Focus
Ukraine

Markets
Economics
Public Debt

Research team
Vitaliy Vavryshchuk

Macro Insight

Eurobonds: Pros and Cons of Restructuring

MONDAY, 20 JUNE 2022

The Ukrainian economy has been badly hit by the war and is operating in an extremely challenging environment. Budget revenues plummeted while expenditures are elevated. The government has maintained all necessary social and military-related payments so far. A huge budget deficit and continuing extraordinary financing needs has brought the topic of restructuring Ukraine's Eurobonds into the spotlight. The Minister of Finance has repeatedly claimed that Ukraine will keep honoring its debt obligations, including Eurobond payments, in time and in full. Indeed, a restructuring doesn't look imminent given generous financial aid that Ukraine is receiving from its allies. Meanwhile, investors' perception remains cautious as indicated by Eurobond (maturing in 2023 and beyond) prices of 32-40 cent per dollar. The 2022 Eurobond price is significantly higher at 69 cent, implying the investors believe a full and timely redemption is likely. The balance of pros and cons is not static and may change depending on how long the war continues. Eurobond prices are unlikely to recover significantly and ample volatility will persist until there is clarity about when russia's war against Ukraine may end.

Ukraine is set to face a significant one-off increase in its debt-to-GDP ratio in 2022. By our estimates, Ukraine's nominal GDP will be in the range of US$130–140bn in 2022 (based on the official UAH:US$ exchange rate, which is likely to weaken by year-end), down from US$200bn in 2021. Meanwhile, Ukraine's public debt will increase significantly in absolute terms.

The expected monthly financing needs (budget deficit + debt repayments) are close to US$5bn in June–December, as indicated by the Ministry of Finance. By our estimates, they will be covered by a mix of external (70–80% of total financing) and domestic (20–30%) sources.

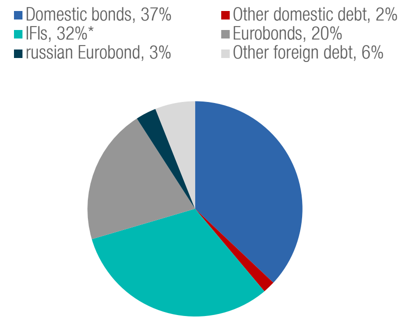
Recent news sheds more light on how Ukraine's partners will support the country's budget:

- The G-7 aid package of US$19.8bn, which includes US$7.5bn budget support from the US. According to the FT, this amount also covers the commitments and earlier disbursements from the IMF and the WB. Grants reportedly will account for about US$8.5bn of total aid from the G-7.

- EUR9.0bn in macro-financial assistance from the EU in the form of loans.

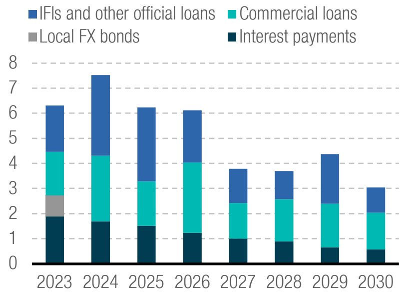
All of the above adds up to nearly US$30bn, which can be further topped up with smaller amounts from other countries and IFIs. This money is expected to be fully disbursed in 2022.

Structure of Ukraine's public debt, end-1Q22



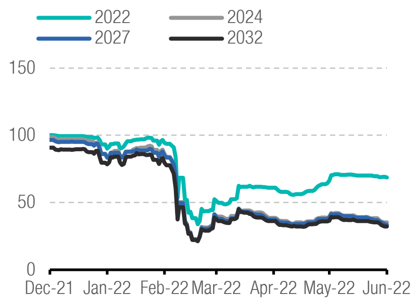
* includes SDR allocation by the IMF
Source: MoF, ICU.

Yearly FX debt redemptions, US$bn



Source: MoF, ICU.

