Ukraine economy update

Growing slowly but surely

July 14, 2016

CONCORDE CAPITAL

Summary

The Ukrainian economy is definitely on the recovery path. GDP inched up 0.1% yoy in 1Q16, growing for the first time since 4Q13. Industrial production grew 3.1% yoy for 5M16. Organized retail trade also returned to black, adding 2.9% in 5M16.

At the same time, the path is a slow slog. The low comparative base after two years of contraction is the main reason for the positive numbers. The spring recovery in metal and iron ore prices also contributed to the good statistics. However, this statistical effect will ease already in 2H16 while resource price prospects remain gloomy. Against this backdrop, we view improved consumer confidence amid a stabilized economic situation as the only factor that will drive some growth this year. We project GDP growing 0.9% yoy in 2016 and 2.1% yoy in 2017.

Strengthened external prices and delayed natural gas imports have already translated **into an external accounts improvement**. In 5M16, the C/A deficit narrowed slightly to USD 424 mln from USD 461 mln a year ago. Since we expect gas imports intensify in 2H16 (Ukraine imported only 3 bcm of gas in 1H16 while 11 bcm will be needed for the year) and non-energy imports will steadily rise (+12% yoy for 5M16), we project a resumed C/A deficit widening in 2H16. We project a USD 4.0 bln C/A deficit (4.5% of GDP) in 2016 and we see the trend will only strengthen in 2017, expanding the C/A deficit to USD 5.1 bln (5.8% of GDP).

Though we expect external trade to worsen in the nearest future, **we remain optimistic about capital and financial flows**. Resumed confidence in the national currency has prompted Ukrainians to return foreign cash to the banking system. What's more, we still expect the IMF to resume financing soon (likely in the fall), bringing at least USD 1.0 bln from the Fund. That should unfreeze EUR 1.2 bln from the EU and USD 1.0 bln in Eurobonds under U.S. guarantees. These inflows should enable gross international reserves to swell to USD 18.0 bln (4.2 months of imports) in 2016. Next year, we expect the trend to continue with gross reserves increasing to USD 23.3 bln (5.1 months of imports).

The hryvnia has been benefiting from an excess supply of foreign currency. By the date of this report, Ukraine's national currency has hovered below UAH 25/USD. Since we expect the C/A deficit to start expanding soon, we project depreciation pressure will resume in the upcoming months. Capital inflow, especially loans from IFIs, will enable accumulating gross reserves. But for hryvnia dynamics, the C/A deficit will be more important. We expect the hryvnia to weaken to UAH 27.0/USD by the year end. In 2017, we expect the hryvnia to touch UAH 28.5/USD.

Fiscal accounts are also in good shape. In 5M16, budget revenue increased 12% yoy. And this growth was achieved without the one-off collections of 5M15 (NBU profits, additional import duties and proceeds from 3G mobile license sales). Solid inflation and the expanded tax base ensured the strong fiscal performance. In light of such trends, we do not see much risk of the government falling short of the revenue target. Thus, we also see it safe for the Finance Ministry to adhere to the 3.7% of GDP deficit limit that it committed to the IMF in 2016.

Key macro indicators

	2014	2015	2016F	2017F
Real GDP, yoy	-6.8%	-9.9%	0.9%	2.1%
Nominal GDP, USD bln	132.8	90.3	88.4	92.8
C/A balance, USD bln	-4.6	-0.2	-4.0	-5.1
Gross int'l reserves, USD bln	7.5	13.3	18.0	23.4
External public debt, USD bln	38.8	43.4	47.7	50.3
Total public debt, USD bln	69.8	65.5	70.6	73.7
Budget balance, % of GDP	-4.3%	-1.6%	-3.4%	-3.0%
CPI, average	12.1%	48.7%	14.5%	8.9%
UAH/USD, average	11.9	21.8	25.7	28.0
UAH/USD, eop	15.6	24.0	27.0	28.5

Source: UkrStat, MinFin, NBU, Concorde Capital research

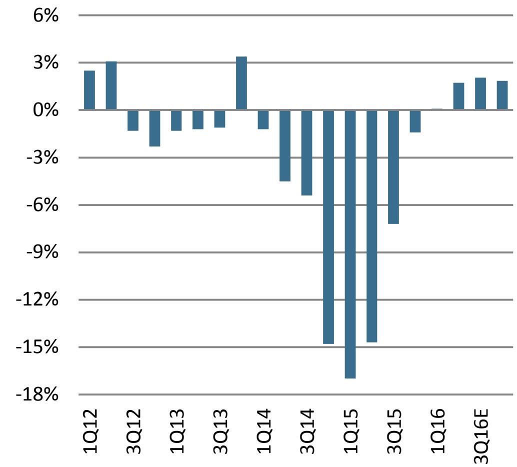
GDP: modest growth to be driven by internal consumption

Ukraine's GDP inched up 0.1% yoy in 1Q16, beating our initial expectations. The main drivers were a faster recovery of investments (+4.2% yoy), as well as improved external accounts with a positive contribution of net exports. Declining private consumption slowed to -2.1% yoy in 1Q16 after a 13.1% yoy plunge in 4Q15.

