



Bond Market Insight

New challenges and risks

This year began with tremendous geo-global and domestic political volatility which immediately had an impact on the debt policy and financial situation in Ukraine. The reinstatement of the Ukrainian government, the Russian invasion and annexation of Crimea, the escalation of the situation in eastern Ukraine (especially Donetsk and Luhansk oblasts), the presidential elections, and the renewed natural gas war caused market sentiment to undulate. When at the end of 2013 and at the beginning of January all eyes were on Russia and its offering of US\$15bn of financing, decreasing gas prices, etc., in February an acute political crisis that raged for three months ended with former incumbents fleeing to Russia to avoid prosecution in Ukraine. The new government was abhorred by Russia to the extent that the Kremlin withdrew its promised Russian financing, invaded and annexed Crimea, and assembled its troops on the border to prepare in invade eastern Ukraine. Not only did these moves cancel all possibilities for the new Ukrainian government to negotiate on financing and new gas prices with Russia, but in June Russia closed its gas supply to Ukraine, keeping only transit to Europe.

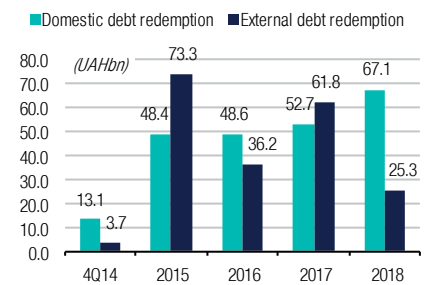
Although Ukraine currently does not need significant FX funds for debt repayments, the debt markets are closed for new issues, reflecting the increased risk of sovereign default or debt restructuring. The chances of default and restructuring could rise due to many factors, although not directly from the Ukrainian government. While significant redemptions are scheduled over the next three years, the largest is the Russian Eurobond redemption scheduled next year which should not be restructured, while in 2016 and 2017 there are many quasi-sovereign and guaranteed Eurobonds which will also not be included in sovereign debt for restructuring.

Meanwhile, we saw stable financing from domestic sources this year, using not only occasional domestic QE demand but also domestic market demand for bonds with maturities up to 3-years.

Ukraine's future is now defined by new steps by the government which immediately began negotiations with the IMF. At the end of April, the IMF adopted a US\$17.01bn stand-by loan and new program for Ukraine, the US offered to guarantee a US\$1.0bn Eurobond issue for Ukraine which was successfully placed in May, and the EU also provided support and funds as well.

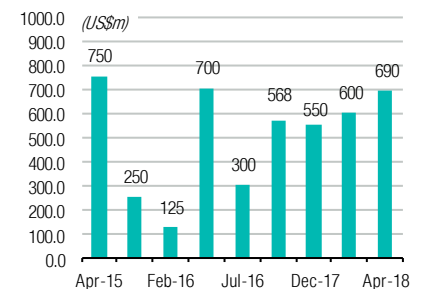
FRIDAY, 24 OCTOBER 2014

Future sovereign debt redemptions



Sources: Ministry of Finance of Ukraine, ICU.

Redemptions of quasi-sovereign Eurobonds



Sources: Bloomberg, ICU.

Yields of some Ukrainian Eurobonds, last 12-month period



Sources: Bloomberg, ICU.

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View on the sovereign debt restructuring issue

Since the beginning of this year when Ukraine experienced an acute political crisis followed by severe geopolitical and economic crises, talks of a possible sovereign debt restructuring have been gaining more and more weight. In our debt review at the end of January¹, we anticipated problems with debt redemption if the US\$15bn 2-year financing offered by Russia were to be fully utilized. Later in the year, government changes caused significantly different performance and resulted in new anticipations. After it failed to receive new tranches of funding from Russia, with renewed cooperation with the IMF and EU, Ukraine issued new instruments such as US-backed Eurobonds. However, the risks of debt restructuring remained high, as the 5-year CDS rose above 1,300bp at the end of September, spreads to the benchmark widened significantly, and the yield curve adjusted to above 11%. Whether Ukraine should restructure the debt or repay it as originally schedule remains the market's main dilemma. While the debt burden is not so significant that it must begin negotiations, Ukraine's FX reserve is insufficient to meet its scheduled repayments and, aside from specific loans from the IMF or EU, there are no additional inflows.

Total debt rose to about US\$70.0bn...

According to MoF official statistics, the total volume of sovereign debt rose to US\$69.51bn (or UAH945.77bn) through the end of August. At the same time, a large portion of debt is denominated in local currency and not sensitive to FX exchange rates. Ukraine received a new tranche from the IMF in September, issued UAH25.94bn of bonds to fund Naftogaz's share capital increase to repay the company's Eurobond and other local currency bonds. As a result, the total volume of sovereign and guaranteed government debt did not increase significantly by our estimates.

