Research Report on Ukraine

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Ratings

Sovereign Government Credit (LC)	B
Sovereign Government Credit (FC)	B
Outlook (LC)	Stable
Outlook (FC)	Stable

* These ratings are unsolicited

Main Economic Indicators of COUNTRY

Macro indicators	2018	2019	2020
Gross gov. debt, UAH bn	2156,0	1998,3	2551,9
Nominal GDP, UAH bn	3560,6	3974,6	3995,0
Real GDP growth, %	3,4	3,2	-4,3
Gross gov. debt/GDP, %	60,6	50,3	63,9
Deficit (surplus)/GDP, %	-2,1	-2,0	-7,6
Inflation rate, %	9,8	4,1	5,0
Current Account Balance/GDP, %	-3,3	-2,7	4,3
External debt, USD bn	-	-	122,8*

Development indicators	2020
Inequality adj. HDI	0,779**
GDP per capita, USD th	12,7

Default indicator	26.02.2021
5-Year CDS spread, Bp	550,9***
10Y Gov Bond Yield, %	7,15

Source: RAEX-Europe calculations based on data from IMF, National Bank of Ukraine, Ministry of Finance of Ukraine and State Statistic Service of Ukraine.
*as of 3Q2020; **Data for 2019; *** as of 29.09.2020

RAEX-Europe assigned at ‘B’ the credit ratings of Ukraine with stable outlook.

RAEX-Europe assigned the sovereign government credit ratings (SGC) of Ukraine at ‘B’ (Moderately low level of creditworthiness of the government) in national currency and at ‘B’ (Moderately low level of creditworthiness of the government) in foreign currency. The rating outlook is stable, which means that in the mid-term perspective there is a high probability of maintaining the rating score.

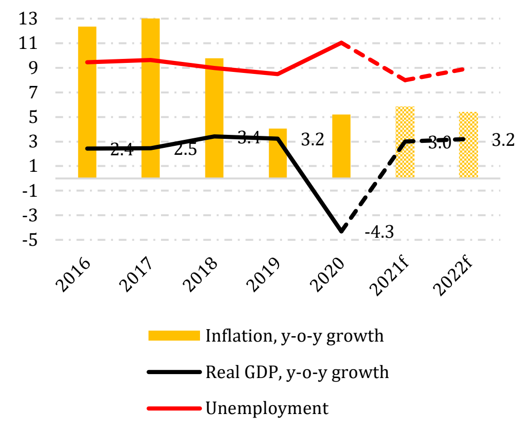
Summary

Ukraine's ratings are supported by the authorities' success in implementing consistent monetary and fiscal policies, which have created the conditions for credible fiscal consolidation, price stability and strengthened international reserves. At the same time, risks to the country are the banking system weakened by problem loans, the government's high dependence on external financing, which is reinforced by the costs of supporting measures to deal with the impact of COVID-19.

The economy contracted less significantly after easing of the lockdown. Between 2016 and 2019 the Ukrainian economy experienced an average steady growth of 2,9% in real terms per year due to strong agricultural exports, favorable external trade conditions and demand, as well as stable domestic consumption and investments. However, this trend came to a halt in 2020 when the real economy contracted by 4,3% y-o-y (see Graph 1).

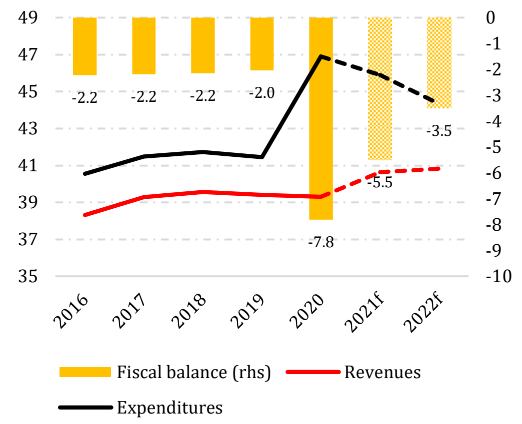
Ukraine introduced severe anti-pandemic measures after the first cases appeared in the country back in 2020. Extensive restrictions were imposed on movement, as well as on economic and social activities. As the number of new cases levelled off in May, the authorities began gradually easing containment measures. However, as a result of the anti-pandemic policies, and weaker demand for metals and mining commodities, the economy contracted by 11,4% y-o-y in 2Q 2020, bringing in 1H 2020 GDP decline to 6,5% y-o-y. However, in 2H 2020 the authorities imposed a less strict quarantine with most services functioning. At the same time, a recovery in real wages and a continued inflow of remittances supported the domestic demand.

