Focus
**Ukraine**

Scope
**Economics**

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# Quarterly Report

## Muddling through Election Cycle

**23 JANUARY 2019**

READ THE DISCLOSURES SECTION FIRST FOR IMPORTANT DISCLOSURES AND ANALYST CERTIFICATION

# Contents

# Executive rundown

**IMF: SBA program helps Ukraine to muddle through the election year.** IMF approval of the new SBA program significantly raises Ukraine's ability to repay the US$9bn FX debt coming due in 2019. However, even with the $1.2bn external financing available in total from the EU and the guarantees provided by the World Bank, the government will have to refinance 100% of domestically issued FX bonds, and come to the capital markets for $1-2bn Eurobond issuance. The government will have to repay US$8.3bn of domestic FX and local-currency bonds in 2019, including US$5.4bn in 1H19. In case markets are unfavourable, the government will have to ask the IMF to redirect one of the SBA tranches to the state budget. April–May are critical for the government's efforts to secure financing of external debt payments, as they peak at $1.6bn in September.

**Fiscal policy: More restrained on risks of underperforming budget revenues.** The IMF praised Ukraine's 2019 state budget as sound, as its revenue assumptions are conservative, current spending is contained and deficit is targeted at 2.3% of GDP. However, budget revenues still face high risk of underperformance, which may nudge the government to spend even more cautiously this year. Eventually, such restrained fiscal policy will negatively affect domestic demand and quell inflation, although at the cost of slowing economic growth.

**Monetary policy: Remains tight with cautious rate decrease.** NBU will maintain tight monetary policy focused on bringing inflation down to the target of 5±1%. Both ICU's and NBU's forecasts predict that the YE2019 inflation will be north of this range. However, the risk of inflation rising significantly above the target remain and will determine the conservative behavior of the NBU throughout the year. Regulator might commence the cycle of rates decrease as early as January 2019 by cutting the key rate by 50bps as the current rhetoric suggests but will abstain from dramatic moves. We expect the key rate to reach 16% by the end of 2019 (-200bps from current). UAH deposit rates will gradually decline in 1Q19 by 100bps and will follow the path of the NBU's monetary policy. As for corporate lending, average rates on UAH loans may decrease by 400bps to 17% by the end of 2019.

**Banking sector: Profit recovery will be slow but steady.** In 2018, the sector returned to profitability due to moderate provisioning expenses and strong interest margins. However, scarcity of creditworthy corporate borrowers still constrains Ukrainian banks. High interest rates boosted by the NBU's key rate hikes is another key obstacle to corporate-lending growth. At the same time, consumer lending should expand by a further 30% YoY in 2019, driven by households' high demand for credit and banks' seeing it as an opportunity.

**GDP and inflation: Weighed by tighter policies and cooling world markets.** We maintain our forecast of Ukraine's 2018 real GDP growth at 3.5%, boosted by rising household incomes and business investments. In 2019, we expect GDP growth to slow to 2.3%. The key headwinds will be more cautious spending by the government, tight monetary policy of the NBU, a slowing global economy, and weaker commodity markets. These factors will also depress inflation, which should slow to 8.5% by YE2019. We see further growing incomes and high inflation expectations during the election period as the key risks, which should drive inflation above the NBU's target range as of YE19.

**UAH: Soft deprecation to continue; elections bring more uncertainty.** A slowdown in trade-deficit growth, further growth in remittances from labour migrants and a decline in dividends' repatriation will be supportive for the current account and the hryvnia in 2019. The current-account deficit should shrink to 3.3% of GDP in 2019 from 3.8% in 2018. Tight UAH liquidity caused by restrictive policies, as well as robust supply of hard currency from agri exporters should keep the hryvnia near the UAH28/USD level in 1Q19. We expect the national currency to go through its seasonal strengthening in 2–3Q19, and then resume its soft depreciation to UAH29.5/USD by year-end. At the same time, devaluation expectations and the election-year factor introduce substantial uncertainty and downside risk to our FX forecast.

# Sovereign debt: IMF helps to muddle through election cycle

- **IMF approval of a new SBA program significantly increases Ukraine's chances of repaying US$9bn FX debt in 2019**
- **To repay debt in 2019, the government either has to refinance 100% of domestic debt repayments in FX and issue US$1bn Eurobonds, or ask for the IMF's tranche**
- **1H19 is fraught with heavy domestic debt repayments**

## IMF SBA program unlocks external financing

The IMF's approval of a new stand-by assistance (SBA), 14-month, $3.9bn programme significantly increases the chances that Ukraine will be able to meet its FX obligations in 2019. As a result, in December, Ukraine received the first US$1.4bn tranche from the IMF, the first EUR500m tranche of EU's macro-financial aid from the EU, and US$750m in credit guarantees from the World Bank.

*IMF deal has unlocked financial aid from the EU and the World Bank, and given access to financial markets*

The Memorandum on Economic and Financial Policies, which Ukraine plans to follow during the SBA programme's implementation during 2018–2020, contains eight structural benchmarks (Table 1). The benchmarks take into account Ukraine's reduced ability to make reforms during the election period, and they look to be less demanding compared with previous IMF programmes. However, they still require the political will of Ukrainian authorities. The IMF will decide on further tranches in May and November 2019, depending on Ukraine's success in fulfilling the terms of the Memorandum.

Table 1. Structural benchmarks of Ukraine's cooperation with the IMF on the SBA program

| | Structural benchmark | Term of implementation |
|---|---|---|
| 1 | Increase of heating tariffs from January 1, 2019 | End of December 2018 |
| 2 | Changing NBU rules for reducing regulatory capital by volume of loans to related parties | End of December 2018 |
| 3 | Passing the Split law to revise the distribution of supervision powers over financial intermediaries | End of March 2019 |
| 4 | Report on the progress of asset recovery and litigation involving the four state-owned banks | End of March 2019 |
| 5 | Division of the State Fiscal Service (SFS) into the Tax Service and the Customs Service | End of April 2019 |
| 6 | Appointment of at least 35 anti-corruption judges for work at the Highest Anticorruption Court | End of April 2019 |
| 7 | Supervisory measures by the NBU against banks that do not meet capital requirements | End of June 2019 |
| 8 | Completion of the external audit of the National Anticorruption Bureau of Ukraine | End of July 2019 |

Sources: Ministry of Finance of Ukraine

We estimate the government has $2bn in its FX accounts as of YE2018. To cover debt $9.2bn of repayments coming due in 2019, the government will use $1.2bn of financial assistance from the EU and the World Bank. If Ukraine manages to refinance 100% of $4.3bn domestic FX bonds, it will still have to borrow $1-2bn on the financial markets. The political uncertainty of the double elections, as well as the likely unfavourable market conditions make issuing sovereign Eurobonds a challenging task in 2019. In the worst case, the government may need to seek IMF approval to redirect the next tranche directly to the state budget.

