Bond Market Insight

VAT bonds: New yield guidelines

INVESTMENT CAPITAL UKRAINE
INVESTMENT BANKING

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RESEARCH INSIGHT

VAT-bonds with 5-year maturities with semiannual coupon payments and amortizations were in high demand by non-residents in 2004 and 2010 when similar bond offerings were issued. Although the MoF anticipated similar demand after issuing a debut tranche and second tranche, the bonds have not traded actively since being issued.

As we mentioned in our previous notes on VAT-bonds, the duration of these bonds was 2.4 years and they were issued at a discount to assure a market rate. Moreover, the duration declined to 2.1-2.2 years.

At primary auctions held in June and at the beginning of July, although the MoF offered bonds with maturities of up to five years, the market saw demand for bonds with maturities no longer than two years, mostly with redemptions in June 2016. The duration of this issue originally was at 1.8 years and the YTM was 17.7%, signaling that demand from non-residents was at yields of nearly 20% which, with a discount, could yield about 18-20% to attract demand from large portfolios.

However, in mid-July the MoF slightly decreased the nominal interest rate on 2-year bonds. This change could push yields on VAT-bonds down by at least 25-50bp and decrease the attractiveness of VAT-bonds for non-residents. Thus, there has been no active trading because of negative anticipations of yields.

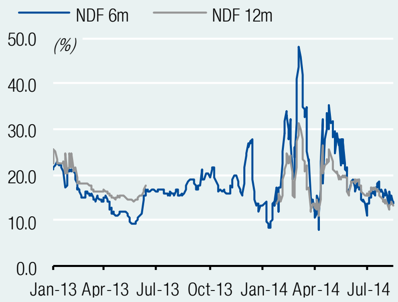
At the same time, the MoF sold 2.5-year bonds to non-residents last week and this past Tuesday. This issue extended the yield curve at the primary market to 2.2 years, which is very similar to the current duration of VAT-bonds. These recent issues of ordinary bonds were made at 19.94-19.97% to meet anticipated market demand.

In issuing ordinary bonds to non-residents, the MoF satisfied pent-up demand for VAT-bond yields and durations. As recent primary auctions confirmed that demand for VAT-bonds could take place with YTMs at about 20%, which will require a discount to adjust the rate to 18-20%, slightly declined due to accrued interest and a slightly shorter maturity.

As a result, tax payers who received VAT bonds could have a problem trading these bonds unless they increase the discount to increase the yields. This situation could result in keeping discounts at about 20% to provide investors yields at 21%. As the MoF still offers bonds with similar duration at yields near 20% as well as 2-year bonds at a slightly lower interest rate, demand for these maturities could be satisfied at the primary market.

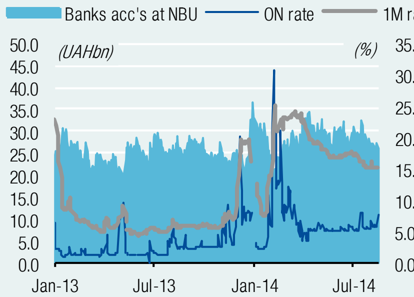
If the MoF satisfies all non-residents' demand, local investors' demand will likely be insufficient to buy the remaining VAT-bonds, thus warranting deeper discounts and higher YTMs to attract investors.

NDF yields
since 2013



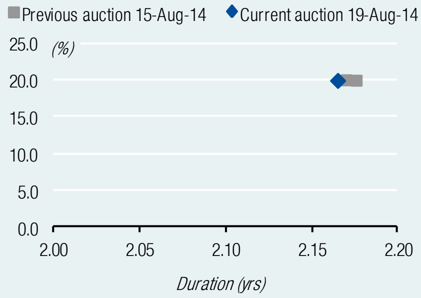
Sources: Bloomberg, Investment Capital Ukraine LLC.

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



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

Term structure of yields



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

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The current time is more opportunistic for non-residents to invest in the local market than was a few weeks ago. After the hryvnia weakened to nearly UAH13/USD, the attractiveness of investing in local currency debt rose. For the same amount of funds in FX, non-residents could purchase more local currency denominated bonds. If the local currency becomes stronger, non-residents could receive a double boost to enhance their profit.

Chart 1. Non-residents portfolio and share in total government bonds outstanding

Since 2010.

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

Disclosures

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