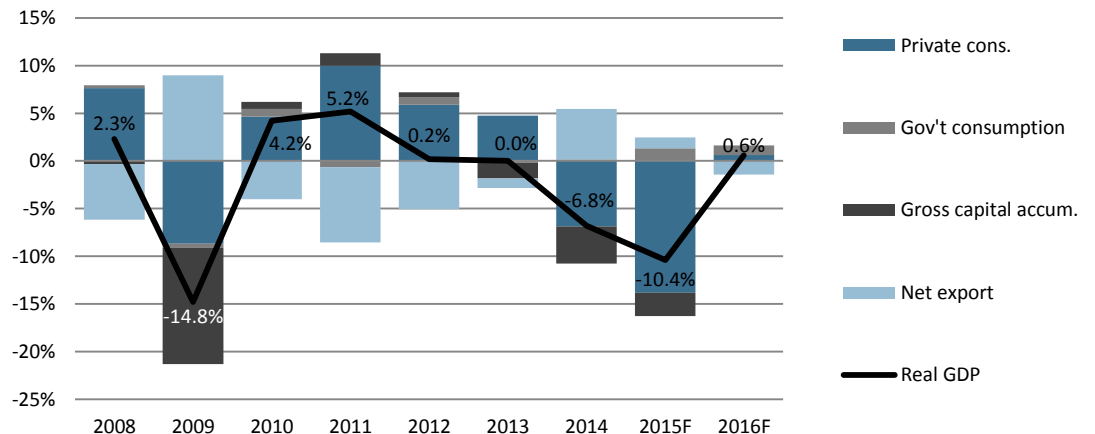
Real GDP change, quarterly data & outlook



Organized retail trade, yoy chg



Drivers of real GDP change



Industrial output creeps to the bottom

Ukraine's industrial output decline slowed to single digits in August, or -5.8% yoy compared to -20.5% yoy for 1H15.

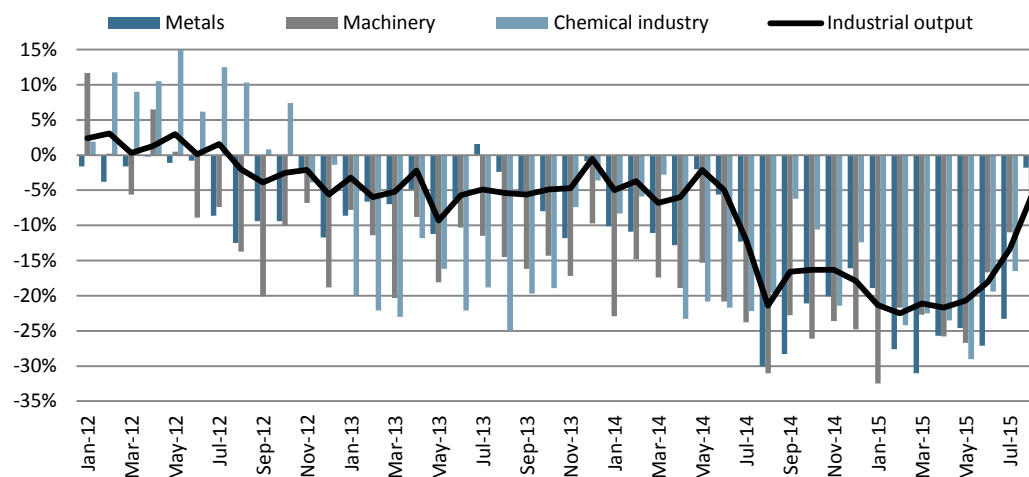
The statistical effect of the low comparative base is the main reason for the outcome. In particular, in June 2014, industry contracted 5.0% yoy while in August that year, it plunged 21.4% yoy.

In 2H15, we expect industrial output decline to hover in the range of 5-7%. Sliding resource prices at the global market, as well as tightening competition on the back of the devalued yuan do not offer any grounds for optimism. At the same time, a single-digit decline is certain due to the statistical effect.

