Ukraine Macro Outlook

Growth Under Construction

UKRSIBBANK
BNP PARIBAS GROUP

Serhiy Yahnych
serhiy.yahnych@ukrsibbank.com

Macroeconomic Summary:

Ukrainian economy is to deliver moderate (2.7%) growth next year, bouncing back from distressed levels. Consumption would remain broadly stable in nominal terms providing opportunities for import substitution. Growth is to be net-export driven.

Some adjustments take place in current account and export mix, improving resistance to possible fluctuations on steel market. Still, vulnerability of Ukrainian economy to movements of global steel prices remains pronounced. Ukraine would see C/A surplus next year due to weak currency.

Ukraine will go through election cycle in early 2010, while the IMF cooperation is likely to be frozen for some time.

Public finance will see the second consecutive year of double-digit deficits as a percentage of GDP. The budget is likely to be redrafted with participation of IMF technical experts over 2010.

CPI is declining due to subsiding pressures on demand side, but it would remain high slipping in single-digit zone only in 2011.

Local currency is cheap comparing to CEE peers, but high public deficits coupled with Ukraine's sensitivity to global conjuncture introduce downside risks over the course of 2010.

Banking system can cope with asset quality, albeit it might still need capital injections and would not be able to restore growth soon. Central bank should seek ways to inject UAH funding to the system.

Domestic interest rates are well in double digits and would remain high in 1H2010 due to crowding-out by public debt, de-leveraging of external debt and limited inflow of deposits to domestic banking system. From 2H2010 onwards we expect domestic rates to decline.

	Baseline case				
	2008	2009F	2010F	2011F	2012F
Business Cycle					
Real GDP (%)	2.1%	-13.3%	2.7%	4.5%	6.0%
Real Household Consumption	11.8%	-12.6%	1.5%	3.7%	5.8%
Real Gross Fixed Capital Formation	1.6%	-47.1%	12.0%	15.2%	25.0%
Real Government Consumption	0.4%	-4.4%	-3.1%	1.5%	2.4%
Nominal GDP (UAH bn)	950.5	935.3	1061.5	1236.8	1402.8
Nominal GDP ($bn)	179.3	115.5	122.0	152.7	194.8
GDP per Capita (at F/X rate; $)	3890.2	2504.8	2646.5	3312.1	4226.2
Real Industrial Output (% y/y)	-2.3%	-20.5%	4.4%	10.9%	9.8%
Real Agricultural Output (% y/y)	17.2%	0.5%	-1.5%	3.0%	4.5%
Prices					
GDP Deflator	29.1%	13.5%	10.5%	11.5%	7.0%
CPI	22.3%	13.1%	11.0%	9.5%	6.5%
PPI	23.0%	13.5%	10.5%	12.0%	7.5%
Public Finance					
Revenues	231.6	192.1	228.9	280.1	317.7
Expenditures	241.0	274.0	300.0	310.0	331.7
Budget balance (% of GDP)	-1.0%	-8.8%	-6.7%	-2.4%	-1.0%
Budget deficit (UAH bn, "-" is deficit)	-9.4	-81.9	-71.1	-29.9	-14.0
Total Public Debt (USD bn)	24.6	40.7	53.4	57.1	59.0
Total Public Debt (% of GDP)	13.7%	35.2%	43.7%	37.4%	30.3%
Gross External Debt (USD bn)	103.0	91.5	112.0	125.0	150.0
Gross External Debt (% of GDP)	57.4%	79.2%	91.8%	81.9%	77.0%
External Balances					
Exports (USD bn)	67.7	36.2	46.9	52.5	60.4
Imports (USD bn)	84.6	40.7	50.9	59.4	68.6
Merchandise trade balance	-16.9	-4.5	-4.0	-6.9	-8.2
Services Trade Balance (USD bn)	2.4	2.2	4.4	4.6	6.1
Current Account Balance (USD bn)	-12.9	-1.6	1.9	-1.2	-0.2
Current Account Balance (% of GDP)	-7.2%	-1.4%	1.6%	-0.8%	-0.1%
Capital and Financial Accounts Balance (USD bn)	9.9	-12.5	-5.8	5.7	10.3
FDI Inflow (USD bn)	9.7	4.2	4.0	7.3	10.4
FDI Inflow per Capita ($)	210.4	91.1	86.8	158.4	225.6
Gross F/X Reserves (USD bn)	31.5	27.0	28.9	31.1	27.7
MM&FX					
Narrow Money (Monetary Base, % y/y)	31.5%	-4.5%	15.0%	21.0%	15.0%
Money Supply (M3, % y/y)	29.9%	-5.0%	17.0%	25.0%	8.0%
UAH:USD (rate; eop)	7.8	8.4	8.7	7.5	7.2
UAH:USD (avg.)	5.3	8.1	8.7	8.1	7.2

