Research Report on Ukraine

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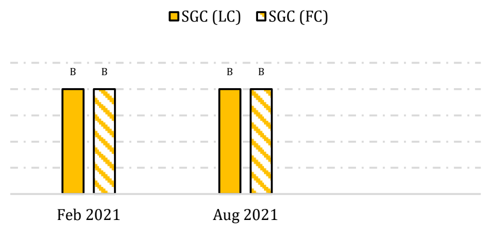
Ratings

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

* These ratings are unsolicited

Ratings dynamics



Main Economic Indicators of Ukraine

Macro indicators	2018	2019	2020
Gross gov. debt, UAH bn	2156,0	1998,3	2551,9
Nominal GDP, UAH bn	3560,6	3974,6	4090,5
Real GDP growth, %	3,4	3,2	-4,2
Gross gov. debt/GDP, %	60,6	50,3	62,4
Deficit (surplus)/GDP, %	-2,1	-2,0	-6,2
Inflation rate, %	9,8	4,1	5,0
Current Account Balance/GDP, %	-3,3	-2,7	3,4
External debt, USD bn	-	-	125,8

Development indicators	2020
Inequality adj. HDI	0,779*
GDP per capita, USD th	13,1

Default indicator	20.08.2021
10Y Gov Bond Yield, %	6,9**

Source: RAEX-Europe calculations based on data from IMF, National Bank of Ukraine, Ministry of Finance of Ukraine and State Statistic Service of Ukraine.
*Data for 2019; **Maturity in 2032

RAEX-Europe confirmed at 'B' the ratings of Ukraine with stable outlook.

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 is stable, which means that in the mid-term perspective there is a high probability of maintaining the rating score.

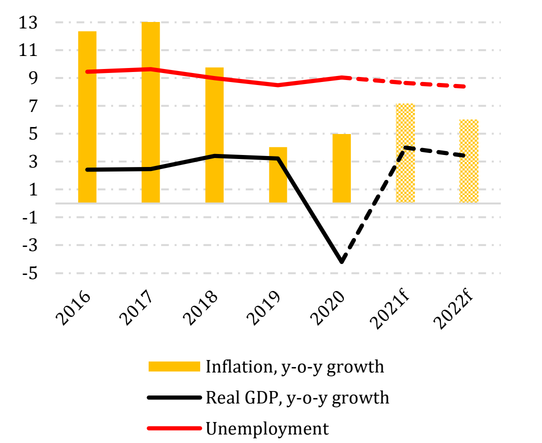
Summary

The confirmation of the ratings at 'B' mainly reflects Ukraine's ongoing reforms and more effective government fiscal and monetary policies, which have provided stability and access to external financing. This, in turn, has supported the economy during the pandemic and strengthened international reserves.

On the other hand, high dependence of the economy on the external commodity markets, currency risks of the government debt and a weakened banking system are the factors negatively affecting the credit rating. In addition, uncertainty stems from possible new pandemic waves amid low vaccination rates in the country, as well as the protracted military conflict in eastern Ukraine.

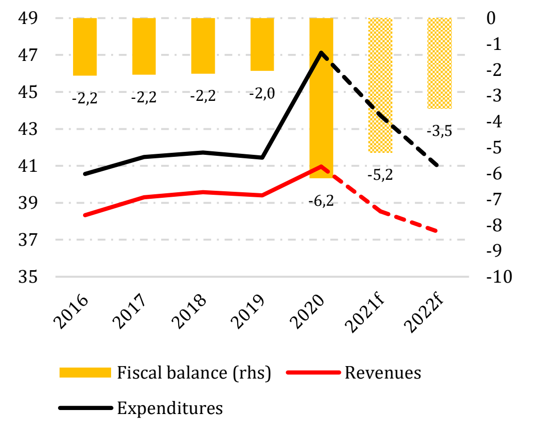
The rebound in economic growth after the weakening of the lockdown. After a contraction of 4,2% in 2020, caused mainly by COVID-19 effects and lower demand for the country's export commodities, the economy showed a rebound in January-April 2021 after the lockdown was lifted, with the composite output index rising by 0,7%, mainly propelled by industrial production and domestic trade. From 3Q 2021 we expect further stabilization and economic growth with support from agriculture export and construction. Domestic consumer demand is supported by remittances from labor migrants and further growth in the purchasing power of households driven by rising real wages. In addition, price conditions on foreign commodity markets will contribute to faster growth. Consequently, we expect GDP growth to reach the projected 4% y-o-y growth rate at the end of 2021. The main downside risk to our forecast is the uncertainty of the future COVID-19 situation due to the insufficient current level and dynamics of vaccination in the country.