Table 2. Government FX debt payments and their funding, 2019 (US$bn)

| | | | |
|---|---|---|---|
| Government FX accounts at 1Jan19 | 1.4 | | |
| Government FX funding | 8.5 | Government FX debt payments | 9.2 |
| IMF | 1.0 | IMF | 1.0 |
| Eurobonds | 2.0 | Eurobonds | 0.7 |
| World Bank | 0.6 | US Guarantee | 1.0 |
| EU | 0.6 | Other external debt repayments | 0.5 |
| Domestic FX bonds | 4.3 | Domestic FX bonds | 4.3 |
| | | Interest payments | 1.7 |
| Assumed balance at the end of 2019 | 0.7 | | |

Sources: Ministry of Finance of Ukraine, World Bank, European Commission, IMF, ICU.

## April–May critical to secure financing of 2019 redemptions

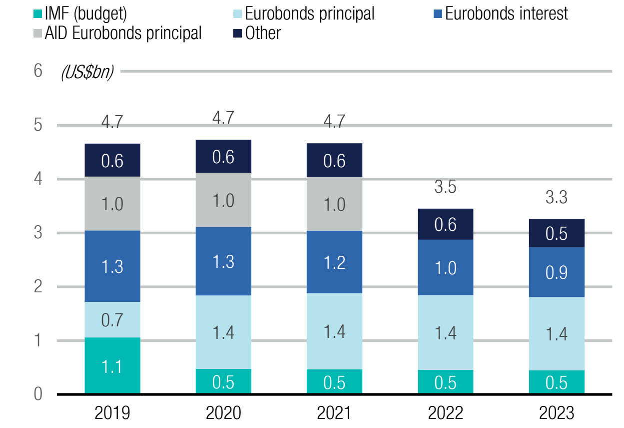
***Government should have enough funds for repayments in 1H19, but also needs to be prepared for big repayments in September***

With the currently available FX cash balance, expected financial aid from the EU, and loans issued under the WB guarantee, the government could make debt repayments through 1H19, but it will also need to borrow in the financial markets to secure September repayments.

The government has to repay US$4.7bn of external debt repayments, US$2.7bn of which is scheduled for 1H19 (Charts 1, 2). Ukraine's monthly debt repayments peak at US$1.4bn in May, and US$1.6bn in September. In May, the MoF has to redeem US$1bn of US-backed bonds (also called AID bonds), and in September, US$0.7bn of Eurobonds that were issued in 2015 during the sovereign debt restructuring.

Chart 1. Ukraine's external debt annual payments

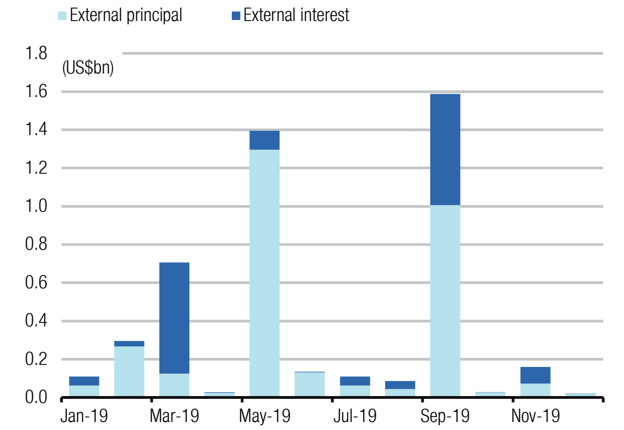
*Ukraine has to repay $4.7bn of external debt each year in 2019-21*




Source: Ministry of Finance of Ukraine, ICU.

Chart 2. Ukraine's external debt monthly payments

*External debt payments peak to US$1.4bn in May and US$1.6bn in September 2019*




Source: Ministry of Finance of Ukraine, ICU.

***New external borrowings will cover repayments only with full refinancing of domestic FX-denominated bonds***

At the beginning of 2019, we estimate that the government has accumulated at least a US$1.4bn FX cash balance. With borrowings under the WB guarantee, the government should be able to repay debt until the end of May, but only if it manages to refinance 100% of payments for FX-denominated domestic bonds. The second EUR500m tranche from the EU should support the government in debt repayments until the year's second peak in September. However, to fund the peak September payment, the government would need to raise at least an additional $1bn in the financial markets. Therefore, Ukraine will need to issue Eurobonds no later than May, otherwise it may have to request that the IMF directs the next tranche to the state budget.

## Need to fully refinance domestic bonds will boost their cost

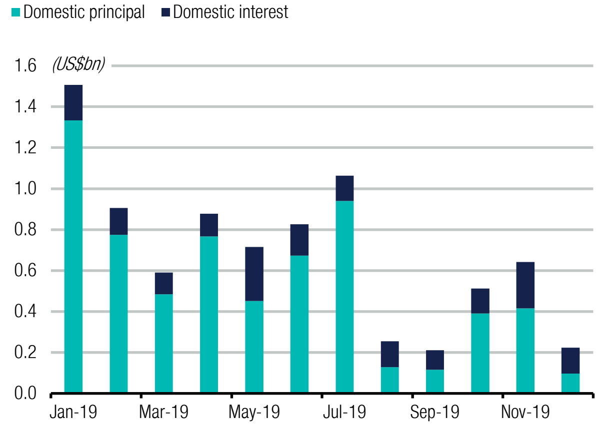
*In 2019, MoF has to repay US$8.3bn of domestic bonds, including US$4.5 in FX bonds, and UAH107bn in local-currency bonds*

Given significant debt repayments in 2019, the government will do its best to refinance 100% of domestic UAH and FX bonds maturing during this period.

During 2019, the government has to repay US$4.5bn (including interest) on FX-denominated bills, US$2.7bn of which is scheduled for 1H19. For local-currency debt, the government has to repay about UAH107bn in debt repayments, including UAH76bn in 1H19 (US$3.8bn and US$2.7bn at current exchange rate, respectively). Therefore, in total, the government has to pay US$8.3bn in 2019, including US$5.4bn in 1H19 (see charts below).

Chart 3. Ukraine's domestic debt service by type

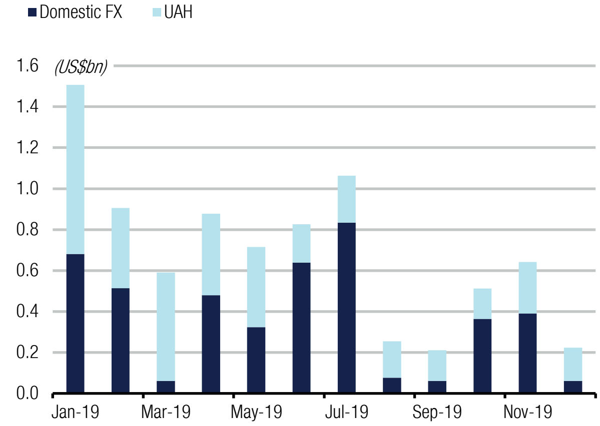
*65% of domestic bond payments should be made in 1H19*




Source: Ministry of Finance of Ukraine, ICU.