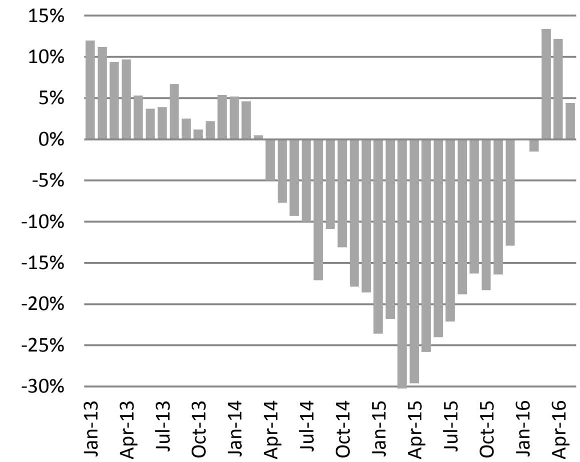
Though the macroeconomic numbers of the first quarter were barely positive, they confirmed a positive GDP trend. Investment consumption grew at a decent pace in 1Q16 while private consumption lagged behind, catching up only in March and April. Amid stabilization in consumer prices and the currency rate, we anticipate private consumption to be the main driver of 0.9% GDP growth in 2016.

We expect that economic recovery in 2017 will speed up on the back of strengthening consumption sentiments and an improving investment environment. On the negative side, the poor competitiveness of industry will be weighing on growth and recovering imports. Still, we expect the economy will be in a position to grow 2.1% yoy in 2017.

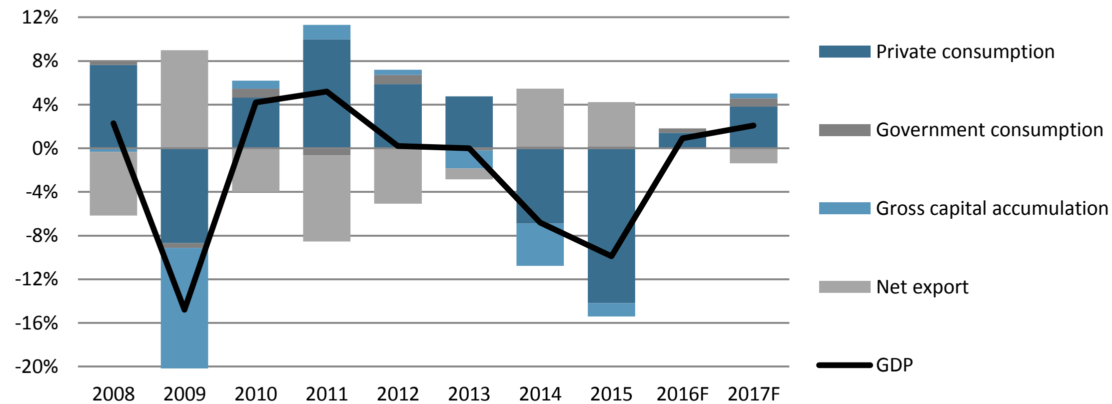
Real GDP change, quarterly data & outlook



Organized retail trade, yoy chg



Drivers of real GDP change



Source: UkrStat, Concorde Capital research

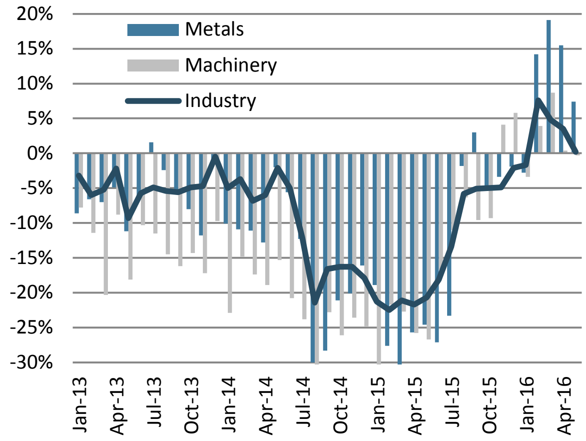
Industrial output increased 3.1% yoy in 5M16. Effectively, a 10.7% yoy growth in metal production was the only source for industrial recovery at the year's start. Remarkably, the fast industrial growth in February-March (7.6%-4.8% yoy) was dampened by quite poor results in May (+0.2% yoy). The main factors were metal production growth slowing to 7.4% yoy in May (from 15.5% yoy in the prior month), as well as mining (falling 3.5% yoy from 3.0% yoy growth in April). Prompting these trends were decreasing metal prices (the IMF metal price index decreased 3.4% m/m in May).

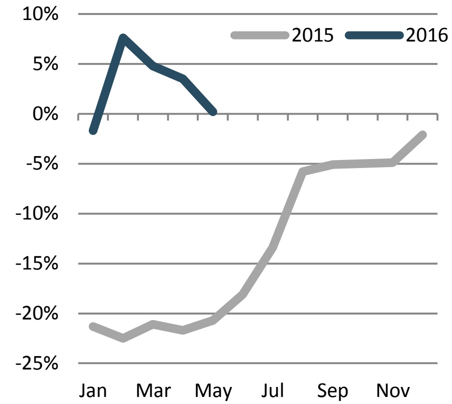
Importantly, output in five of the six most industrialized regions of Ukraine (accounting for over 60% of the nation's output) was growing in 5M16.

Industrial growth was actually easy to achieve after a 21.2% yoy plunge in 5M15. Yet the effect of the low comparative base will fade away gradually and an expected reverse in the current strength in resource prices will also take its toll. Already for June, we expect to see rather poor results due to weak steel and mining performance. We expect low- to mid-single digit growth in 2H16, and nearly 2.0% yoy average growth in the full year.

