Ukraine
Economy / Fixed Income

March 19, 2015

Ukraine's debt operation

A bold and timely move, but its purposes are unclear

Alexander Paraschiy
ap@concorde.com.ua

By initiating a debt restructuring process, the Ukrainian government made a very bold move that we earlier didn't believe it's capable of (refer to our Jan. 29 note). Such a move is consistent with the launch of a government reform campaign (again, what we earlier didn't believe in) and it's currently priced in by Ukraine-related Eurobonds. While having agreed in general with the necessity of some state debt restructuring, we found a lot of questions that bond holders may ask during the process and few answers to most of them.

The key question is whether Ukraine critically needs the up to USD 15.3 bln in foreign currency savings that the initiated debt operation could bring. The alleged planned use of such funds – replenishment of gross reserves of Ukraine's central bank – looks either ill-grounded (we question whether Ukraine indeed needs reserves in excess of five months of future imports) or insincere (maybe there are other potential needs the government isn't disclosing). We hope that the government will be able to address these and other concerns to increase the likelihood of bond holders to be more cooperative.

What debt is included in restructuring consultations?

Our understanding is that it's all Eurobonds issued by the Ukrainian government and its related entities that mature in 2015-2018. If we add all the outstanding amounts of Eurobonds of the government and state entities, we would receive numbers very close to those disclosed in the recent IMF staff report.

Bonds that may be subject to debt operations, USD mln outstanding

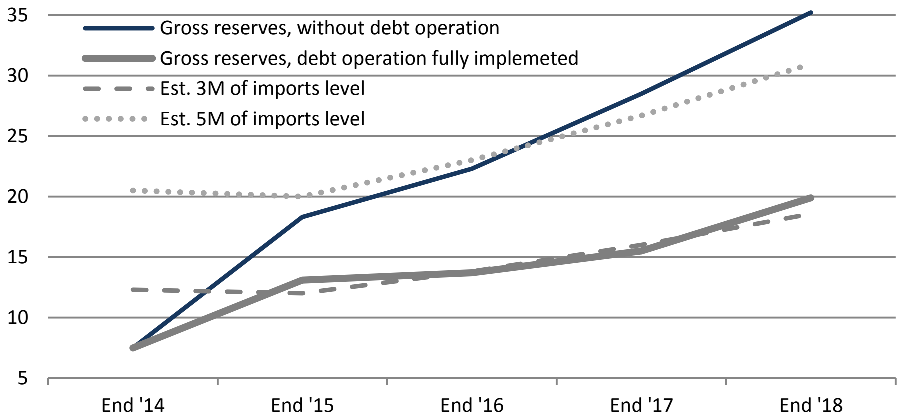
	2015	2016	2017	2018
UKRAIN (publicly traded bonds)	1,160	2,250	3,300	-
UKRAIN (loan of Russian state fund)	3,000	-	-	-
UNRINF	-	-	1,118	690
CITKIE	250	300	-	-
EXIMUK	750	150	-	600
OSCHAD	-	700	-	500
RAILUA	-	-	-	500
Total	**5,160**	**3,400**	**4,418**	**2,290**
Amounts from the IMF staff report	**5,200**	**3,400**	**4,400**	**2,300**

Sources: IMF, Bloomberg, Concorde Capital research

Why would Ukraine need to hike sharply its international reserves at the cost of bond holders?

Without the intended debt operation, the government plans gross reserves as of end-2015 at USD 13.1 bln (and USD 19.9 bln as of end-2018), which is near three months of imports. With debt operations fully implemented, Ukraine's reserves are planned to reach USD 18.3 bln as of end-2015 and USD 35.2 bln as of end-2018 (to exceed 4-5 months of imports).

Ukraine's gross international reserves outlook, USD bln



Sources: IMF, Concorde Capital estimates

The natural questions, therefore, are:

- Wouldn't a level of three-month imports be enough for the state, which is having huge difficulties with external financing?
- Why does Ukraine need to accumulate much more reserves at the cost of bond holders (who are asked to contribute USD 5.2 bln in 2015 and USD 10.1 bln more afterwards)?
    - Theory #1: to boost public confidence in macroeconomic stability. This is not what will boost confidence, which needs to be achieved with reforms, not debt restructuring. Moreover, citizens might be more concerned with restructuring international debt, as we discuss in item 4 below.
    - Theory #2: to boost confidence in Ukraine's overall stability and future statehood, in the eyes of international investors. Come on, at the expense of international bond holders? Does anybody really hope that this financial operation alone will enable Ukraine to improve its image as a country worth investing in?

The only realistic answer we have is the Ukrainian government is not sure of the sustainability of its BoP outlook for 2015 and on, so it needs to create additional reserves in case it's not able to fulfill its reform promises (to enhance private capital inflow) or in case an escalation of warfare happens. Again, thus far, we do not have a firm answer as to why it should be done at the expense of private international debt holders.

What messages is Ukraine sending by asking to restructure some of its Eurobonds?

1. The government is not sure of its ability to fulfill reforms and facilitate capital inflow in "a natural way", as mentioned above. That's clearly not the best message to the international community.

2. Russia's armed invasion of Ukraine heavily damaged the Ukrainian economy. Such a message raises even more questions:
   - Why doesn't Ukraine demand financing (or compensation) from the Western states that signed the 1994 Budapest Memorandum and assumed the responsibility to protect and assist Ukraine from foreign invasion? Why are the U.S., U.K. and Russia merely minority contributors, if at all (see the next section) in the overall financing process?
   - Why should private funds that are beyond politics pay for the consequences of political decisions?

3. IFIs and foreign governments are not capable of bringing, or do not want to bring, enough money to Ukraine to stabilize its economy and secure economic growth.

