Research Report on Ukraine

18 February 2022

Responsible Expert:

Denys Anokhov
Rating Associate

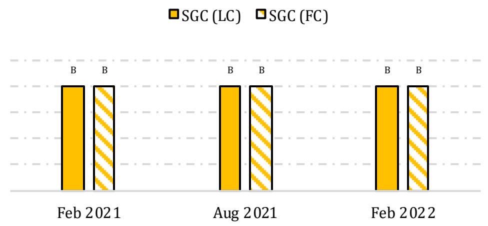
For further information contact:
Rating-Agentur Expert RA GmbH (RAEX-Europe)
Walter-Kolb-Strasse 9-11,
60594 Frankfurt am Main, Germany
+49 (69) 3085-45-00 ext. 1212
E-mail: anokhov@raexpert.eu
www.raexpert.eu

Ratings

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

* These ratings are unsolicited

Ratings dynamics



Main Economic Indicators of Ukraine

Macro indicators	2019	2020	2021e
Gross gov. debt, UAH bn	2008,2	2551,9	2671,8
Nominal GDP, UAH bn	3977,2	4191,9	5213,0
Real GDP growth, %	3,2	-4,2	3,2
Gross gov. debt/GDP, %	50,5	60,9	51,3
Deficit (surplus)/GDP, %	-2,0	-6,0	-3,6
Inflation rate, %	4,1	5,0	10,2
Current Account Balance/GDP, %	-2,7	6,6	-1,1
External debt, USD bn			125,0*
Development indicators		**2021**	
Inequality adj. HDI		0,728**	
GDP per capita, USD th		14,1	
Default indicator		**18.02.2022**	
10Y Gov Bond Yield, %		11,25	

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 3Q 2021 **as of 2019

RAEX-Europe confirmed at ‘B’ the ratings of Ukraine with negative outlook. The ratings are withdrawn.

RAEX-Europe confirmed 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 changed from stable to negative, which means that in the mid-term perspective there is a high probability of downgrading the rating score.

Summary

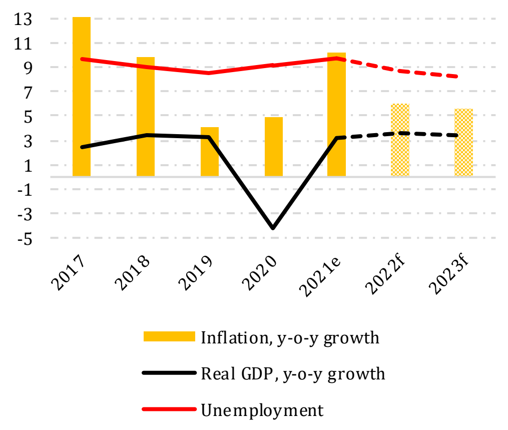
The Agency maintained the current sovereign credit ratings at ‘B, which are supported by the rebound in economic growth, improved management of public finances, and positive dynamics of the banking system indicators.

Meanwhile, our decision to change the outlook to negative mainly reflects the increased tension in relations with Russia and the threat of an escalation of the military conflict in eastern Ukraine, which could lead to increased external financial risks for the country through capital outflows, restrictions on financing and a decrease in international reserves.

The economy is recovering from the negative impact of COVID-19 pandemic. Rebound of economic activity in 2021 with GDP growth accelerating in Q3 is attributable to support from agricultural exports and strong domestic consumption. GDP growth for the year is estimated at 3,2%, which is lower than in our previous forecast (see graph 1). The government is taking active measures to reduce the risks of lockdowns and increased pressure on the healthcare system by encouraging people to get vaccinated through cash incentives. As of February 13, 2022, 36,3% of the population is fully vaccinated in Ukraine.