Source: NBU, SSC, MinFin. Forecasts: UkrSibbank

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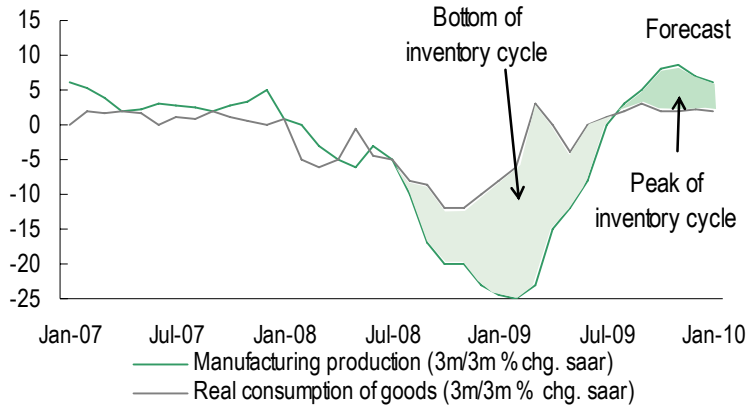
GLOBAL ENVIRONMENT

Global economy re-emerges from ashes. Growth has surprised on the upside, primarily due to quick recovery in manufacturing output contrasting to catastrophic plunge late last year and early this year. The ongoing recovery has its roots into re-stocking and global stimuli. **Distortions to global export finance, cancellation of investment orders and massive de-stocking contributed to undershooting of industrial production relative to what could be expected given normal developments in GDP growth.** We now see a technical return to these levels. While most of Asian countries are done with re-stocking, US is entering a period in which corporates have to place more orders than they actually need (see graph), creating stronger demand than they normally do. The restocking is to peak out somewhere in 1H2010, returning to normal levels of consumption afterwards.

Distortions to global export finance, cancellation of investment orders and massive de-stocking contributed to undershooting of industrial production relative to what could be expected given normal developments in GDP growth

Interest rates have been slashed at unprecedented pace and unconventional policy has kept bond yields at extremely low levels. Access to credit has improved recently, and while the banking systems across the globe are still unable to provide credit, bond placements have soared to record levels, crossing 1 trln mark. Investors have become less risk averse, readily taking on books risks, at least in investment grade universe.