Chart 4. Ukraine's domestic debt service by currency

*1Q19 is the heaviest for domestic FX bond payments—45% of 2019*



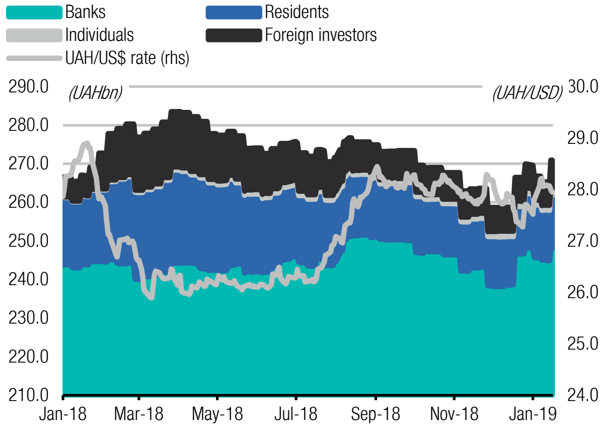

Source: Ministry of Finance of Ukraine, ICU.

*Government faces big challenge to refinance all domestic debt repayments, especially in 1Q19*

In 2018, demand for domestic bonds had critical support from investors in the three-month UAH bills. They either had moved back into FX bills or exited the Ukrainian market later in 2H18 (Charts 3, 4). However, in 2019, the majority of such investors are unlikely to enter positions in Ukrainian bills until they get a clearer vision of the elections outcome in April–May. Therefore, to make three-month bills attractive enough in 1Q19, the MoF will have to keep their rates at 19-19.5%, much higher than 18% cost of funding for banks, provided by the NBU.

Chart 5. Local-currency government bond portfolios

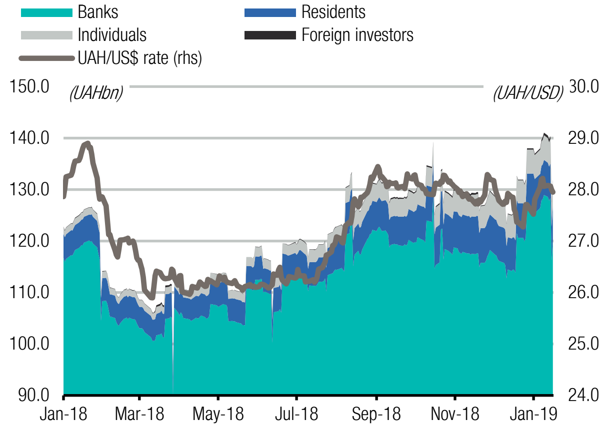
*Amidst election outcome concerns and devaluation expectations, portfolios of domestic UAH bonds continue to shrink*




Source: National Bank of Ukraine, Bloomberg, ICU.

Chart 6. FX-denominated bonds portfolios

*Portfolios of the government's FX-denominated bonds keep expanding*




Source: National Bank of Ukraine, ICU.

# Fiscal policy: More restrained

- **Ukraine likely ended 2018 with the budget deficit below the targeted 2.5% of GDP through underperforming the expenditure plan**
- **In 2019, the government plans to contain spending, but likely challenges in collecting revenues may lead it to pursue even more cautious fiscal policy**

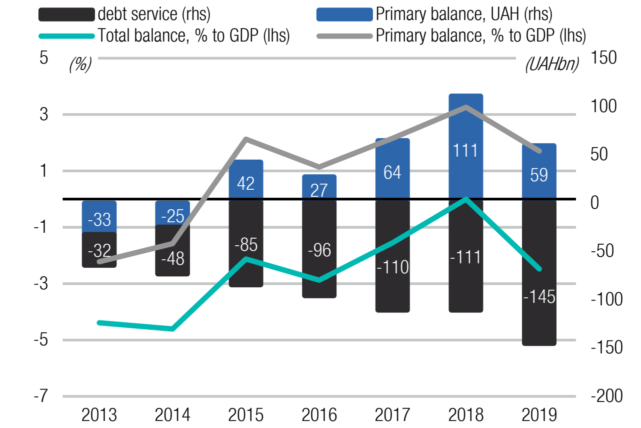
*The government manages to target budget deficit through underperformance of budget expenditures*

As the government traditionally achieves the targeted budget deficit through underperformance of its expenditure plan, this should also be the case for realizing the 2018 and 2019 state budget goals. In 10M18, the government underperformed the budget plan by 2% for revenues and by 8% for expenditures.

The 2019 state budget qualified for the IMF's recommendation. The Fund praised the 2019 budget as sound, as it contains conservative revenue assumptions, provides for containing current spending and has the budget deficit target at 2.3% of GDP. However, the revenue part of the budget still faces multiple risks of underperformance, which mean the government, subject to the IMF's scrutiny, may have to be even more cautious with spending compared with 2018.

Chart 7. Budget deficit

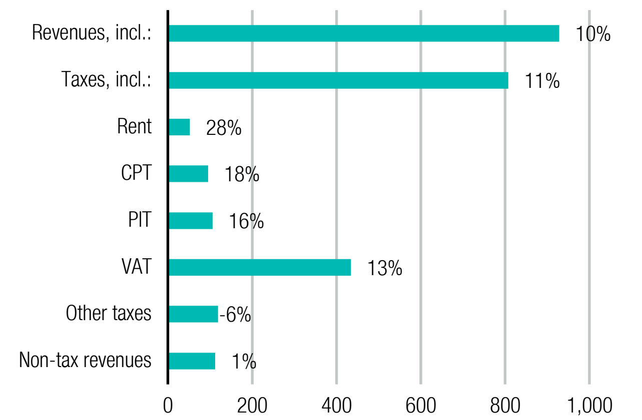
*The government targets an even lower budget deficit in the double-election year of 2019*




Source: National Bank of Ukraine, Bloomberg, ICU.

Chart 8. Key sources of budget revenue growth in 2019

*The key sources of budget revenue growth are subject to high risks*




Source: National Bank of Ukraine, ICU.

*Government has to be even more restrained in expenditures in 2019 to meet a 2.3% GDP deficit target*

In 2019, the government plans to increase general fund revenues by 10% or UAH86bn to UAH928bn, and expenditures by 12% or UAH99bn to UAH1tn. The main sources of the revenue increase are corporate profit tax (+UAH14bn or 18% YoY), rent from natural gas production (+UAH11bn or 28% YoY), and VAT (+UAH50bn or 13% YoY), see Chart 8.

However, cooling export markets, particularly for steel and iron ore, and slowing domestic demand, are likely to negatively affect corporate profits. As we expect average oil and natural gas prices to decline 2-5% YoY, a ramp-up in domestic gas production and the IMF-guided hike of gas tariffs for the population may be insufficient to raise gas royalties as planned. The same risks of slowing domestic demand and lower energy prices may impede the planned growth in VAT collection.

Additional high risks come from collection of funds from the NBU, which the government plans to increase by 36% or UAH12.7bn to UAH47.6bn. Availability of such funds will become known after the annual audit of the central bank, so they are highly uncertain. Finally, the likelihood of raising the planned UAH17bn from privatization is low in this double election year.