...and with a debt-to-GDP ratio of nearly 60%, there are higher risks of violating the covenant of UKRAIN 5.00% '15

Due to our forecast of nominal GDP at UAH1,547.0bn, Ukraine currently has a debt-to-GDP ratio near 60% but this indicator is very sensitive to FX exchange rates and official data on GDP and debt at the end of the year. As new borrowings and debt redemptions could be made in local currency, the same as a new tranche of IMF loans that could be received, Ukraine could fall below certain loan covenant ratios by which Russia could demand early redemption. To exercise this covenant, Russia has to receive official GDP and debt data at the end of this year, and statistics will be available no sooner than at the end of February.

Except for the UKRAIN 5.00% '15 redemption, Ukraine has low debt repayments

This covenant and possible request for redemption is only one reason for payments out of schedule. Other repayments are significantly lower and will present no significant problems for the Ukrainian government. Debt repayments by quasi-sovereign borrowers are also not very significant during the next two years. Except for the scheduled repayments to the IMF this year and the Russian Eurobond repayments next year, the MoF has only two bond redemptions scheduled each year in 2015 and 2016. Beyond Eurobond redemptions, Ukraine has significant local currency debt and other obligations which are totally included in the table below.

The next peak in debt repayments will be in 2017

The US\$3.0bn (about UAH39bn) Russian Eurobond redemption scheduled next year is the most significant, and the second peak is in 2017 with the US\$2.6bn UKRAIN 9.25% '17 redemption. Other years have lower debt pressure, especially in FX denominated debt. As a significant portion of domestic debt is in the NBU's portfolio, these redemptions are less important because they can be refinanced via domestic QE at any time and pose no

¹ See *Bond Market Insight* "Sovereign debt: Challenges postponed for a while" published on 21 January 2014 ([here](#)).

problems for the government. FX-denominated debt is a small portion of total debt outstanding (for details, please see p.5).

Table 1. Debt repayments schedule (UAHbn)

	2014 (Until the end of year)	2015	2016	2017	2018	2019
Total volume of debt repayments						
All debt repayments	29.83	181.18	137.79	165.60	127.84	96.19
Principal repayments	16.95	121.35	84.65	119.04	92.44	69.76
Interest repayments	12.88	59.42	52.77	46.21	35.05	26.13
Domestic debt repayments						
Total volume	21.92	90.31	86.42	90.03	92.91	57.26
Principal repayments	13.16	48.21	48.48	57.29	67.11	39.66
Interest repayments	8.76	41.69	37.56	32.38	25.48	17.30
External repayments						
Total volume	7.91	90.87	51.36	75.58	34.92	38.93
Principal repayments	3.78	73.14	36.17	61.75	25.34	30.10
Interest repayments	4.12	17.73	15.20	13.83	9.58	8.83

Notes: next five years.

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

Government guaranteed debt is at US\$10.34bn

The table above includes only direct debt and does not include any guaranteed issues or loans. Of the US\$11.94bn (UAH162.39bn) of guaranteed debt Ukrainian government had at the end of August, US\$1.60bn of which was repaid at the end of September, decreasing the total outstanding to US\$10.34bn. New large repayments of guaranteed debt, including principal repayments to the IMF on new loans received this year, will begin in 2017.

Also, quasi-sovereign entities issued large bond offerings

Beyond sovereign and guaranteed debt, Ukrainian companies have a significant debt burden on borrowings from abroad, much of which was issued by quasi-sovereign borrowers, such as Ukreximbank and Oschadbank, in addition to Naftogaz's payments for gas imports. Because these loans require FX for repayments, these loans pose the largest problem for Ukraine due to the significant decline in FX reserves and closed markets for debt refinancing.

Except for the Russian Eurobond redemption next year, Ukraine has low need for FX. As for next year, following the scheduled redemption of US\$500m next September and EUR600m next October in sovereign Eurobonds, the City of Kyiv must repay US\$250m in Eurobonds in November and at the end of April Ukreximbank has to repay US\$750m, most likely invested in government FX-denominated bonds which have to be repaid by the MoF to provide funds for Ukreximbank.

2016 is similar to 2015. Two sovereign Eurobond redemptions are scheduled: US\$1.0bn in June and US\$1.25bn in November. In addition, the City of Kyiv has to repay US\$300m in July 2016, Oschadbank is scheduled to repay US\$700m, and Ukreximbank's US\$125m Eurobond comes due as well.

Of the quasi-sovereign issues, only UKRINF Eurobonds are guaranteed by the government

Out of the list of bonds described above and in the table below, only UKRINF Eurobonds are guaranteed by the government and could request the same direct support as was granted for the Naftogaz offering this September. While the MoF could issue bonds for banks and the UKRINF share capital increase for debt redemptions, the availability of FX funds is the main challenge.

However, quasi-sovereign and guaranteed debt will not be included if sovereign debt is restructured

On the other hand quasi-sovereign bonds and guaranteed debt will be not included in the volume of sovereign debt which could be restructured, the same as debt on UKRAIN 5.00% '15 is the subject of political discussions and due to the current state of Ukraine-Russia cooperation looks like impossible. So, Ukrainian government has low debt burden for 2015 and 2016, and currently debt restructuring will not solve any problems with needs in FX for all repayments described above.