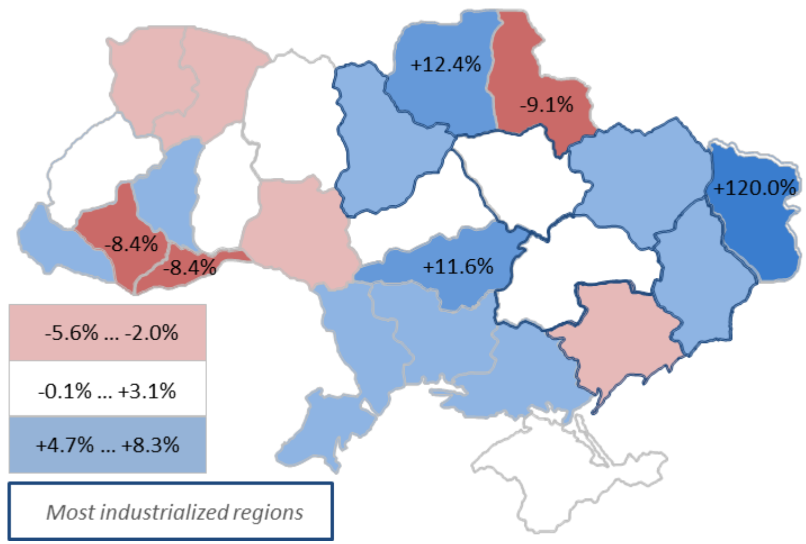
In 2017, we do not expect industry strengthening given that external markets are not sending encouraging signals to metal-exporting countries. In light of such trends at the global markets, we expect industrial performance slowing to 1.8% yoy in 2017.

Industrial output, yoy chg





Industrial output by regions, 5M16



Source: UkrStat, Concorde Capital research

CONCORDE CAPITAL

External accounts: C/A deficit to expand in 2H16 on energy imports catching up

At the year's start, we observed a controversial tendency in external accounts. On the one hand, the C/A deficit decreased 8% yoy to USD 424 mln. However, this occurred amid a substantially expanded trade deficit to USD 1.28 bln in 5M16, compared to USD 0.75 bln a year ago.

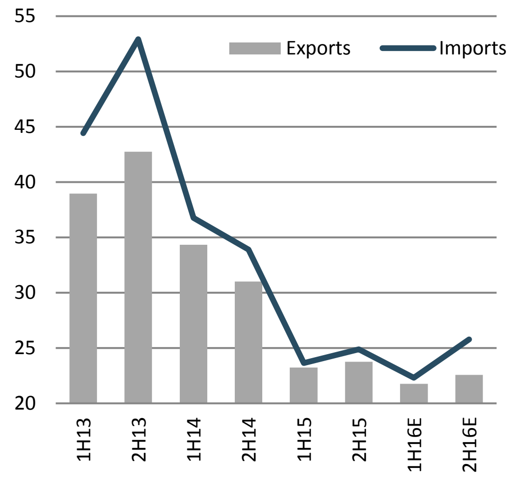
Interestingly, the increase in trade deficit has happened despite a slump in energy imports (down 54% yoy, or by USD 2.85 bln in 5M16). To some extent, imports decrease is related to the energy price drop; however, the main reason is delayed imports of natural gas. For instance, Ukraine imported only 2.99 bcm of gas in 5M16 and 3.01 bcm in 1H16 (vs. 8.78 bcm and 10.08 bcm in 5M15 and 1H15, respectively). This year's gas import need of about 11 bcm suggests that trade deficit expansion should be expected in 2H16 as well.

We also observe a strong tendency of non-energy imports recovery: +11.5% yoy in 5M16, with substantial acceleration in the last few months (+19.7% yoy in May and +21.9% yoy in April). In light of hryvnia stabilization and consumer confidence recovery, we should expect non-energy imports to only strengthen with time, which is another factor in the approaching C/A deficit expansion.

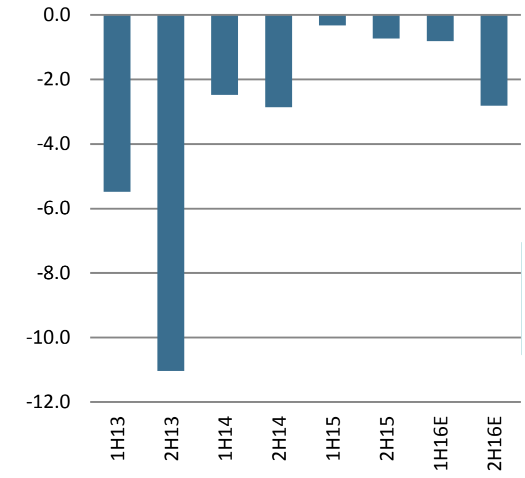
The exports decline early this year substantially slowed owing to strengthened metal and iron ore prices. In April and May, the commodity exports decline slowed to 0.2% yoy and 2.3% yoy, respectively, following steady double-digit contraction till March 2016. Interestingly, exports to Russia keep plunging (-38% yoy in 5M16) while exports to the EU have already started recovering (+4.4% yoy).

The observed tendencies lead us to conclude that exports will recover very slowly amid relatively sluggish resource prices. At the same time, imports promise a fast rebound owing to stronger energy imports already in 2H16 and steadily accelerating non-energy imports. Against this backdrop, we are leaving our 2016 C/A deficit forecast almost unchanged at USD 4.0 bln (4.5% of GDP). And we project further expansion of the trade deficit on the back of increasing import consumption: in 2017, we expect the C/A deficit will reach USD 5.1 bln (5.8% of GDP).

