

# New UAH sovereign bonds

## Secondary market gets busier

### Market volume USD 2.1 bln and could grow further

At the end of August, the government hit the market with UAH 16.4 bln (USD 2.1 bln) in special UAH sovereign bonds (VAT bonds) to securitize its VAT arrears to exporters. The bonds, issued in four tranches, have already started to reach the secondary market, where they now trade with 14.5%-15% yield and are attracting high demand. The bonds mature in five years and have duration of ~2.2 years. It now costs about 7.7%-8% (mid-quotes) to hedge UAH forex risks for up to 1Y, while longer term UAH NDFs are not readily available in sufficient size.

We expect some 50% of the issue (USD 1 bln) to be sold by primary recipients on the secondary market. Further, the Finance Ministry could make an additional issuance of VAT bonds as the state has another UAH 10-12 bln (USD 1.3-1.5 bln) due in VAT reimbursements on top of already securitized debt, according to Iryna Akimova, first deputy head of the Presidential Administration.

Additional VAT bonds would likely not be issued before December-January. Firstly, it requires IMF approval as the current loan memorandum caps the volume of VAT bonds at UAH 16.4 bln. Secondly, the Finance Ministry could postpone timing in order to not to push yields up too soon, as the government is still planning to raise up to UAH 10 bln on the local market by yearend (incl. to repay UAH 7.1 bln in bonds due in 2010). Finally, it will take time for the government to organize the process.

The government started accumulating VAT reimbursement arrears in end-2008, when budget liquidity started to squeeze under the slumping real economy (-15.1% in 2009) and jittery financial markets. The Ukrainian government repaid VAT arrears to exporters by issuing bonds back in 2004. Then, it issued UAH 1.9 bln in sinkable bonds, with a 14% coupon. The bonds were repaid on time and in full by 2009.

### Yields should stay in 14%-16% range

VAT bond yields of 14.5%-15% constitute about a 200-250 bps spread over the regular UAH sovereign debt yield curve. We do not see a large potential for VAT bond yields to shrink further as public debt supply on the market (both UAH and USD) is set to rise. Going forward rather we see activity on the VAT bond market pushing yields for regular sovereign papers up.

As VAT bonds reach secondary market, demand for sovereign UAH papers at regular auctions has vanished. At the first primary auction in September, the government managed to sell only UAH 115 mln of six month papers with a 9.5% yield, while a week earlier 6.7 times that was attracted at 9% with similar maturity.

At the same time, we also do not see yields for regular or VAT sovereign papers going much above ~16% in the near term as the new IMF deal has spurred fiscal consolidation. On top of that, we now see strong demand for VAT bonds from:

- local banks (which still have abundant liquidity with lending dormant)
- foreign investors (providing high yield with reasonable credit risks given the low interest-rate environment elsewhere in the world; and low UAH forex risks)

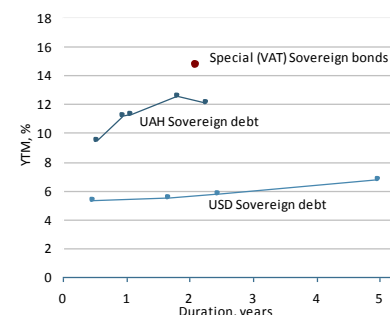
Potential risk of increasing yields stems now from accelerating inflation (8.3% y-o-y in August vs. 6.8% y-o-y in July), although we expect high demand and IMF's support to trump this factor for the time being.