Prices of selected Ukrainian Eurobonds

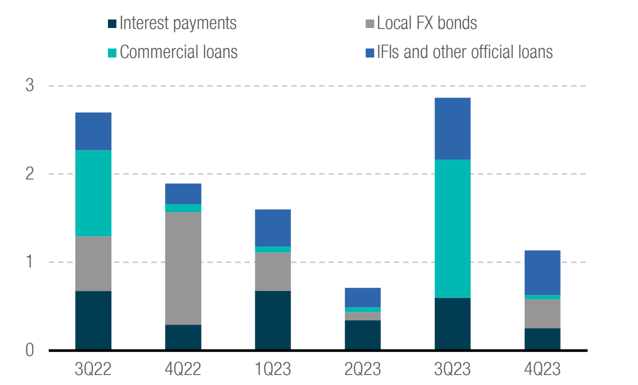


Source: Bloomberg, ICU.

Meanwhile, domestic financing will be heavily dominated by the direct sale of bonds to the NBU. YTD, local banks have reduced their portfolios of both UAH and FX-denominated debt, but we expect they will be able to keep their portfolios of UAH bonds broadly unchanged in 2022. The Ministry of Finance recently confirmed that its goal is to ensure full rollover of domestic debt. We believe that the restructuring of domestic debt will not be on the government's agenda under any circumstances. Such a restructuring would not produce any practical benefits while significantly undermining credibility of the government.

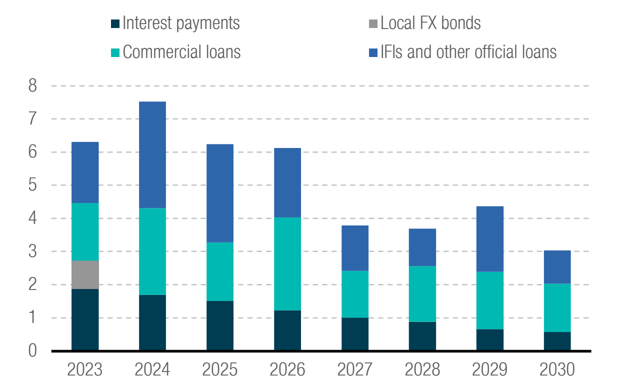
Factoring in the above, Ukraine's total debt may exceed US$120bn at the end of 2022. The above implies that the debt-to-GDP ratio will be in the 85–95% range at end-2022, up from 49% at end-2021. This ratio is unlikely to decline significantly in subsequent years as Ukraine is expected to run a hefty state budget deficit, which will be needed to finance the post-war economic recovery.

Chart 1. Ukraine's quarterly FX debt redemptions, US$bn



Source: MoF, ICU.

Chart 2. Ukraine's yearly FX debt redemptions, US$bn



Source: MoF, ICU.

Arguments against Eurobond restructuring

- Debt-to-GDP close to 90% is significantly above the threshold of 60% that the IMF deems safe for market-access countries[1]. However, that doesn't necessarily imply that this level of debt is not sustainable. The concessional funding is now committed for a long period of time – the majority of loans that Ukraine received since the beginning of the war have a tenor of more than 10 years. Redemptions are unlikely to be concentrated in time. Moreover, it is reasonable to expect that such loans could be refinanced in the future by the same creditors if circumstances necessitate. Thus, Ukraine's new borrowings are very unlikely to increase the risk of significant concentrated cash outflows and refinancing pressures in any given year in the mid-term. The flipside is that the majority of new loans will be in foreign currencies, which will make the budget more exposed to FX risks. The share of hryvnia in public debt stood at 36% in April 2022.
- Official creditors are likely to take even more steps to ease Ukraine's debt pressures. The US House of Representatives passed an Act calling for an immediate suspension of all debt service payments owed by Ukraine to IFIs and for provision of additional concessional financial assistance to Ukraine. The US efforts are very likely to be supported by Ukraine's other allies. This initiative is unlikely to result in debt write-offs; more, it is very likely to lead to significant extensions of maturities.
- Eurobonds (excluding $3.0bn Eurobond sold to russia) made up just 20% of Ukraine's total public debt in April, and their share may decrease to about 15% at the end of 2022. A hypothetical 20% haircut on Eurobonds (same as applied in 2015) would imply a

[1] Public debt of 60% of GDP or more should trigger a detailed discussion of potential risks to debt sustainability as per the IMF Framework for Fiscal Policy and Public Debt Sustainability Analysis.

reduction in debt-to-GDP ratio by 3pp. However, such a reduction is in no way a game changer in terms of debt load.

