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VAT Bonds

The state paper to be offered by private companies

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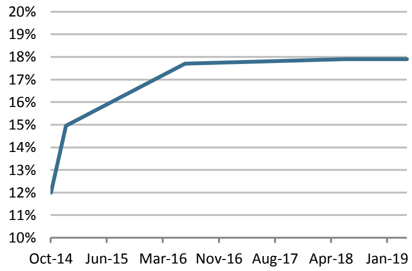
The Finance Ministry issued USD 3.7 bln out of a total planned issue of UAH 7.0 bln in state bonds (so-called VAT bonds) aimed at repaying the government's arrears in VAT refunds. The VAT bonds are provided directly to exporters whom the government has failed to fully refund VAT before 2014.

We believe that exporters, which need cash rather than debt paper, will be willing to sell the bonds on the open market. If a sizeable amount of the issued bonds will be offered to the market, this would create an overhang that would prompt the sellers to agree to the larger discounts (much higher YTM) as compared to other state bonds. In the short-term, once the overhang has vanished, the YTMs of VAT bonds should converge to those of other state bonds, to create an opportunity for short-term capital gains.

The potentially attractive yields of the VAT bonds, as well as the exhausted devaluation potential of the local currency, in which the bonds are denominated, may make them a hot story for the near couple of weeks.

Yield curve for state UAH bonds

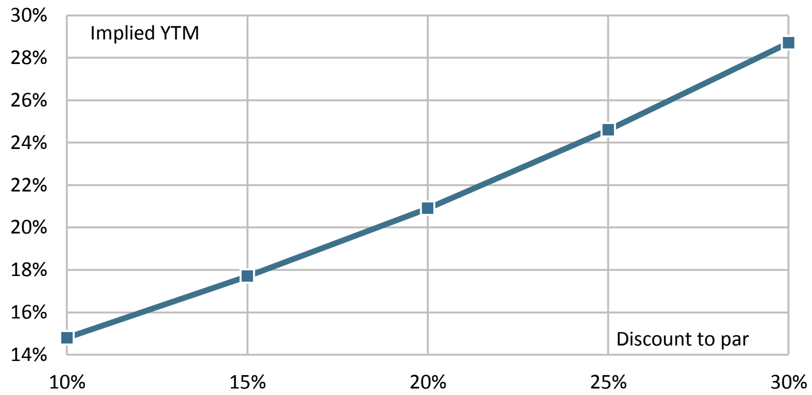


Source: Concorde Capital

VAT bond parameters:

- Issued by the Finance Ministry and treated *pari passu* with other state bonds
- Total issue: UAH 7.0 bln, with a possibility to issue up to 3.0 bln additionally
- Amortization: 10% of par each half-year over the next five years: 6 Jan '15, 7 Jul '15, 5 Jan '16, 5 Jul '16, 3 Jan '17, 4 Jul '17, 2 Jan '18, 3 Jul '18, 1 Jan '19, and finally 2 Jul '19.
- Coupon rate: 9.5%, paid semiannually with the amortizing part of the bonds

Pricing and YTM of VAT bonds



Source: MinFin, Concorde Capital calculations

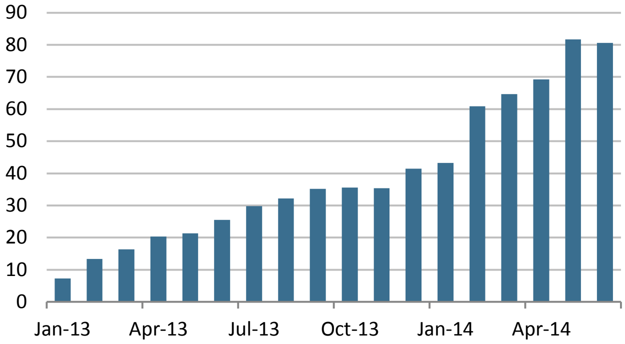
VAT bonds: investment case

The main feature that differentiates VAT bonds from other, regular local currency bonds issued by the state is that they will not be bought out by the National Bank (NBU). The NBU is the biggest buyer of state bonds, which are issued by the Finance Ministry to finance the budget deficit (over the last six months, the NBU purchased 84% of the government's total bond issue). The NBU has a clear incentive to help the government finance its gap, while it has no need to finance the gaps of private companies, the recipients of VAT bonds.