# BoP: Under less pressure

## Balance of payments: 2019 C/A deficit to taper off

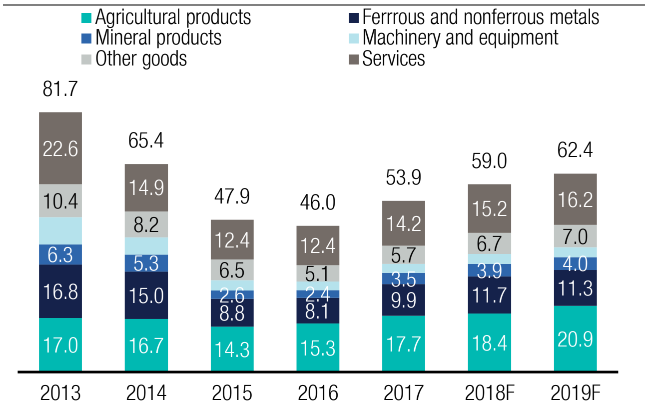
- **The trade-balance deficit will widen marginally in absolute terms, but shrink as a percentage of GDP, as lower prices and volumes weigh on energy imports**
- **The C/A deficit will contract to 3.3% of GDP thanks to higher volumes of private remittances and subsiding dividend repatriation**

***Lower metal and oil prices will push down both export and import growth rates in 2019***

We expect the trade-balance deficit to slip to 8.6% of GDP (US$12.5bn) in 2019, down from 9.1% of GDP (US$11.9bn) in 2018. In 2018, world oil prices grew 29% YoY versus 11–12% YoY growth in prices of Ukraine's main export revenue sources, steel and grains (Chart 12), which contributed heavily to the widening trade deficit. We expect this effect to wear off in 2019, with average prices of these three commodity segments changing mostly in line. Rising domestic natural gas production (+8% to 23bcm) will further help Ukraine to spend 5% less on energy imports in 2019. That said, imports will be driven mostly by consumer demand. At the same time, agriculture, food, and services will drive Ukraine's exports. Cooling export markets for steel and iron ore, as well as a further introduction of protectionist measures will be the key headwind for Ukraine's export revenues, and pose the key downside risks.

Chart 9. Exports from Ukraine (US$bn)

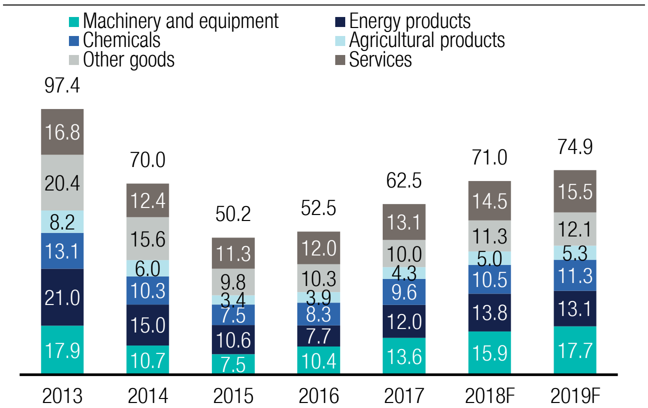
*Exports of agriculture, food products, and services will drive a 6% growth in exports in 2019*




Source: National Bank of Ukraine, ICU.

Chart 10. Imports in Ukraine (US$bn)

*Domestic consumer and investment demand will be the key engine of a 5% imports growth to Ukraine, while energy imports will subside by 5% in 2019*



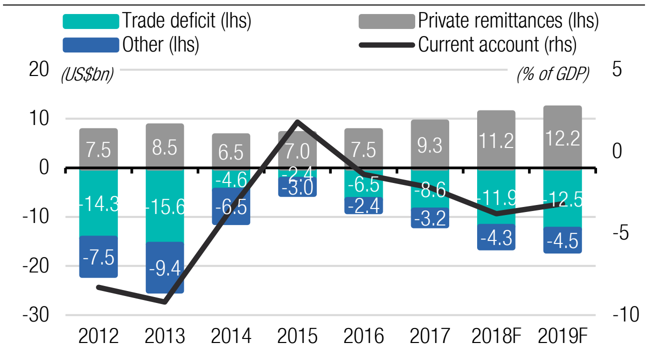

Source: National Bank of Ukraine, ICU.

***Rising remittances from labour migrants and lower dividend repatriation will cause the C/A deficit to contract in 2019***

While the trade-balance deficit is expected to rise marginally, the C/A balance will be supported by 1) further growth of private remittances from Ukrainian labour migrants, albeit at a slower pace—to US$12.2bn in 2019, from our estimate of US$11.2bn in 2018, and 2) decreased volumes of dividend repatriation, which should decline to US$3bn in 2019 vs. the estimated US$3.5bn in 2018. That said, we expect the C/A deficit to decrease to 3.3% of GDP (US$4.8bn) in 2019, down from an estimated 3.8% of GDP (US$5.1bn) in 2018.

Chart 11. Ukraine's current account (US$bn, % of GDP)

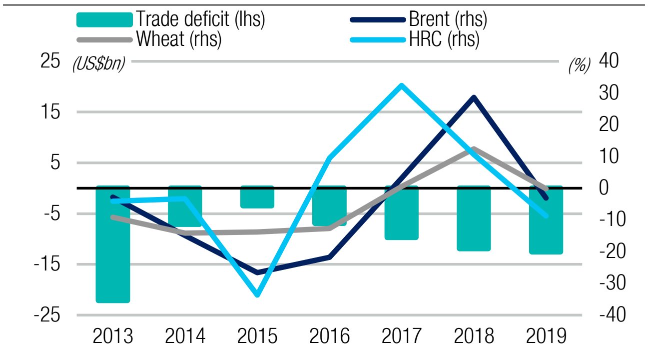
*Current account deficit will contract to 3.3% of GDP*




Source: State Statistics Service of Ukraine, ICU.

Chart 12. Ukraine's trade deficit (US$bn) versus growth in commodity prices (%)

*Oil prices sliding in line with grain and metals mean less pressure for trade balance*




Source: National Bank of Ukraine, ICU.

## UAH: Soft depreciation continues, but elections bring uncertainty

- **Hryvnia is unlikely to weaken significantly in 1Q19, supported by the National Bank and the government tight policies**
- **Elections, devaluation expectations, and softer export markets keep downside risks high for the UAH**
- **We assume no political shocks in our base case, and, hence, expect the national currency to seasonally strengthen to average UAH27.5/USD in 2Q19, and then depreciate to UAH29.5/USD by YE2019**

*We expect the hryvnia to temporarily rebound in 2Q19, before ending 2019 at UAH29.5/USD*

The hryvnia finished the year of 2018 unexpectedly strong, at UAH27.69/USD. We think that despite the traditional end-year headwinds, the key mitigating factors for the hryvnia were the successful unlocking of the IMF programme, the resulting FX inflows from the Fund and other international financial institutions in 4Q18, strong revenues of agri exporters, tight UAH liquidity and the government's moderate end-year payments from the budget.