Table 2. Schedule of sovereign and quasi-sovereign Eurobonds

Year of maturity	Bonds	Issue volume, millions	Currency	Coupon rate	Maturity date
2015					
	EXIMUK 8.375% '15	750.00	USD	8.375%	24/04/2015
	UKRAIN 6.875% '15	500.00	USD	6.875%	23/09/2015
	UKRAIN 4.95% '15	600.00	EUR	4.950%	13/10/2015
	CITKIE 8% '15	250.00	USD	8.000%	06/11/2015
	UKRAIN 5.00% '15	3,000.00	USD	5.000%	20/12/2015
Total 2015		5,268.00			
2016					
	EXIMUK 8.4% '16	125.00	USD	8.400%	09/02/2016
	OSCHAD 8.25% '16	700.00	USD	8.250%	10/03/2016
	UKRAIN 6.25% '16	1,250.00	USD	6.250%	17/06/2016
	CITKIE 9.375% '16	300.00	USD	9.375%	11/07/2016
	UKRAIN 6.58% '16	1,000.00	USD	6.580%	21/11/2016
Total 2016		3,375.00			
2017					
	UKRAIN 9.25% '17	2,600.00	USD	9.250%	24/07/2017
	UKRINF 8.375% '17	568.00	USD	8.375%	03/11/2017
	UKRAIN 6.75% '17	700.00	USD	6.750%	14/11/2017
	UKRINF 9% '17	550.00	USD	9.000%	07/12/2017
Total 2017		4,418.00			
2018					
	EXIMUK 8.75% '18	600.00	USD	8.750%	22/01/2018
	UKRINF 7.4% '18	690.00	USD	7.400%	20/04/2018
Total 2018		1,290.00			
Total volume of repayments		14,351.00			

Notes: Volume of redemption UKRAIN 4.95% '15 included in the total figures using current USD/EUR exchange rate

Sources: Bloomberg, Investment Capital Ukraine LLC.

Describing the current debt inventory and future repayment schedule is necessary to understand debt restructuring. Ukraine has nearly crossed the 60% debt-to-GDP ratio. When evaluating the impact of the devaluation on local currency debt, it could be even higher. Most likely, the covenant ratio for the Russian Eurobond and Ukraine's budget ceiling will be calculated based on year-end data which will be available next year.

As a restructuring is unlikely to resolve problems, restoring market viability is a better option

As sovereign Eurobond debt repayments over the next two years will be not very large (except for the Russian bond, which is the subject of political discussions), the restructuring of sovereign debt is not a viable solution to handling debt repayments. If Ukraine even announces a sovereign debt restructuring or hints at the possibility of defaulting on a payment, the Eurobond market could very likely be closed for a few years. As 2016 and 2017 are the most problematic for Ukraine to fulfill sovereign, quasi-sovereign and guaranteed debt, Ukraine needs to restore market viability by then. If Ukraine's government does initiate a sovereign debt restructuring, we could see a situation similar to that in 2000

when it could not borrow until 2003, albeit background developments in the country will be different².

*Domestic debt is mostly
in local currency and
held by the NBU*

At the same time, as only UAH61.72bn of bonds are denominated in FX, or about 16% of total domestic bonds outstanding, domestic debt is less sensitive to local currency devaluation. Also, the NBU holds nearly 70% of domestic debt, or UAH273.64bn of bonds, and increased its portfolio during this year to UAH126.59bn, amounting to about 90% of the increase in total bonds outstanding. This part of the debt can be managed by the government as recent cooperation confirms that the NBU's domestic QE will continue to provide domestic bond market support.

² Back in 2000, when Ukraine's government agreed with its creditors to undergo a sovereign debt restructuring in April of that year, the domestic political environment nosedived into an acute political crisis as investigative reporter Georgiy Gongadze was declared lost in September and months later found dead in the woods of Kyiv oblast. A bunch of secretly recorded tapes were leaked to the opposition and then to the media to put the blame on then president Kuchma. The crisis lasted for months with large public rallies that ended only by the authorities' heavy-handed clampdown on political opponents. The EU and Western countries effectively put Kuchma into isolation. Kuchma's pro-EU agenda, which he used as a popular electoral issue to be re-elected for the second presidential term, was effectively in tatters and shelved. Kuchma managed to survive the string of opposition rallies against him and then later managed to restore his relations with the West by pledging military support to the US in the Iraq war that began in 2003. Improving relations between Ukrainian and US authorities at the time could be that coincidence that took place the same year when Ukraine did return to the Eurobond markets for financing. The Kremlin, led then by a younger Putin, was mostly consumed by the Chechen war at the time. Putin was a frequent visitor to Kiev, constantly pushing Kuchma to squeeze democracy even further, effectively training him to bow under his influence. Hence, Putin used a different sort of stick-and-carrot policy at that time.

