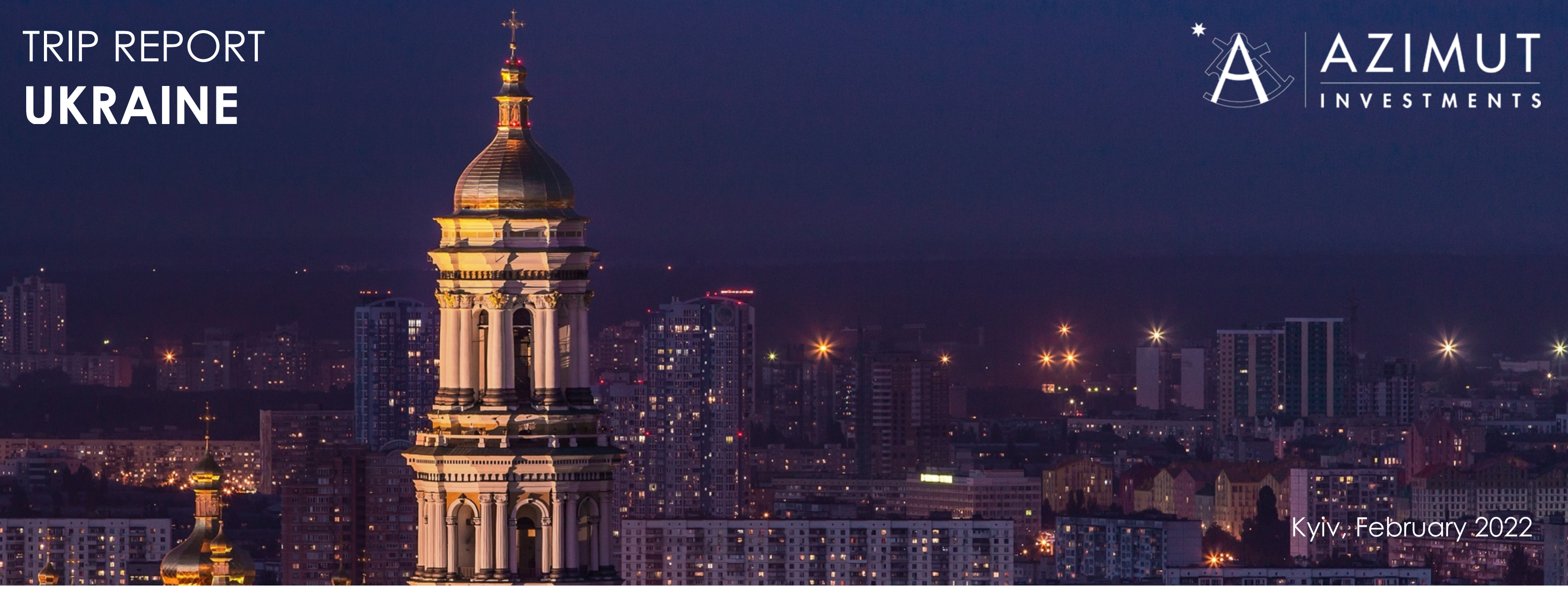
TRIP REPORT
# UKRAINE




*Not only is Ukraine at the centre of attention of world events, the country is one of the most important investment destinations in the Frontier universe. Given this, we felt that time was of the essence (if slightly close to the wire) to pay a visit to Kyiv, for some long overdue meetings with the Central Bank and Ministry of Finance, but also to test the temperature on the ground.*

**Life in Kyiv**

During my visit there seemed to be a certain ‘business as usual’ feel to life in the capital last week, as instability has to a certain extent been a feature of life since Russian incursions in the Donbas region in eastern Ukraine 2014. Since then, the media has dripped a relatively uninterrupted release of daily news bulletins, highlighting the number of Ukrainian civilians killed or injured in the fighting.

The only noticeable difference to the recent past is that expatriates and foreigners have been temporarily relocated to Warsaw or London (especially those holding US passports) limiting our opportunities for social interaction with such individuals. While there, only President Macron and other European dignitaries were in town visiting President Zelensky.

The Europeans via the recently re-established Normandy format (France, Germany, Ukraine, Russia gatherings) are pushing for compliance with the Minsk Agreements as the only practical way to progress towards a peaceful resolution. However, the sticking point for Ukrainians is engagement with Donetsk and Luhansk People’s Republic, and recognition of special status for the territories means they will have a veto on Ukraine’s request to join NATO.

**When elephants fight…**

The majority of Ukrainians that I spoke to seem lukewarm towards the idea of ‘Finlandisation’, a neutrality like status for their country, and even but even the rather one-sided US Secretary of State Anthony Blinken is favouring a step back on the NATO application (without compromising the principle of free initiative by any State to apply for NATO) by saying recently "the (Minsk) agreement speak of special status for the Donbas and I believe that with the appropriate sequencing, the Ukrainian would be prepared to move forward”.