Throughout 2019, we expect the hryvnia to continue its slight depreciation, driven by devaluation expectations and a widening external trade deficit. The latter, however, should slow down because of dropping energy prices and smaller growth in consumer demand. Furthermore, tight monetary and fiscal policies, at least in 1H19, will weigh on UAH liquidity and support the national currency. With political shocks absent, we see a slight depreciation of UAH to continue in 2019, with traditional seasonal strengthening driven by the demand for the UAH from agri exporters to take place in 2Q19.

Nevertheless, elections bring greater unpredictability to the hryvnia's 2019 outlook. Escalation of a political standoff may stem devaluation fears of the population, as well as domestic and foreign investors.

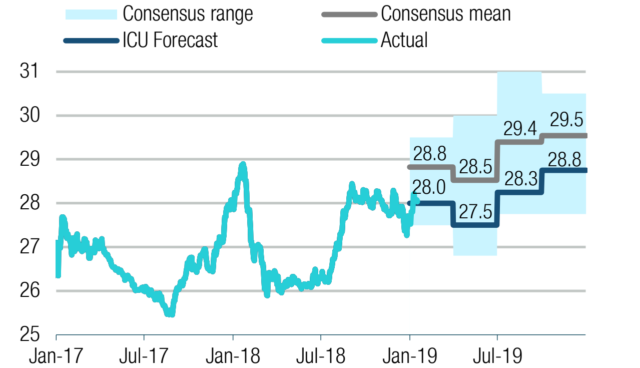
Chart 13. UAH/USD rate in 2016–19

*High devaluation expectations changed UAH's seasonal pattern in 2018, but the currency finished 2018 stronger than 12M ago*


Source: National Bank of Ukraine, Bloomberg, ICU.

Chart 14. UAH/USD forecast

*Given no political shocks, we expect the hryvnia to slightly depreciate over the course of 2019, with seasonal strengthening in 2Q19*




Source: National Bank of Ukraine, ICU.

# GDP and inflation: Slowing

## Economy: Weighed by tighter fiscal and monetary stance

- **Economic growth to slow to 2.3% in 2019**
- **Key headwinds are tight monetary and fiscal policies, as well as less favourable export markets**

*Private consumption to remain key growth booster through 2019*

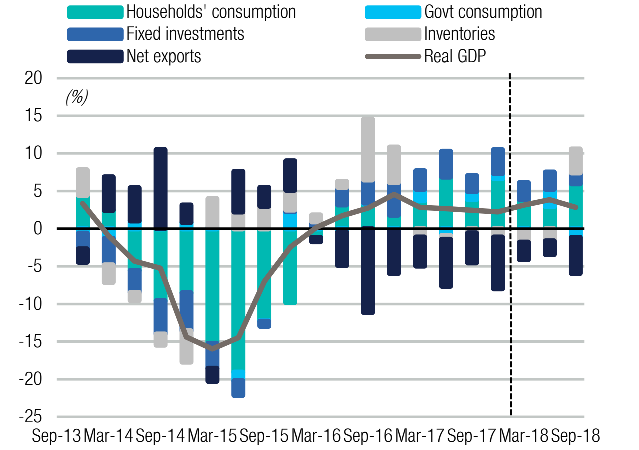
Household consumption will continue to drive economic growth next year, supported by rising real and nominal incomes. However, real GDP growth should slow to 2.3% in 2019, being under pressure from: 1) the NBU's tight monetary policy, which makes domestic credit more expensive, 2) cooling growth of Ukraine's main trading partners against the backdrop of a weaker global economy, 3) conservative fiscal policy due to the need to make large payments on state debt, and 4) souring business expectations given political and economic uncertainty in the election year.

*Real GDP growth in 4Q18 will accelerate to 3.6% YoY*

In 4Q18, we expect real GDP growth to accelerate to 3.6% YoY thanks to 1) better yields of late crops, particularly corn, 2) acceleration of expenditures of central and local governments, and 3) further growth of consumer demand. Thus, we maintain our forecast of 3.5% real GDP growth for 2018.

Chart 15. The structure of real GDP growth (YoY) (%)

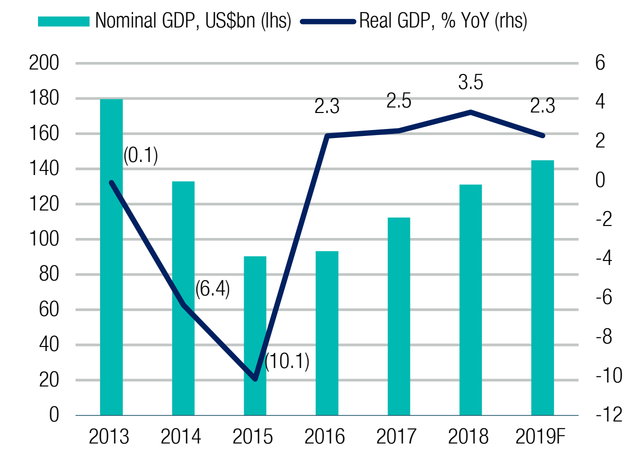
*Consumption and investments will continue to be the key drivers of GDP growth*




Source: State Statistics Service of Ukraine, ICU.

Chart 16. Real GDP growth (YoY) (%)

*Economic growth will slow to 2.3% in 2019*




Source: State Statistics Service of Ukraine, ICU.

## Inflation: Moderating due to tighter policies, softer commodity prices

- **Inflation decelerated to 9.8% YoY in December 2018**
- **In 2019, consumer-prices growth will slow to 8.5% YoY thanks to tight monetary and fiscal policies.**

*YE19 inflation will be close to 8.5% YoY*

The still hawkish stance of the NBU, cautious spending by the government, cooling markets for commodities, and, importantly, sliding energy prices, will further quell inflation in Ukraine. The CPI will continue to decelerate in 2019, and will finish the year at 8.5%.

Consumer-prices growth slowed to 0.8% MoM and 9.8% YoY in December, averaging 10.9% YoY in full-year 2018. This missed our and the NBU's updated forecasts (10.2% YoY and 10.1% YoY, respectively) primarily due to the unexpected slowdown in growth rates of transport prices. Transport prices, in turn, were influenced by world oil prices, which dropped 30% during 4Q18.

In 2019, the following factors will further contain inflation: 1) the National Bank's tight monetary policy, which still has room for further transition, 2) slowing economic growth, and

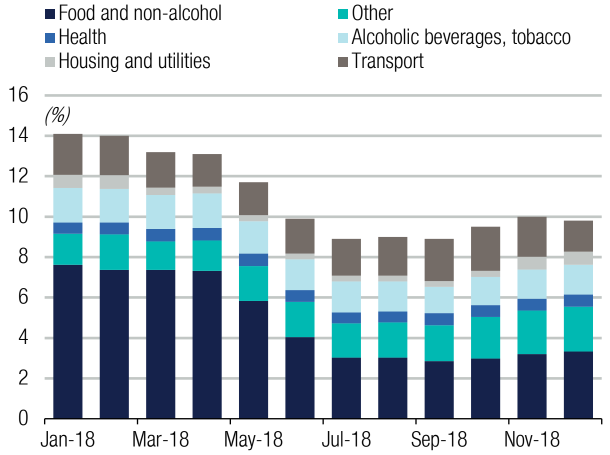
3) restrained fiscal policy of the government, which needs to contain spending and keep the 2019 budget deficit within the targeted 2.3% of GDP under the IMF's watchful eye.