Graph 1: Macroeconomic indicators, %



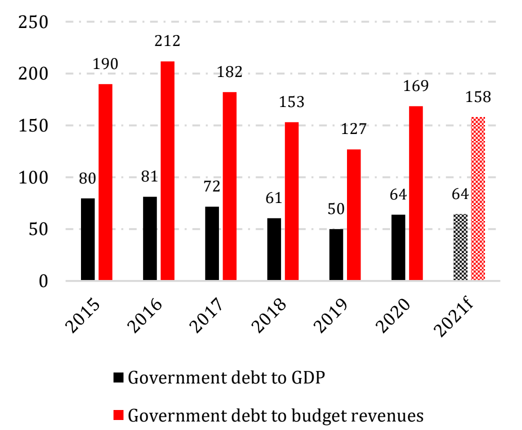
Source: RAEX-Europe calculations based on data from the **SOURCE**

Graph 2: Fiscal budget dynamics, % of GDP



Source: RAEX-Europe calculations based on data from the **SOURCE**

Graph 3: Government debt dynamics, %



Source: RAEX-Europe calculations based on data from the **SOURCE**

The authorities temporarily loosened fiscal, monetary and financial policies to absorb the shocks, and financing has been requested from the IMF to support government measures and the economy. Due to the low base effect, economic growth in 2021-2022 is projected to return to pre-crisis levels of around 3% per annum. Positive drivers for stronger growth may come from the removal of anti-pandemic restrictions, positive trends in external markets and progress in achieving structural reforms.

Fiscal policy was loosened in response to the COVID-19 crisis. Due to impressive fiscal consolidation and pension reforms in 2017, the overall fiscal deficit was limited throughout 2016-2019 to average 2%. However, as response to COVID-19, the fiscal policy was temporarily loosened, and a widening of the deficit is estimated to reach 7,8% of GDP in 2020 (see Graph 2) driven by both lower tax revenues, mainly from private business, tax relief for small and medium-sized enterprises and wider expenditure on social support and health care.

We expect a gradual return to fiscal consolidation this year. However, as the government proposed to increase the minimum wage by 30% during the year, this factor can slowdown the consolidation. Fiscal space and a capacity to finance government spending will also depend on the cooperation with the IMF, which has put forward a number of necessary conditions for continued financing. These key anchors include the steps towards strengthening the independence of the National Bank, intensifying work on problem loans of SOBs, creating a land market and removal of the state regulation of gas prices for households, and more determined efforts against corruption.

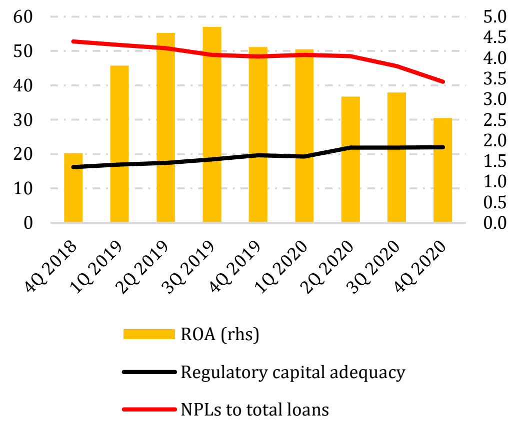
The government financing shortfalls are fully covered by new borrowing. The level of the gross government debt[1] of Ukraine grew dramatically and reached 63,9% of GDP in comparison with 50,3% a year earlier (see Graph 3). Apart from the active build-up of new debt, the revaluation of FX liabilities due to a 20% appreciation of the UAH against USD in 2020 has contributed significantly to the increase in debt levels. The share of FX liabilities stood at 65% at the end of 2020, so the debt position is highly sensitive to currency risks on the back of a weak UAH. The debt position has a high concentration on bonds, (65% of total debt), while loans from IFIs and governments account for only 19%.