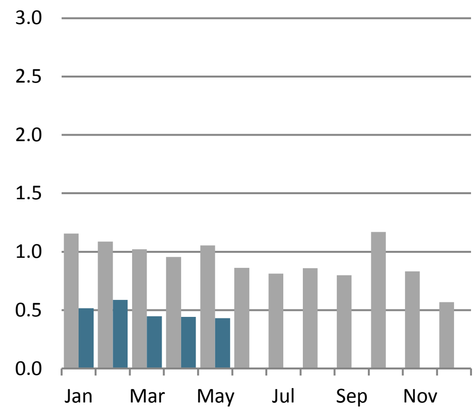
Goods & services trade, USD bln



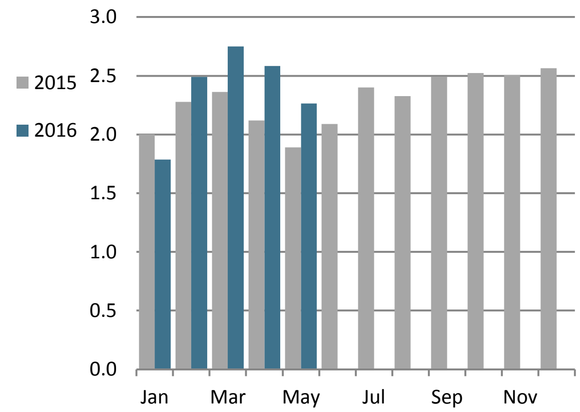
C/A balance, USD bln



Mineral product imports, USD bln



Other imports, USD bln



Source: NBU, UkrStat, Concorde Capital research

The hryvnia strengthens but depreciation to return soon

The situation at the ForEx market remains tranquil. The hryvnia strengthened to below UAH 25/USD amid improved resource prices in 2Q16. The positive tendency enabled the National Bank of Ukraine (NBU) to purchase USD 1.4 bln at the ForEx in April-June.

This strength was built on a relatively good C/A balance and improved capital and financial accounts (USD 0.94 bln surplus for 5M16, a 69% yoy increase). The single factor for the improvement, in our view, is a stronger return of foreign cash to the banking system (USD 1.90 bln in 5M16, rising from just USD 0.07 bln a year ago).

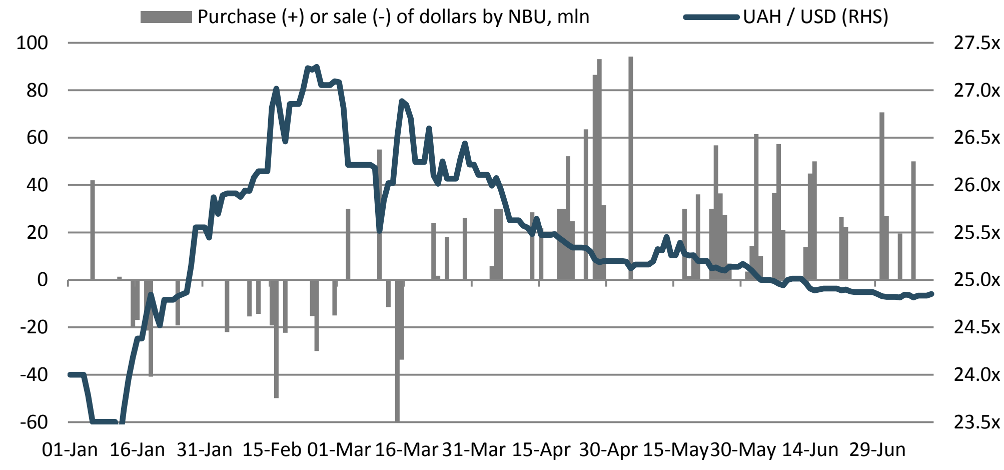
We expect positive financial flows to continue, fueled by resumed IMF cooperation in 2H16. This should unfreeze EU funding of EUR 1.2 bln and a USD 1.0 bln Eurobond placement under U.S. guarantees. It is not clear how much we should expect from the IMF, but it should be at least USD 1.0 bln, according to Ukrainian officials.

All in all, we anticipate a worsening C/A deficit and improved financial and capital accounts in 2H16, as compared to the first half.

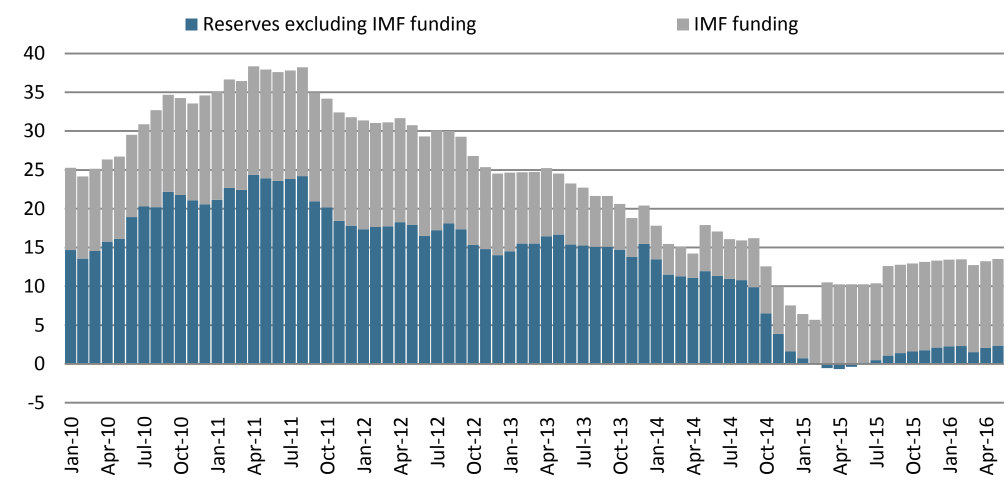
The negative C/A deficit will dominate in determining the hryvnia trend. Funds arriving from IMF and the EU, as well as U.S. loan guarantees, will most likely be stocked away as gross international reserves. That said, we see the hryvnia gradually weakening throughout 2H16 to UAH 27.0/USD by the year end. Gross international reserves should increase to USD 18.0 bln (4.2 months of imports) from USD 14.0 bln currently.

As regards to 2017 prospects, we expect the pattern to remain unchanged with expanding C/A pressuring the national currency and growing capital inflow accumulating in gross reserves. We project the hryvnia will touch UAH 28.5/USD as of end-2017 and gross international reserves to increase to USD 23.3 bln, or 5.1 months of imports.

