Ukraine debt operation: Update and preliminary conclusions

Research / Ukraine / Fixed Income

Below we provide our versions of answers to frequently asked questions and our vision on the outcomes of debt operation (talks with private holders on restructuring of Ukraine's state deb) that has been initiated by the Ukrainian government as a part of EFF program with the IMF.

At this stage, we can conclude that:

- Ukraine does not critically need the successful debt operation if things are going in line with macro forecasts outlined in the documents developed jointly with the IMF. Though, it will help Ukraine to "restore high probability of debt sustainability" in case of minor deviations from the base-case. Any success in debt operation is a plus, but we did not find any proof that the failed operation will undermine Ukraine's future cooperation with the IMF.
- Eurobonds of state enterprises have a much smaller risk of hostile restructuring than sovereign paper.
- It should easy for the government to agree with bond holders on the restructuring (via maturity extension) of state notes maturing in 2015-2018.
- For longer state bonds (due in 2020-2023), the most likely restructuring scenario will be some coupon decrease.
- It is very unlikely that the government will be able to agree with debt holders on any haircut of the bonds as (1) Implementation in full (with heavy haircut) does not look achievable; (2) such a measure does not look much helpful for Ukraine if just "partially" implemented.

Summary table: perimeter of debt operation

Entity/Instrument	Outstanding, USD mln	Maturity	Debt operation target	Possible restructuring parameters
State and guaranteed Eurobonds maturing in 2015-2018				
UKRAIN	500	Sep ' 15	1, 2, 3	Extension (very likely), haircut (unlikely), coupon cut (possible)
UKRAIN	635	Oct '15	1, 2, 3	- // -
CITKIE	250	Nov '15	1, 2, 4	- // -
UKRAIN	3,000	Dec '15	1, 2, 3	- // -
UKRAIN	1,250	Jun '16	1, 2, 3	- // -
CITKIE	300	Jul '16	1, 2, 4	- // -
UKRAIN	1,000	Nov '16	1, 2, 3	- // -
UKRAIN	2,600	Jul '17	1, 2, 3	- // -
UKRINF	568	Nov '17	1, 2, 3	- // -
UKRAIN	700	Nov '17	1, 2, 3	- // -
UKRINF	550	Dec '17	1, 2, 3	- // -
UKRINF	690	Apr '18	1, 2, 3	- // -
Sub-total	**12045**			
State Eurobonds maturing after 2018				
UKRAIN	1,500	Sep '20	2, 3	Haircut (unlikely), coupon cut (very likely)
UKRAIN	1,500	Feb '21	2, 3	- // -
UKRAIN	2,250	Nov '22	2, 3	- // -
UKRAIN	1,250	Apr '23	2, 3	- // -
Sub-total	**6,500**			
Eurobonds of state enterrpises				
EXIMUK	750	27 Apr '15	1	7Y extension, amortised repayment, coupon increase (offered)
EXIMUK	125	Feb '16	1	Extension (up to 10Y), coupon increase (very likely)
OSCHAD	700	Mar '16	1	- // -
EXIMUK	600	Jan '18	1	- // -
OSCHAD	500	Mar '18	1	- // -
RAILUA	500	May '18	1	- // -
Sub-total	**3,175**			
Guaranteed debts of state enterprises				
Ukravtodor	1350*	2015 - 2017	1, 2, 4	Unclear
Pivdenne Design Bureau	260*	2018	1, 2, 3	- // -
UkrMedPostach	90*	2020	1, 2, 3	- // -
Sub-total	**1,700***			
TOTAL	**23,420**			
- Subect to Target 1	**16,920**			
- Subject to Target 2, 3	**20,255**			

** Estimated*

Source: Cabinet of Minister of Ukraine, Concorde Capital research.

What are the targets and instruments of the debt operation?

- **Target 1:** to generate USD 15.2 bln in BoP savings in 2015-2018. This is planned to be reached by **an extension of maturity of all the state and quasi debts maturing in 2015-2018**.
- **Target 2:** to bring the public and guaranteed debt to GDP ratio from a projected 80% of GDP to about 71% of GDP by 2020. In the framework of debt operations, this target can be reached by a **decrease of the par value of the debt (the haircut).** No explicit amount of haircut is stated in any document, but based on the 2020 GDP forecasts presented in the IMF Staff Report (USD 135 bln), the total desired savings from Target 2 is USD 12 bln.
- **Target 3:** to keep the budget's gross financing needs at an average of 10% of GDP for 2019–2025. In the framework of debt operations, this target can be reached **by haircut or a decrease of interest rates on the debts**. It's hard to quantify the government's plans regarding this target.

What is the deadline?

Ukraine is committed to bring some result from talks with creditors by the IMF's first review of the EFF program (mid-June 2015). The government plans to finalize it earlier (mid or late May).

What debt is subject to the debt operation?

The Ukrainian government has included 29 sovereign, guaranteed and quasi-sovereign debt issues into the perimeter of debt operation (see the table above). This includes 22 Eurobond issues of the government, the city of Kyiv, and state companies, as well as 7 issues of state-guaranteed private debt. The total face value of the debt is about USD 23.4 bln, we estimate.