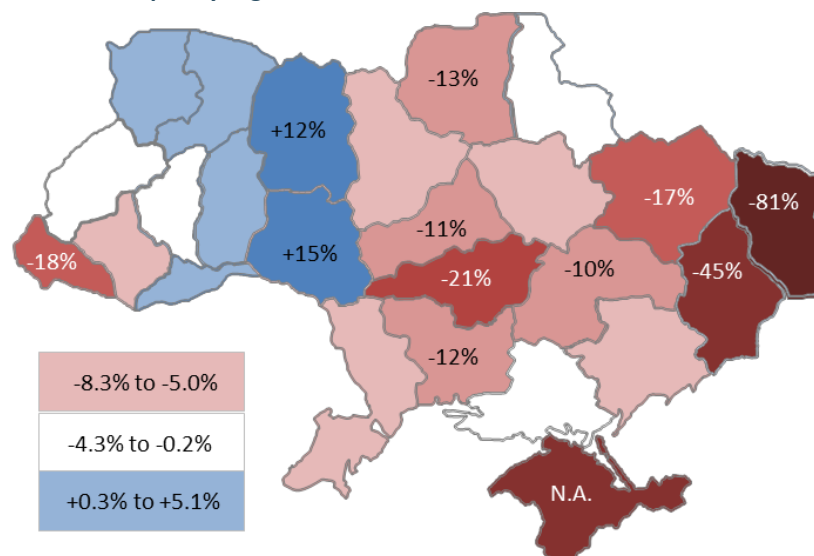
We project 14.6% industrial output contraction for 2015.

In 2016, we expect very modest improvement of industrial output (0.7% yoy), fueled by an assumed improvement of the economic situation in 2H16. At the same time, we expect industrial growth hovering at the near-zero mark at the start of the year.

Industrial output, monthly yoy chg



Industrial output by regions, 8M15



The hryvnia stabilized, with prospects of gradual weakening

Ukraine's ForEx market has calmed down since April 2015 – owing to improved external accounts – and the hryvnia has hovered close to UAH 22/USD.

The debt restructuring deal promises continued cooperation with IFIs and growing gross international reserves, which should underpin the hryvnia's stability.

By the end of 2015, we expect gross international reserves increasing to USD 16.9 bln and growing up to USD 22.7 bln as of end-2016.

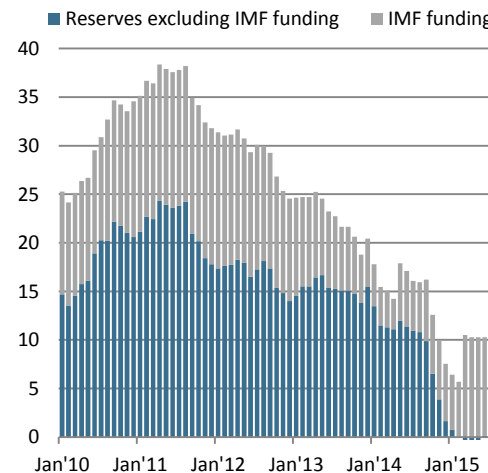
Prospects for a deficit in external accounts outline some gradual devaluation pressure in 2015-2016. Local elections scheduled for Oct. 25 could add some uncertainty regarding UAH stability, we believe. This, as well as strengthened budget spending through the autumn, leads us to believe that the hryvnia could weaken through the year's remainder, when we anticipate its value approaching UAH 23/USD.

In 2016, we project the gradual devaluation trend to continue with reviving imports as the main factor. Thus, we project the hryvnia will approach UAH 25/USD by the end of 2016.