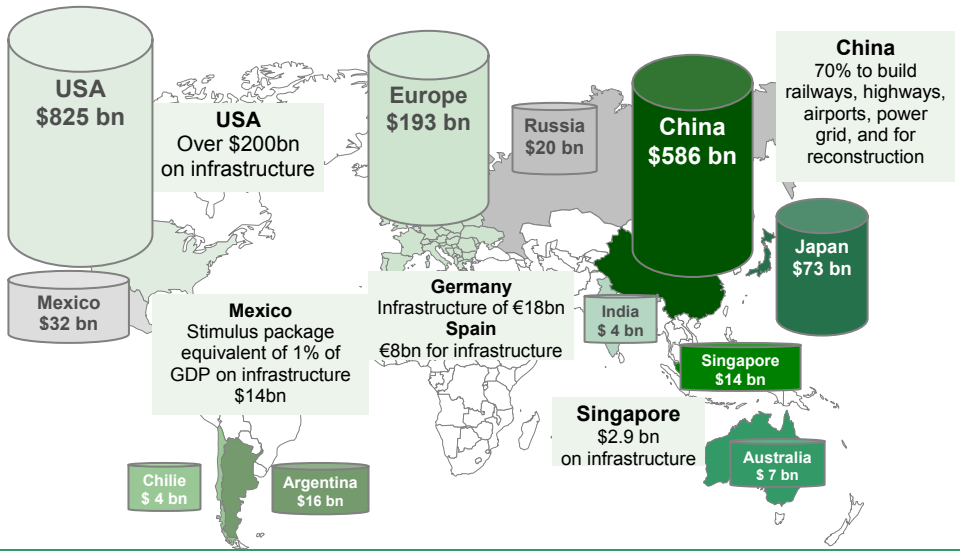
Re-stocking in the US to peak out in 1H2010



Source: BNP Paribas

This bounce is well supported by solid $1.7 trln of global fiscal stimuli – tax cuts, various programs in automobile industry, capital injections, asset buyouts and various infrastructure programs. Three out of four dollars in global stimuli were aimed at short-term impact, creating strong short-term economic impulses. Only 25% of funds were spent on infrastructure projects which are to have positive impact on economic growth over protracted period of time.

Scale of global stimuli: abundant

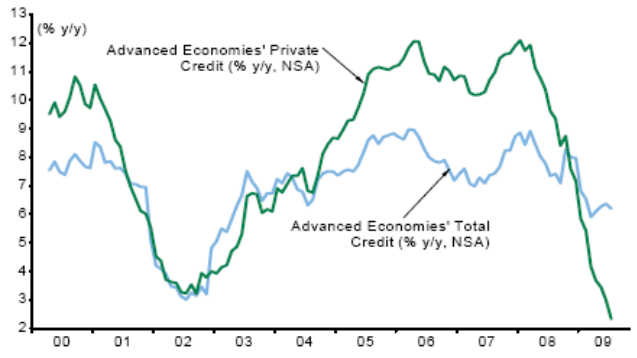


Source: UkrSibbank

OECD countries are lagging behind and threaten robustness of global recovery. We expect "a soft patch" to take place later next year in the developed world. Neither inventory cycle nor fiscal efforts can guarantee sustainable economic growth.

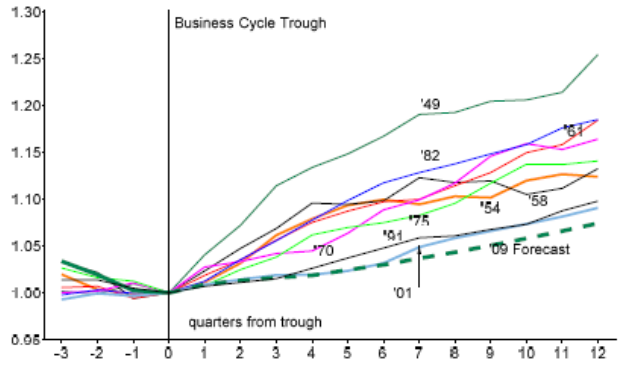
Banking systems are weak and many future losses remain to be dealt with. Leverage is still being unwound while households in many countries are dealing with excessive leverage and need to go through lengthy period repair of balance sheets.