Interbank currency market in 2016



Gross NBU reserves, USD bln



Source: NBU, Concorde Capital research

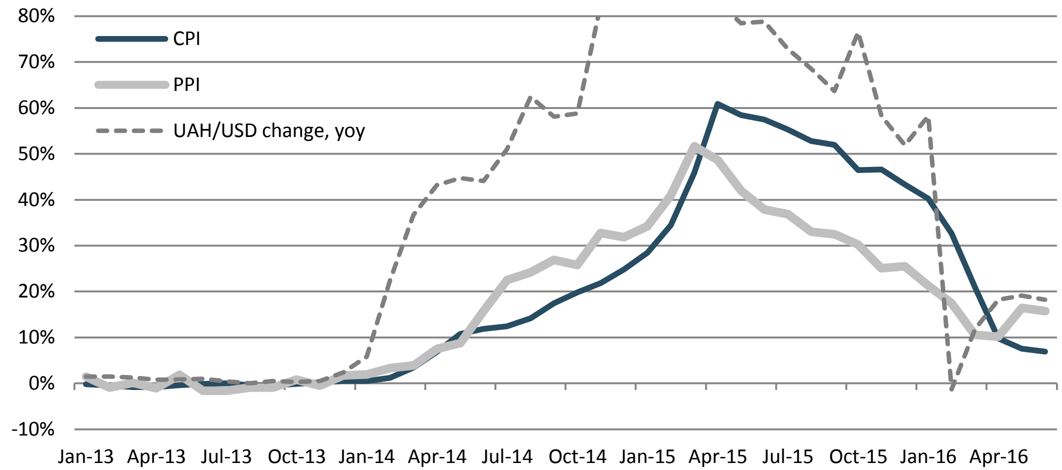
Inflation slows to single-digits, speed up ahead on the back of utility rates

After inflation peaked in mid-2015, caused by heavy devaluation of the local currency, price growth eased this year. Consumer prices increased only 4.9% YTD in 1H16 in what was the lowest inflation in the last two years. Already for three months in a row, inflation has been in the single digits. In particular, CPI increased 9.8% yoy in April, 7.5% yoy in May and 6.9% yoy in June.

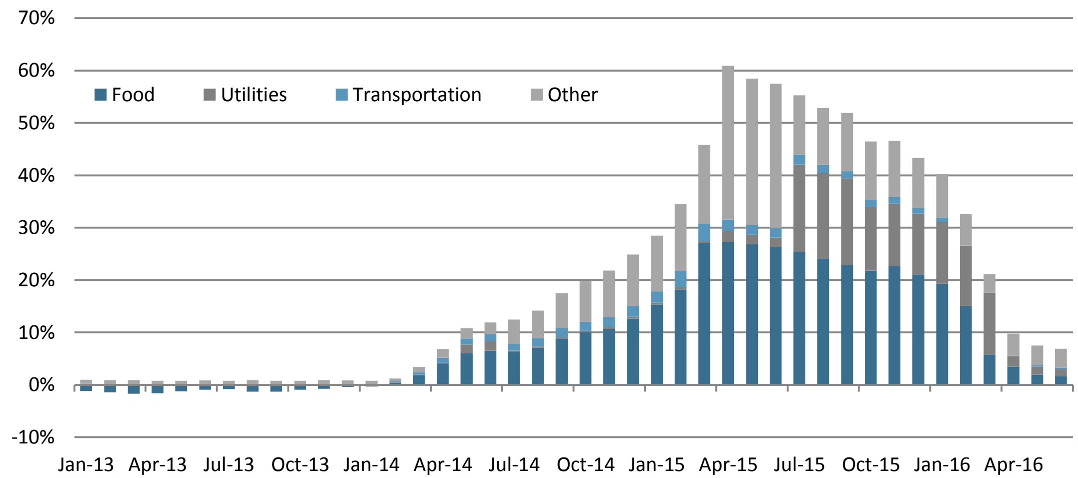
Though the disinflation tendency has dominated, we anticipate some price acceleration in September on the back of higher utility rates. In particular, electricity rates for households will increase by nearly 28% in September. By October, consumers will be feeling the effect of doubled heating rates, which were hiked in July but not implemented until the start of the heating season. Against this backdrop, we anticipate CPI increasing 10.5% YTD (+14.5% yoy) in 2016.

In 2017, we expect the slowing inflation tendency to continue, with the main price pressures being rising electricity rates in March 2017 (by an extra 28%) and further hryvnia weakening. We estimate CPI increasing 7.8% YTD (+8.9% yoy) in 2017.

Inflation indicators, yoy



Breakdown of headline CPI



Source: UkrStat, Concorde Capital research

Fiscal accounts in good stance: 3.7% of GDP deficit remains a realistic target

General budget collections are maintaining robust growth. Total budget revenue increased 12.2% yoy in 5M16, which is faster than the government's targeted 10.1% yoy average growth for 2016. And this result was achieved without the one-off collections of the previous year (NBU profits, additional import duties and proceeds from 3G license sales).

