CONCORDE CAPITAL

Ukraine | Research
Fixed Income
Desk Note

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Ukrainian corporate bonds

In tumult, longer bonds are more attractive

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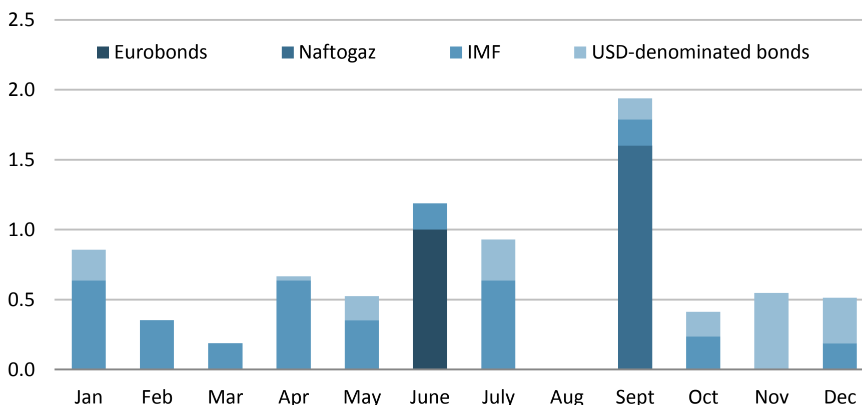
February looks to be a quieter month politically in Ukraine, compared to December and January. The ruling government and opposition are engaged in something they call negotiations, which we view as little more than an attempt by both sides to gain time and strengthen their positions. During this time, macroeconomic troubles are only mounting and the outlook of a smooth repayments in the government's loaded debt schedule in 2014 is worsening. Hence, we anticipate another round of spikes in sovereign risk in February, specifically on the shorter end of the curve, unless Ukrainian President Viktor Yanukovych secures Russian macroeconomic aid during his planned visit to Sochi on Feb. 7, or future visits during the Olympics. Russia's renewal of plans for a USD 12 bln bailout in 2014 would be a quick fix to restore market confidence. But that's not likely when Yanukovych behaves as if he's negotiating with the opposition. On the other hand, the "negotiations" might continue till the end of the Olympics to maintain the appearance of a peaceful political process in Ukraine. Possible elevating uncertainty in sovereign solvency resembles the economic pretext of the Dec. 17 deal with Russia.

We recommend favoring bonds with longer maturity, which proved to perform better before and after that deal. Specifically, we like MHP 2020 and Mriya 2018. Ukrlandfarming 2018 offers an ample spread to sovereign currently. Notably, all the issuers of picked bonds are nearly indifferent to change of Ukraine's political course.

Political deadlock in Ukraine – calm before the storm. After bloody clashes erupted in Kyiv and other regions of Ukraine in January, the ruling party and opposition ended up literally frozen in a stalemate at the beginning of February. The opposition is not taking much physical offensive action, thus trying to avoid casualties. The authorities seem to be getting involved more in political negotiations currently, rather than accelerating its terror campaign against the EuroMaidan. The government's "toned down" approach may stem from an attempt to maintain a calm picture on the television screens during the Winter Olympics in neighboring Russia. Yet as soon as all the medals are handed to the winners in Sochi, there is a risk that an active conflict can return to Ukrainian streets. Neither side appears to be willing to compromise.

Abundant payout scheduled for 2014, hot summer expected. Apart from the uprisings and political infighting, 2014 would have been difficult for Ukraine anyway as the country is facing an USD 8.1 bln payout throughout the year of sovereign and quasi sovereign debt. That's a record level (compared to USD 4.9 bln in 2012 and USD 6.6 bln in 2013) in a time when the capacity to pay has worsened yoy, along with dwindling economic activity. The redemptions will peak in June and July, at around USD 1 bln per month, to Eurobond holders and the IMF. The monthly payments will reach their peak in September, according to the government's schedule, when state natural gas production and transit monopoly Naftogaz (NAFTO) will have to redeem USD 1.6 bln in Eurobonds, guaranteed by Ukraine. While refinancing options are available from both the west-and eastwards, the Ukrainian government may lack time to implement the changes necessary to satisfy either the IMF/EU or Russia.