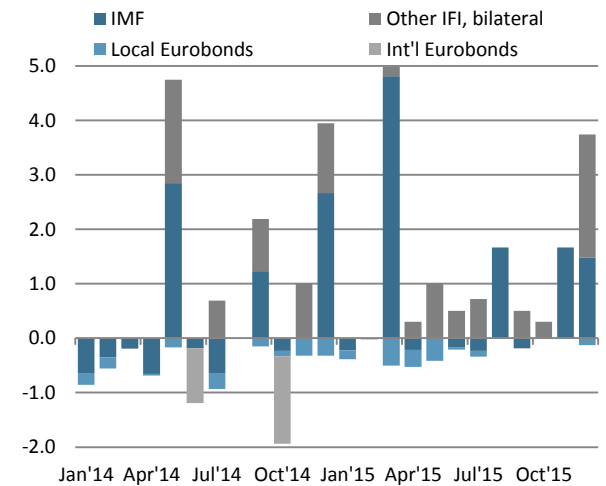
UAH/USD interbank rate



Gross NBU reserves, USD bln



Net sovereign borrowing, USD bln



External accounts: C/A deficit to start widening in 2H15

Ukraine's trade deficit for goods and services narrowed to USD 466 mln in 8M15 compared to USD 2.2 bln a year ago. Sharp contraction of non-energy imports (-37% yoy) and a shrinking energy bill (-24% yoy) amid a somewhat slower decline of exports are responsible for the outcome.

Exports of goods and services contracted 31.6% yoy in 8M15 to USD 31.1 bln on the back of both an exports decline to Russia (-59% yoy) and exports contraction to the non-Russian market (-29% yoy) – all explained by the trade war with Russia and the loss of export-oriented Donbas.

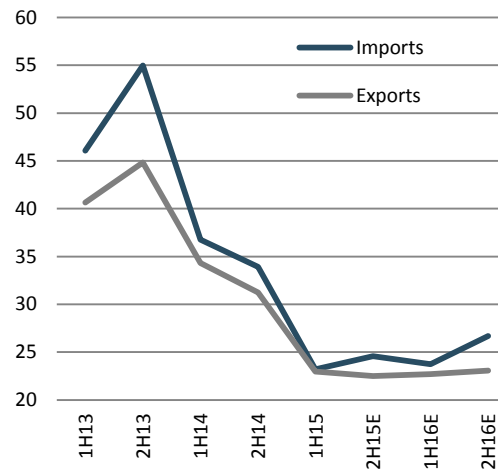
Imports of goods and services plunged much stronger, 33.9% yoy to USD 31.5 bln on the back of the hryvnia's decline.

Starting autumn, we expect the trade deficit will widen. Firstly, the stabilized hryvnia exchange rate will stimulate faster import consumption. Secondly, aggravating global markets, as well as trouble in the Russian economy, promise a tough recovery path for exports. Thirdly, starting 2016, an interim import duty will be abolished in what will stimulate demand for imports.

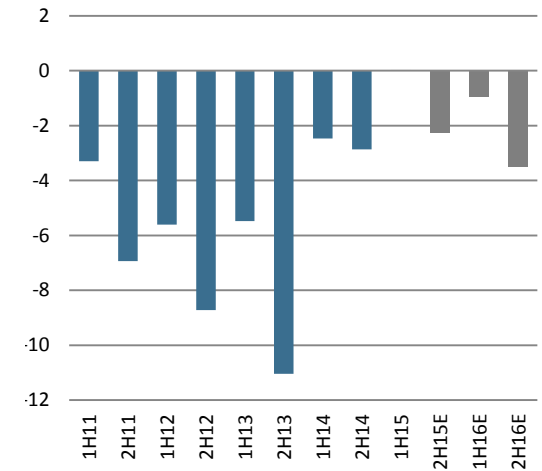
We project a USD 2.6 bln trade deficit in 2015 and USD 4.6 bln deficit in 2016.

The current account (C/A) was reported with an USD 133 mln deficit in 8M15 (vs. USD 2.3 bln deficit a year ago). In the year's remainder, we expect the deficit to widen. By the end of 2015, we project a C/A deficit of USD 2.2 bln (2.4% of GDP). In 2016, we anticipate a C/A deficit of USD 3.7 bln (3.9% of GDP).