However, the authorities have made steps to diversify the debt and signed a new concessional USD 5 bn stand-by agreement with the IMF last year. This agreement is aimed at supporting Ukraine's macroeconomic and financial stability and covers, among other matters, fiscal, monetary,

[1] State debt and State guaranteed debt.

financial sector, energy and anti-corruption policies. In June 2020, the first tranche USD 2,1 bn was disbursed to finance the budget deficit. Besides, we assess the liquidity risks as low, due to the fact that the average maturity of the government debt is 7 years, and the short-term debt to GDP is estimated at 11,7% in 2021 and covered 1,3x by reserves.

Graph 4: Financial soundness indicators, %

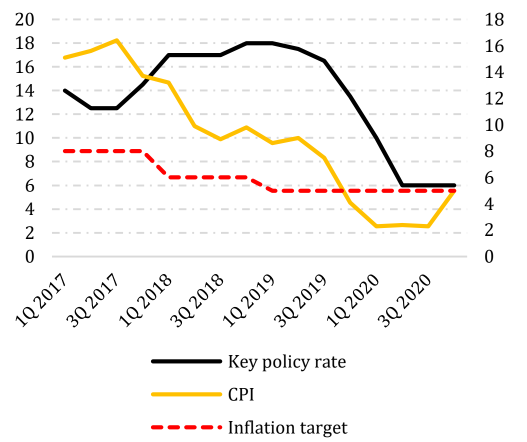


Source: RAEX-Europe calculations based on data from the **SOURCE**

The banking sector continues to cleanse assets from problem loans. The banking sector is stagnating, with the number of banks contracting from 96 to 73 since 2016, with the concentration on SOBs remaining at just over 50%. The sector's profitability declined by 30% in 2020, with the government Privatbank accounting for more than 50% of the profits; without taking this bank into account, the sector would present negative profitability. Profitability indicators for ROE and ROA at the end of 2020 were 20% and 2,5%, compared with 34% and 4,3% at the end of 2019. At the same time, regulatory capital increased by 21% y-o-y and regulatory capital adequacy was 22%, well above the minimum threshold of 10% (see Graph 4). Dollarization of deposits in the banking sector does not present a significant risk and is gradually declining, dropping to 38% as of the end-2020.

Net assets of the banking system increased by 15% over 2020, mainly due to an increase in the share of domestic bonds on banks' balance sheets. Lending remained subdued, but rebounded in 2H 2020, allowing net lending to increase by 6%. At the same time, lending rates continued to fall, narrowing interest margins.