Report date **14 Sept 2010**

#### Special (VAT) sovereign bonds

Amount	UAH 16.4 bln (USD 2.1 bln)
Maturity	Jul-Aug 2015
Duration, years (at 15% YTM)	2.2
Coupon	5.5%, s.a.
Sinkability provision	10% every ½ years

#### Yield curves



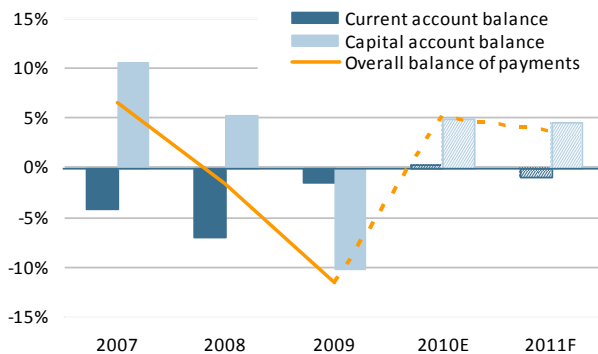
Source: Bloomberg, Concorde Capital

## FX risks are low

Since last November, the USD/UAH exchange rate has remained stable at 7.9-8.1. Fundamentally, we do not see significant devaluation pressure in the nearest future, although seasonal short-term volatility in the fall is possible.

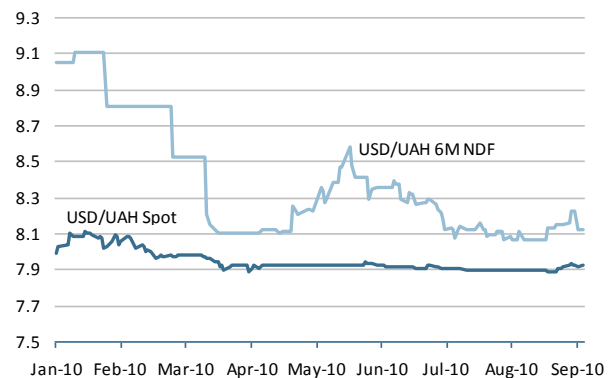
- The balance of payments has been improving this year. In 7M10, the current account was USD 24 mln in the black (vs. a deficit of USD 1.1 bln over the same period last year), while the financial account saw a surplus of USD 5.1 bln (as opposed to a deficit of USD 7.1 bln in 7M09), with FDI accounting for almost half of this amount. For 2010 in total, we expect the current account to be around zero or at a marginal surplus of up to 0.3% of GDP, while the financial account should post a surplus of 4.3% of GDP.
- Ukraine secured a USD 15 bln (50% of current central bank's reserves), 2.5-year new stand-by facility from the IMF, USD 1.9 bln of which has already been received. We see access to the additional forex liquidity keeping UAH risks low and supporting market confidence in the hryvnya.
- Public confidence in the hryvnya has also improved: in 8M10 retail deposits in UAH rose 30.3% vs. only 8.7% for retail deposits in foreign currency. On the local retail market, over 8M10, demand exceeded supply by USD 2.6 bln vs. USD 5.1 bln in 8M09.

Balance of Payments, % of GDP



Source: NBU, Concorde Capital estimates

UAH spot exchange rate, 6M NDF\*



\* Bloomberg composite  
Source: UkrDealing, Bloomberg

Seasonal volatility in the exchange rate in fall could be possible as we have seen 0.4% UAH depreciation since the beginning of September, while local elections, scheduled for October 31, could trigger some volatility as well. Eventually, accelerating inflation might also translate into depreciation pressure on the hryvnya, although for now we see this as remote given strong net currency inflow through the BoP currently.

## Ukraine's sovereign credit quality stable

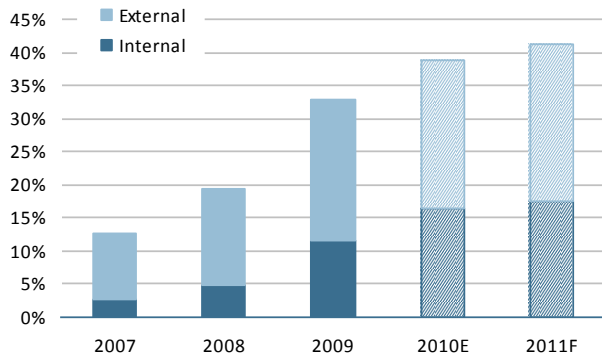
We view the government as capable and willing to service and repay its debts in the mid-term, as in the past. The USD 15 bln stand-by facility secured in July from the IMF also supports this as it facilitated fiscal consolidation. In order to comply with IMF stipulations, in July the Ukrainian parliament cut the planned 2010 fiscal deficit by 7%, reducing outlays by 5.3% and making more conservative estimates of future revenues. The government also increased household gas tariffs by 50% as of August 1.