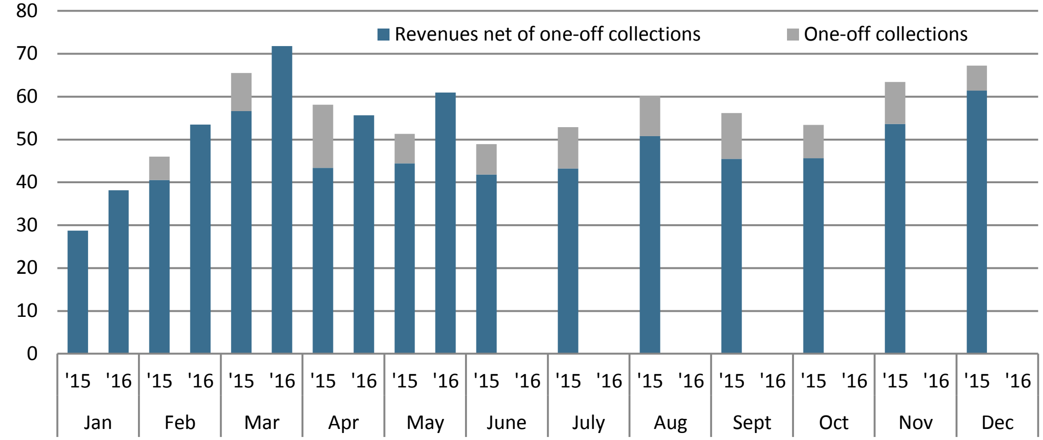
Statistics on budget revenue remain volatile, dropping 4.2% yoy in April before swelling 18.8% yoy in May. However, this volatility stems primarily from a change in taxation rules while the general trend remains positive. In particular, the enterprise profit tax was deducted monthly in 2015. Starting 2016, the payment schedule became quarterly, prompting the revenue drop in April and hike in May when 1Q16 profit taxes were due.

In light of such developments, we see a good chance for authorities to meet their outlined revenue target:

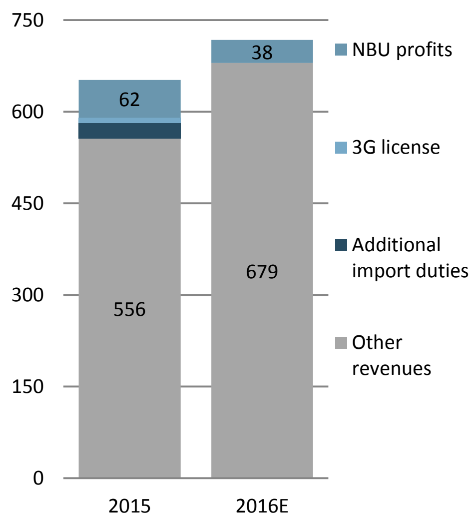
- the tax base was widened in 2016 and we have observed fast growth in core revenues (collections from VAT increased 27.0% yoy in 5M16, the personal income tax rose 39.5% yoy, excise duties gained 49.9% yoy, and the rent on mineral extraction almost doubled).
- the Finance Ministry has left untouched UAH 38 bln of the "dividends" from the NBU budgeted for this year, which is a good reserve to improve budget statistics.

Against this backdrop, we estimate budget collections to be close to their targeted level, creating a solid chance to keep the state budget deficit below 3.7% of GDP, as had been committed to the IMF.

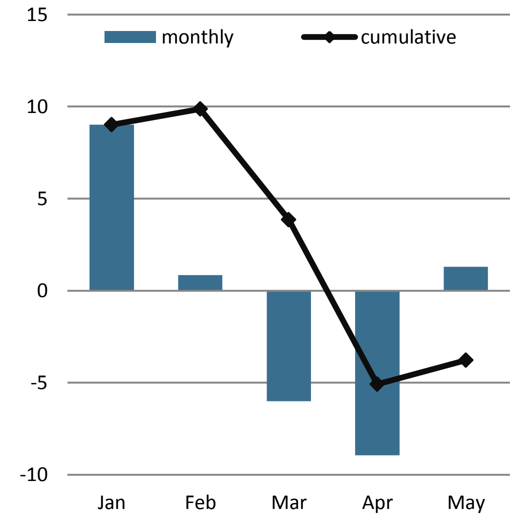
General budget revenue, UAH bln



Budget revenue breakdown, UAH bln



General budget balance in 2016, UAH bln



Source: MinFin, Concorde Capital research

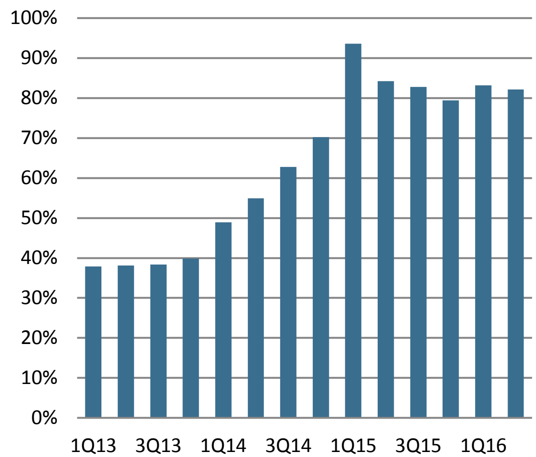
State debt hovers near 80% of GDP amid delayed IMF support

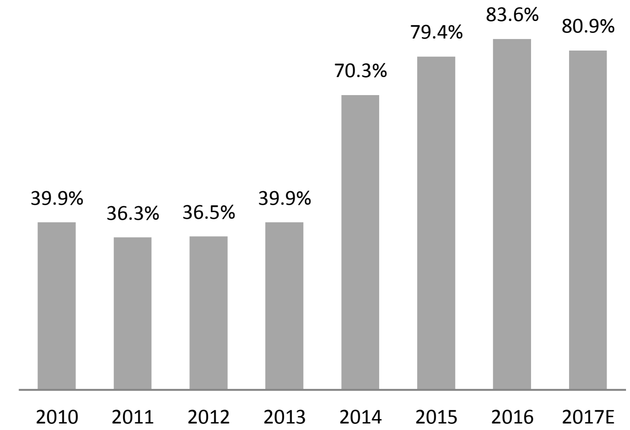
As of April 2016, Ukraine's state debt reached USD 67.1 bln (which is nearly 82% of GDP), compared to USD 65.5 bln at the year start. The main sources of new debt was an issue of USD 431 mln in state debt securities for completing a debt restructuring and a USD 334 mln loan from the Japan International Cooperation Agency. The hryvnia exchange rate strengthening in April-May also contributed to boosted debt, in USD terms.