The only possibility for exporters, who will receive VAT bonds, to turn them into cash is to sell them on the open market, to banks or other private institutions. Demand for state bonds among them was rather limited, as we can see: over the last six months, the total amount of bonds purchased by private firms was UAH 7.2 bln, which is nearly equal to the total amount of VAT bonds to be issued soon. Clearly, not all the recipients of VAT bonds will feel the urge to sell them, as not all of them face tough liquidity constraints. However, even an offer of a 10-20% portion of total VAT bonds will create an overhang on the local market – such an amount will be equal to about a one-month demand for state bonds from the private sector.

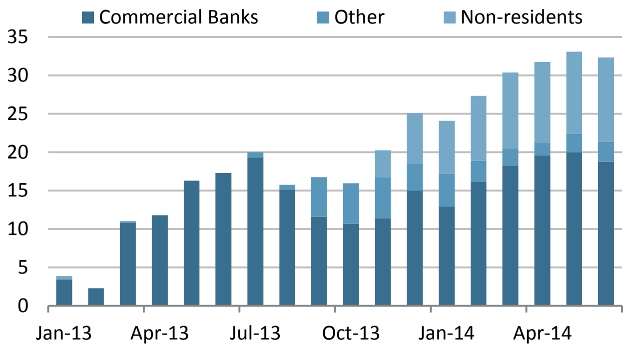
Net change in portfolio of state UAH-denominated bonds since end-2012, UAH bln

Central bank (NBU)



Source: NBU

Other

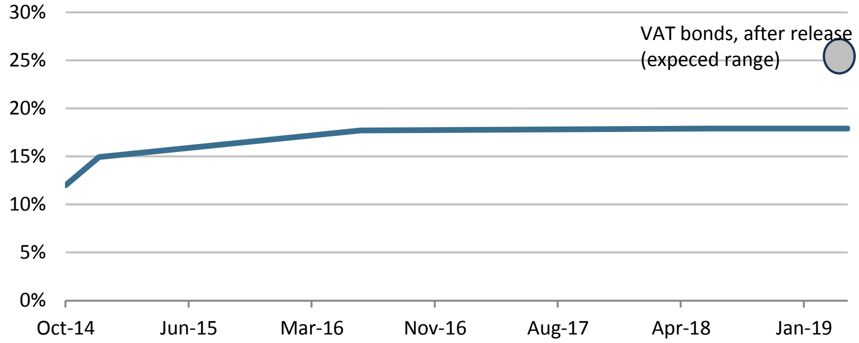


Source: NBU

With an overhang on the market, we believe the buyers will be able to bargain a good discount for VAT bonds. Yields on the bonds may exceed those offered by regular state bonds.

We expect annualized yields on VAT bonds can exceed 25% in the nearest couple of weeks. At the same time, as soon as overhang is exhausted, the yields on bonds will converge to those visible for other state bonds. Such convergence will allow investors into VAT bonds to receive a short-term capital gain, we expect.