Credit in advanced economies



Source: BNP Paribas

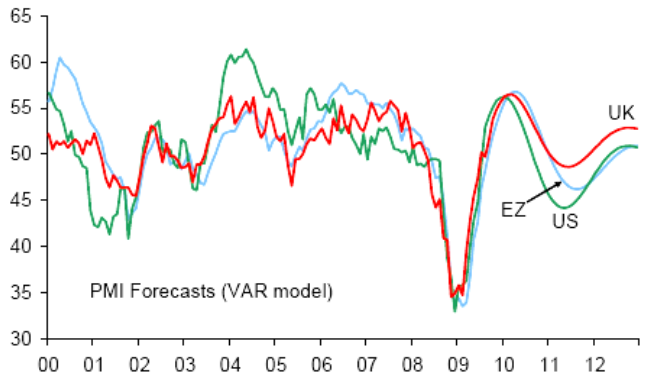
Speed of recovery, quarters from trough



Source: BNP Paribas
US: slowest recovery in post war era

Employment is falling, so do earnings per hour. Public finance has been already stretched and many sovereigns need to pull back deficits in order to bring their total debt closer to sustainable path. Private investment in the developed world would remain subdued for uncertain period of time since there is a substantial share of spare capacity.

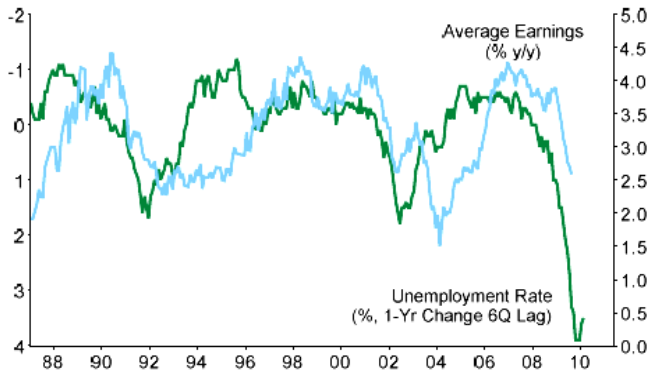
Purchasing managers indices* forecasts imply W-shape recovery



Source: BNP Paribas

Results are quantified in an index in which values above 50 indicate an expected increase of business conditions and values below 50 signal an expected deterioration.