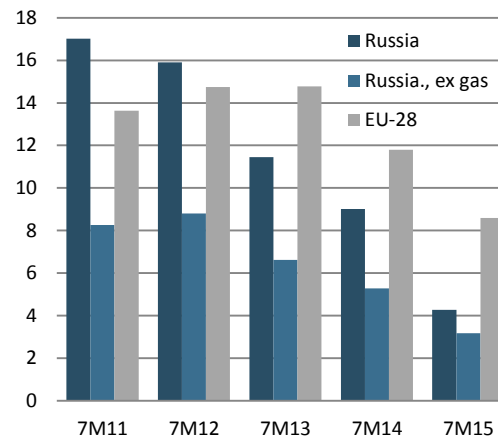
Goods & services trade, USD bln



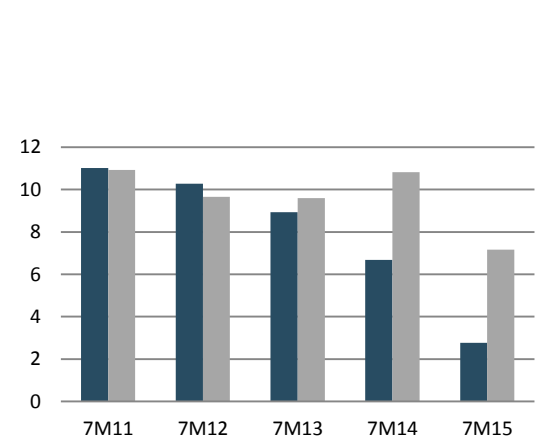
C/A balance, USD bln



Good imports, USD bln



Good exports, USD bln



Inflation to ease owing to sliding resource prices

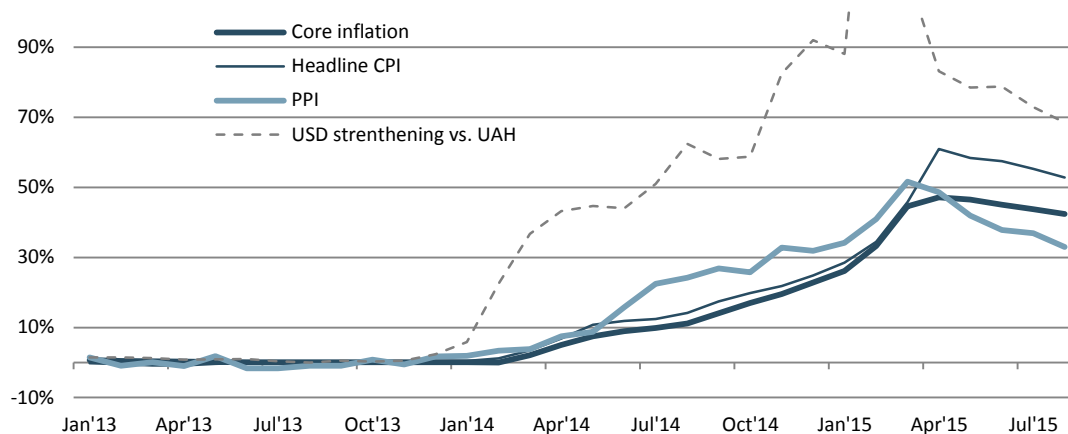
Hryvnia devaluation and the dramatic power and heating rate hike at the year's start triggered harsh inflation. In 8M15, CPI increased 38.2% YTD, sending other price indices close to 50% on a yoy basis.

During the summer months, inflation eased dramatically due to the strengthened hryvnia. In July and August, CPI even fell 1.0% m/m and 0.8% m/m, respectively, on the back of seasonal food price deflation.