Graph 5: Target vs inflation rate, %

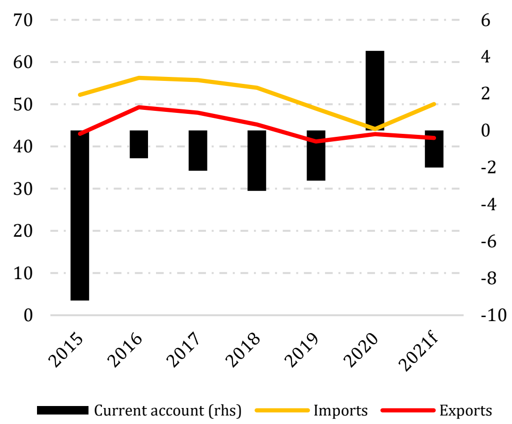


Source: RAEX-Europe calculations based on data from the **SOURCE**

The main risk to Ukraine's banking system is the high amount of the low quality assets. In early 2017, the NBU introduced new internationally accepted rules for the classification of problem loans, which recognize NPLs that are more than 90 days overdue and those for which timely repayment is unlikely. As a result, the average NPLs for the sector soared to over 50%. A positive trend in the reduction of NPLs has been evident since 2019, due to both increased lending activity and restructuring of loans by SOBs. Furthermore, banks continue to sell NPLs and write them off. Thus, the share of NPLs declined to 41% as of the end of 2020. Specifically, SOBs reduced the share of NPLs from 63,5% to 57,4%. In addition, provision coverage of problem loans is favorable. However, despite the positive trend, the negative impact of the pandemic could lead to a deterioration in payment discipline and worsen the situation with problem loans.

Monetary policy was eased. In the first half of 2020, the NBU implemented an accommodative monetary policy by reducing the key policy rate by 7,5p.p. to a historic low of 6% (see Graph 5). During the year, household deposit rates and the cost of corporate UAH loans fell by more than 6p.p. while remaining accommodative, monetary policy remains focused on price stability and exchange rate flexibility. At the same time, the central bank retains autonomy and independence in decision-making and monetary policy remains focused on implementing inflation-targeting policies and preserving exchange rate flexibility. Inflation was successfully curbed in 2019 and fell to 4,1%. In 2020, year-end inflation accelerated but was at the NBU target of 5%, which is influenced by temporary pro-inflationary factors and further inflationary pressures will be contained by weak domestic demand and a slowdown in devaluation.

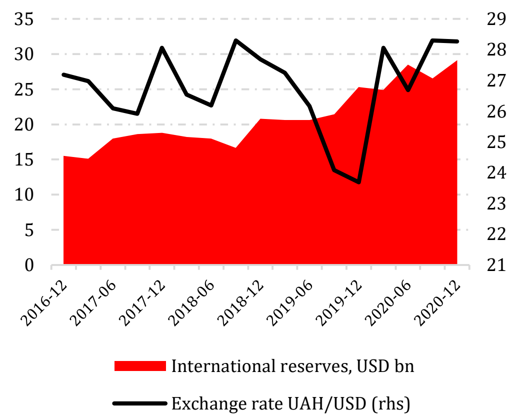
Graph 6: External sector indicators, % of GDP



Source: RAEX-Europe calculations based on data from the **SOURCE**

International reserves strengthened thanks to a favorable external position. For 2020, the current account balance ran a surplus of 4,7% of GDP as compared to a deficit of 2,7% a year earlier (see Graph 6). Trade deficit contracted drastically as exports showed resilience to the COVID-19-related recession, while imports have shrunk by 18% due to the lower domestic demand following the introduction of anti-pandemic measures and lower global energy prices. Migrant remittances support the current account and were maintained at figures of 2019, as there is a high demand for Ukrainian workers in countries such as Poland. The current account surplus has reduced external financing needs and strengthened international reserves by 15% to USD 29,1 bn (see Graph 7). This is equivalent to about 5 months of imports next year by the end of 2020.

Graph7: International reserves and exchange rate



Source: RAEX-Europe calculations based on data from the **SOURCE**

Stress or Support factors:

- In 2014, following the self-proclaimed Donetsk and Luhansk People's republics, a military campaign was launched in the eastern Ukraine, so called the Joint Forces Operation. Ukraine, Russia, the self-proclaimed republics, and the OSCE agreed to a roadmap for an end to the conflict on 1 October 2019, but even in the late 2020, an end to the conflict was not in sight. (weak stress-factor)

SENSITIVITY ASSESSMENT:

The following developments could lead to an upgrade:

- Substantial rehabilitation of the banking system with an accelerated reduction in non-performing loans;

- Continuation of government reforms, ensuring independence of monetary authorities to allow access to concessional funding;
- Faster than expected fiscal consolidation and reduction of the government debt level.

The following developments could lead to a downgrade:

- Delaying or reversing reforms, which could lead to worsening access to external finance and pressure on government finances;
- Further deterioration of the government debt position if the continuation of the pandemic crisis prompts continued fiscal loosening.