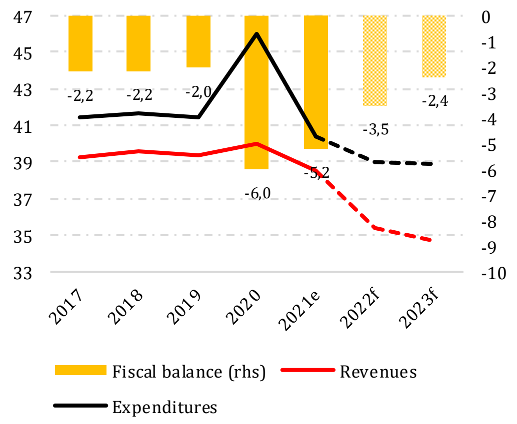
The Agency expects GDP growth at the level of 3%-3,5% in 2022, with a restraining effect caused by increase of gas prices and decrease of domestic demand. In addition, threat of a military conflict with Russia creates a high degree of uncertainty and puts additional pressure on the economic growth forecasts.

Graph 1: Macroeconomic indicators, %



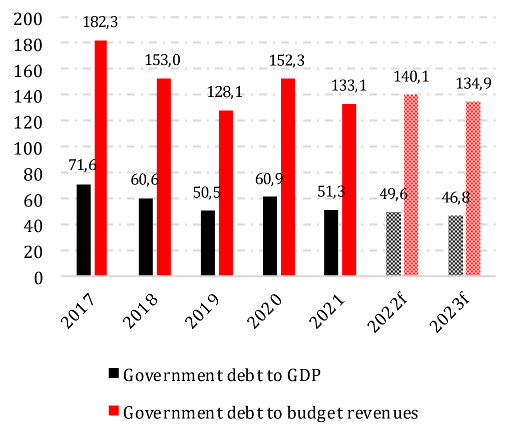
Source: RAEX-Europe calculations based on data from IMF, National Bank of Ukraine and State Statistic Service of Ukraine

Graph 2: Fiscal budget dynamics, % of GDP



Source: RAEX-Europe calculations based on data from IMF and Ministry of Finance of Ukraine

Graph 3: Government debt dynamics, %



Source: RAEX-Europe calculations based on data from IMF and Ministry of Finance of Ukraine

Budget deficit is showing positive dynamic. In 2021, the consolidated budget deficit narrowed more significantly than we had previously projected. Tax revenues supported budget revenues and despite higher-than-expected pension spending, the consolidated budget deficit in 2021 was 3,6% of GDP. Higher revenues allowed the authorities to expand spending on road construction and repair, utility subsidies for households, pay raise for military personnel, and other social needs.

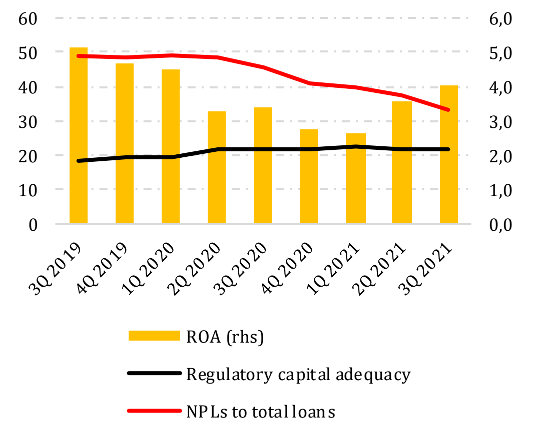
The Agency forecasts that given current government spending plans the consolidated budget deficit will remain at 3,5% of GDP in 2022 (see graph 2). The overall financing needs in 2022 are projected to be moderate and expected to be covered mainly by domestic debt and funds of international financial institutions.

Public debt declined by almost 10 p.p. in 2021. After rising to 61% in 2020 due to depreciation of the national currency, the public debt level fell to 51,3% of GDP in 2021 (see graph 3). Despite concessional financing, the debt position is characterized by a high concentration of bonds (65,3% of total debt). Moreover, the share of debt denominated in foreign currency (mostly in US dollars) remains high and stable at 62%, so the debt position is highly sensitive to currency risks. At the same time, we assess liquidity risks for the government as low due to the favorable average maturity of public debt of 7 years. The current level of short-term debt to GDP is 8% and it is covered 2x by international reserves.