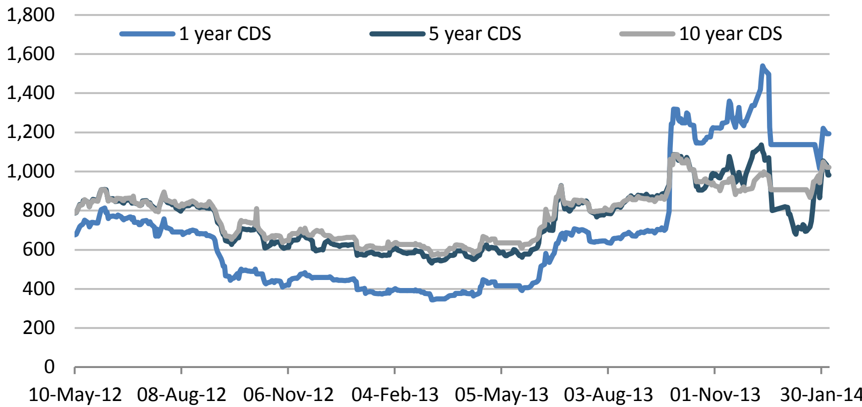
Ukraine's sovereign and quasi sovereign repayments in 2014, USD bln



Source: National Bank of Ukraine

Dwindling NBU reserves to increase sovereign risk. Ukraine's foreign currency reserves fell USD 2.6 bln (13%) just in January 2014 to USD 17.8 bln. That will raise sovereign risk, reflected in CDSs and yields. Ukrainian CDSs can test new highs, and the shorter CDSs will be the most affected, impacting bond prices respectively.

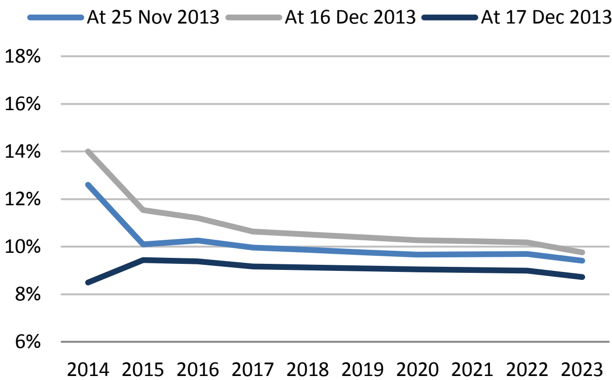
CDS on Ukrainian sovereign Eurobonds, bps



Source: Bloomberg

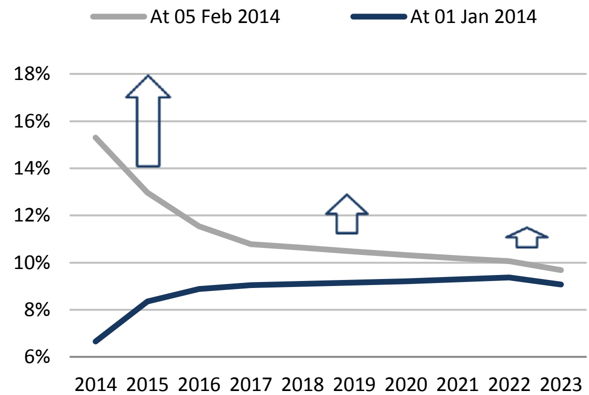
Inverted sovereign curve may coil further before possibly normalizing. Things may get much worse before they can get better, if they ever will. Since the beginning of January, short-term risks have again pushed the sovereign curve to an inverted form, with macroeconomic and solvency issues for Ukraine having reached new extremes. We see no quick-fix of these risks unless Russia urgently secures bailout financing, notwithstanding the protracted political standoff in Kyiv. While this outcome is not impossible, we acknowledge Moscow's reluctance to finance its politically "unstable" or "undetermined" neighbor. Possible financial help from the IMF, though widely discussed, isn't a solution in the near term, requiring certain legal and political events to occur. There is a possibility of some financial help from EU, but not much details on such package are available so far. So before the financial aid finally comes from the East the yields of Ukraine's sovereigns may experience another round of upward movement, with shorter end suffering the most.

Sovereign curve before and after the Nov. 30 dispersals, and after the Dec. 17 deal with Russia



Source: Bloomberg

Sovereign curve beginning January, February 2014, possible further movement by the end of February



Source: Bloomberg, Concorde Capital research

Richer spreads for longer bonds. The inverted slope of the sovereign curve has pushed short-term bonds (Metinvest, DTEK, MHP and Avangardco with maturity in 2015) to an expensive position in terms of spread to the sovereign benchmark. Based on our expectation of further steepening of the short end of the curve, these bonds appear not very attractive for the period by the end of February. Metinvest and DTEK 2018, Ferrexpo 2016, and Mriya 2016 trade at spreads to sovereign lower than historical averages, but not so drastically as the shorter papers. A relative comparison with the average historical spread to sovereign reveals that longer bonds – Mriya 2018, and Ukrlandfarming 2018 and MHP 2020 – currently trade at rich spreads. These three bonds look also attractive if their current YTMs are compared to their historical average (by 180-250 bps higher).