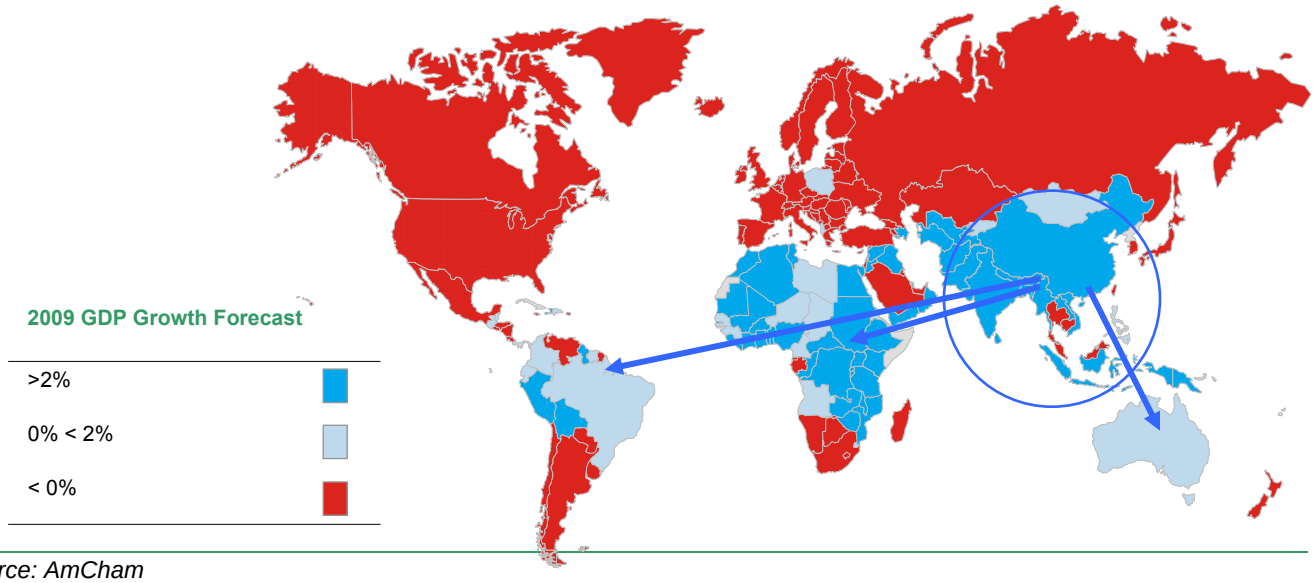
Unemployment rate and average earnings



Source: BNP Paribas

Unemployment has yet to recover, while average earning haven't seen the bottom yet

Global growth pattern – Asia is a key recovery driver



Source: AmCham

The rapid growth phase is coming to its end and a painful transition from "lift to carry" is under way

The rapid growth phase is coming to its end and a painful transition from "lift to carry" is under way. A key trigger for this transition is that demand indicators should show signs of broadening across sectors and countries. And this broadening should be accompanied by more balanced income growth as this year's rebound in corporate profits gradually provides room for rising employment and labor income which is crucial for a sustainable recovery.

A successful transition to more broadly based growth in the coming quarters is the key for sustaining a synchronized expansion through 2010-2012. As earlier, we see Asia to be the key driver of global recovery. Commodity countries with firm financial systems such as Brazil and Australia would be better off against the backdrop of strong demand from Asian region.

With most of developing countries being traditional Ukrainian export destinations, this promises support for Ukraine's growth. Especially since UAH is a worldwide devaluation champion and its weakness provides additional support for Ukrainian exports and growth.

GDP Forecasts, CEE (% y/y)	2008	2009	2010	2011	2012
Russia	5,9	-7,5	3,2	4,3	5,5
Ukraine	**2,1**	**-13,3**	**2,7**	**4,5**	**6**
Poland	5	0,9	1,8	2,8	4
Hungary	0,7	-6,4	0,8	3,2	3,4
Czech Republic	2,7	-4,5	2	2,3	5
Bulgaria	6,1	-5,3	-1,3	1,4	1,9
Romania	7,4	-7,1	1,5	2,5	4,5
Turkey	0,9	-5,5	2,5	3,5	4,5

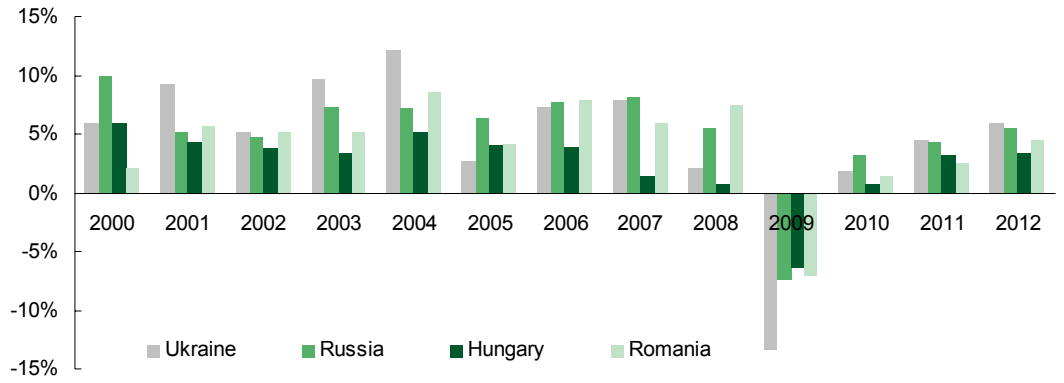
Source: BNP Paribas, UkrSibbank

GDP

Economy to accelerate significantly from 2011 due to broader global growth

We retain our key macro forecast unchanged, anticipating marginal growth in 2010 (+2.7%), accelerating from 2011 onwards due to broader global growth. Two percentage points following 13% slump can hardly be called optimistic scenario, but given that Ukrainian economy would be strongly dependent on exports and global outlook remains highly uncertain, it is hard to sketch sustainable growth drivers at this moment of time. However, forecast tails are fat due to extension of re-stocking and global stimuli and their impact on commodities prices yet have to be tested. In that sense one could expect growth in Ukraine to surprise on upside in 2010.