Continued cooperation with the IMF is an important factor for Ukraine to gain access to external financing. In 2021, the IMF completed the first review of the stand-by program for Ukraine and based on its results decided to grant the country the second tranche of USD 699 mln, extending the program until June 2022. Under the program, the Ukrainian authorities pledged to maintain the fiscal policy in accordance with medium-term debt sustainability, ensure the independence of the central bank and focus on aligning inflation with target levels, ensure financial stability of the banking system, fight corruption and promote judicial reforms. In cases of accelerated realization commitments are accelerated, the program's remaining funds of USD 2,3 bn are expected to be released in 2022.

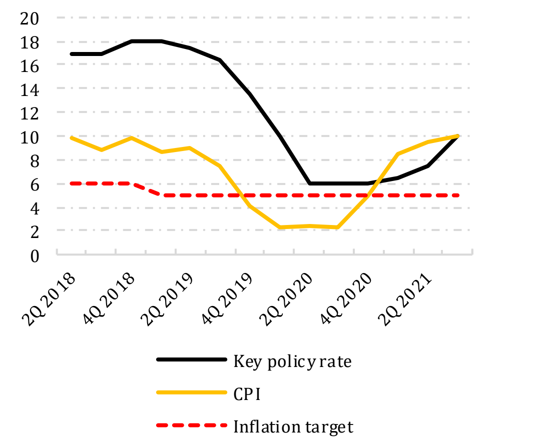
Inflationary pressure is growing. Inflation accelerated significantly from the end of 2020, reaching 11% in September 2021 (see graph 5), what was driven by strong consumer demand, rising global commodity prices and growth of wages. Since late 2021,

Graph 4: Financial soundness indicators, %



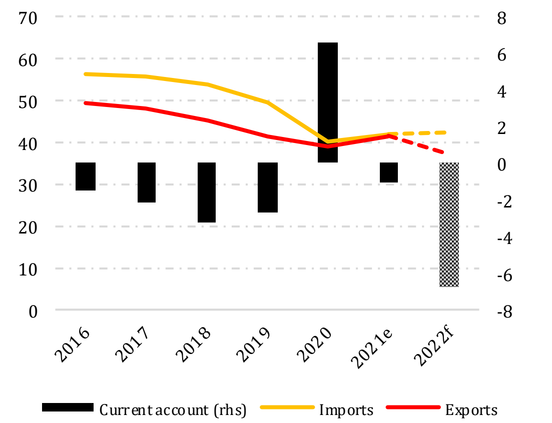
Source: RAEX-Europe calculations based on data from IMF and National Bank of Ukraine

Graph 5: Target vs inflation rate, %



Source: RAEX-Europe calculations based on data from IMF and National Bank of Ukraine

Graph 6: External sector indicators, % of GDP



Source: RAEX-Europe calculations based on data from IMF, World Bank and National Bank of Ukraine

inflation has slowed due to tighter monetary policy, record agricultural output and stabilization of utility tariffs.

However, inflationary pressure will continue in 2022. The recent jump in gas prices has so far had a limited inflationary impact due to fixed-price gas contracts for households, but it is expected to gradually translate into higher food price inflation.

Due to increased inflation risks, the NBU worsened its inflation forecast for 2022 from 5% to 7,7% (the target range of 5%±1%). The regulator continued to tighten monetary policy: the discount rate was raised by 4 p.p. to 10% during the year.

The banking system shows positive results. The banking sector demonstrated a more moderate growth in 2021 (6,8% y-o-y), although recovery from the COVID-19 crisis has contributed to easing lending conditions and growth in corporate and retail lending in 1H 2021. The growth rate of consumer loans is returning to pre-crisis levels, the growth of net corporate loans accelerated in 2Q 2021. Nevertheless, bank lending to the economy remains low.