Following these moves, we expect the fiscal deficit (including Naftogaz) to total 6.5%-6.8% of GDP in 2010, in line with the IMF target of 6.5%. According to the IMF program, Ukraine must maintain its fiscal deficit at 3.5% of GDP in 2011 and 2.5% in 2012, and reduce public debt to below 35% of GDP by 2015 (compared to 33% now and the 40%-42% projected for yearend 2010).

At the end of July, total public debt had reached some USD 45.9 bln (up by 15% YTD) or around 35% of GDP. By end-2010, we foresee it reaching 39% of GDP or USD 52.2 bln (accounting for VAT bonds). This is slightly above the IMF estimate for the emerging market average of 37.2% as of end-2010.

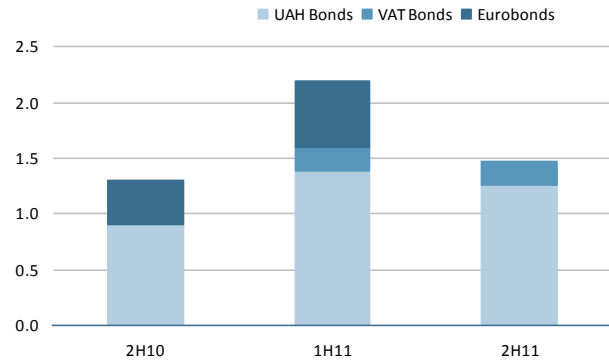
We see debt service expenditures in 2010 amounting to UAH 15-18 bln or 5% of total consolidated budget revenue, 1.5% of GDP, up from 1.1% in 2009.

**Public debt (direct and guaranteed), % of GDP**



Source: Finance Ministry, Concorde Capital estimates

**Public debt scheduled redemptions, USD bln**



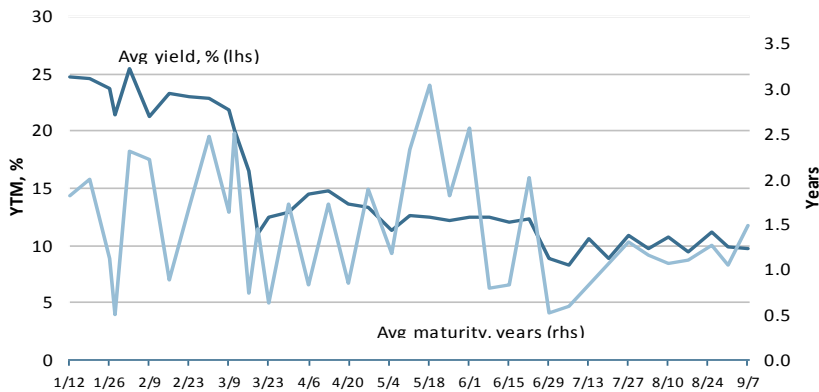
Source: Finance Ministry, Concorde Capital estimates

Scheduled public debt principal redemptions through yearend amount to UAH 7.1 bln (USD 0.9 bln) in local UAH bonds and USD 0.4 bln in Eurobonds. The current structure of public debt implies that in 2011 the government will redeem UAH 21 bln (USD 2.7 bln) in UAH bonds (incl. UAH 3.3 bln of VAT bonds) and USD 0.6 bln in Eurobonds.