- The average cost of external public debt will go down by the end of 2022. This is contrary to a typical relationship whereby higher debt ratios lead to a higher cost of debt. The explanation here is that generous concessional loans are coming in at an extremely low interest rate of below 1%. The average cost of Ukraine's public debt stood at about 7.2% in 2021. While the cost of external debt will decline on new cheap concessional funding, the new local debt may become significantly more expensive after the NBU hiked its key policy rate to 25% from 10%. However, new UAH debt that carries higher interest rate is unlikely to change the cost of the total stock of debt in a material way.
- Importantly, an argument emphasized by the Ministry of Finance – getting through the crisis without restructuring may help build reputational capital for decades to come.
- Finally, any restructuring these days would hardly be possible given the huge uncertainty around key macroeconomic indicators. Even if there is some clarity regarding the potential fall in real and nominal GDP in hryvnia, the official exchange rate cannot be used to estimate GDP in US$ equivalent. The only practical approach at this stage would be to solicit a "stand still" agreement with creditors and stop servicing external debt such that coupons / interest is accrued, but not paid. Any constructive restructuring negation is only possible after the war is over.

Arguments favoring restructuring

- Economizing cash (via suspension of payments) of more than US$3.0bn over the next 18 months may prove to be the only correct approach if the war lingers too long and international financial assistance subsides in the future.
- A possible restructuring would not be a consequence of economic mismanagement, but solely a direct consequence of external factors. Before the war, Ukraine was doing a great job in terms of fiscal consolidation and public-debt management. Thus, no one will blame Ukraine for restructuring debt, and restructuring is very unlikely to have a major impact on the international perception of Ukraine post war. Many Eurobond holders believe the suspension of debt servicing is inevitable given unprecedented fiscal pressures on Ukraine. This expectation is reflected in the Eurobond price of 32-40. Countries with debt trading at yields as high as Ukraine's rarely manage to normalize credit risk premiums without going through a restructuring process.
- Restructuring will place foreign investors in Eurobonds and UAH-denominated bonds on a more equal footing. Those with investments in UAH bonds are now treated in a much less favorable manner. Due to tough FX restrictions, proceeds from local UAH bonds cannot be converted into hard currency and sent out of Ukraine. In fact, non-residents are forced to roll over their bonds at least until April 2023. More favorable treatment of FX debt vs UAH debt might in the future undermine government's efforts to de-dollarize public debt.
- Official creditors – ally countries and IFIs – are likely to be reluctant to carry the full burden by patching Ukraine's financing gap. Loans from such creditors are provided at below market rate and effectively represent a subsidy to Ukraine. Using cheap official funding to service expensive private debt may bring about legitimate question from the official creditors about the purpose of their assistance. In particular, the Ukraine Comprehensive Debt Payment Relief Act voted by the US House of Representatives says that the US representative should "commence immediate efforts with other governments and commercial creditor groups . . . to pursue comprehensive debt payment relief for Ukraine." Commercial groups of creditors are thus explicitly mentioned in the document.

What is the future for Ukraine Eurobond prices?