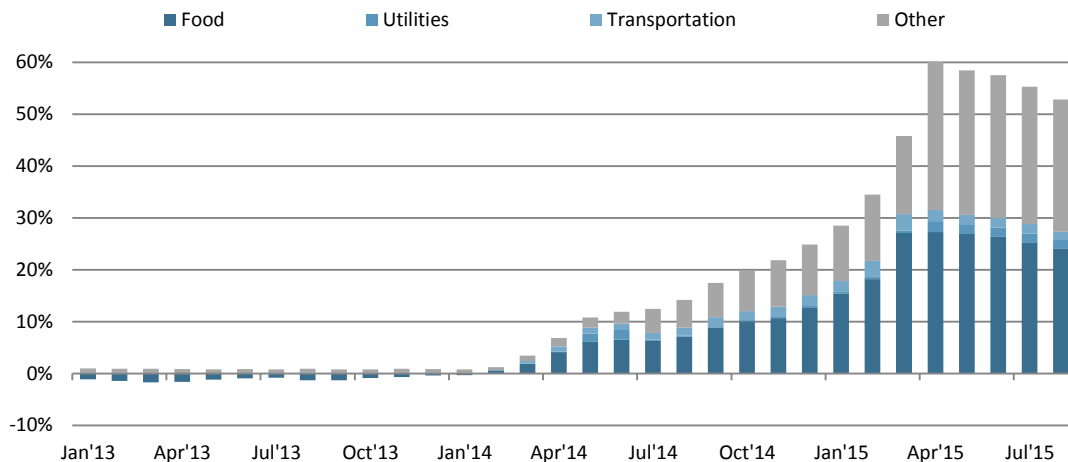
In the context of sliding resource prices at the global markets, we see disinflation will continue in Ukraine in the coming months. We project CPI increasing 49.1% yoy (42.9% YTD) in 2015.

For 2016, we expect price growth rates slowing further. Resource prices are unlikely to recover that fast and further minor hryvnia weakening is seen as the main source of inflation next year. For 2016, we project a 13.7% yoy (8.6% YTD) CPI increase.

Inflation indicators, yoy



Breakdown of headline CPI



Inflation puts 2015 budget on the safe side, now all eyes are on the 2016 plan

Ukraine's general budget revenue surged 39.2% yoy to UAH 411.7 bln in 8M15 on the back of devaluation-driven inflation.

To a large extent, such budget revenue growth was due to temporary collections like:

- 3G mobile license proceeds (UAH 8.9 bln),
- additional interim import duties (UAH 14.0 bln in 8M15);
- distribution of NBU profits (UAH 39.1 bln in 8M15);

Even net of such temporary revenue sources, the general budget revenue increase remained impressive at 28.1% yoy (UAH 249.7 bln) in 8M15. This growth, no doubt, was driven solely by inflation.

Successful fiscal collections put the budget on the safe side in 2015: the general budget has accumulated a UAH 28.3 bln surplus in 8M15 (vs. UAH 28.6 bln deficit in 8M14). Thus, the targeted budget deficit of 4.2% of GDP in 2015 looks easily achievable.

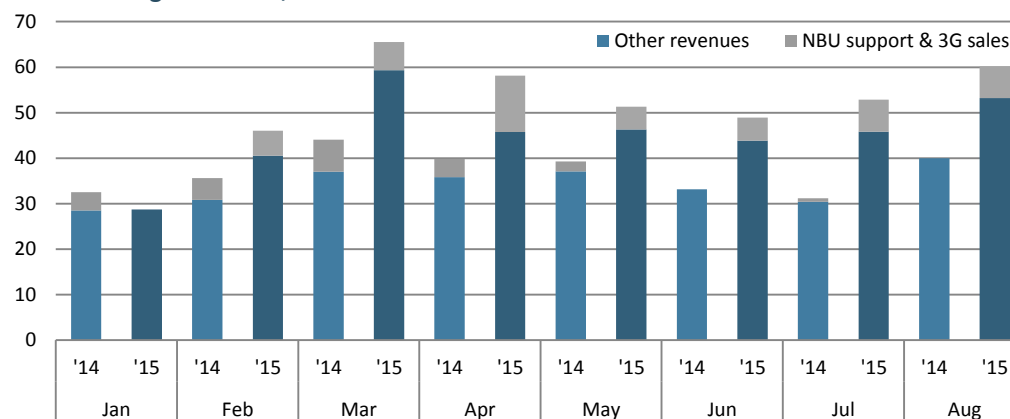
The situation is different for the next year, when the Finance Ministry will face a problem of having to narrow the general deficit to 3.7% of GDP while at the same time drying out some 2015 revenue sources like:

- abolished extra import duties starting 2016 (UAH 24 bln in 2015E);
- NBU profits from hryvnia printing (expected decline by UAH 30 bln in 2016);
- A heightened natural gas production tax in 2015 (extra UAH 4.7 bln in 2015E).