Yield map for local currency government bonds



Source: Concorde Capital

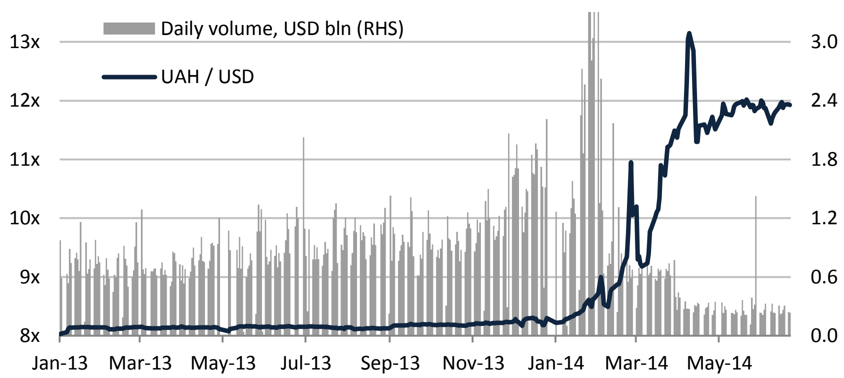
The core risk for investing into VAT bonds is exposure to the Ukrainian currency. Our analysis suggests that in the short term, this is an opportunity rather than a risk. We see a higher probability for the hryvnia to strengthen by the end of 2014 rather than weaken. If we are right, the short-term investment in VAT bonds will offer not only gains related to increased prices for the paper, but also gains from UAH strengthening.

Outlook for hryvnia: strengthening is more likely

Against the backdrop of a considerable C/A deficit (9.2% of GDP in 2013), the political turmoil of 2013-14 was the last straw for hryvnia devaluation in early 2014. The prior government was trying its best to maintain its "hryvnia stability" course at almost any cost, but in light of the fast gross reserves contraction during the violent revolts, the NBU withdrew from the interbank and thus launched a free-float regime for the hryvnia in February 2014.

As a result, the hryvnia has declined more than 30% this year and has stabilized at UAH 12/ USD for the moment. For now, we see the devaluation potential as having been totally released (no further decline expected). What's more, we see the potential even for the national currency strengthening.

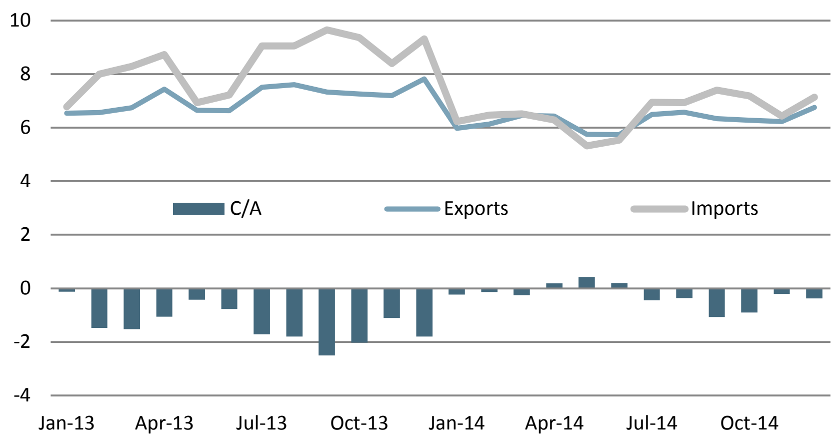
UAH/USD market



Source: Interbank currency exchange

Current account (C/A) deficit to shrink 5x yoy in 2014
Due to the positive trend in external trade, we anticipate the C/A deficit to shrink at least 5x yoy in 2014 to USD 3.2 bln from USD 16.4 bln in 2013.