Which debts should be affected in order to help to achieve Target 1, 2 and 3?

Target 1 can be met by a rescheduling of the debts maturing in 2015-2018 for a longer period. This implies that holders of debt papers with maturity longer than 2018 (all state bonds will be maturing 2020-2023) will not be asked for an extension of maturity.

Target 2 (and Target 3) can be met by haircuts of all the bonds that will remain outstanding in end-2020. As was clearly stated by the MinFin**, Eurobonds of Ukreximbank, Oschadbank and Ukrzaliznytsia will not be subject to this target.**

Clearly, the haircut will be a subject of discussion for the state debt that is currently due after 2018 (UKRAIN '20, '21, '22, '23). The haircut is less likely (or the size of the desired haircut is smaller) for other debt instruments.

Will the EXIMUK restructuring offer affect the debt operation of the MinFin?

Ukreximbank's updated restructuring offer of the 2015 notes **does not have a direct implication on the parameters of the debt operation** that the MinFin is going to pursue with sovereign debt. The MinFin was stressing that the Eurobonds of state banks, as well as Ukrzalizhnytsia, may be treated differently "targeting their specific situations".

Though, there could be some indirect implications from Ukreximbank's offer. In particular, the offered coupon increase by the bank (something that looked almost impossible to us earlier) suggests that the negotiating position of the MinFin (and the bank, and its advisors) does not look strong. We believe that **by demonstrating such a weakness, the MinFin increases appetites of all holders of Ukrainian bonds.**

Needleless to say, appetites of bond holders of other Ukreximbank's bonds, as well as of Oschadnbak and Ukrzalizhnytsia has also increased significantly.

Is the operation with state debt critical for Ukraine's debt sustainability?

The IMF Staff Report highlights that "The authorities' intention to undertake a debt operation is critical to restoring a high probability of debt sustainability and for providing the financing necessary for [the EFF] program success".

This only means that Ukraine is being encouraged to try negotiating with private debt holders. In our view, a **successful debt operation is helpful** indeed for Ukraine **to mitigate** minor risks, i.e. **minor negative deviations from the base-case** macroeconomic scenario that is outlined in joint documents with the IMF.

In case deviations will be more than "minor" (i.e. Ukraine is unable to implement outlined reforms, to improve the investment climate, or the war in Donbas escalates) the debt operation will not help.

Is Target 1, pursued by the debt operation, critical for Ukraine?

By meeting Target 1 (a savings of USD 15.3 bln by not repaying on time all the state and quasi Eurobonds maturing in 2015-2018), Ukraine is going to increase its gross international reserves to USD 18.3 bln in 2015 and to USD 35.2 bln in 2018 (to roughly 5M of future imports). Without the debt operation, the IMF forecasts that the NBU reserves would be USD 13.1 bln in 2015 and USD 19.9 bln in 2018, or roughly 3M of future imports.

The 3M level looks like an "acceptable" benchmark for any country, meaning that the savings generated by debt operation does not look critical, if things go in line with macro forecasts outlined in the Staff Agreement.

This means **bond holders are being asked to contribute to the creation of a safety cushion for Ukraine**. It clearly is not critical for Ukraine to create it, but it is something that can be acceptable for bond holders.

Is Target 2, pursued by debt operation, critical for Ukraine?

In our view, Target 2 (to achiveve 71% ratio of state debt/GDP in 2020) **looks much less critical to achieve for Ukraine**, as compared to other targets:

- We do not see any radical difference between 80% and 71% of debt/GDP in 2020;
- There is no guarantee that the 71% debt ratio will be achieved in 2020 even in the case of a successful debt operation. In particular, the GDP forecast for 2020 rests on the assumption that UAH/USD rate will be 23.7. If the exchange rate will differ slightly, the ratio will be spoiled. E.g. if the rate would be UAH 27/USD, the debt/GDP ratio would come back to 80%, even if all the efforts made under Target 2 are successful. Needless to say, such an exchange rate is not something unreal: in the last week of February 2015, we observed an even higher rate (UAH 27.8 – 30.0 / USD).

Is Target 2 achievable?

Target 2 looks very ambitious if we look at the MinFin desired size of debt savings (via haircut):

- The difference between 80% and 71% of GDP in 2020 is USD 12 bln, or almost 60% of the total USD 20.3 bln debt that might be subject to Target 2. It's hard to believe that debt holders will accept the average 60% haircut.

We could assume that bond holders, especially those holding bonds maturing in 2020-2023, could accept some minor level of haircut, in order to be treated equally with the holders of 2015-2018 notes (who will most likely suffer from maturity extension). At the same time, "partial" implementation of Target 2 by the government makes little sense, so the MinFin is very unlikely to make much effort to implement it. From this standpoint, **we see small likelihood that even a partial implementation of Target 2 (i.e. any haircut) will be made.**

Is Target 3 achievable?

In our view, bond holders **could accept some decrease of coupon rates of state bonds** (especially on longer ones), and this might be helpful to decrease the debt servicing burden on Ukraine's state budget.

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