***Slowing economic growth and tight monetary policy to contain CPI in 2019***

However, consumer-price growth will still be supported by: 1) high inflationary expectations among businesses and households against the backdrop of election uncertainties, 2) still-solid consumer demand and rising nominal wages, which will cause a transition of production costs to final customers, 3) high UAH devaluation expectations, and 4) a further increase in gas prices for the population required by the IMF (ICU est. +15%). We think that these factors pose significant upside risks for inflation, and, therefore, lead us to expect CPI growth of 8.5% YoY by YE2019, versus 6.3% forecast by the NBU.

Chart 17. Headline inflation by components (YoY) (%)

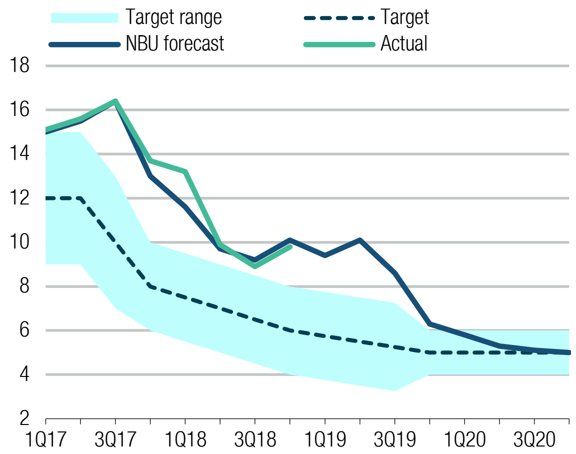
*In 2018 inflation slowed to 9.8%, the lowest since 2013*




Source: State Statistics Service of Ukraine, ICU.

Chart 18. Inflation: forecast and target of the NBU (YoY) (%)

*NBU expects inflation to slow to 6.3% in 2019 vs. ICU forecast of 8.5%*




Source: NBU.

# Banking sector: Modest profits amid rising rates

- **NIMs and the relatively low cost of risk allowed banks to earn solid profits in 2018**
- **Interest rates to fall in 2Q19**
- **Consumer lending to remain the fastest growing sector**

With 11M18 net Income of UAH20bn, the Ukrainian banking sector is likely to finish its first year since 2013 with a profit due to moderate provisioning expenses and strong interest margins. However, we expect 2019 to be a stable period rather than one of solid growth. Following the vast number of defaults in both the corporate and retail sector, banks are constrained by a scarcity of creditworthy borrowers.

After a number of capital injections in previous years, bank capitalization is solid. The capital adequacy ratio (N2) has been above 15% since June 2017. The 2018 stress test revealed a UAH6.1bn need for capital, which is 5% of the system's regulatory capital. Most of the banks managed to cover the capital needs by the year end.

The stress-test result showed no need for capital injection in any of the state-owned banks under the base-case scenario. However, Oschadbank argues that a further UAH10bn capital increase is needed to form provisions for the pre-2014 loan portfolio. That will make the bank more attractive for the potential minority investors such as EBRD. However, the NBU expects the bank to work more intensively on NPL collection.

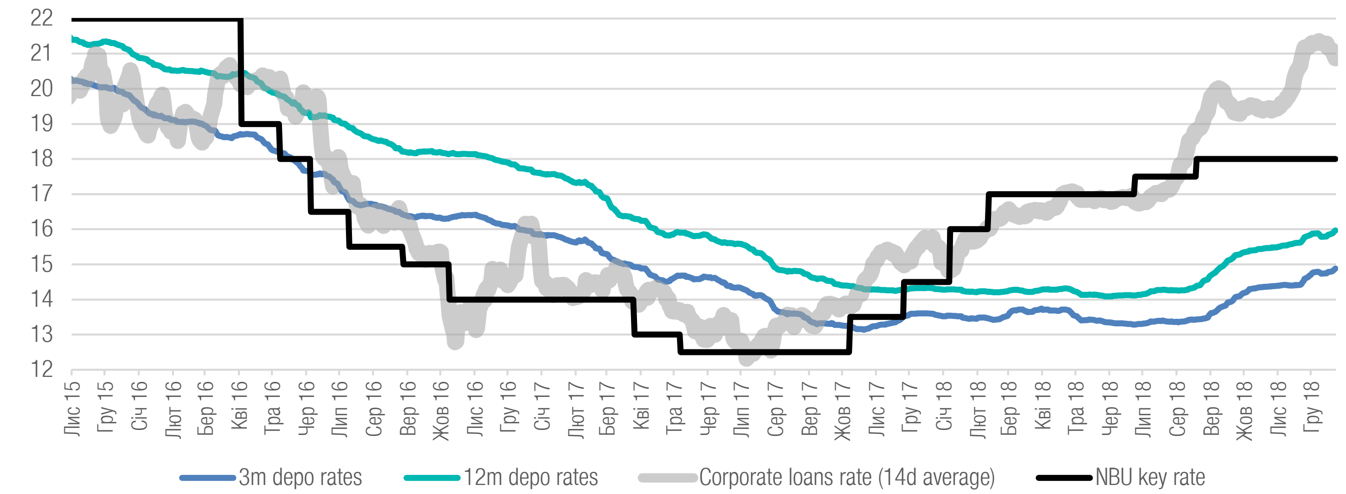
## Interest rates should begin to fall

*The cycle of interest-rate decreases might commence in January 2019, but the NBU is unlikely to go below 16% by the end of the year*

**A new cycle of interest-rate decreases** may begin as early as January 2019, as inflation is likely to continue declining in response to tight monetary policy of the NBU. The structural surplus of liquidity is unlikely to repeat in 1H19, which would keep interest rates from significantly decreasing. However, regulator will try to avoid the previous mistake of cutting rates too fast. Therefore, we expect the key rate to gradually decrease to 16% in December. In the base-case scenario, the NBU sticks to inflation targeting and remains independent. Both are the key issues in the new IMF Memorandum and they should remain in place unless Ukraine decides to abort cooperation with the Fund.

Chart 19. UAH interest rates dynamic (%)

*Credit rates closely followed the pattern of the NBU's key rate*




Sources: NBU, ICU estimates.

Deposit interest rates will largely follow the trajectory of the NBU's policy. However, the decline is unlikely to be as steep as it was in 2016, since the deposit rates lagged behind the rate increase and are significantly below the NBU's rate. Banks will not enjoy the structural surplus of hryvnia as they did in 1H18. Therefore, banks will slowly reduce the deposit rates.

Corporate lending rates in UAH proved to closely follow the path of the NBU key rate. Even though we do not expect policy-rate cuts in 1H19, they should decrease in January–March, as the hryvnia liquidity shortage fades. Average rates on UAH loans to corporates are to decrease by 400 bps to 17% by the end of 2019.