C/A stats and outlook, USD bln



Source: UkrStat, Concorde Capital research

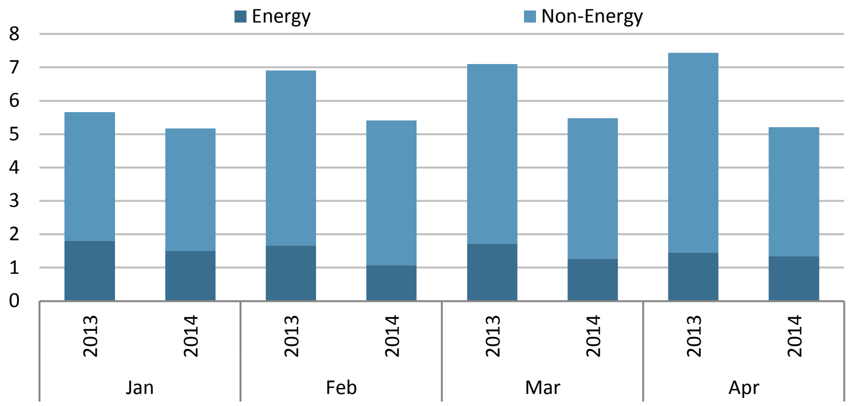
There is some risk related to exports prospects (in light of the current military conflict) and Ukraine's still unknown natural gas price (since April), which is an upside risk for the C/A deficit. However, non-energy imports contraction will definitely exceed 20% due to devaluation and the energy bill also is set to drop by at least USD 2.0 bln, even if Ukraine accepts Moscow's gas price proposal of USD 385/tcm in 2Q14 and on.

Trade balance improving as imports shrink faster than exports

The sharp hryvnia devaluation caused the trade balance to improve despite exports falling quickly (-8.4% yoy for 5M14), with the trade conflict in Russia being the main reason. Imports have been falling much faster (-16.2% yoy for 5M14) due to a lower energy bill and sliding demand for imported consumer goods.

Lower gas prices in 1Q14 contributed a lot to the improved trade balance as Ukraine saved USD 1.0 bln due to a price discount from Russia (which has since been reneged). Nevertheless, it has been shrinking non-energy imports (-20.0% yoy for 5M14) that have stood behind the improved external accounts.

Structure of Ukraine's import, USD bln



Source: UkrStat

IMF, EU and U.S. are helping to replenish foreign cash

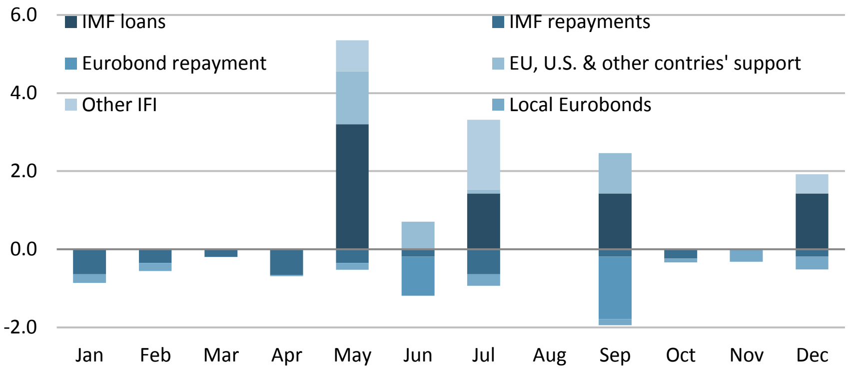
At the year-start, capital flow was negative (USD 2.2 bln) on the back of deposit withdrawals, individual demand for foreign currency and capital flight. In May, the trend was broken as:

- Ukraine signed an IMF agreement that opened up external funding while smooth presidential elections stabilized internal political risks;
- In just two months, Ukraine received USD 3.2 bln in IMF funding, placed USD 1.0 bln in Eurobonds and signed agreements for support from the World Bank and the EU;

By the year's end, general support from the IMF is expected to be about USD 7.5 bln (with USD 3.2 bln already received). Other support from IFIs and states will reach USD 5.3 bln. Net total inflow will amount to at least USD 5.7 bln in 2014, we expect.

In general, we expect capital flow to be positive in 2H14, which should provide for building up gross reserves of up to USD 20.5 bln (up from USD 17.1 bln as of end-June).