In between, from the end of the 1990s until late 2003, Ukraine's authorities adhered to a tight fiscal policy by limiting the government budget deficit to near zero as a share of GDP and by lowering budget expenditures to 26% in 2002 from 30% in 1998 and 38% in 1997 (in consolidated terms, Naftogaz's balance was not an issue at the time). Hence, Ukraine's authorities had started a pro-growth macroeconomic policy before the external debt restructuring took place and adhered to it for next several years ended in mid-2004.

This time, in 2014-15, there is a risk that Ukraine's authorities, in our view, being reluctant for a tight fiscal policy right now, could easily wean itself from a much tighter (unpopular) fiscal policy (required going forward) if it is being allowed a reprieve by creditors through an external debt restructuring. Having restored its IMF program since May 2014, the government still displays little progress in reducing public sector deficits and trimming expenditures. State budget expenditures in consolidated terms now stand near 34%. The budget deficit is expected to be at 6% this year and 5% next year. Naftogaz's balance still has a glaring deficit of 4% as projected by the IMF for this year. In our view, this risk of still prevailing fiscal imbalances is evident in the ongoing trust destruction in the economy and in the financial markets. Not only do Eurobond sovereign investors consider debt claims on Ukraine's government as high risk, but domestic players - like bank depositors who have been withdrawing deposits to purchase hard currency all this year - think the same way. If Ukraine were to request external debt restructuring before it achieves the necessary fiscal consolidation, domestic financial conditions would only deteriorate further. A flight to safety would gain momentum and only result in increased FX devaluation, higher bank recapitalization needs, and more public debt. To avoid further trust destruction in the economy, the government will make a concerted attempt to restore business and consumer confidence by reducing corruption and tightening fiscal discipline.

General conditions in Ukraine

2014 became a challenge for Ukraine and its debt policy. While the year began with an upbeat outlook, the situation became diametrically opposite after changes in the government, the postponement of a new Russian tranche, and the closing of financing after implementing a new Ukrainian government and announcing new presidential elections. Although conditions significantly improved at the end of 2013 and at the beginning of this year, new borrowings became very expensive and impossible for Ukraine. As the government took positive steps to cooperate with the IMF, the US and the EU to open market access for Ukraine, the political situation severely restricted Ukraine. Despite the positive impact of presidential elections and announcement of new parliamentary elections, the impact of new IMF loans was reduced by the unstable situation in eastern Ukraine, and market conditions remained untenable.

Ukraine had large debt repayments this year...

This year is very challenging for Ukraine from a debt point of view. Without any chance to get new financing in 1Q14, Ukraine had to repay a large portion of funds to the IMF and also pay interest on other borrowings. The most challenging event was at the beginning of June when the US\$1.0bn redemption of UKRAIN 7.95% '14 was scheduled. Repayments to the IMF in May, July and August were made partially using new tranches from the IMF. However, the government also had to support Naftogaz with its US\$1.60bn Eurobond redemption scheduled for this September. Through the end of the year, the MoF had numerous interest repayments on Eurobonds and domestic debt repayments denominated in US dollars and Euros. With the significant hryvnia devaluation that occurred this year, the Ukrainian government has increased needs in budget funds to fulfill these repayments in local currency equivalent.

...which were successfully fulfilled with funds provided by the IMF and others

Ukraine's newly restored government, following changes to the constitution and new presidential elections, caused a lot of challenges which could not be postponed. Some had to be resolved immediately. For example, while the gas price and Naftogaz's debt on payments for gas imported since last year was repaid partially on imported gas in 1Q14, other debt, a new gas price, and the future supply of gas became the subject of new negotiations. Moreover, having received two tranches of the IMF stand-by loan, issued US\$1.0bn in US-backed Eurobonds and receiving financing from the World Bank, the EU, and other sources, including domestic QE support, Ukraine made all debt repayments properly and on time.

According to the latest MoF data on debt inventory, sovereign direct and guaranteed debt amounted to US\$69.51bn at the end of August, with US\$45.18bn denominated in FX. Budget expenditures depend on UAH/FX exchange rates.

In 9M14, Ukraine repaid 91.08% of its external principal repayments scheduled for this year

The table below illustrates that of the UAH148.04bn of debt repayments scheduled for this year, during 9M14 Ukraine repaid UAH113.10bn, including UAH60.08bn in domestic and UAH53.02bn in external repayments. All figures above and below are calculated using market exchange rates, actual rates for already made repayments, and the latest for future repayments. At the same time, Ukraine repaid 91.08% of external principal repayments while only 71.58% of domestic principal repayments scheduled for this year were repaid during 9M14. Needs in FX inflows from abroad to cover repayments are mostly complete. Ukraine will need US\$0.72bn of FX for external repayments in 4Q14, with principal repayments will mostly for mature IMF loans.

