

ULF and Avangardco bonds:

Under pressure

Executive summary

The recent campaign of Ukrainian law enforcement bodies to prosecute businessmen who owe large amounts to the state did not bypass Oleg Bakhmatyuk, the owner of Ukrlandfarming (UKRLAN) and key shareholder of Avangardco (AVINPU).

Being incapable of pressuring the really “big fish” like the former shareholders of Privatbank, the state has concentrated its efforts on prosecuting Bakhmatyuk and Kostyantyn Zhevago. While the pressure on Zhevago does not look very harmful for his key business Ferrexpo – which has some stable corporate governance system – attacks on Bakhmatyuk could be disastrous for his farming business, which looks like a one-man band.

As we discuss below, we see it as very probable that Bakhmatyuk and his alleged partners at the National Bank, all of whom are suspected in conspiracy, will be able to prove in court the lack of grounds in the allegations of the National Anti-Corruption Bureau (NABU). However, this does not guarantee that state pressure on Bakhmatyuk will stop.

Feeling the heat, Bakhmatyuk revealed a possible debt resolution plan that he claimed to be actively discussing with government authorities. Commenting to Debtwire last week, Bakhmatyuk said he was close to reaching a deal in which he would pay up to UAH 8.5 bln to the State Deposit Guarantee Fund during eight years, which is 60% less than the total claim made by the fund and the central bank. If fulfilled, the plan would have paved the way for Bakhmatyuk to continue debt restructuring talks with international creditors, perhaps on even better conditions than had been offered last winter.

At the same time, a possible debt deal with the state entities looks too good to be true. Taking this into account, as well as the recent NABU pressure, we see the worst-case scenario as being more probable now. This scenario assumes continuing government pressure on Bakhmatyuk and his loss of control over Ukrlandfarming, which will likely result in this business falling apart. This assumes little recovery of any of Bakhmatyuk’s debt, particularly the claims of international creditors and state entities.

Our negative outlook on UKRLAN and AVINPU bonds remains in place.

Bloomberg ticker	UKRLAN	AVINPU
Par value, USD mln	542.75	213.73
Maturity	Mar. 26, 2018	Oct. 23, 2018

Bond price, % of par



Reasons behind NABU conspiracy case

NABU has said it has been investigating a criminal case involving VAB Bank (controlled by Bakhmatyuk by December 2014) since October 2016. But in February 2019, the then-prosecutor general transferred the investigation to the National Police. The police closed the case in August, being unable to find any crime. However, the newly appointed prosecutor general ordered in September that NABU restart the investigation. This resulted in former NBU and VAB Bank officials being declared suspects in the conspiracy (see more details on the next slide) on Nov. 11-13, as well as Bakhmatyuk being placed on a national search on Nov. 21.

From this sequence of events, we can conclude **that there was an order from top officials to prosecute the top businessmen at failed banks.**

- Recall, the IMF is demanding that the government do all its best to recover the losses of failed Ukrainian banks. Being unable to prosecute “the biggest fish”, the former owners of Privatbank, the government seems to have concentrated on “smaller fish.”
- Possibly as part of such attempts, the State Bureau of Investigations (DBR) declared in October Kostyantyn Zhevago a suspect in the embezzlement of funds from Finance & Credit Bank, which he used to own until September 2015. At that point, the bank was declared insolvent and owing a UAH 7.1 bln debt to the NBU, with the Deposit Guarantee Fund (DGF) having spent UAH 10.3 bln for the repayment of the bank’s guaranteed deposits. Therefore, the total claim against Zhevago from the NBU and the DGF could amount to UAH 17.4 bln.
- Two failed banks controlled by Oleg Bakhmatyuk (including VAB and Finansova Initsiatyva) owe even more: UAH 10.6 bln to the NBU and UAH 11.0 bln to the DGF.

It comes as no surprise, therefore, that Bakhmatyuk is also in the list of candidates for prosecution.

However, by prosecuting the owners of failed banks, the government will not necessarily recover the costs spent for the banks (as the IMF would like to see). Unlike the case of Zhevago, who never indicated his willingness to compensate costs to the government, Bakhmatyuk has repeatedly declared his desire to agree on some compensation. His latest declaration on his willingness to repay up to UAH 8.5 bln (or about 40% of the debt owed to the NBU and the Deposit Guarantee Fund) seems more than what these entities are likely to get from Bakhmatyuk in case they take over his businesses and sell them.