Profitability indicators improve the sustainability of the banking system: due to the rapid growth of operating income, ROE rose to 35,2%, and ROA to 4,1% as of December 2021 (see graph 4). The main drivers of profitability in the banking sector were further growth in operating efficiency and a significant reduction of provisions for reserves. Thus, the annual increase in net interest income and commission income was 39% and 25%, respectively. Banks are continuing building up regulatory capital, which increased by 13,7% y-o-y as of September 2021. Regulatory capital adequacy stood at 21,6%, well above the minimum threshold of 10%. Dollarization of banks' deposits and loans continues to decline: the share of deposits in foreign currency amounted to 35,6% and the share of corporate loans in foreign currency – to 36,4% at the end of 3Q 2021.

During the pandemic, share of non-performing loans continued to decline, driven by both increased lending activity and SOB’s loan restructurings. Thus, the percentage of NPLs fell to around 30% as of December 2021, down from 41% a year earlier. In the banks of foreign banking groups and banks with private capital, the share of NPLs decreased to less than 10%. However, despite positive dynamics and high NPL provisioning ratio (close to 90%), large amount of low-quality assets is a major risk for Ukraine's banking system.

The external position is showing signs of weakness. Despite a favorable results of the agricultural sector and rising prices on foreign commodity markets, growth in imports of goods and services, as well as 2x growth of investment payments led to a transition from surplus to current account deficit of 1,1% of GDP (see graph 6). During 2021, the NBU has been accumulating international reserves, but as of 01.02.2022 the reserves have not significantly exceeded the reading of beginning of 2021 and amount for USD 29,3 bn covering 4,6 months of imports.

In 2022, the external position is expected to be affected by a number of negative factors, including the outflow of funds from government debt due to the geopolitical risks, decline of Ukraine's gas transit revenues, and the outflow of funds associated with reinvested earnings. Combined with the limited opportunities for external financing, this situation may lead to the weakening position of international reserves.

Stress factor:

- The military conflict in eastern Ukraine involving the self-proclaimed Donetsk and Luhansk People's Republics has dragged on since 2014. The conflict periodically escalates, and there is still no progress on the road map drawn up by Ukraine, Russia, the DPR, the LPR, and the OSCE. Buildup of Russian troops near Ukraine's border increases the risks of further military conflict and puts additional pressure on the credit ratings (moderately 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;
- Reduction of geopolitical tensions, which will lead to macroeconomic stability, strengthening the external position and favorable prospects for economic growth.

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.
- Implementation of a negative scenario of a military conflict with Russia, which would lead to negative economic consequences, deterioration of government finances and external position.

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: N/A. The full sovereign rating calendar can be found at Sovereign Rating Calendar 2022.

For further information contact:

Responsible expert:
Denys Anokhov, Rating Associate of RAEX-Europe
+49 (69) 3085-45-00, ext. 1212
anokhov@raexpert.eu

Reviewer:
Mikhail Kaptsov, Rating Analyst of RAEX-Europe
+49 (69) 3085-45-00, ext. 1216
kaptsov@raexpert.eu

Rating-Agentur Expert RA GmbH (RAEX-Europe)
Walter-Kolb-Strasse 9-11,
60594 Frankfurt am Main, Germany
+49 (69) 3085-45-00
E-mail: info@raexpert.eu
www.raexpert.eu

RATING HISTORY:

Date	Review reason	SGC		Outlook	
		National currency	Foreign currency	National currency	Foreign currency
20.08.2021	Scheduled review of both types of ratings for the country	B	B	Stable	Stable
26.02.2021	First assignment of both types of ratings for the country	B	B	Stable	Stable

Minute's summary

The rating committee for Ukraine was held on 18 February 2022. 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 August 2020). 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.

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.