Public debt flow in 2014, USD bln



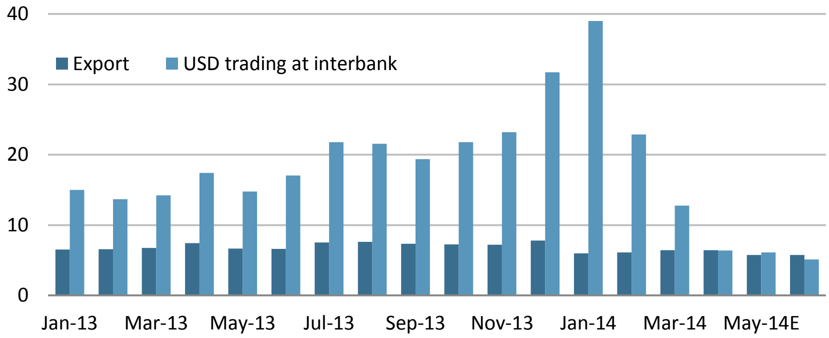
Source: UkrStat, NBU, MinFin, IMF, Concorde Capital research

Trade volumes at interbank are comparable to total imports

After hryvnia devaluation, ForEx trading volumes slumped to nearly USD 200-300 mln per day vs. USD 1.2 bln, on average, in 2013. In fact, we have observed that demand for foreign cash is covered primarily from exports revenue while capital operations are subdued. We see this trend as a good signal for the hryvnia, which means that current demand for foreign currency is rather weak.

Thin trading volumes also mean that any recovery of financial operations with even a minor increase in foreign currency supply might strengthen the hryvnia very quickly.

UAH trading volumes and export, monthly data, USD bln



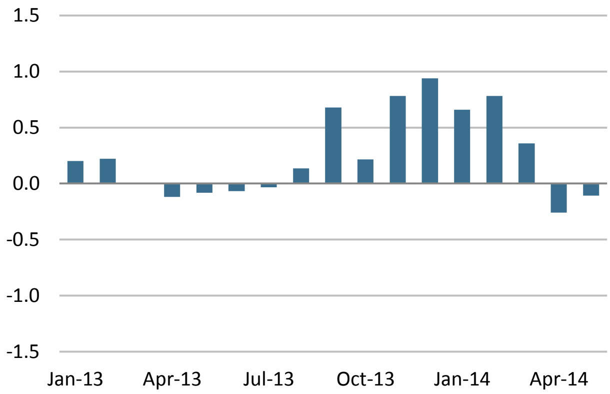
Source: UkrStat, Interbank Currency Exchange, Concorde Capital research

Pressure of households on ForEx market is decreasing

Decreased individual demand for foreign currency is another factor that makes us believe the hryvnia has strengthening potential. In April-May, we observed households selling more U.S. dollars than buying, indicating the population does not believe in further weakening in the national currency.

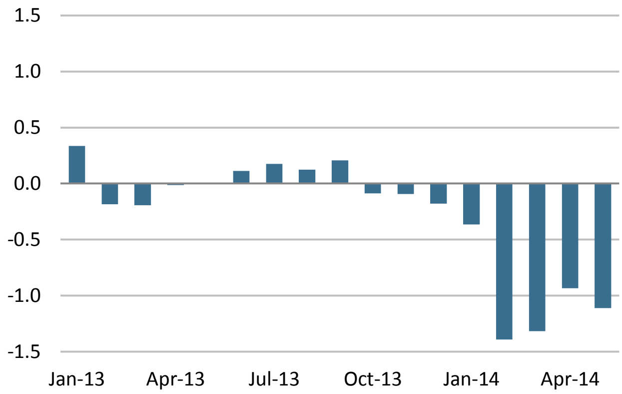
At the same time, against the backdrop of military actions, we observed substantial foreign currency deposit outflow from the banking system (primarily in the east) – almost USD 5.0 bln for 5M14 – which added substantial devaluation pressure on the hryvnia. The good news is that the deposit outflow stopped and inflow is anticipated as soon as military actions end (in June, deposits increased 1.5% m/m, according to preliminary data from the NBU). Moreover, we believe that the foreign cash withdrawn from the banking system may add extra revaluation pressure on the hryvnia in the coming months.

Net purchase of foreign currency by households, USD bln



Source: NBU

Foreign currency retail deposits change, m/m, USD bln



Source: NBU

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