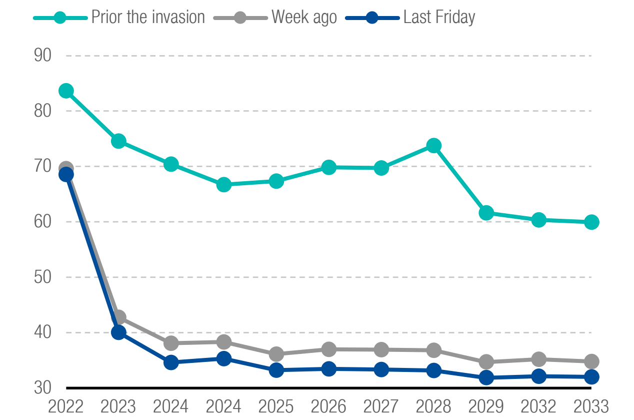
Current Eurobond quotations clearly show that investors believe the Eurobond restructuring is a possible scenario. This is despite the repeated assurances from the Ministry of Finance that they see no need for debt reprofiling. What keeps investors cautious is not the fear that MinFin may move away from its promise / commitment, but, rather, the huge uncertainty that lies ahead for Ukraine's economy. The risk that the war will continue into 2023 is a real one. If it materializes, Ukraine will need to continue to rely heavily on external loans thus pushing its debt burden to levels that are hardly sustainable. Ukraine will also need to secure additional financing from its allies at US$5bn per month beyond 2022. A major debt relief operation involving both official and commercial creditors will be impossible to avoid in that case.

Huge uncertainty about the length of the war and its ultimate impact on Ukraine's economy are the two most important factors that will keep the prices of Ukraine Eurobonds at depressed levels. The yield curve will remain largely defined by news from the battlefields. Clearly, this also implies significant price volatility of bonds in the coming months.

Meanwhile, the price of 2022 Eurobond will remain sensitive to news about inflows of FX liquidity to government's accounts over the summer. Investors currently believe the probability of a full timely redemption is reasonably high. If the 2022 Eurobond is redeemed in due course, this might have a positive impact on papers across the board.

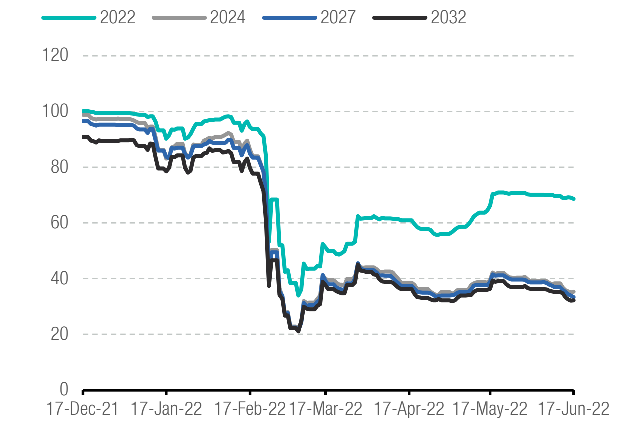
Last week, the City of Kyiv made a timely US$31mn payment on its Eurobond. The nearest event to watch is the redemption of Nartogaz US$335mn Eurobond in the middle of July. The company also indicated the payment will be made on time and in full. While the debt is not guaranteed by the government, its timely redemption will send yet another strong signal to the market about the Ukrainian authorities' determination to honor sovereign and quasi-sovereign debts.

Chart 3. Ukrainian Eurobond prices



Source: Bloomberg, ICU.

Chart 4. Prices of selected Ukrainian Eurobonds



Source: Bloomberg, ICU.

11th floor, LEONARDO Business Centre
19-21 Bogdan Khmelnytsky Street
Kyiv, 01030 Ukraine
Phone/Fax +38 044 3777040

WEB www.icu.ua

RESEARCH

Vitaliy Vavryshchuk
Head of macro research
vitaliy.vavryshchuk@icu.ua

Alexander Martynenko
Head of corporate research
alexander.martynenko@icu.ua

Taras Kotovych
Senior financial analyst (Sovereign debt)
taras.kotovych@icu.ua

Mykhaylo Demkiv
Financial analyst (Banks)
mykhaylo.demkiv@icu.ua

Dmitriy Dyachenko, CFA
Financial analyst
dmitriy.dyachenko@icu.ua