**…grass gets trampled on**

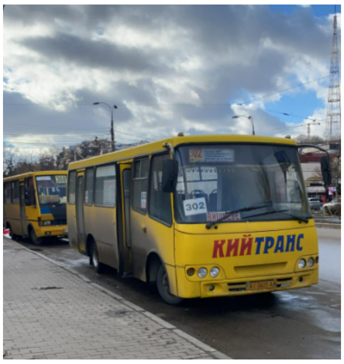
Ukraine seems to be caught in the middle of a confrontation between Russia and the US: Putin has been catapulted back on the international stage due to poor energy planning by the West, leaving the Russia and Saudi Arabia with a stranglehold on the world’s energy supplies.

**Russian checkmate?**

The seemingly unresolvable paradox remains the fact that the US and its allies have since the outset ruled out any military intervention should Russia invade. Given that NATO membership entails military solidarity, is Ukraine going to be invaded by Russia for not dropping the possibility of a NATO application which de facto the West is not prepared to accept? It is our view that Putin remains in a stronger position while threatening an invasion, rather than actually carrying one out.

### It's also the economy stupid

In the meantime, Zelensky has good reason to believe that of equal risk to his survival is not an (improbable) full invasion with Russian boots on the ground but rather an economic recession. Should the current uncertainty derail the country's economic recovery then the legitimacy of his government will surely be tested.




Ukraine enjoyed the best terms of trade in a decade in 2020/21 as during the Covid crisis the main country's exports in iron ore and agricultural commodities rallied, so lifting the balance of payments. As a result, grain, sunflower oil, miners sold USD to the Central Bank replenishing reserves to an astonishing USD 31bn by December 2021.

As we move into a paradigm of higher energy prices, the full fragility of the Ukrainian economy emerges: an obsolete manufacturing industry suffers, families spend a greater part of their salaries for heating and transportation leaving less to consumption which has been the main driver of economic growth in the last decade.

Liquified petroleum gas (LPG), which is widely used as car fuel, is now sold at 19 Hryvna at the pump, which compares to 11 Hryvna at the beginning of 2021. And in addition, the cars that populate Kiev streets remain largely out of date and not particularly energy efficient. It is unfortunate that we did not see a single electric car, which, unlike the Tesla in neighbouring Poland fuelled by electricity generated from coal plant, could in theory be fuelled in Kiev by carbon neutral nuclear power from the four active nuclear reactors or the recently installed wind power plants.

### Meeting – The National Bank of Ukraine

Sergiy Nikolaychuk, Deputy Governor

The National Bank of Ukraine (NBU) has not been dilly-dallying on inflation but has acted swiftly by raising interest rates from 6% in January 2021 to the current 10% (with expectations of further tightening in March). Food inflation has marginally receded, and higher real rates will attract capital in 2022 should the geopolitical situation stabilize. Hryvna liquidity is very ample in the banking system and the NBU will probably revisit reserve requirements to mop up excess liquidity.
Nikolaychuk is also confident that an economic transformation is underway; the most important factor being the extraordinary development of the IT sector which contributes strongly to exports and to remittances. Employees of the largest 50 IT companies grew from 31k in January 2016 to 86k in July 2021 and exports are USD 4.9bn for the first 11 months of 2021 compared to USD 1.8bn for the full 2016 (NBU data). Several US companies also employ workers remotely (extremely coveted as local universities enjoy the Soviet tradition for maths and scientific studies). Their salaries are accounted among" remittances", which are expected to continue their growth at an impressive rate over the coming years.

| | |
|---|---|
| **2018** | USD 11.1 |
| **2019** | USD 11.9 |
| **2020** | USD 12.0 |
| **2021** | USD 15.0 |
| **2022** | USD 16.2 |
| **2023** | USD 17.0 |

Source: NBU (remittances historical data and projections)

California style IT salaries go a long way in Ukraine and have prompted some very unusual economic local miracles with the office of statistics reporting extraordinary construction and redevelopment activity in rural areas and other positive cascade effects.