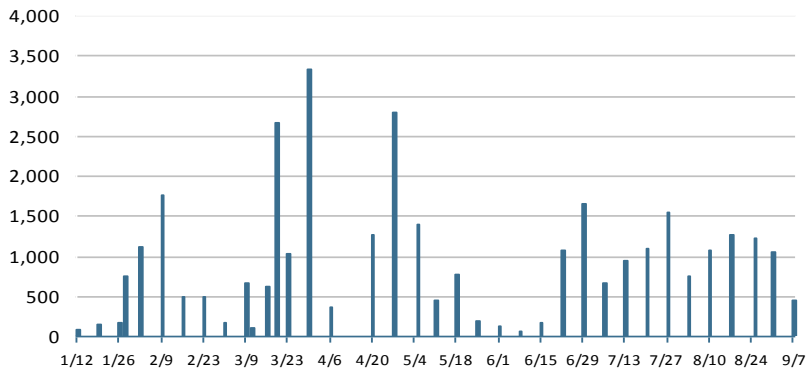
We believe the VAT bond issue to be unique in CEE in terms of liquidity, backing by a sovereign government, issued in a currency yet to win back ground lost in the crisis (the UAH plunged 60% in 2008) and yielding 14%-16%.

## Ukraine's VAT sovereign bond issue parameters

	<b>Tranche 1</b>	<b>Tranche 2</b>	<b>Tranche 3</b>	<b>Tranche 4</b>
Total nominal amount	UAH 48.453 mln	UAH 2,047.815 mln	UAH 8,304.873 mln	UAH 6,041.548 mln
ISIN	UA4000078141	UA4000082531	UA4000082622	UA4000083059
Date of issue	August 2, 2010	August 27, 2010	August 30, 2010	August 31, 2010
Date of first coupon	January 31, 2011	February 25, 2011	February 28, 2011	March 1, 2011
Coupon period, days	182	182	182	182
Maturity date	July 27, 2015	August 21, 2015	August 24, 2015	August 25, 2015
Nominal value	1,000	1,000	1,000	1,000
Denominating currency	UAH	UAH	UAH	UAH
Coupon	5.5%, s.a.	5.5%, s.a.	5.5%, s.a.	5.5%, s.a.
Principal payment	Semiannual, 10% of original par	Semiannual, 10% of original par	Semiannual, 10% of original par	Semiannual, 10% of original par

**Sovereign UAH bond avg YTM, time to maturity at primary auctions in 2010**


Source: Ministry of Finance, Concorde Capital

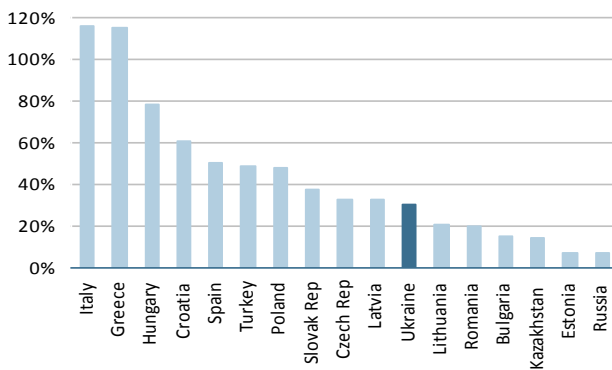
**Sovereign UAH bond primary auction placement volumes in 2010, UAH mln**


Source: Ministry of Finance

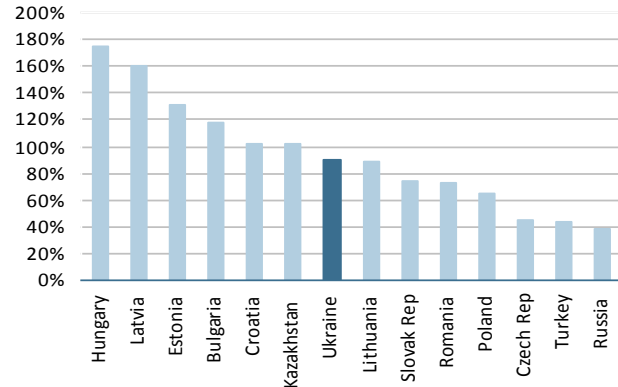
**Sovereign UAH bond (OVDP) placements at primary auctions**