   It's difficult to believe that governments and IFIs have no money. But, for some reason, they are not ready to provide more financial aid to Ukraine. So, this looks more like a problem of trust between the Ukrainian and Western governments. If there's no trust on the government level, why will private funds trust Ukraine?

4. Perhaps the riskiest message to local debt holders is - if Ukraine dared to start restructuring talks on international debt, the risk increases that the holders of domestic debt will be treated even more badly. Domestic debts, by default, are inferior to international obligations in Ukraine.

   At this stage, however, we do not see a risk that the situation will worsen for domestic debt holders. The restructuring of domestic bonds won't help much to improve the BoP, which is the core target of the initiated debt operation.

Why should private bond holders provide more financial help than Western governments and IFIs?

According to financing plan provided on the IMF website, Ukraine will seek to finance its USD 40 bln gap in 2015-2018 from the following sources:

- The IMF will provide USD 17.5 bln to Ukraine in 2015-2018, and net funding will result in just USD 13.1 bln for that period, as Ukraine will have to repay the earlier attracted IMF debt smoothly.
- International donors have, thus far, committed USD 7.2 bln in financing. This includes USD 2.0 bln from the U.S. and USD 1.8 bln from the EU.
- The rest of the financing, or USD 15.3 bln, is suggested to be raised via the debt operation, or restructuring of all sovereign and quasi-sovereign debts (except from the IMF) that mature in 2015-2018. Out of this debt:
  - USD 3.0 bln is targeted from debt operations with the Russian State Welfare Fund;
  - USD 12.3 bln is from debt mostly held by private investors.

So the net debt provision for 2015-2018 is targeted at USD 35.6 bln, with the contribution of private bond holders (about 35%) being nearly as large as the IMF contribution (about 37%). Again, why is the contribution of those who declared their readiness to protect Ukraine under the Budapest Memorandum so much smaller?

Should the debt restructuring be considered as the price of bondholders' earlier trust in the Yanukovych regime?

Interestingly, among the bonds that fell under the debt operation target, USD 2.8 bln is debt that was issued by Ukraine and its entities before 2010 (that is, before the Yanukovych presidency), during the pro-Western Orange era. That said, the initial buyers of such bonds were believers in a new Ukraine integrating with the West, yet they will be inconvenienced with the government's plan to restructure all this debt. Meanwhile, the longer debt (which was issued only under the Yanukovych presidency) is not going to be restructured, at least at this time, which essentially rewards those who supported a Putin-oriented authoritarian regime.

Will the USD 3.0 bln debt to Russia be restructured?

The core question for bond holders is whether Ukraine has the sincere intention to restructure the Russian bond that matures in December 2015. The Russian finance minister recently confirmed he is expecting smooth repayment "as had been promised." Though, in our view, a deep restructuring of this loan (or even refusal to pay) would be a very strong argument for other bond holders that they also can participate in financial aid to Ukraine. And *vice versa*, if Ukraine intends to repay the debt to Russia, many bond holders would demand *pari passu* treatment.

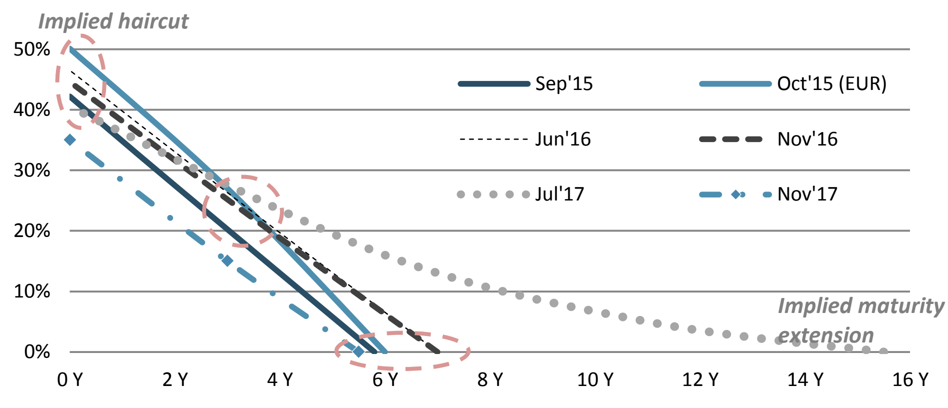
In the ideal case, international debt holders would be happy to see that Ukraine is pursuing a very soft (if any) restructuring of its "marketable" Eurobonds, and it's defaulting on the Russian bond. At least, we see a high likelihood that holders of "marketable" bonds will provide a waiver to change the cross-default covenant that would enable such a scenario. That will also enable Ukraine to reserve some safety cushion in case its BoP outlook unexpectedly worsens. Perhaps that's the ultimate plan behind all this operation?

What restructuring parameters can bondholders tolerate?

Ukraine's sovereign Eurobonds were trading at distressed levels for a long time, so their prices already assume restructuring risk. Based on the simple assumption that the required rate of return for Ukrainian paper is 20%, we can conclude that prices of Ukrainian Eurobonds, as of March 13 (before restructuring talks officially started), included the following assumptions:

- 6 -7 years of maturity extension, with no haircuts and coupon changes;
- 40%-50% haircut with no maturity extension;
- a combination of 3-4 years of maturity extension and 20%-25% haircut.

Parameters of state bond restructuring priced in as of Mar. 13, 2015



Sources: Bloomberg, Concorde Capital research

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

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

RESEARCH

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

Macroeconomics
Alexander Paraschiy ap@concorde.com.ua

Metals & Mining, Consumer
Roman Topolyuk rt@concorde.com.ua

Utilities, Energy, Financials, Consumer
Alexander Paraschiy ap@concorde.com.ua

Politics
Zenon Zawada zzawada@concorde.com.ua

Editor
Zenon Zawada zzawada@concorde.com.ua