GDP growth in Ukraine and neighboring countries

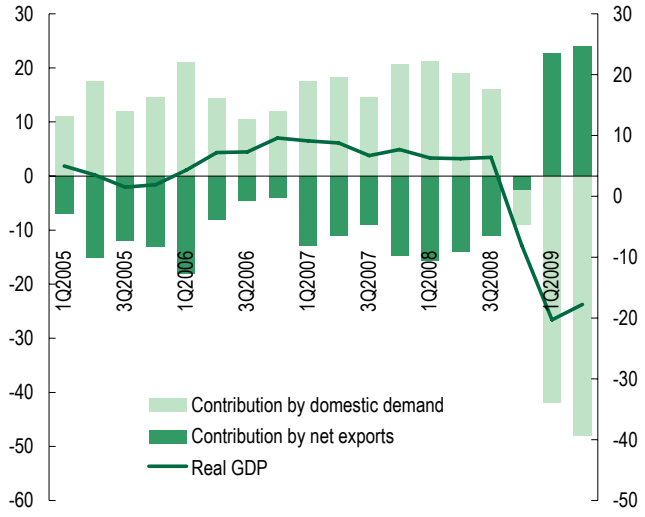


Source: BNP Paribas

Current recovery is export-driven

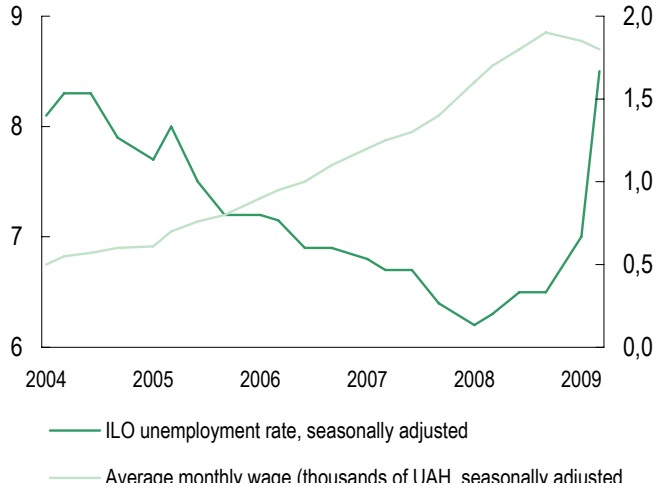
Economic recovery in Ukraine will be export-driven, domestic consumer is unable to support the recovery in some meaningful way. Earlier in the decade against the backdrop of rising exports Ukraine became an attractive market, absorbing billions in debt and direct investment. This triggered a skyrocketing growth in domestic incomes and significant increase in wages. Since 2005, a large chunk of growth was generated by domestic demand, accelerated by rapid increases in consumer credit. Since financial flows to the country have collapsed last year, growth pattern has turned upside down. Nominal wage has stumbled recently, pulled down both by sharp fall in corporate earnings and rising unemployment. Double digit inflation gnaws real incomes. High leverage in foreign currencies takes its toll while new loans to private sector remain restrictively expensive. Government social spending remains the key source of domestic consumption, but runs risk of becoming dribbling.

