Focus
Ukraine

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Ukraine and the IMF

New SBA deal to unlock FX financing

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The IMF and Ukraine reached a piliminary agreement on a new US$3.9bn 14-month Stand-By Arrangement (SBA) on Friday, 19 October. The new SBA programme replaces the previous Extended Fund Facility (EFF) and provides Ukraine with double the funds compared with those left from the EFF. Resuming cooperation with the Fund enables Ukraine to unlock financing from other international financial institutions, and tap the Eurobond markets as soon as this year, in order to meet the challenging US$12bn in FX obligations in 4Q18–2019. Increased availability of external funding should boost Ukraine's FX reserves to US$20bn as of YE2018 and provide some support to the depreciating hryvnia.

New SBA programme replaces EFF. According to the IMF's statement, the new SBA will provide an anchor for Ukrainian authorities' economic policies during 2019 with a focus on fiscal consolidation, reducing inflation, and reforms to strengthen tax administration, the financial sector, and the energy sector. The SBA programme replaces a $17.5bn Extended Fund Facility (EFF), which expires in March 2019, and has stalled since 2017 when the Ukrainian government froze gas tariffs for the population. The agreement between the IMF and Ukrainian government was reached on the staff level, and is subject to approval by IMF management and the IMF Executive Board. The IMF Board approval is conditional on Ukrainian parliament's passing a government budget consistent with IMF staff recommendations and an increase in household gas and heating tariffs.

IMF deal unlocks US$7bn FX financing for 4Q18–2019. With the IMF programme back on track, Ukraine will be able to meet a challenging repayment of US$12bn scheduled for this period. The funding sources include EUR1bn macro-financial aid from the EU, and US$0.8bn guarantees from the World Bank, both of which include the key precondition of Ukraine having a working programme with the IMF. The government will be also able to return to the financial markets for sovereign issuance, in the amount to US$1.5bn in 4Q18 and US$3bn in 2019.

Parliament's approval of the IMF-compliant state budget bears the key risks. The main condition of the IMF is the passing of the 2019 state budget in parliament's final reading. We see two major remaining threats to the approval of the budget. The primary one is the Capital Exit Tax (CET), which should replace the Corporate Profit Tax. The IMF sees it as a threat to financial stability, since income tax revenues amount to 2.3% of GDP. We believe that the compromise solution will suggest gradual replacement of the income tax with CET. The other possible problem might be lack of parliamentary support of a budget with spending, which does not satisfy MPs' election-year appetites due to the IMF criteria. We believe that such a scenario is possible, but not plausible. In our base-case scenario, Parliament supports the deal, and we expect final voting on the budget to take place before the last week of November.

Chances of sovereign issuance in 4Q18 are rising. Resumption of the IMF programme helps to quell investors' fears and prompts the Ukrainian government to start marketing a sovereign Eurobond this week. We expect the yields of prospective 2028 sovereigns to fall within the 9–9.5% range. While the progress with the IMF had a very short-term positive effect on Ukrainian sovereigns' pricing, we expect that the ultimate realization of the deal will improve Ukraine's credit risk profile and moderately support prices of short-dated sovereigns.

New SBA facility replaces EFF

EFF is replaced with SBA programme with double the funds through 4Q18-2019, and less strict conditions for reforms

The new US$3.9bn 14-month SBA will provide an anchor for Ukrainian authorities' economic policies during 2019 with a focus on fiscal consolidation, reducing inflation, and reforms to strengthen tax administration, the financial sector, and the energy sector. The SBA programme replaces a $17.5bn Extended Fund Facility (EFF) that expires in March 2019, and which was supposed to provide Ukraine with the last US$1.9bn tranche for the 4Q18–2019 election period. The agreement between the IMF and Ukrainian government was reached on the staff level and is subject to approval by IMF management and the Executive Board. The agreement is conditional in the IMF Board's approval of Ukrainian parliament's passing a government budget consistent with IMF staff recommendations, and an increase in household gas and heating tariffs.

IMF deal unlocks FX financing for 4Q18–2019

As a result of the IMF deal, Ukraine will be able to repay $4bn of debt redemptions scheduled for 4Q18…

The new deal will help Ukraine to unlock $4bn of FX financing for 4Q18, including a $1.5bn Eurobond issue, EUR0.5bn MFA tranche from the EU, and $0.4bn in World Bank guarantees. We think reaching an agreement with IMF on the staff level may be sufficient for the WB and EU to provide their financial aid to Ukraine this year, as it basically meets their key precondition of progress with Ukraine's programme with the Fund. The $4bn financing lump sum will be sufficient for Ukraine to pay FX debt redemptions in 4Q18.

Table 1. Government FX debt payments and their funding, 4Q18-2019 (US$bn)

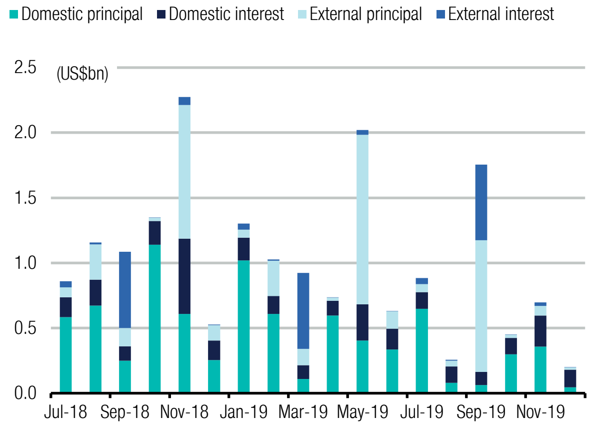
	4Q18	2019	4Q18-19		4Q18	2019	4Q18-19
Government FX debt payments	**4.1**	**8.3**	**12.4**	**Government FX funding**	**4.1**	**8.2**	**12.3**
IMF	0.7	1.0	1.7	IMF	--	1.5	1.5
Eurobonds	0.7	--	0.7	Eurobonds	1.5	3.0	4.5
US Guarantee	--	1	1	World Bank	0.4	0.4	0.8
Domestic FX bonds	1.7	2.6	4.3	EU	0.5	0.7	1.2
Interest payments	1.0	3.7	4.7	Domestic FX bonds	1.7	2.6	4.3