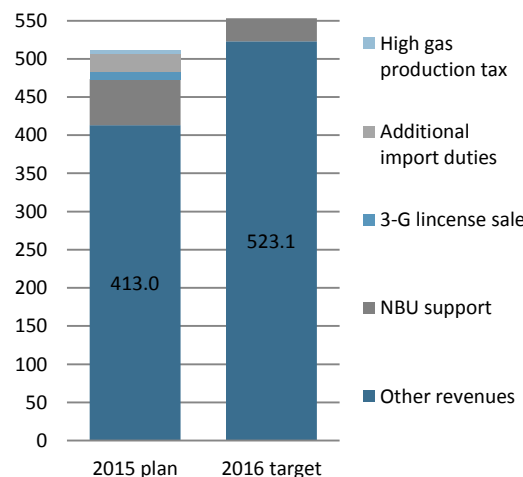
The drafted budget revenue plan, net of the identified eliminations, implies that "other revenue" should increase 26% yoy. This increase cannot be only driven by inflation (+14% yoy, we estimate), meaning the government should find additional sources in the next year's budget.

In any case, we do not expect the Cabinet will dare violate the 3.7% GDP deficit limit for 2016 outlined by the IMF.

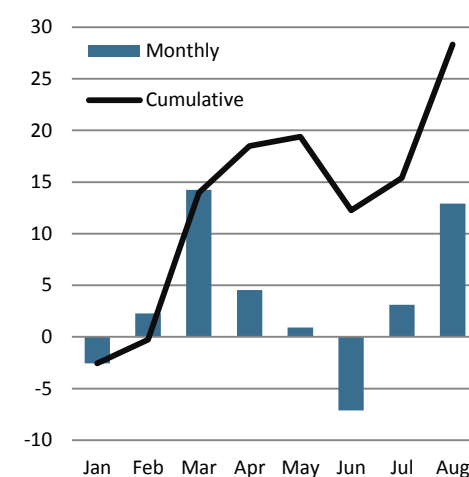
General budget revenue, UAH bln



Budget revenue breakdown, UAH bln



General budget balance in 2015, UAH bln



State debt to decline in 2016

By June 2015, the state debt decreased to 84.9% of GDP from 94.1% of GDP at the end of March. The strengthened hryvnia is the main reason for the positive trend.

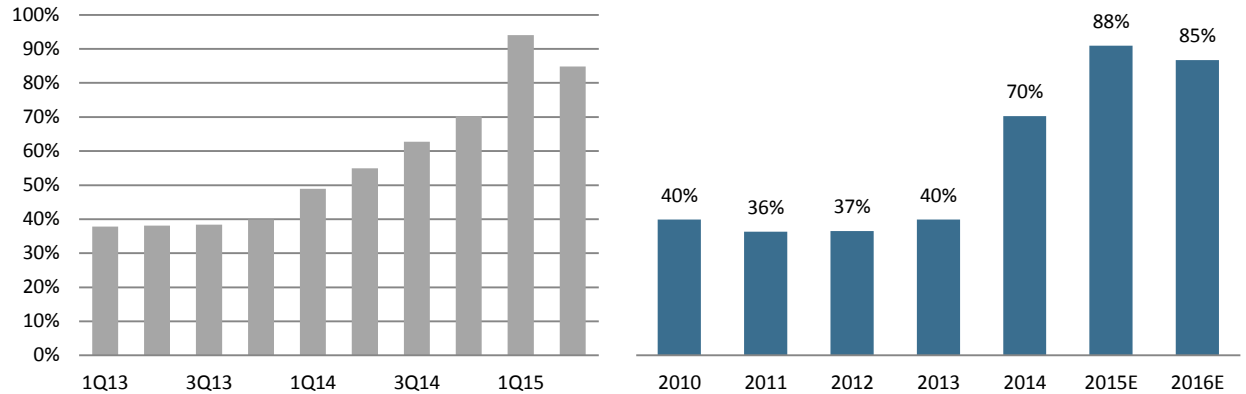
By the end of 2015, the state debt will reach 88% of GDP, we estimate. A 20% haircut on sovereign and guaranteed Eurobonds will shave nearly USD 3.6 bln off Ukraine's debt.