Auction date	Volume, UAH mln	Avg yield, %	Avg. maturity, years
<b>Short-term placements</b>			
3/16/10	626	16.50	0.73
3/19/10	2,662	11.00	1.45
3/23/10	1,041	12.40	0.62
4/6/10	367	14.46	0.83
4/20/10	1,270	13.50	0.84
5/5/10	1,395	11.31	1.17
6/8/10	67	12.41	0.79
6/15/10	177	12.00	0.81
6/29/10	1,659	8.74	0.50
7/6/10	668	8.25	0.58
7/13/10	942	10.58	0.82
7/20/10	1,105	8.82	1.07
7/27/10	1,539	10.81	1.29
8/3/10	750	9.72	1.15
8/10/10	1,078	10.71	1.06
8/17/10	1,261	9.43	1.09
8/25/10	1,225	11.16	1.26
8/31/10	1,060	9.84	1.04
9/7/10	453	9.69	1.48
<b>Medium-term placements</b>			
3/2/10	177	22.85	2.47
3/9/10	658	21.77	1.62
3/11/10	109	20.00	2.51
3/30/10	3,337	12.84	1.71
4/27/10	2,786	13.27	1.89
5/11/10	453	12.58	2.31
5/18/10	772	12.46	3.04
5/25/10	183	12.12	1.81
6/1/10	139	12.42	2.56
6/22/10	1,083	12.26	2.01