Eurobond	Current YTM, %	Historical average YTM, %	Current spread to sovereign	Historical average spread	Valuation on historical spread
Metinvest 2015	11.1	9.0	-188	102	Expensive
Metinvest 2018 (to 2017)	12.3	9.8	112	127	Less expensive
DTEK 2015	12.1	9.0	-85	107	Expensive
DTEK 2018 (to 2017)	12.3	9.6	104	41	-
Ferrexpo 2016	12.1	9.4	39	125	Less expensive
Ukrlandfarming (ULF) 2018 (to 2017)	**15.5**	**13.7**	**427**	**322**	**Cheap**
MHP 2015	10.8	9.4	-213	142	Expensive
MHP 2020	**12.8**	**10.3**	**254**	**125**	**Cheap**
Mriya 2016	13.0	11.6	129	341	Less expensive
Mriya 2018 (to 2017)	**15.3**	**12.3**	**404**	**298**	**Cheap**
Avangard 2015	9.5	12.5	-360	523	Expensive

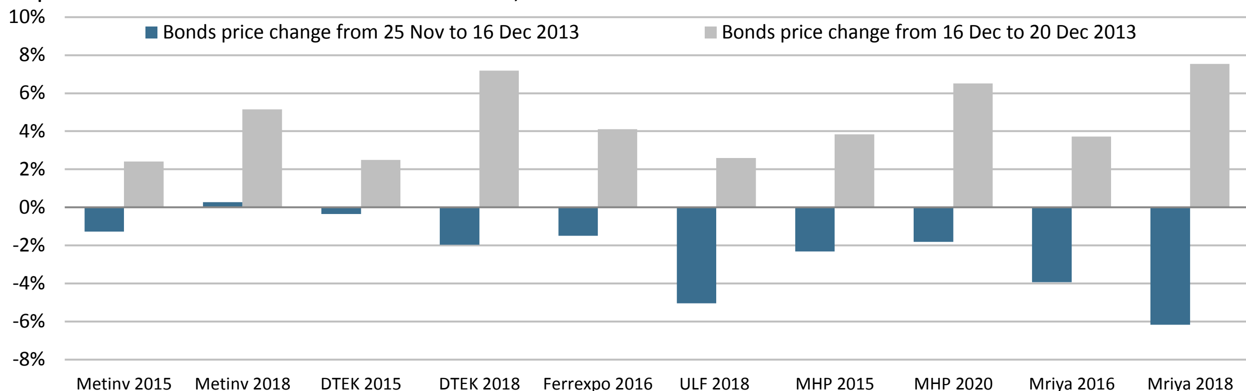
Source: Bloomberg, Concorde Capital

Longer bonds perform better when the dust settles. We have examined how this set of names performed during two periods:

1) when street protests escalated in Kyiv on Nov. 30 but before the Dec. 17 deal with Russia;
2) shortly after the signing of the Dec. 17 deal, when the market became less risk-averse to Ukraine.

Interestingly, Eurobonds of MHP 2020 and Mriya 2018 advanced significantly during the 2nd period (though Mriya also declined the most during the 1st period proving its riskiness). Metinvest and DTEK 2018 showed remarkable growth in the 2nd period, compared to limited declines during the 1st one. Combined with the expectation of rising shorter yields, we recommend cutting exposure to shorter issues while preferring longer ones, with MHP 2020 and Mriya 2018 as our top picks.

Bond performance before and after the deal with Russia on Dec. 17, %



Source: Bloomberg, Concorde Capital estimates

East or West, pick the best. Since we don't see Ukraine being able to tackle debt issues on its own in 2014, it will have to make a final decision on a geopolitical vector after February to gain a bailout. To sum, the implications for Ukrainian companies are:

- In case of a deal with Russia – natural gas price discount, limited hryvnia devaluation, possible sanctions from EU for those who support president;
- Cooperation with EU – more expensive natural gas, liberalized hryvnia exchange rate, possible trade wars with Russia.

Natural gas price is particularly relevant for Metinvest and Ferrexpo. Metinvest is one of the most sensitive to trade sanctions, either from the West or East, though 6% of the company's total revenue is protected via sales of semi-products to own rolling mills in the EU. Most names will benefit from a hryvnia devaluation, except for DTEK and MHP, which generate their revenue primarily in hryvnia. On the bright side for MHP, its expected ample free cash flow generation in 2015-17 will enable the servicing and redemption of its 2020 bonds issue, in case of limited devaluation of the national currency.