Contributions to real GDP growth



Source: IMF, UkrSibbank

Unemployment and nominal wages



Source: SSC

GDP Dissection

GROWTH

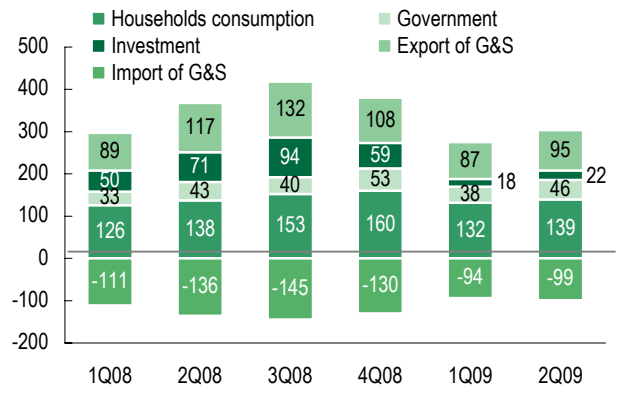
	2Q2006	3Q2006	4Q2006	2006	1Q2007	2Q2007	3Q2007	4Q2007	2007	1Q2008	2Q2008	3Q2008	4Q2008	2008	1Q2009	2Q09
Agriculture	104.9	95.3	111.5	102.0	104.8	107.1	90.5	94.7	95.0	100.5	99.5	121.9	120.7	117.2	101.3	102.3
Extracting industry	110.7	111.9	108.8	109.9	106.2	103.8	102.3	104.2	104.1	104.4	106.0	103.9	82.3	98.5	83.8	80.4
Processing industry	110.3	111.8	111.5	109.2	115.7	112.9	112.9	110.8	112.8	109.0	109.4	101.8	77.4	97.7	63.5	67.0
Gas. electricity. water	96.6	105.7	98.0	100.1	94.0	106.3	103.7	103.8	101.3	103.3	95.5	100.9	83.0	95.2	80.7	79.7
Construction	100.3	101.4	101.7	100.3	114.3	110.4	112.6	115.4	113.2	98.5	93.7	83.0	67.3	82.5	45.9	52.7
Trade and services	116.5	120.2	123.6	117.7	115.8	119.8	125.3	119.7	120.6	115.7	110.9	102.2	86.1	101.8	82.0	82.4
Transport&Communications	108.0	110.3	106.5	107.6	107.5	108.6	111.4	115.1	111.0	110.2	114.1	110.8	95.7	107.1	85.6	91.4
Education	103.2	99.1	104.1	102.1	101.0	105.1	105.6	105.0	104.3	100.8	99.6	96.6	100.4	99.4	97.2	97.4
Medicare	103.8	101.8	100.4	102.4	101.8	102.9	101.9	92.9	99.6	94.9	101.7	100.6	99.7	99.4	95.4	96.4
Financial Services	X	X	X	X	111.8	110.5	113.8	117.4	113.7	99.3	87.5	77.0	71.0	81.3	97.5	92.8
Real Estate	X	X	X	X	100.3	102.0	109.4	110.9	106.4	101.1	105.6	119.4	120.3	113.2	85.8	93.2
Government	X	X	X	X	97.5	99.4	99.8	89.0	96.1	103.4	100.3	108.2	100.6	103.1	87.3	91.9
Intermediaries (-)	X	X	X	X	X	X	X	X	X	108.5	101.4	96.0	89.3	97.4	127.5	113.9
Taxes	102.6	115.5	124.7	114.1	119.0	106.4	90.4	98.7	102.4	107.5	111.6	116.9	97.5	108.0	63.6	79.6
Output	**101.8**	**108.8**	**106**	**106.8**	**108.9**	**108.6**	**106.2**	**107.4**	**107.6**	**106.3**	**106.2**	**106.4**	**92**	**102.1**	**79.7**	**82.2**