Source: Ministry of Finance

**Public debt in 2009, % of GDP**


Source: Concorde Capital, CIA

**Total external debt in 2009, % of GDP**


Source: Concorde Capital, IMF

**Yearly economic indicators and Concorde Capital forecasts**

	2002	2003	2004	2005	2006	2007	2008	2009	2010E	2011F
<b>Business cycle indicators</b>										
Real GDP, % chg yoy	5.2	9.6	12.1	2.7	7.3	7.9	2.3	-15.1	4.3	4.9
Nominal GDP, UAH bln	226	267	345	441	544	721	948	915	1059	1211
Nominal GDP, USD bln	42.4	50.1	65.0	86.1	107.8	142.7	179.9	117.4	134.1	153.3
GDP per capita, UAH	4685	5591	7273	9372	11630	15372	20495	19901	23146	26572
GDP per capita, USD	880	1048	1371	1829	2303	3044	3890	2555	2930	3364
Consumption, % chg yoy	9.5	11.5	13.1	20.6	15.9	17.1	11.8	-14.1	3.0	5.0
Investment, % chg yoy	-1.5	24.3	5.5	14.0	18.5	22.1	5.1	-52.9	6.8	7.5
Industrial output, % chg yoy	7.0	15.8	12.5	3.1	6.2	10.2	-3.1	-21.9	7.8	7.7
CPI (eop), % chg yoy	-0.6	8.2	12.3	10.3	11.6	16.6	22.3	12.3	10.0	8.0
PPI (eop), % chg yoy	5.7	11.1	24.1	9.5	14.1	23.3	23.0	14.4	10.0	15.0
<b>External indicators</b>										
Current account balance, USD bln	3.2	2.9	6.9	2.5	-1.6	-5.9	-12.5	-1.8	0.4	-1.5
Current account balance, % GDP	7.5	5.8	10.6	2.9	-1.5	-4.1	-7.0	-1.5	0.3	-1.0
Trade balance, USD bln	1.9	1.3	5.0	0.7	-3.1	-7.9	-13.7	-2.0	0.0	-1.0
Trade balance, % GDP	4.4	2.6	7.7	0.8	-2.8	-5.5	-7.6	-1.7	0.0	-0.7
Exports, USD bln	23.4	29.0	41.3	44.4	50.2	64.0	85.7	54.1	62.9	70.1
Exports, % chg yoy	10.7	24.0	42.6	7.5	13.2	27.4	34.0	-36.9	16.2	11.5
Imports, USD bln	21.5	27.7	36.3	43.7	53.3	71.9	99.4	56.1	61.2	68.6
Imports, % chg yoy	5.0	28.7	31.3	20.4	22.0	34.8	38.3	-43.5	9.1	12.0
Capital account balance, USD bln	-1.2	0.1	-4.3	8.0	4.1	15.1	9.5	-11.9	5.7	7.0
Capital account balance, % GDP	-2.9	0.2	-6.7	9.3	3.8	10.6	5.3	-10.2	4.3	4.6
FDI net, USD bln	0.7	1.4	1.7	7.5	5.7	9.2	9.9	4.5	4.0	6.0
NBU reserves (eop), USD bln	4.4	5.1	9.5	19.4	22.3	32.5	31.5	26.5	35.6	41.1
<b>Debt indicators</b>										
Public debt, USD bln	13.8	14.5	16.0	15.5	15.9	17.6	24.6	39.7	52.2	63.5
Public debt, % GDP	32.5	29.0	24.7	18.0	14.8	12.3	13.7	34.8	38.9	41.4
Corporate external debt, USD bln	n/a	13.0	17.8	25.5	42.7	67.6	85.0	79.3	84.5	90.5
Corporate external debt, % GDP	n/a	25.9	27.3	29.6	39.6	47.4	47.2	67.5	63.0	59.0
Gross external debt, USD bln	n/a	23.8	30.6	38.9	54.5	80.0	101.7	103.3	114.5	125.5
Gross external debt, % GDP	n/a	47.5	47.1	45.2	50.6	56.0	56.5	88.0	85.4	81.9
<b>Monetary indicators</b>										
Monetary base, UAH bln	30.7	40.1	53.8	82.8	97.2	141.9	186.7	195.0	225.8	259.6
Monetary base, % chg yoy	33.6	30.5	34.1	53.9	17.5	46.0	31.6	4.4	15.8	15.0
Money supply (M3), UAH bln	64.9	95.0	125.8	194.1	261.1	396.2	514.7	487.3	575.7	688.0
Money supply, % chg yoy	41.8	46.5	32.4	54.3	34.5	51.7	29.9	-5.3	18.1	19.5
Monetary multiplier (eop MB/M3)	2.1	2.4	2.3	2.3	2.7	2.8	2.8	2.5	2.6	2.7
Monetization (avg M3/GDP), %	24.9	30.3	32.0	36.7	42.3	46.4	46.0	55.0	50.2	52.2
<b>Exchange rate</b>										
Interbank UAH/USD (avg)	5.33	5.33	5.32	5.10	5.04	5.03	5.30	8.11	7.90	7.90
<b>State budget</b>										
Revenues, UAH bln	n/a	55.1	70.3	105.2	133.5	165.9	231.7	210.3	267.5	302.7
Expenses, UAH bln	n/a	55.8	79.5	112.8	137.1	174.2	241.5	242.4	323.6	339.0
Balance, % GDP	n/a	-0.4	-3.0	-1.8	-0.7	-1.4	-1.3	-3.5	-5.3	-3.0
<b>Social indicators</b>										
Population, mln (eop)	48.0	47.6	47.3	46.9	46.6	46.4	46.3	46.0	45.8	45.6
Unemployment (ILO methodology, avg), %	9.6	9.1	8.6	7.2	6.8	6.4	6.4	8.0	7.5	7.0
Average monthly salary, UAH	376	463	591	806	1,043	1,351	1,806	1,909	2,163	2,523
Real disposable income, % chg yoy	18.0	5.8	16.8	20.1	16.1	12.8	10.3	-9.4	3.0	8.0

Source: State Statistics Committee, National Bank of Ukraine, Ministry of Finance, Bloomberg, Concorde Capital estimates

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