In fact, the public debt figures are lower than we anticipated. For 1H16, we expected at least one IMF loan tranche of USD 1.7 bln and the placement of USD 1.0 bln in Eurobonds under U.S. guarantees. Yet it's July now and Ukrainian officials are still speculating on when the IMF will issue the next loan.

We remain optimistic about potential funding from the IMF since a lot has been done, such as bringing gas prices to market rates. And there is a good chance the government will complete the IMF's entire To Do list. However, in light of statements of Ukrainian officials, it looks like the sum of the nearest tranche will be lower than initially expected, or closer to USD 1.0 bln. Against this backdrop, we are lowering our 2016 public debt estimate to USD 70.6 bln, or 83.6% of GDP. For 2017, we expect the state debt to touch USD 73.7 bln, or 80.9% of GDP.

State debt as % of GDP





Source: MinFin, Concorde Capital research

Key macro indicators

	2009	2010	2011	2012	2013	2014	2015	2016 E	2017 E
Economic activity									
Real GDP, yoy	-14.8%	4.1%	5.2%	0.2%	0.0%	-6.8%	-9.9%	0.9%	2.1%
Household consumption, yoy	-14.2%	7.2%	15.0%	9.0%	7.8%	-9.6%	-19.9%	2.1%	5.5%
Investments in fixed capital, yoy	-46.2%	4.0%	10.1%	2.5%	-6.6%	-23.0%	-8.7%	2.3%	3.4%
Nominal GDP, UAH bln	913	1,083	1,302	1,411	1,465	1,567	1,980	2,279	2,597
Nominal GDP, USD bln	117.1	136.5	163.4	176.6	183.3	132.8	90.3	88.4	92.8
GDP per capita, USD	2,545	2,980	3,583	3,873	4,029	3,088	2,120	2,092	2,209
Industrial output, yoy	-21.9%	11.2%	8.0%	-0.7%	-4.3%	-10.1%	-13.0%	2.0%	1.8%
Inflation									
CPI (eop)	12.3%	9.1%	4.6%	-0.2%	0.5%	24.9%	43.3%	10.5%	7.8%
CPI average	15.9%	9.4%	8.0%	0.6%	-0.3%	12.1%	48.7%	14.5%	8.9%
PPI (eop)	14.3%	18.7%	14.2%	0.3%	1.7%	31.8%	25.5%	14.9%	10.1%
External accounts									
Current account balance, USD bln	-1.7	-3.0	-10.2	-14.3	-16.5	-4.6	-0.2	-4.0	-5.1
% GDP	-1.5%	-2.2%	-6.2%	-8.1%	-9.0%	-3.5%	-0.2%	-4.5%	-5.5%
Financial account balance, USD bln	-12.0	8.1	7.8	10.2	18.5	-8.7	1.0	7.0	8.1
% GDP	-10.3%	5.9%	4.8%	5.8%	10.1%	-6.6%	1.1%	7.9%	8.7%
Net FDI, USD bln	4.7	5.8	7.0	7.2	4.1	0.3	3.0	4.2	5.0
% GDP	4.0%	4.2%	4.3%	4.1%	2.2%	0.2%	3.3%	4.8%	5.4%
Gross NBU reserves (eop), USD bln	26.5	34.6	31.8	24.6	20.4	7.5	13.3	18.0	23.4
Public debt									
Total public debt, USD bln	39.8	54.3	59.2	64.5	73.2	69.8	65.5	70.6	73.7
% GDP*	34.0%	39.9%	36.3%	36.5%	39.9%	70.3%	79.4%	83.6%	80.9%
Public external debt, USD bln	26.6	34.8	37.5	38.7	37.6	38.8	43.4	47.7	50.3
% GDP*	22.7%	25.5%	23.0%	21.9%	20.5%	39.1%	52.7%	57.6%	56.1%
Gross external debt, USD bln	103.4	117.3	126.2	134.6	142.1	126.3	118.7	127.1	135.6
% GDP*	88.3%	85.9%	77.2%	76.2%	77.5%	95.1%	131.5%	144.3%	146.6%
Exchange rate									
Official UAH/USD (eop)	7.97	7.96	7.99	7.99	7.99	15.8	24.0	25.7	28.0
Official UAH/USD (avg)	7.79	7.94	7.97	7.99	7.99	11.9	21.8	27.0	28.5
Fiscal indicators									
Consolidated budget revenues, USD bln	37.0	39.6	50.0	55.7	54.3	38.9	29.8	28.6	29.6
% GDP	31.6%	29.0%	30.6%	31.6%	30.2%	29.5%	32.9%	32.2%	31.9%
Consolidated budget expenditures, USD bln	39.4	47.6	52.3	61.5	62.1	43.9	31.1	31.6	32.4
% GDP	33.7%	34.9%	32.0%	34.9%	34.5%	33.4%	34.3%	35.6%	34.9%
Consolidated budget balance, USD bln	-2.4	-8.0	-2.3	-5.9	-7.8	-6.1	-1.4	-3.0	-2.8
% GDP	-2.1%	-5.9%	-1.4%	-3.3%	-4.3%	-4.3%	-1.6%	-3.4%	-3.0%

** Based on UAH value of debt and GDP*
Source: UkrStat, NBU, MinFin, Concorde Capital research

CONCORDE CAPITAL

Disclaimer

THIS REPORT HAS BEEN PREPARED BY CONCORDE CAPITAL INVESTMENT BANK INDEPENDENTLY OF THE RESPECTIVE COMPANIES MENTIONED HEREIN FOR INFORMATIONAL PURPOSES ONLY. CONCORDE CAPITAL DOES AND SEEKS TO DO BUSINESS WITH COMPANIES COVERED IN ITS RESEARCH REPORTS. AS A RESULT, INVESTORS SHOULD BE AWARE THAT CONCORDE CAPITAL MIGHT HAVE A CONFLICT OF INTEREST THAT COULD AFFECT THE OBJECTIVITY OF THIS REPORT.