Table 3. Debt repayments scheduled for 2014 and currently repaid through the end of September 2014

	2014	2014 (actual repayments)	%
Total volume of debt repayments			
All debt repayments	148.04	113.10	76.40
Principal repayments	100.47	80.88	80.50
Interest repayments	47.56	32.22	67.74
Domestic debt repayments			
Total volume	85.77	60.08	70.04
Principal repayments	54.52	39.03	71.58
Interest repayments	31.25	21.05	67.36
External repayments			
Total volume	62.26	53.02	85.16
Principal repayments	45.95	41.85	91.08
Interest repayments	16.30	11.16	68.47

Notes: all figures are calculated using market exchange rates, actual rates for already made repayments, and the latest one for future repayments.

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

The debt significant increase in domestic was due to the local currency devaluation...

Ukraine also had a significant increase in domestic debt due to new additional issues, just as bonds outstanding rose due to the local currency devaluation. According to our calculations, there was US\$5.79bn in domestic bonds denominated in FX at the beginning of the year. Although the nominal volume of these bonds to date has declined to US\$4.77bn, the volume outstanding in local currency rose UAH18.10bn during 9M14 due to the increase in the official UAH/USD exchange rate. FX-denominated bonds outstanding increased from UAH46.28bn to UAH61.52bn.

...as well as significant new issues

During 9M14, the MoF issued UAH47.40bn of domestic bonds at primary auctions and UAH96.61bn of bonds for Naftogaz's share capital increase. The total volume of bonds issued at the primary market also includes zero-coupon bonds, with UAH13.26bn issued, of which UAH8.15bn has already been redeemed. Total bonds outstanding (according to NBU data, with FX bonds calculated using the official exchange rate) during 9m14 rose UAH133.69bn, of which UAH18.10bn was due to devaluation. About 89% of new bonds outstanding ultimately were purchased by the NBU, increasing its share to about 69% of total domestic bonds outstanding.

While direct sovereign debt is important, government-guaranteed debt also plays a role. Naftogaz recently redeemed its government-guaranteed US\$1.60bn Eurobond. It should be included in our view due to the company's deficit and possible problems with repayments, with its large debt burden on gas payments to Gazprom to be repaid this year. In the domestic bond market, UAH1.55bn of bonds issued by KSAMC³ was redeemed in August. NBU debt payments on IMF loans are also government-guaranteed.

³ Kharkiv State Aircraft Manufacturing Company

Future debt deals in 2014

Although June and July showed a slight reprieve, market conditions at the end of September became unacceptable for the MoF. Eurobond YTMs during 9M14 were mostly above 9.0% and once more rose above 10.0% during September as a result of negative anticipations of a Naftogaz bond redemption default and rumors of a sovereign debt restructuring. The domestic bond market was quiet with low demand for bonds up to three years and should not change significantly, mostly using domestic QE for supporting demand, especially for long-term bonds.

Ukrainian risks reversed this spring and market conditions became untenable

As mentioned above, this year started with positive movements in the Eurobond market as Ukraine benefited from a debut tranche of financing from Russia, a lower gas price, and US\$12bn of additional promised financing during this year. However, due to political changes in Ukraine, particularly with the Crimean annexation, yields rose significantly, and it was not until May and the beginning of June that we saw a significant improvement in the Eurobond market after Ukraine restarted IMF cooperation talks, issued USD-backed bonds, and completed both successful presidential elections and the redemption of UKRAIN 7.95% '14. Yields declined below 9% during the debut in June with slight volatility; the correction mostly held between 8.0% and 9.0% through the end of July. As spreads also remained steady with insufficient volatility, at the beginning of July, Ukrainian Eurobond YTMs fluctuated on news from the US and followed US Treasuries. While market conditions did improve significantly, they were still not attractive enough for new market issuances. However, anticipations for the following part of the year appeared promising.

However, loans and the recently received second tranche from the IMF had some agreed upon political components that relied on economic data to attain a new tranche. The timing of the issue will depend on the political situation, including the rising turmoil in eastern Ukraine. If Ukraine loses part of its territory, new loans and issues of bonds could be problematic.

Summer showed improving market conditions...

Promising market conditions during this summer increased anticipations of a new market issue, as spreads could tighten and allow yields to decline below 8.0%, providing Ukraine with a coupon rate on new Eurobonds at about 7.5-8.0%, an acceptable level for new issues. However, a new wave of escalated conflict in eastern Ukraine causing negative anticipations and rumors of a restructuring pushed the yield curve above 10% with the short-term end of it to about 20.0%.

...but markets will be closed through the end of this year at least

As a result, Ukraine's access to the market should be closed most likely through the end of this year. Risks of economic problems caused mainly by industrial shutdowns in eastern Ukraine, combined with the local currency devaluation, which could increase the possibility of a GDP decline and higher debt volume, could cause the debt-to-GDP ratio to rise above 60%. If this occurs, Russia could exercise its right of early redemption of US\$3.0bn in Eurobonds as written in the prospectus.