Graph 1: Macroeconomic indicators, %



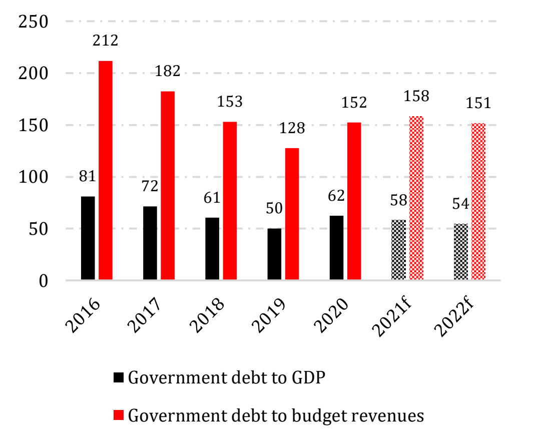
Source: RAEX-Europe calculations based on data from IMF, National Bank of Ukraine and State Statistic Service of Ukraine

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

Vaccination rates in Ukraine are among the lowest in Europe, and as of early August 2021, only less than 7% of population was fully vaccinated.

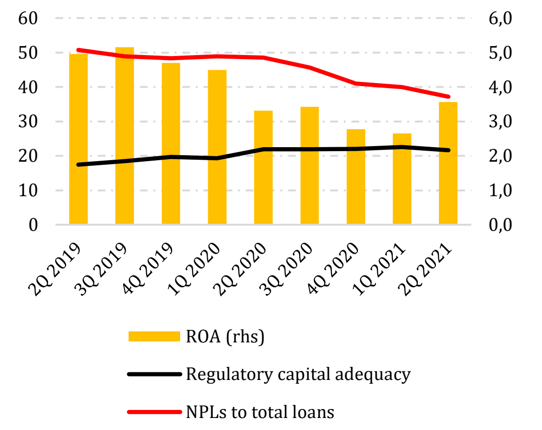
Wide budget deficit will remain in 2021. Despite the economic slowdown in 2020, Ukraine's consolidated budget revenues increased by 6,7% y-o-y, both due to one-off payments and an increase in tax revenues. However, after a relaxation of the fiscal policy to provide support in response to the COVID-19 crisis, the consolidated budget deficit ended the year at 6,2% to GDP. Government support measures included increased spending on health care and social support, including increases in unemployment benefits, pensions and minimum wages. In 2021, we do not expect a significant reduction in the consolidated budget deficit and it is projected at 5% of GDP, which corresponds to the government's targets. In 1H 2021, we observed a budget execution better than initially planned, both of budget revenues and expenditures; however, in the second half of the year, a gradual increase in the minimum wage and deferred capital spending could slow consolidation.

Ukraine continues reforms to access concessional funding. The active build-up of new debt and the depreciation of the national currency brought Ukraine's gross public debt level to 62,4% of GDP in 2020. We assess liquidity risks for the government as low, due to the favorable average maturity of public debt at 7 years and the current level of short-term debt to GDP is 9,2% and it is covered 2x by international reserves. At the same time, the share of foreign currency liabilities was 63,5% as of July 2021, with predominance in USD (37%), so the debt position is highly sensitive to currency risks.

Given the still high budget needs, concessional financing will remain important for Ukraine. A positive factor was the recent IMF's decision to allocate USD 2,7 bn in SDRs to Ukraine to support liquidity. In addition, the government continues to implement reforms in order to receive a new tranche of USD 0,7 bn under the current stand-by program with the IMF. Moreover, implementing reforms opens the door to borrowing from the World Bank and the EU. Despite concessional financing, the debt position is characterized by a high concentration of bonds (66% of total debt), while concessional agreements account for only 18,4%. Furthermore, the government continues to issue bonds this year to raise funds on domestic and foreign markets.