In 2016, we project the state debt will decrease to 85% of GDP, primarily due to increasing nominal GDP.

If Ukraine's debt operation is completed in full, as planned, by the end of November, Ukraine will ease its debt repayment schedule for the next three years by USD 11.1 bln, we estimate:

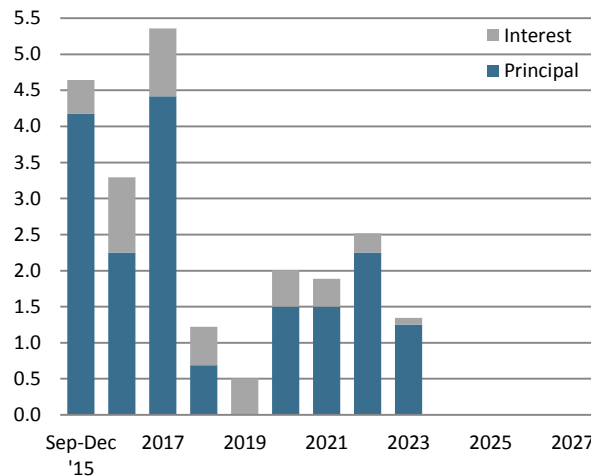
- Savings of principal will amount to USD 11.5 bln for Sept. 15 - Dec. 18;
- Additional payments of coupons for the period will amount to USD 0.44 bn.

State debt as % of GDP

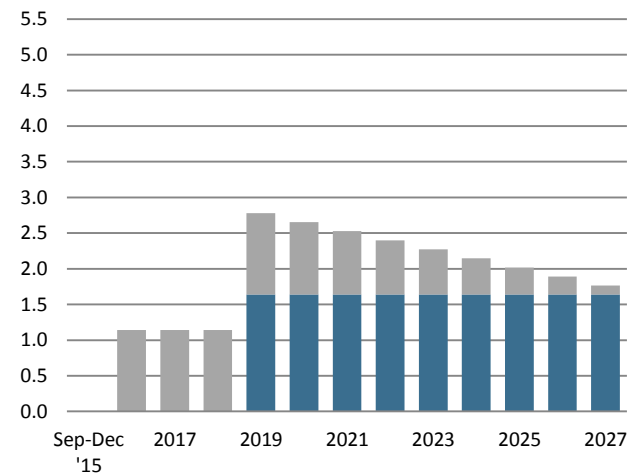


Payment schedule on state and guaranteed Eurobonds (UKRAIN, UKRINF), USD bln:

Before debt operation



If debt operation fully completed



Key macro indicators

	2008	2009	2010	2011	2012	2013	2014	2015 E	2016 E
Economic activity									
Real GDP, yoy	2.3%	-14.8%	4.1%	5.2%	0.2%	0.0%	-6.8%	-10.4%	0.6%
Household consumption, yoy	13.1%	-14.2%	7.2%	15.0%	9.0%	7.8%	-9.6%	-19.3%	-1.8%
Investments in fixed capital, yoy	-1.2%	-46.2%	4.0%	10.1%	2.5%	-6.6%	-23.0%	-17.5%	-0.1%
Nominal GDP, UAH bln	948	913	1,083	1,302	1,411	1,465	1,567	1,929	2,286
Nominal GDP, USD bln	181.8	117.1	136.5	163.4	176.6	183.3	132.8	90.0	95.8
GDP per capita, USD	3,944	2,545	2,980	3,583	3,873	4,029	3,088	2,113	2,265
Industrial output, yoy	-5.2%	-21.9%	11.2%	8.0%	-0.7%	-4.3%	-10.1%	-14.6%	0.7%
Inflation									
CPI (eop)	22.3%	12.3%	9.1%	4.6%	-0.2%	0.5%	24.9%	42.9%	8.6%
CPI average	25.2%	15.9%	9.4%	8.0%	0.6%	-0.3%	12.1%	49.1%	13.7%
PPI (eop)	23.0%	14.3%	18.7%	14.2%	0.3%	1.7%	31.8%	27.1%	7.2%
External accounts									
Current account balance, USD bln	-12.8	-1.7	-3.0	-10.2	-14.3	-16.5	-4.6	-2.2	-3.7
% GDP	-7.0%	-1.5%	-2.2%	-6.2%	-8.1%	-9.0%	-3.5%	-2.4%	-3.9%
Financial account balance, USD bln	9.7	-12.0	8.1	7.8	10.2	18.5	-8.7	3.1	7.8
% GDP	5.3%	-10.3%	5.9%	4.8%	5.8%	10.1%	-6.6%	3.4%	8.1%
Net FDI, USD bln	9.9	4.7	5.8	7.0	7.2	4.1	0.3	2.8	3.9
% GDP	5.4%	4.0%	4.2%	4.3%	4.1%	2.2%	0.2%	3.1%	4.1%
Gross NBU reserves (eop), USD bln	31.5	26.5	34.6	31.8	24.6	20.4	7.5	16.9	22.7
Public debt									
Total public debt, USD bln	24.6	39.8	54.3	59.2	64.5	73.2	69.8	74.0	77.5
% GDP*	13.7%	34.0%	39.9%	36.3%	36.5%	39.9%	70.3%	88.2%	84.7%
Public external debt, USD bln	18.5	26.6	34.8	37.5	38.7	37.6	38.8	49.3	52.8
% GDP*	10.2%	22.7%	25.5%	23.0%	21.9%	20.5%	29.2%	54.8%	55.1%
Gross external debt, USD bln	101.7	103.4	117.3	126.2	134.6	142.1	126.3	131.4	135.6
% GDP*	55.9%	88.3%	85.9%	77.2%	76.2%	77.5%	95.1%	146.0%	141.5%
Exchange rate									
Official UAH/USD (eop)	7.58	7.97	7.96	7.99	7.99	7.99	15.6	23.0	25.0
Official UAH/USD (avg)	5.27	7.79	7.94	7.97	7.99	7.99	11.9	21.8	23.8
Fiscal indicators									
Consolidated budget revenues, USD bln	56.5	37.0	39.6	50.0	55.8	55.4	38.3	28.5	28.0
% GDP	31.1%	31.6%	29.0%	30.6%	31.6%	30.2%	28.8%	31.7%	29.2%
Consolidated budget expenditures, USD bln	58.7	39.4	47.6	52.3	61.6	63.3	43.9	32.3	31.5
% GDP	32.3%	33.7%	34.9%	32.0%	34.9%	34.5%	33.1%	35.9%	32.9%
Consolidated budget balance, USD bln	-2.2	-2.4	-8.0	-2.3	-5.9	-7.9	-5.6	-3.8	-3.5
% GDP	-1.2%	-2.1%	-5.9%	-1.4%	-3.3%	-4.3%	-4.2%	-4.2%	-3.7%
State budget + Naftogaz balance, USD bln	n/a	-5.3	-10.7	-3.2	-7.0	-8.7	-13.7	-5.2	-3.7
% GDP	n/a	-4.5%	-7.8%	-2.0%	-4.0%	-4.7%	-10.3%	-5.8%	-3.9%

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