Bond Market Insight

VAT bonds: Revisiting prior offering terms

INVESTMENT CAPITAL UKRAINE
INVESTMENT BANKING

THURSDAY, 29 MAY, 2014

RESEARCH INSIGHT

The Ukrainian government will issue bonds to pay VAT refund for the third time. Approximately UAH2.0bn in VAT-bond debt debuted in 2004, and was amounted to below, followed by a second offering of UAH16.4bn in 2010. The MoF could issue UAH17.0bn of new VAT bonds this year, according to the Minister of finance.

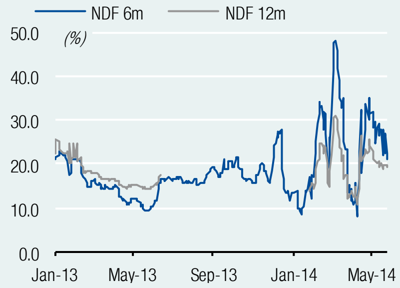
Historically, when these bonds have been offered, global conditions have been quite similar. In 2004, the MoF offered 5-year bonds with a flexible interest rate at 120% of the NBU discount rate and yearly coupon payments. In 2010, the MoF also issued 5-year bonds, but with semi-annual coupons and a fixed 5.5% coupon rate. This year, the Cabinet of Ministers combined the previous offering terms, this time for semi-annual coupons at a set fixed coupon rate of 100% of the NBU discount rate (currently 9.5%) for the same 5-year maturity. This year also canceled the requirement that only state-owned banks could purchase sizeable portions of the offering.

The resolution that was adopted last week and published on Monday included several required tasks prior to issuance: analyze all debt on the VAT refund, have the new Cabinet of Ministers establish a debt ceiling for the VAT refund, and prepare register of tax payers and their refund volumes which will be restructured for each tax payer. There is a two month deadline.

A more detailed look on these requirements and deadlines could show that the Ministry of Taxation must set a debt ceiling by the beginning of June, and then the MoF to prepare a new CoM resolution. Issues could be placed within a few days after the debt ceiling is adopted as the final register of tax payers could be completed in up to two months. If the final register is submitted within the 2-month deadline, we could see the final issue of these bonds no later than the end of July 2014. However, the receipt of bond could be determined by tax payers, depending on their demands.

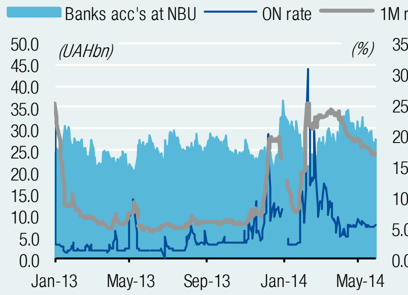
While this offering will have duration at about 2.4 years, which is longer than the latest domestic bond issuances, the discount will increase as duration decreases. So, if we compare the new issue with a recent 2-year local currency bond with a 17.78% yield (17.00% coupon rate) and secondary bond market yields, a new VAT-bond could yield 20.0% or higher. However, with the coupon rate for new bonds set at 9.5%, which is higher than the previous offerings of these bonds, it is still below market and tax payers should sell them at a discount. To give to the buyer a 20.0% yield, the discount should be at about 20.0%. If demand is low, the discount could rise to 30%, increasing yields to about 28-30%.

NDF yields
since 2013



Sources: Bloomberg, Investment Capital Ukraine LLC.

Banks' acc' with the NBU and KyivPrime rates
since 2013



Sources: National Bank of Ukraine, Bloomberg, Investment Capital Ukraine LLC.

Cash flows on new VAT bonds

Coupon payments	Amortization (UAH)	Coupon payments (UAH)	Total flow (UAH)
1 coupon	100.0	47.50	147.50
2 coupon	100.0	42.75	142.75
3 coupon	100.0	38.00	138.00
4 coupon	100.0	33.25	133.25
5 coupon	100.0	28.50	128.50
6 coupon	100.0	23.75	123.75
7 coupon	100.0	19.00	119.00
8 coupon	100.0	14.25	114.25
9 coupon	100.0	9.50	109.50
10 coupon	100.0	4.75	104.75

Sources: Ministry of Finance of Ukraine, Investment Capital Ukraine LLC.

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Placing these bonds is problematic with non-residents. Taking into account the current NDF rates, the UAH/USD exchange rate is expected to be UAH13-14/USD for the 6-month and 12-month periods, investments in local currency denominated bonds with yields below 20.0% are less attractive. Demand from non-residents could rise if Ukraine's sentiment improves, particularly in the UAH/USD exchange rate and market sentiment, thus increasing the profitability of investments in VAT-bonds.

However, domestic investors should submit some demand for the new VAT-bonds which will depend on local currency liquidity in banking system. If the issue only partially covers the refund and will take some time, the supply of new bonds will be insignificant and they will be more attractive to domestic investors. If the full amount is issued at once, we could see less demand and a significantly higher discount.

As a result, demand and prices of the new bonds will depend on the political and economic situation in Ukraine. If the current exchange rate for non-residents' is undervalued and they anticipate local currency appreciation in the short-term, new VAT bonds will be in much higher demand.

Chart 1. Non-residents portfolio and share

Since 2010.

Source: National Bank of Ukraine, Investment Capital Ukraine LLC.

Disclosures

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