ESG Disclosure:

Inherent factors

- Quality of fiscal policy; quality of monetary policy; natural resources; natural and climatic threats; environmental threats; level of corruption, CPI; Government Effectiveness Index; quality of the business environment; position in Doing Business Ranking; level of investment in human capital, adjusted for inequality; Rule of Law Index; transparency of government policymaking Index; level of information transparency of the government; Political Stability and Absence of Violence/Terrorism Index; natural disasters, constant exposure to difficult natural conditions.

Drivers of change factors

- None.

Next scheduled rating publication: **20 August 2021.** The full sovereign rating calendar can be found at Sovereign Rating Calendar 2021

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Minute's summary

The rating committee for Ukraine was held on 26 February 2021. The quorum for the rating committee was present. After the responsible expert presented the factors, which influenced the rating assessment, the members of the committee expressed their opinions and suggestions within the framework of the Sovereign methodology. The chairman of the rating committee ensured that every member of the committee expressed his/her opinion before proceeding to the voting.

The following methodology was used for the rating assessment: Methodology for Assigning Sovereign Government Credit Ratings – Full Public Version (from April 2019). Descriptions and definitions of all rating categories can be found under the Rating scale section. The user of the rating shall read the methodology in order to have a full understanding of the rating procedure.

The definition of default can be found on the Agency's website in the section for Internal policies.

These ratings are unsolicited. The rated entity did not participate in the rating process. DISCLOSE IF ANY OTHER THIRD PARTY PARTICIPATED IN THE PREPARATION OF THE RATING.

Main sources of information: World Bank, International Monetary Fund, National Bank of Ukraine, Ministry of Finance of Ukraine, State Statistic Service of Ukraine, World Federation of Exchanges.

ESG Disclosure

We consider Environmental, Social, and Governance (ESG) risks and opportunities in the creditworthiness analysis of our Sovereign entities. The disclosure document can be found on the Agency's website in the section: ESG factors in RAEX-Europe's Credit Ratings

Limits of the Credit Rating

During the rating assignment process, Rating-Agentur Expert RA GmbH (the Agency) used publicly available information that was considered to be reliable, complete and non-biased. The responsible expert performed the rating assessment of the country with information considered as the most reliable and up to date in accordance to the overall position of the country and the Agency's internal criteria for selecting data providers. The information and data used for this specific assessment can be considered as of sufficient quality.

Regulatory use

SGC ratings can be used for regulatory purposes according to the ESMA definition.

Conflict of interest

The responsible expert was neither influenced nor biased by third parties during the rating assessment. All employees involved in the rating assessment and revision of the rated entity have reported absence of conflicts of interests before initiation of the rating process.

Rating-Agentur Expert RA GmbH is completely independent from the activities of other agencies of the RAEX group.

Risk warning

The Agency disclaims all liability in connection with any consequences, interpretations, conclusions, recommendations and other actions directly or indirectly related to the conclusions and opinions contained in the Agency's press-release and research report.

This press-release represents the opinion of Rating-Agentur Expert RA GmbH and is not a recommendation to buy, hold or sell any securities or assets, or to make investment decisions.

Office responsible for preparing the rating

The office responsible for the preparation and issuance of this credit rating is the office of Rating-Agentur Expert RA GmbH in Frankfurt am Main, Germany.

Rating-Agentur Expert RA GmbH is a credit rating agency established in Germany and therefore shall comply with all applicable regulations currently in force in the European Union.

The European Securities and Markets Authority (ESMA), the EU's direct supervisor of credit rating agencies (CRAs), has registered Rating-Agentur Expert RA GmbH as a CRA under Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies, with effect from 1 December 2015.

Rating-Agentur Expert RA GmbH applies the Code of Conduct Fundamentals for credit rating agencies issued by the International Organization of Securities Commissions (IOSCO Code) and includes the basic principles of IOSCO Code in its Code of Conduct.