NABU allegations do not look well-grounded

In recent weeks, NABU declared Bakhmatyuk, former National Bank Deputy Governor Alexander Pizaruk, as well as eight other VAB Bank and NBU officials to be suspects in a criminal case involving an alleged conspiracy aimed at expropriating a UAH 1.2 bln loan from the central bank.

NABU alleges Pizaruk, during his NBU tenure, illegally provided the stabilization loan to VAB Bank (whose major shareholder was Bakhmatyuk) in October 2014. Forty days after the bank received the loan, the NBU declared the institution to be insolvent.

The loan's alleged illegality is based on two key NABU arguments:

1. The bank provided an incomplete set of documents while applying for the loan – so the NBU should have refused it. In particular, NABU alleges the bank provided no financial recovery plan, which should have been an integral part of the documentation for a stabilization loan.
2. Among the loan application documents, the bank provided a falsified evaluation report of collateral in which its value was overestimated by multiple times, and NBU officials were allegedly aware of that fact.

In addition to that, the NABU alleges that:

- a. There was a conspiracy between VAB and NBU officials since they were meeting before the loan was provided.
- b. The provided loan was used for the benefit of related parties of the bank (companies and individuals).

In our view, NABU's allegations of conspiracy do not look well-grounded, and most likely will be rejected in an impartial court of law.

In particular:

1. Bakhmatyuk and the NBU are arguing that VAB Bank did indeed provide a complete package of documents. Our conclusion is that the recovery plan did exist, based on the following:
 - VAB Bank was declared a "problem bank" in early October. By law, such a bank must provide a financial recovery plan within seven days, and there is no information that that wasn't done.
 - In its Nov. 21 press release declaring VAB Bank to be insolvent, the NBU mentioned that the bank had provided a financial recovery plan.
2. Bakhmatyuk and the NBU are also claiming the collateral evaluation report was prepared in line with legislation. We believe there could have been an overestimate of collateral value in the report. However, given the bank's urgent need in liquidity, the NBU might have decided to give the benefit of the doubt to the bank by overlooking possible discrepancies in the report (otherwise, the NBU would have had to refuse the loan until another report was prepared, which could have resulted in a quick bank's collapse).

Also:

- a. The fact that VAB Bank and NBU officials were meeting to discuss a possible loan does not prove conspiracy. Meetings are a usual part of the negotiation process. In our view, the quick declaration of the bank's insolvency proves there was no undercover deal between the NBU and Bakhmatyuk. In case there was a deal, the NBU is unlikely to have been so fast in declaring the bank insolvent.
- b. Both Bakhmatyuk and the NBU claimed that VAB Bank spent the entire amount of the UAH 1.2 bln loan to repay individual deposits. It's hard to confirm this info, but we do not rule out that the statistics available will prove the NBU's claim.
- c. Even if it's proven the bank had spent money for the wrong purposes, such spending has nothing to do with the conspiracy charge.

Prospects for the NABU case

The National Police has already proven its inefficiency in investigating the VAB Bank case, so some other law enforcement bodies will have to be involved to try and reach some tangible outcome.

Bakhmatyuk's case cannot be investigated by the DBR, whose scope is limited to investigating high-ranking officials, including members of parliament like Zhevago.

Of the remaining options, it seems that only NABU has the intellectual capacity, resources and political will to investigate the cases of Bakhmatyuk's banks.

But to have any legal grounds to conduct deeper investigations, NABU has to prove there was corruption here, meaning that some NBU officials were involved.

That means:

If NABU is unable to prove to the High Anti-Corruption Court that there was a conspiracy between Bakhmatyuk and NBU officials, then it won't be able to investigate further.

In our view, there is a high probability for that outcome, as both the NBU and the Bakhmatyuk side (irrespective of their being fierce foes) will work together to prove the absence of conspiracy.

All in all, we expect this case will have little prospects in court.

However, this does not mean that a possible failure of the conspiracy case will stop law enforcement agencies from pressuring Bakhmatyuk.

NABU pressure producing possible deal

All the recent loud NABU activity resulted in Bakhmatyuk's revelation of a possible deal that he allegedly was close to reaching with the NBU and the Deposit Guarantee Fund (DGF).