Most of the banks are earning a healthy net interest margin (6% on average), which, alongside the moderate cost of risk (2.6%), are the main drivers behind the solid 2018 profitability of the sector. However, particular banks with exceptionally high levels of NPLs, such as state-owned Ukreximbank and Oschadbank, still are not profitable at the operational level.

## Corporate lending rates are too high for substantial growth

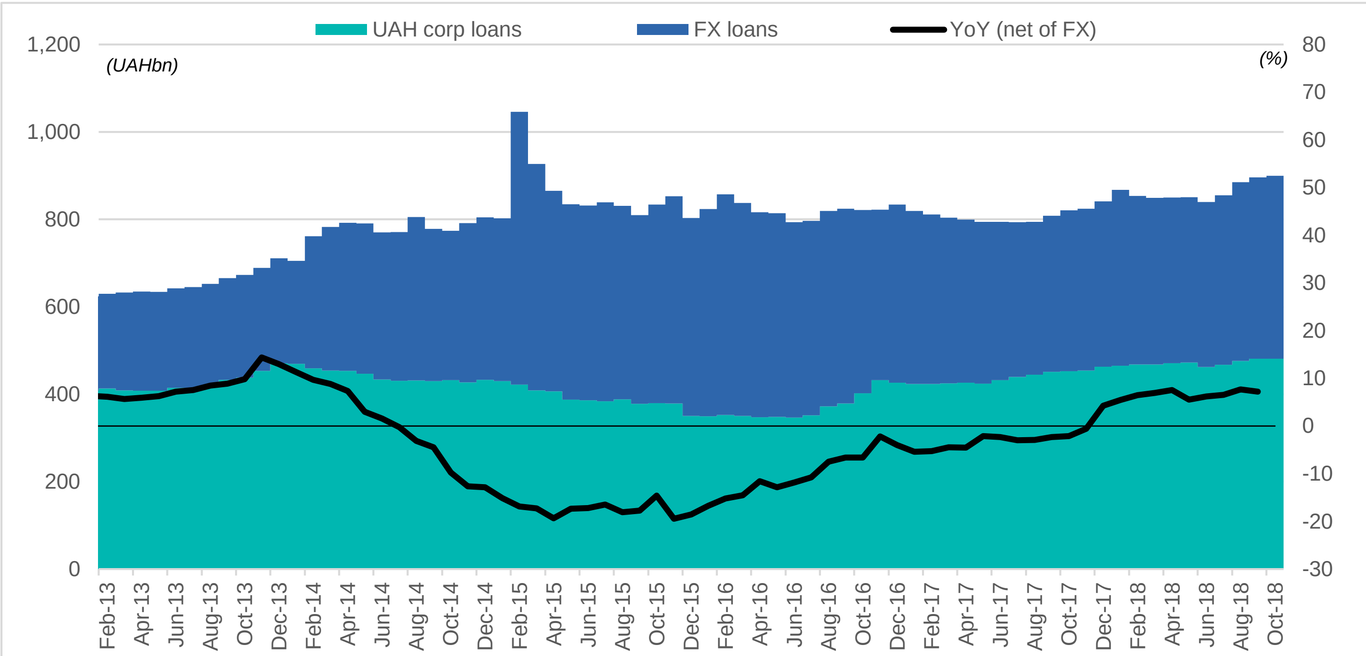
*Corporate lending will grow moderately due to the tight macroeconomic policy*

**Corporate lending struggles to grow.** Outstanding loans to the corporate sector grew 7.2% YoY in October 2018, net of FX revaluation. Foreign currency lending is growing by at a higher pace—8.4% YoY—than UAH lending—6.2% YoY. Lending is generally constrained by the current monetary policy of the NBU, as the interest on UAH loans to the corporate sector increased alongside the key rate, from 13% before the cycle began to the current 21%. Despite the absence of NBU rate hikes in 4Q18, corporate lending rates continued to rise as banks' liquidity diminished.

Lack of decent borrowers is another problem for the banks that have to compete for such clients. Certain industries such as chemicals and machinery have a very small share of companies that are capable of servicing their debt obligations. On the other hand, the agricultural sector, electricity production, and light industry have a high number of enterprises with low debt ratios and good EBITDA margins.

Chart 20. Gross loans to corporate clients

*Corporate lending is picking up slowly due to the shortage of creditworthy borrowers, unlikely to-change in 2019*




Sources: NBU, ICU estimates.

Considering the tight macroeconomic policy that we expect to continue in 2019, we don't expect rapid growth in corporate lending. The gross corporate loan portfolio is likely to expand by 10–12% YoY in 2019.

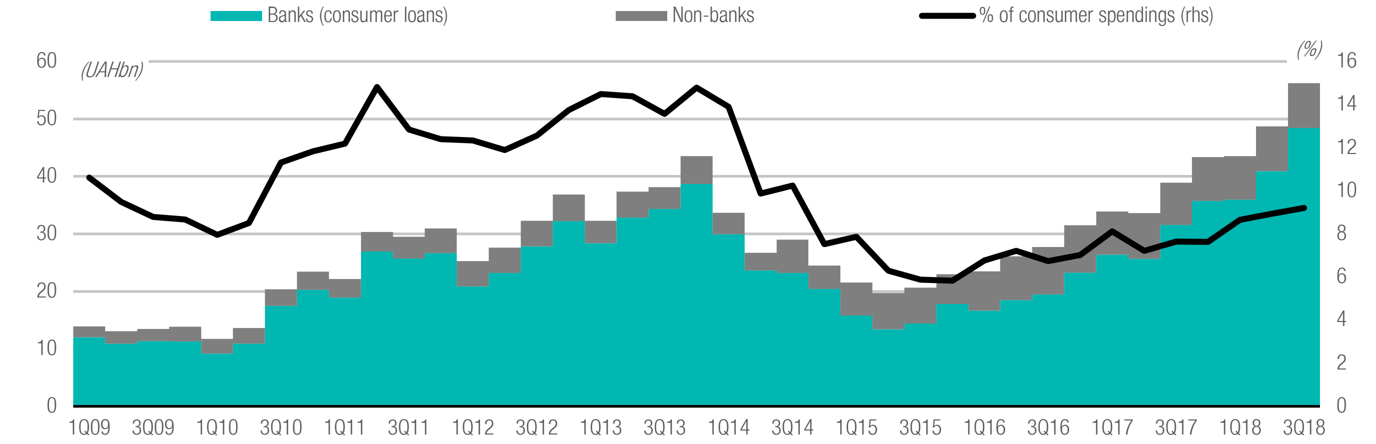
## Consumer lending flourishing, but far from bubble

*Despite significant YoY growth, consumer lending is still far from booming*

**Retail lending to grow 30% YoY in 2019**. Banks are increasing the amount of consumer lending, as demand for those services grow. During the 2014/15 crisis, banks significantly cut their lending, and many banks with strong positions in the segment ceased to exist. As a result, non-banking financial institutions expanded their share of new consumer loans issued by as much as 32% during the peak in 2Q15. Despite the two-fold decrease of this share, non-banking financial institutions managed to maintain the amount of loans issued.