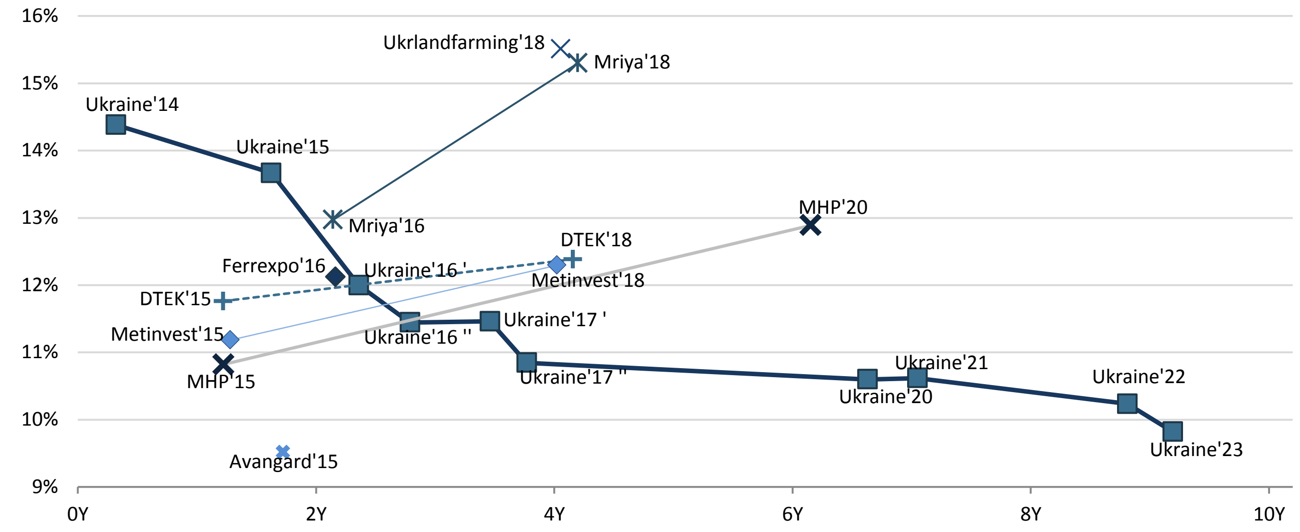
Deeper integration with Russia: implications for bond issuers

	Risk of EU pressure on shareholders	Effect of possible worsening trade relations with Europe	Effect of a moderate currency devaluation	Effect of natural gas price discount (by USD 132/tcm) from Russia
Metinvest	Exists	Potential barriers for finished steel products sold to EU in 2-3 years (17% of total revenue).	> 50% of costs are hryvnia-based, while revenue sticks to dollars	Annual savings at USD 200 mln
DTEK	Exists	Neutral. Not large exposure to the EU	Only 10% of revenue is generated in USD, 95% of debt is in USD and EUR	Neutral
Ferrexpo	No	Neutral	> 50% of costs are hryvnia-based, while revenue sticks to dollar	Annual savings of USD 26 mln
Ukrlandfarming	No	Neutral	88% of revenue and 89% of costs are generated in hryvnia.	Neutral
MHP	No	Neutral	Neutral	Neutral
Mriya	No	Neutral	Revenue is dollar-linked, while 74% of costs are hryvnia-based	Neutral

A step towards the EU: implications for bond issuers

	Risk of Russia's political pressure on shareholders	Effect of possible worsening trade relations with Russia	Effect of a deep currency devaluation	Effect of cancelled discount for natural gas price
Metinvest	No (a Russian shareholder owns 24% of Metinvest)	Around 12% of revenue generated from sales of finished products to Russia will be under threat	Positive. > 50% of costs are hryvnia based, while revenue sticks to dollar	Decreases competitiveness to Russian peers on the cost side
DTEK	Possible administrative hurdles for coal mining business in Russia (though not material)	Neutral	Only 10% of revenue is generated in USD, 95% of debt is in USD and EUR	Slightly negative
Ferrexpo	No	Neutral	> 50% of costs are hryvnia-based, while revenue sticks to dollar	Decreases competitiveness on the global scale
Ukrlandfarming	No	Neutral	88% of revenue and 89% of costs are generated in hryvnia.	Neutral
MHP	No	Russia accounted for almost 10% poultry sales in 2013. But access to EU market diminish Russian risk	Slightly negative	Neutral
Mriya	No	Neutral	Revenue is dollar-linked, while 74% of costs are hryvnia-based	Neutral

Yield map as of Feb 7, 2014



Source: Bloomberg

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