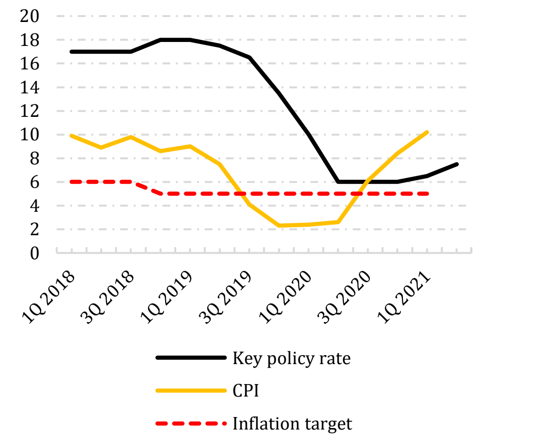
Tightening of monetary policy amid growing inflationary pressure. After a significant reduction of the key policy rate in 2020 by 7,5 p.p. to a historic low of 6%, the National Bank of Ukraine (NBU) has been tightening its monetary policy throughout the first 7 months of 2021, gradually raising the key policy rate to 8%. The acceleration in inflation

Graph 4: Financial soundness indicators, %



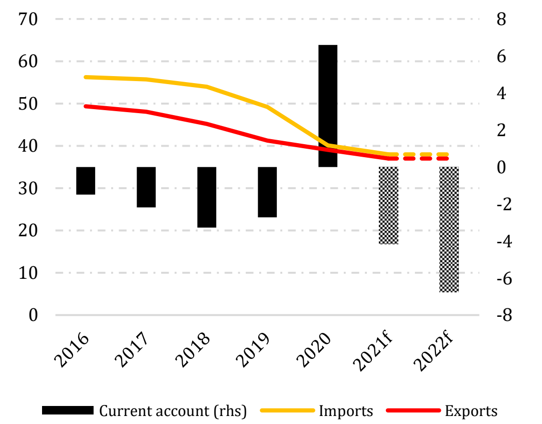
Source: RAEX-Europe calculations based on data from IMF and National Bank of Ukraine

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

that began in late 2020 caused the rate to post a reading of 10,2% in July 2021 due to solid consumer demand, coupled with increase in production costs (in particular raw materials, energy, and wages), further accelerated the growth in food prices. The priority of the monetary policy is to achieve price stability using the inflation-targeting regime, and the regulator's decision to raise the key rate is directly related with returning inflation to the target level. Inflation is expected to peak in the autumn and begin to slow down by the end of the year, returning to the target range of 5% ± 1%.

The banking system shows resilience, although there are still high NPL rates. Banks continue to build assets, as these hiked by 11,5% in 2020 up to 54% of GDP. The recovery from the COVID-19 crisis has contributed to easing lending conditions and growth in corporate and retail lending in 1H 2021. During the pandemic, the positive trend in the share of non-performing loans continued, driven by both increased lending activity and SOB's loan restructurings. Thus, the percentage of NPLs fell to 37,2% as of June 2021, down from 48,5% a year earlier. Despite the positive dynamics and high NPL provisioning ratio close to 90%, the large amount of low-quality assets is a major risk for Ukraine's banking system. Profitability indicators improve the sustainability of the banking system: due to the rapid growth of operating income, ROE rose to 28,6%, and ROA was 3,6% as of June 2021. Banks are building regulatory capital, which increased by 12,2% y-o-y as of June 2021, and 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 36,7% and the share of loans – 34,5% at the end of 2Q 2021.

The external position is favorable, primarily due to the build-up of international reserves in 2020. This was made possible by a surplus in the balance of payments and net borrowings from the IMF (USD 975 m). A record current account surplus of 3,4% of GDP was achieved in 2020, compared to a deficit of 2,7% in 2019. The COVID-19 crisis led to a larger decline in imports into the country, while exports showed resilience to the recession, supported by agriculture and services, and declined by only 4,6%. Migrant remittances supported the current account and remained in line with 2019 figures. As a result, international reserves were up 15% in 2020 and remain favorable at USD 29,1 bn as of August 2021, providing nearly 5 months of import financing. We expect the current account surplus to narrow in 2021 caused by a rebound in import demand. However, in the mid-term perspective, the threat to the external position will be driven by a lower transit of gas revenues from Russia.

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. (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: **TBD December 2021.** The full sovereign rating calendar can be found at Sovereign Rating Calendar 2021

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RATING HISTORY:

Date	Review reason	SGC		Outlook	
		National currency	Foreign currency	National currency	Foreign currency
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 20 August 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 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.

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Office responsible for preparing the rating

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