With closed markets and the possible early redemption of UKRAIN 5.00% '15, the MoF faces no significant funding challenges, especially if the US issues a new guaranty for the US\$1.0bn issue. In mid-September, according to the Minister of Finance, Ukraine had UAH9.0bn and US\$2.0bn in MoF accounts, with a scheduled year-end review of the IMF program and a possible new tranche approved before the end of this year.

Without the early redemption of UKRAIN 5.00% '15, Ukraine has to repay only UAH0.72bn in external debt repayments during 4Q14, including UAH0.23bn of principal repayments, mostly for IMF loans received in 2010. If the debt-to-GDP ratio remains below 60% through

the end of this year, Ukraine, with US\$2.0bn of reserves, should have sufficient funds for external debt repayments with no new external borrowings.

The Ukrainian MoF will continue to issue domestic bonds, mostly in local currency. Domestic borrowings are needed not only to refinance repayments, but also to provide the state budget with financing any time when the government has gaps in budget revenues. This year we saw a lot of short-term bond offerings to cover gaps, particularly in FX financing.

In 4Q14, the MoF is scheduled to repay UAH25.72bn in domestic principal and interest repayments, including the following:

1. Local currency principal repayments of UAH7.43bn and interest repayments of UAH8.65bn (including USD-indexed bonds without indexation);
2. FX-denominated principal repayments of US\$0.62bn (UAH8.09bn at current market exchange rate) and interest repayments of US\$0.12bn (UAH1.55bn).

The table below lists the types of bonds and volumes of their repayments scheduled during 4Q14, including UAH9.64bn in FX-denominated bonds, UAH2.04 in USD-indexed bonds, UAH5.09bn in ordinary bonds, and UAH3.68bn in local currency denominated bonds issued for Naftogaz's share capital increase.

The largest repayment of UAH3.78bn is scheduled on 10 December, of which UAH3.03bn (US\$233.87m) is in USD-denominated bonds. USD-denominated bond repayments in 4Q14 amount to US\$664.04m, or UAH8.60bn at the current market exchange rate. For more detailed information, please see the charts and table below.

Table 4. Structure of domestic debt repayments

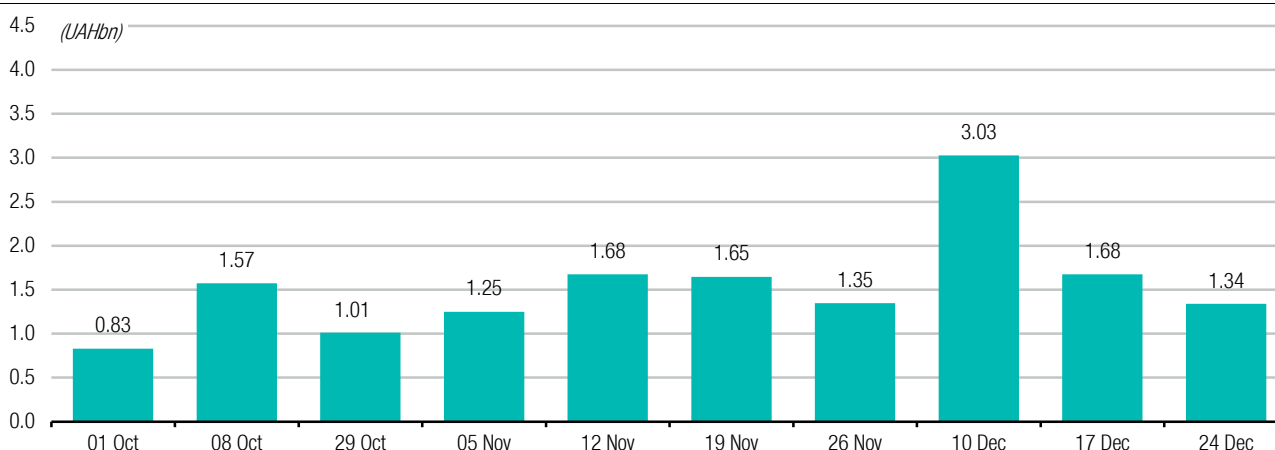
Types of bonds	Total volume	including: principal	interest	
Ordinary bonds	5,093,779,291.85	987,900,670.00	4,105,878,621.85	19.82%
Recap bonds for state-owned banks	1,855,055,927.50	0.00	1,855,055,927.50	7.22%
Recap bonds for Naftogaz	3,638,622,730.00	1,500,000,000.00	2,138,622,730.00	14.16%
Recap bonds for state-owned enterprises	103,312,500.00	0.00	103,312,500.00	0.40%
NBU	3,352,371,325.00	3,196,540,000.00	155,831,325.00	13.05%
USD-indexed bonds	2,042,127,765.00	1,748,410,155.00	293,717,610.00	7.95%
USD-denominated bonds	8,598,262,591.20	7,074,063,365.50	1,524,199,225.70	33.46%
EUR-denominated bonds	1,010,491,392.00	986,808,000.00	23,683,392.00	3.93%
Total	25,694,023,522.55	15,493,722,190.50	10,200,301,332.05	100.00%