THE INFORMATION GIVEN AND OPINIONS EXPRESSED IN THIS DOCUMENT ARE SOLELY THOSE OF CONCORDE CAPITAL AS PART OF ITS INTERNAL RESEARCH COVERAGE. THIS DOCUMENT DOES NOT CONSTITUTE OR CONTAIN AN OFFER OF OR AN INVITATION TO SUBSCRIBE FOR OR ACQUIRE ANY SECURITIES. THIS DOCUMENT IS CONFIDENTIAL TO CLIENTS OF CONCORDE CAPITAL AND IS NOT TO BE REPRODUCED OR DISTRIBUTED OR GIVEN TO ANY OTHER PERSON.

CONCORDE CAPITAL, ITS DIRECTORS AND EMPLOYEES OR CLIENTS MIGHT HAVE OR HAVE HAD INTERESTS OR LONG/SHORT POSITIONS IN THE SECURITIES REFERRED TO HEREIN, AND MIGHT AT ANY TIME MAKE PURCHASES AND/OR SALES IN THEM AS A PRINCIPAL OR AN AGENT. CONCORDE CAPITAL MIGHT ACT OR HAS ACTED AS A MARKET-MAKER IN THE SECURITIES DISCUSSED IN THIS REPORT. THE RESEARCH ANALYSTS AND/OR CORPORATE BANKING ASSOCIATES PRINCIPALLY RESPONSIBLE FOR THE PREPARATION OF THIS REPORT RECEIVE COMPENSATION BASED UPON VARIOUS FACTORS, INCLUDING QUALITY OF RESEARCH, INVESTOR/CLIENT FEEDBACK, STOCK PICKING, COMPETITIVE FACTORS, FIRM REVENUES AND INVESTMENT BANKING REVENUES.

PRICES OF LISTED SECURITIES REFERRED TO IN THIS REPORT ARE DENOTED IN THE CURRENCY OF THE RESPECTIVE EXCHANGES. INVESTORS IN FINANCIAL INSTRUMENTS SUCH AS DEPOSITORY RECEIPTS, THE VALUES OR PRICES OF WHICH ARE INFLUENCED BY CURRENCY VOLATILITY, EFFECTIVELY ASSUME CURRENCY RISK.

DUE TO THE TIMELY NATURE OF THIS REPORT, THE INFORMATION CONTAINED MIGHT NOT HAVE BEEN VERIFIED AND IS BASED ON THE OPINION OF THE ANALYST. WE DO NOT PURPORT THIS DOCUMENT TO BE ENTIRELY ACCURATE AND DO NOT GUARANTEE IT TO BE A COMPLETE STATEMENT OR SUMMARY OF AVAILABLE DATA. ANY OPINIONS EXPRESSED HEREIN ARE STATEMENTS OF OUR JUDGMENTS AS OF THE DATE OF PUBLICATION AND ARE SUBJECT TO CHANGE WITHOUT NOTICE. REPRODUCTION OF THIS DOCUMENT IN WHOLE OR IN PART WITHOUT PRIOR PERMISSION IS PROHIBITED.

NEITHER THIS DOCUMENT NOR ANY COPY HEREOF MAY BE TAKEN OR TRANSMITTED INTO THE UNITED STATES OR DISTRIBUTED IN THE UNITED STATES OR TO ANY U.S. PERSON (WITHIN THE MEANING OF REGULATION S UNDER THE U.S. SECURITIES ACT OF 1933, AS AMENDED (THE “SECURITIES ACT”)), OTHER THAN TO A LIMITED NUMBER OF “QUALIFIED INSTITUTIONAL BUYERS” (AS DEFINED IN RULE 144A UNDER THE SECURITIES ACT) SELECTED BY CONCORDE CAPITAL.

THIS DOCUMENT MAY ONLY BE DELIVERED WITHIN THE UNITED KINGDOM TO PERSONS WHO ARE AUTHORIZED OR EXEMPT WITHIN THE MEANING OF THE FINANCIAL SERVICES AND MARKETS ACT 2000 (“FSMA”) OR TO PERSONS WHO ARE OTHERWISE ENTITLED TO RECEIVE THIS DOCUMENT UNDER THE FINANCIAL SERVICES AND MARKETS ACT 2000 (FINANCIAL PROMOTION) ORDER 2005, OR ANY OTHER ORDER MADE UNDER THE FSMA.

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
Bloomberg: TYPE CONR <GO>

CEO
Igor Mazepa im@concorde.com.ua

SALES & TRADING

Alexandra Kushnir ak@concorde.com.ua
Marina Martirosyan mm@concorde.com.ua
Yuri Tovstenko ytovstenko@concorde.com.ua
Alisa Tykhomirova at@concorde.com.ua

RESEARCH

Head of Research
Alexander Paraschiy ap@concorde.com.ua

Macro, Utilities, Financial, Consumer
Alexander Paraschiy ap@concorde.com.ua

Basic Materials, Consumer
Roman Topolyuk rt@concorde.com.ua

Editor, Politics
Zenon Zawada zzawada@concorde.com.ua