Chart 21 New consumer loans issued to total consumer spending

*Despite the significant consumer lending growth, credit resources comprise far lower share of consumer spending than in 2011-13*

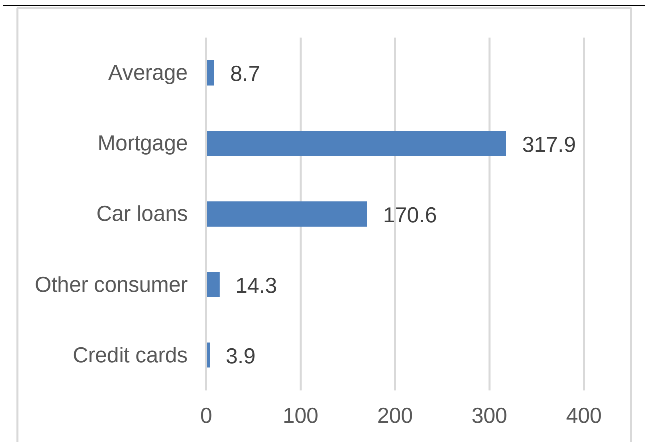



Sources: NBU, National Commission for state regulation in the field of financial services, ICU estimates .

We believe bank consumer lending is going to expand by an additional 30% YoY in 2019, as the demand for credit remains strong, and banks will see it as an opportunity. The current level of consumer debt is still far from what it was during the credit boom of 2012–13, but the NBU already announced it will stress test the segment. Any restrictions are unlikely to be implemented in 2019, but the regulator may impose additional prudential requirements or impose an income cap on consumer lending in 2020, as the segment continues to grow.

Chart 22. Average UAH loans to households (UAH ths)

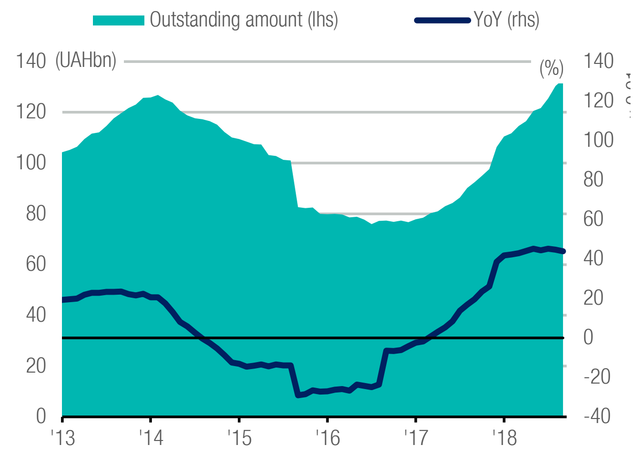
*As of October 2018, solvent banks only*




Source: NBU.

Chart 23. UAH loans to households (stock)

*Consumer lending demonstrates steady growth*




Sources: NBU, ICU estimates.

# Yearly forecast 2018–19

| | Historical data for 2008-17 | | | | | | | | | | Forecast by ICU | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018F | 2019F |
| Activity | | | | | | | | | | | | |
| Real GDP (%, YoY) | 2.6 | -15.0 | 4.2 | 5.1 | 0.5 | -0.1 | -6.4 | -10.1 | 2.4 | 2.5 | 3.5 | 2.3 |
| Nominal GDP (UAHbn) | 948.1 | 913.3 | 1,082.6 | 1,302.1 | 1,404.7 | 1,465.2 | 1,586.9 | 1,988.5 | 2,385.4 | 2,982.9 | 3,571.6 | 4,058.0 |
| Nominal GDP (US$bn) | 147 | 113 | 136 | 162 | 173 | 178 | 108 | 90 | 93 | 112 | 131 | 144 |
| Inflation | | | | | | | | | | | | |
| Headline inflation (%, YoY, e.o.p) | 22.3 | 12.3 | 9.1 | 4.6 | -0.2 | 0.5 | 24.9 | 43.3 | 12.4 | 13.7 | 9.8 | 8.5 |
| Producer price index (%, YoY, e.o.p.) | 21.1 | 15.3 | 18.8 | 17.4 | 0.4 | 1.7 | 31.8 | 25.4 | 35.7 | 16.5 | 14.2 | 11.3 |
| Exchange rates | | | | | | | | | | | | |
| UAH/USD (e.o.p.) | 7.80 | 8.00 | 7.94 | 8.00 | 8.05 | 8.24 | 15.82 | 24.03 | 27.10 | 28.10 | 27.69 | 29.50 |
| UAH/EUR (e.o.p.) | 10.90 | 11.45 | 10.63 | 10.37 | 10.62 | 11.32 | 19.14 | 26.10 | 28.50 | 33.70 | 31.71 | 35.40 |
| External balance | | | | | | | | | | | | |
| Trade balance (US$bn) | -14.4 | -2.0 | -4.0 | -10.1 | -14.3 | -15.6 | -4.6 | -2.4 | -6.5 | -8.6 | -11.9 | -12.5 |
| Trade balance (% of GDP) | -9.8 | -1.7 | -2.9 | -6.2 | -8.3 | -8.7 | -3.5 | -2.6 | -6.9 | -7.7 | -9.1 | -8.6 |
| Current account balance (US$bn) | -12.8 | -1.7 | -3.0 | -10.2 | -14.3 | -16.5 | -4.6 | 1.6 | -1.3 | -2.4 | -5.1 | -4.8 |
| Current account balance (% of GDP) | -14.4 | -2.0 | -4.0 | -10.1 | -14.3 | -15.6 | -3.5 | 1.8 | -1.4 | -2.2 | -3.8 | -3.3 |
| Interest rates | | | | | | | | | | | | |
| NBU's key policy rate (%, e.o.p.) | 12.00 | 10.25 | 7.75 | 7.75 | 7.50 | 6.50 | 14.00 | 22.00 | 14.00 | 14.50 | 18.00 | 16.00 |
| Fiscal balance | | | | | | | | | | | | |
| Budget balance (% of GDP) | -1.3 | -3.9 | -5.9 | -1.8 | -3.8 | -4.4 | -5.0 | -2.3 | -2.9 | -1.5 | -2.4 | -2.3 |

Sources: State Statistics Service of Ukraine, NBU, ICU.

# Disclosures

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This research publication has been prepared by the analyst(s), whose name(s) appear on the front page of this publication. The analyst(s) hereby certifies that the views expressed within this publication accurately reflect her/his own views about the subject financial instruments or issuers and no part of her/his compensation was, is, or will be directly or indirectly related to the inclusion of specific recommendations or views within this research publication.

## EQUITY RATING DEFINITIONS

**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

**Buy:** Forecasted 12-month total return significantly greater than that of relevant benchmark

**Hold:** Forecasted 12-month total return is in line with or modestly deviates from relevant benchmark

**Sell:** Forecasted 12-month total return significantly less than that of relevant benchmark

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