Notes: FX-denominated bonds priced at current market exchange rate

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

Chart 1. The largest domestic debt repayments in 4Q14

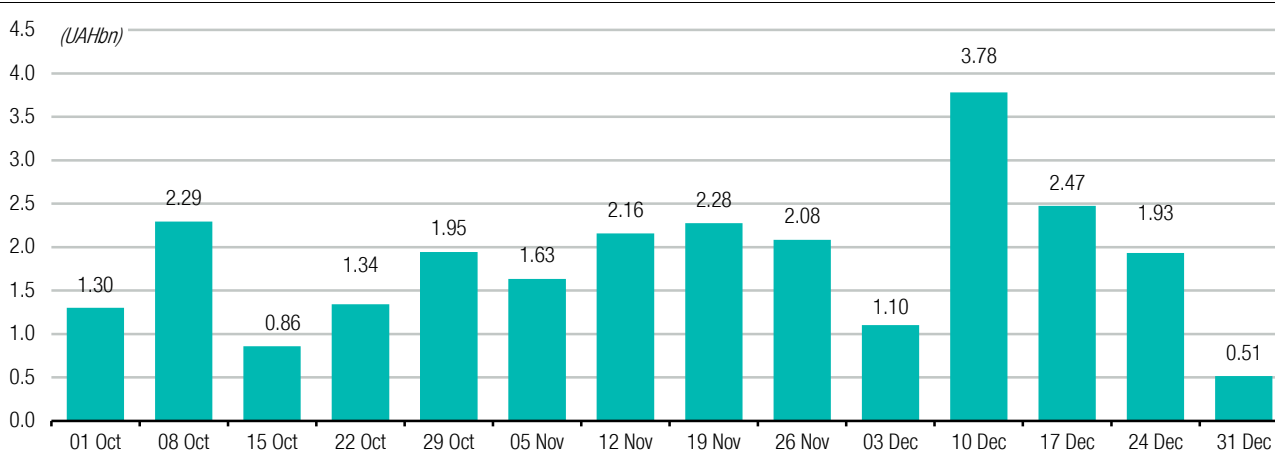
Repayments exceed UAH500.0m. FX-denominated bonds at current market exchange rate



Source: Ministry of Finance of Ukraine, Bloomberg, Investment Capital Ukraine LLC.

Chart 2. Debt repayments 4Q14

Daily schedule of repayments



Source: Ministry of Finance of Ukraine, Bloomberg, Investment Capital Ukraine LLC.

The MoF will likely not refinance FX-denominated domestic bond redemptions, using other sources for repayments...

The MoF will most likely refinance only a small portion of FX-denominated bond redemption. FX-denominated bond offerings usually are scheduled on Tuesday and funds could be received on Thursday, while repayments are scheduled for Wednesday and US dollars must be transferred on Tuesday to be in investors' accounts on Wednesday. As a result, FX-denominated bond redemptions could be repaid using funds from MoF reserves collected earlier in the year or received later from abroad through IMF loans or a possible second issue of US-backed Eurobonds. Funds could be replenished from offerings that occur later.

While local currency denominated debt repayments will be mostly refinanced

As the refinancing of local currency bonds is more easily achieved, the MoF most likely will refinance large local currency denominated repayments. Repayments of bonds issued on debt restructuring held by the NBU or recapitalization bonds, which could be also in the NBU portfolio, could be refinanced using domestic QE. After taking a short break, the MoF began to offer long-term offerings at low interest rates again at the end of September. UAH8.95bn, or 34.83% of debt repayments, are scheduled for 4Q14 (see Table 2 above), with 55.64% of repayments to be done in local currency, including USD-indexed bonds.

Table 5. Daily schedule of domestic debt repayments

Date	Total volume	principal	interest
01/10/2014	1,300,580,000.00	793,618,100.00	506,961,900.00
08/10/2014	2,293,208,150.00	1,500,000,000.00	793,208,150.00
15/10/2014	857,046,140.50	23,464,250.00	833,581,890.50
22/10/2014	1,341,615,782.18	100,787,500.00	1,240,828,282.18
29/10/2014	1,945,039,518.04	1,186,808,000.00	758,231,518.04
05/11/2014	1,634,575,605.13	1,198,410,155.00	436,165,450.13
12/11/2014	2,158,802,793.00	1,598,270,000.00	560,532,793.00
19/11/2014	2,275,645,163.19	1,580,856,468.00	694,788,695.19
26/11/2014	2,083,187,961.45	1,294,850,000.00	788,337,961.45
03/12/2014	1,100,724,848.91	250,000,000.00	850,724,848.91
10/12/2014	3,781,620,412.50	3,083,443,320.00	698,177,092.50
17/12/2014	2,473,771,966.27	1,598,270,000.00	875,501,966.27
24/12/2014	1,933,737,291.40	1,284,944,397.50	648,792,893.90
31/12/2014	514,467,890.00	0.00	514,467,890.00