Sources: Ministry of Finance of Ukraine, World Bank, European Commission, IMF, ICU.

… as well as meet challenging US$8bn debt obligations for 2019

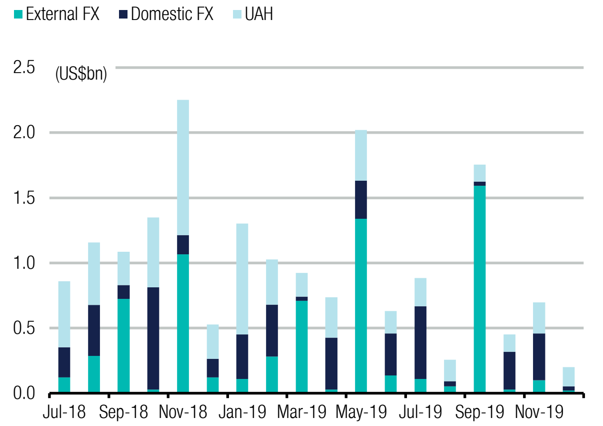
For 2019, we estimate that the new IMF deal unlocks as much as much as $5-6bn of external financing, which will enable the Ukrainian government to fully meet FX debt obligations. The financing sources will include issuance of $3bn Eurobonds, $0.4bn of loans secured by WB's guarantee, and $0.7bn of EU MFA facility. We also expect that the government will build up its borrowing through FX domestic bonds, which may amount to $2.6bn to cover scheduled repayments. Finally, we do not rule out that in the case of FX shortage due to unfavourable markets, the government may ask for channelling a part of the IMF tranches into the state budget as an extraordinary measure.

Chart 1. Schedule of Ukraine's debt service by debt origin



Source: Ministry of Finance of Ukraine, ICU.

Chart 2. Schedule of Ukraine's debt service by currency



Source: Ministry of Finance of Ukraine, ICU.

Budget compliance with IMF recommendations is the key condition

Introduction of the capital exit tax and high spending appetites for the election year pose the key risks to parliamentary approval of the state 2019 budget consistent with the IMF guidelines

The main condition is passing the government budget for 2019 in the final reading. We see two major remaining threats to the approval of budget, and, therefore, the IMF deal.

The primary issue is the Capital Exit Tax (CET) that should replace the Income tax. IMF sees it as a threat to financial stability since the income tax revenues (UAH90bn for 2019) amounts to 2.3% of GDP or 7% of consolidated budget's revenues. We believe that the compromise solution will suggest gradual replacement of the income tax with CET. Smaller entities that provide little or no tax revenues will switch first while major budget donors will continue with the existing taxation mechanism ensuring a proper level of tax inflow in 2019. We expect this tax to be voted for on 8 November.

The other possible problem might be less than 50% parliamentary support of the budget that meets the IMF criteria, but does not fully satisfy MPs demands to increase spending in the election year. We believe that such a scenario is possible, but not plausible. In the base-case scenario, Parliament supports the deal, and we expect final voting on the budget to take place either on 8 November or between 20–22 November. However, there is also a high risk that parliamentary discussion of the budget law will drag on until late December due to a huge number of proposed amendments (as per the first parliamentary reading, more than 2,100).

Chances of sovereign issuance in 4Q18 are rising

On the back of positive news about the IMF deal, Ukraine has mandated banks for its Eurobond issue, and will begin marketing a 10-year and potential five-year deal today, Tuesday, 23 October.

IMF programme back on track quells markets fears and significantly raises the chance of a Ukraine sovereign issuance in 4Q18

We expect the MoF will be targeting $2bn issuance, according to the budget plan. To finance the FX debt service by the end of 2018, the government needs to issue at least $1.5bn of Eurobonds. The current market environment remains far from favourable, with a big pipeline of sovereign issues outstanding. Still, Ukraine may capitalize on relief of market participants caused by cooperation with the IMF coming back on track. We expect the yields of prospective 2028 sovereigns to fall within the 9–9.5% range.

Progress with IMF program should also support Ukrainian quasi-sovereigns, which are considering Eurobond issues as well. Naftogaz has announced they will seek attracting $0.5-1.0bn. Another potential issuer is Ukrzaliznytsia that has previously expressed its interest in returning to the market in 2018.

Potential impact on sovereign yield curve moderately positive

The positive effect from the IMF deal on Ukrainian sovereigns' pricing was quite shortly offset by the beginning marketing of new Eurobonds, high risks related to parliament's approval of 2019 budget and overhang from investors waiting to exit positions in Ukraine on positive IMF news. We think, however, that the IMF deal, ultimately realized, will significantly improve Ukraine's credit risk profile. We expect that should have a moderate positive effect on the 2019-2020s segment of Ukraine's yield curve, as we keep in mind uncertainties around 2019 elections.

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