**Meeting – Ministry of Finance**

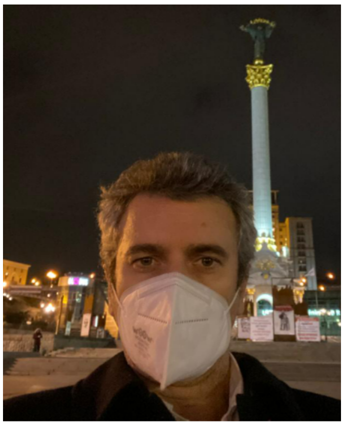
Yuriy Butsa, Government Commissioner for Public Debt Management
Alla Danylchuk, Investor Relations

In January, Ukrainian USD bonds tumbled to the point at which the Ministry of Finance in early February made open market purchases of the 7.75% USD 1.4bn bonds due September 2022 significantly below par leaving USD 912m outstanding for redemption. This bold initiative saves large amounts for the budget and restored some much-needed market confidence.
However, for the time being Ukraine has lost its access to the market and Zelensky has asked the US for USD 5bn of guarantees. The Biden administration is inclined to grant some financial support, although guarantees will require Congressional approval. Since the Trump Presidency, foreign state guarantees have been discontinued, so the process is likely to take some time before being enacted.
In addition, the EU Parliament is fast-tracking EUR 1.2bn of additional financing assistance, while Canada and other countries are lining up with some bilateral assistance. In addition, the World Bank USD 600mm and the IMF has a pipeline of USD 2.2bn of conditional financing for 2022.
Ukraine underwent a soft restructuring of its external debt in 2015 soon after the war in the East started, however at that time the currency did not reflect a free exchange rate and Ukraine did not enjoy the same significant support of western partners.

| 2015 | 2015 | 2019 | 2021 |
|---|---|---|---|
| GDP growth | (9.8%) | 3.2% | 2.7% |
| CPI YoY | 43.3% | 4.1% | 10% |
| Reserves USD | 13.3bn | 25.3bn | 30.9bn |
| Primary balance | 2% | 1% | (0.9%) |
| Debt/GDP | 67.1% | 44.3% | 43.6% |

Source: Ministry of Finance

From an external perspective, Ukraine must finance an estimated USD 8bn current account and its Eurobond maturing in September this year.



2022 External financial requirements and sources of funding (excluding potential USD 5bn US guarantee backstop)

| | Requirements | Source |
|---|---|---|
| 1.C/A deficit | 8.1 | |
| 2.Government refinancing | | |
| Domestic | 3.3 | ~3.3 |
| Eurobonds | 0.9 | ~1.0 |
| Non-IMF loans | 1.2 | ~2.2 |
| 3. IMF | 2.2 | 2.2 |
| 4. Banks | 0.6 | 1.0 |
| Loan-deposits | 0.4 | 0.5 |
| Eurobonds | 0.2 | 0.5 |
| 5. Corporates | 6.2 | 8.0 |
| Loans + deposits | 3.2 | 3.5 |
| Eurobonds | 0.7 | 1.0 |
| Direct investment | 2.2 | 3.5 |
| 6.Other outflows | 0.5 | 1.5 |

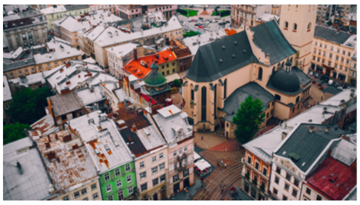
Source: Ministry of Finance, Azimut estimates

The Hryvna market opened to foreigners after Zelensky's election in early 2019 with USD 5bn of inflows from foreign investors who helped extend the curve of the Ministry of Finance bonds to 2026. However, in March 2020 the absence of local bids for long dated bonds quickly led to ~25% yields and thereafter an absence of support for foreign outflows. No other Frontier local market has experienced such an unexpected liquidity drought and gap pricing during Covid.

**Has the local market come of age?**

We spoke to different managers in charge of liquidity-ALM at the major banks: they were ready to buy bargains on the sell-off in January remembering the March 2020 sell off. This time they obtained longer limits from their headquarters, have got more accustomed to managing interest rate risk, and were sitting on a very large Hryvna liquidity buffer. However, foreigner's positions were smaller at around USD 3.5bn at the outset, and outflows cleared with the highest sales of the 2026 at around a 15% yield.
The local market is still developing from an infrastructure standpoint, and we expect bond liquidity to improve further with the adoption of nominee account custody, and with foreign exchange to gain liquidity thanks to the liberalization of the forward FX deliverable market.
As of today, exporters are limited to selling FX only in the spot market and

therefore the foreign exchange market follows a very pronounced seasonal pattern around the harvest season.



**What lies ahead**

Ukraine enters this turbulent 2022 period in a much stronger position than the one it faced in 2015. What is particularly remarkable is the fiscal discipline of the Government which successfully outperformed its tax revenues goals until January 2022.

Looking ahead, a certain amount volatility is to be expected, however we remain confident that the efforts of the Government and the NBU to introduce reforms reinforcing the anti-corruption court and imposing a strong governance sector for the financial sector will yield further results.

Although nobody picks their neighbouring country, among the most successful emerging market stories of the last decade have been South Korea and Israel, which have both moved into another league despite military insecurity.

Political uncertainty notwithstanding, we remain positive for the medium-term outlook for Ukraine.