Notes: FX-denominated repayments priced at the current market exchange rate

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

Table 6. The largest debt repayments through the end of 2014

Redemption date	ISIN	Total volume	Principal	Interest	Bond type
01/10/2014	UA4000180210	830,000,000.00	793,618,100.00	36,381,900.00	Ordinary bonds
08/10/2014	UA4000136451	1,573,125,000.00	1,500,000,000.00	73,125,000.00	Recapitalisation bonds
29/10/2014	UA4000174247	1,010,491,392.00	986,808,000.00	23,683,392.00	EUR-denominated bonds
05/11/2014	UA4000130603	1,249,424,265.00	1,198,410,155.00	51,014,110.00	US\$-indexed
12/11/2014	UA4000063218	1,676,185,662.50	1,598,270,000.00	77,915,662.50	NBU
19/11/2014	UA4000149231	1,646,620,097.07	1,580,856,468.00	65,763,629.07	US\$-denominated
26/11/2014	UA4000173058	1,345,025,437.50	1,294,850,000.00	50,175,437.50	US\$-denominated
10/12/2014	UA4000177133	3,028,200,952.50	2,913,412,500.00	114,788,452.50	US\$-denominated
17/12/2014	UA4000063226	1,676,185,662.50	1,598,270,000.00	77,915,662.50	NBU
24/12/2014	UA4000171649	1,337,948,353.90	1,284,944,397.50	53,003,956.40	US\$-denominated

Notes: FX-denominated repayments priced at the current market exchange rate

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

The tables above explain the schedule of domestic debt repayments, based on currently issued debt and using the market exchange rate for USD-denominated and EUR-denominated bonds. While Table 3 includes all repayments on currently issued domestic bonds, Table 4 illustrates details of which bonds should be redeemed each day (excluding small volumes).

Conclusion

Ukraine's government has been facing a number of challenges this year, of which increased public debt and low demand for sovereign debt *per se* are not that acute, in our view. The largest challenges are (1) the geopolitical crisis involving the Crimean annexation and conflict in eastern Ukraine and (2) the resulting economic crisis. Although risks of possibly violating the covenant which would cause the early repayment of UKRAIN 5.00% '15 (the Russian Eurobond), this most likely will not happen until next year. If such is the case, the MoF appears ready.

Higher financing needs could increase the budget deficit and require new borrowings

The ongoing conflict in eastern Ukraine significantly increased the risks of poor economic development and budget performance. While businesses in Lugansk and Donetsk remain unable to resume operations, many cities require large subsidies to restore their infrastructure. Significant military expenses are also required. As these expenditures significantly increased budget financing needs, we could see an increased budget deficit and new borrowings or decreased social services.

No new Eurobond issues are expected as the current yield curve is too high

The MoF should not have large problems with IMF loans through the end of the year as authorities cooperate with the IMF while meeting performance criteria and asking for modifications. The review of the program which was requested by President Poroshenko averted problems. These funds, combined with earlier received financing in FX and possible US-backed bonds issue (second tranche), should cover FX needs for debt repayments through the end of this year, including repayments to the IMF and interest repayments on Eurobonds, the same as partial coverage of FX-denominated bonds redemptions and servicing. No new Eurobond issues are expected as the current yield curve is too high; a new issue could cause yields to rise significantly.

Official annual data will be available next year and UKRAIN 5.00% '15 will be not repaid this year...

The largest problem could be if the debt-to-GDP ratio exceeds the maximum allowed level by the prospectus of UKRAIN 5.00% '15, causing Russia to exercise a right to early redemption. However, as official annual data of debt and GDP will be available only next year, this covenant poses no threat earlier than next spring if there was a violation. However, with US\$2.0bn of the government cash balance as of mid-September and anticipated FX proceeds, this debt could be repaid per the prospectus.

The MoF should avoid any events of default to maintain market viability for new borrowings

Also, to maintain capital market viability for new borrowings, when the economic situation does stabilize, the MoF must avoid any talks of restructuring or of default. As UKRAIN 5.00% '15 most likely will be not included in a sovereign restructuring due to political issues, other issues are not significant enough to even consider restructuring.

Domestic debt will be refinanced, mostly using domestic QE

Domestic debt in local currency poses no challenge. As some of this debt could be refinanced from market demand, a significant portion of repayments could also be refinanced via domestic QE support. The NBU should continue to purchase new bonds, support budget financing, and also support banks with liquidity to purchase new bonds when the redemption is on bonds purchased by the NBU. The NBU's portfolio could rise in 4Q14 by at least UAH15.0bn, of which UAH6.0bn will be replaced from bond redemptions.

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Buy: Forecasted 12-month total return greater than 20%

Hold: Forecasted 12-month total return 0% to 20%

Sell: Forecasted 12-month total return less than 0%

Note: total return is share price appreciation to a target price in relative terms plus forecasted dividend yield.

DEBT RATING DEFINITIONS

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