According to Bakhmatyuk's version of events (which we can treat with some skepticism), he nearly agreed on some restructuring deal with the DGF, according to which he would commit to repay about UAH 8.5 bln to the fund, including a UAH 0.5 bln down payment and UAH 1 bln annually in eight years. He also highlighted that he was working actively to find external financing for the down payment.

We do not know whether such statements are true:

- On the one hand, we doubt that the NBU, whose management is hostile to Bakhmatyuk, would agree on a deal that implies a significant haircut of Bakhmatyuk's obligations (recall, the NBU estimates Bakhmatyuk's total debt to the NBU and DGF is UAH 21.6 bln). Also, we are observing a new series of NBU's information attack on Bakhmatyuk that stresses the volume of his state debt, as well as the 19 court verdicts against him (though they have yet to be enforced).
- On the other hand, neither the NBU nor the DGF has denied the alleged negotiations. Also, any repayment plan with a clear schedule may prove advantageous for the state entities considering the debt recovery rate from Bakhmatyuk's assets could be much lower otherwise.

Whether or not the government could agree on such a deal (which remains doubtful), it will certainly be beneficial for Bakhmatyuk. By repaying just UAH 8.5 bln of his debt to the state, Bakhmatyuk:

- Would be reducing the risk of future pressure from state bodies, thereby also raising the chance to keep his Ukrainian business.
- Would be gaining more footing in his negotiations with private creditors on the haircut he has been offering (65%-70%). In particular, he could base his arguments on the government agreeing to about a 60% haircut (UAH 8.5 bln repayment vs. a UAH 21.6 bln total claim).
- With such a deal, he won't much violate the interests of ULF/Avangardco's other creditors. Namely, based on our estimates, about UAH 7 bln of ULF's on-balance debt is to his two related banks (which means, now ULF owes this amount to the DGF).

Such a deal could be beneficial for the creditors of ULF:

- At minimum the risk of Bakhmatyuk losing control over its assets would decrease.
- At most, international creditors could count on a higher recovery rate of their debt, including a smaller haircut and faster repayment. Recall, the latest offer from ULF to international creditors was a 65%-70% debt haircut. Such a haircut was in line with our estimates (refer to our July 2018 note on ULF) based on the assumption of Bakhmatyuk's full repayment of debt to the NBU and the DGF. With significantly smaller repayment to state entities, ULF could reserve more funds for repayment to private creditors.

What's next: Worst case looks more likely

The future of ULF and its prospects to agree on any debt restructuring now depends on the government's approach towards Bakhmatyuk:

- In the best-case scenario, Bakhmatyuk and the NBU will be able to withstand the attack of anti-corruption bodies. Afterwards, they and the DGF could reach some restructuring deal within a short period of time. This would open an opportunity for private creditors to renegotiate their restructuring, possibly on some better conditions.
- In the worst-case scenario, pressure from the government on Bakhmatyuk will remain consistent (regardless of whether or not the current NABU attack is neutralized). This will prevent any deal and may lead to the loss of most of Bakhmatyuk's business in Ukraine (especially the farming business of ULF, which relies on land lease contracts). In such case, the recovery rate of Bakhmatyuk's total debt will be slim.

Although the latter scenario does not look efficient for the state as a whole, it looks more likely because:

1. It is simply hard to imagine all the involved government parties (the NBU, the DGF, MinFin, the President's Office) being able to agree on the volume of repayments from Bakhmatyuk.
2. Reaching any deal with a businessman as toxic as Bakhmatyuk won't be a popular move. On the other hand, the government could eventually conclude that deals with former owners of the failed banks (however toxic they are) could be the most efficient way to recover state losses. In any case, such deals require strong "political will," and we doubt it is present now.
3. Such a deal could create a precedent (e.g. effective haircut of 60% applied to total government claim) for the other owners of failed banks, including Zhevago and Kolomoisky. They might be interested in avoiding payment even with such a haircut, and thus might be interested in undermining Bakhmatyuk's deal.

Keeping into account that the worst-case scenario for ULF looks more likely now, we believe the fair value of related Eurobonds (UKRLAN, AVINPU) should be close to the lowest recovery value of the Mriya restructuring case, or about 4% of par.

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