GROWTH

	2Q2006	3Q2006	4Q2006	2006	1Q2007	2Q2007	3Q2007	4Q2007	2007	1Q2008	2Q2008	3Q2008	4Q2008	2008	1Q2009	2Q09
Consumption	116.6	110.4	108.3	112.4	114.3	113.5	111.3	114.5	113.4	117.0	110.1	110.9	101.4	109.0	91.4	90.0
households	119.7	112.8	113.8	115.9	119.1	117.0	113.6	119.0	117.1	122.5	113.3	114.1	101.6	111.8	88.4	88.4
ngo	89.4	90.6	93.3	91.7	93.2	92.7	93.0	87.2	91.5	87.8	87.1	98.5	110.4	95.5	93.9	102.2
Government	108.6	102.5	94.3	102.7	100.2	104.2	104.0	102.4	102.8	99.8	101.3	100.1	100.2	100.4	101.8	94.2
individual	107.1	103.5	95.2	102.5	102.0	104.9	103.8	100.6	102.7	101.3	102.1	96.8	99.2	99.8	104.2	92.9
common	111.3	100.9	92.9	103.0	97.4	103.0	104.4	105.1	102.9	97.0	99.7	105.1	101.8	101.3	97.4	96.4
Investment	106.4	110.7	123.0	118.5	116.6	127.8	119.1	125.1	122.1	113.7	128.7	112.9	75.2	105.1	X	X
Gross Capital Formation	121.0	120.6	121.1	121.2	125.9	125.8	124.5	123.8	124.8	119.4	112.0	103.8	82.6	101.6	51.3	42.2
Change in inventories	X	73.1	99.9	X	X	113.1	81.5	103.3	X	X	X	X	X	X	X	X
Acquiring	70.6	91.8	135.8	107.4	153.1	188.9	126.9	121.7	138.9	87.2	107.7	109.4	107.7	102.5	81.2	200.0
Net Exports (Goods and Services)																
Export of G&S	89.0	102.2	101.4	94.4	102.8	104.6	100.1	105.6	103.2	104.4	107.2	119.2	89.6	105.2	84.1	67.7
Import of G&S	101.8	108.8	106.0	106.8	114.7	120.7	115.5	127.2	119.9	123.8	124.4	129.6	95.8	117.1	64.4	46.5
Output	**101.8**	**108.8**	**106**	**106.8**	**108.9**	**108.6**	**106.2**	**107.4**	**107.6**	**106.3**	**106.2**	**106.4**	**92**	**102.1**	**79.7**	**82.2**

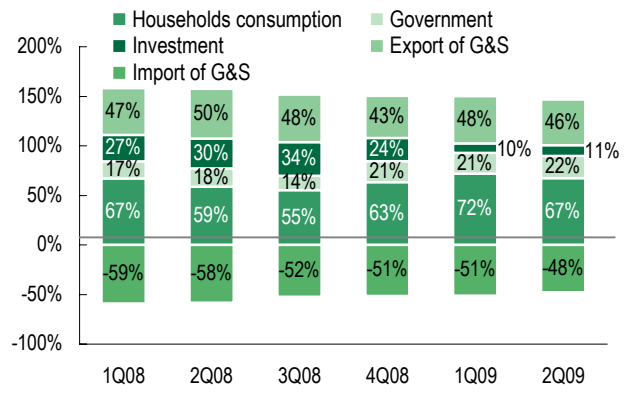
Household consumption remains a cushion, albeit unable to fuel the recovery. In relative terms, Ukrainian consumer made 72% of the GDP in the acute recession phase in Q1, providing opportunities for local businesses to substitute imports. In nominal terms, household consumption stood at UAH 139 bn in Q2, virtually unchanged from Q2 last year (UAH 138 bn). Share of consumption in GDP would gradually decrease over the next year or so, while some pick-up may be expected later on after export receipts can slowly cross-flow into population incomes.

GDP by components, UAH bn



Source: SSC

GDP by components, %GDP



Source: SSC

Similar to consumption, government spending has served a cushion, remaining virtually unchanged over the course of the year. Unfortunately, deep industrial recession, contraction of external trade and subsequent fall in revenues undermine state's ability to implement anti-cyclical policies. In that sense we believe that automatic stabilizers will be the most important tool against sharper economic downturn.

Household consumption and government spending serve as cushions, but it would take time to unleash investments' potential

Investment is well positioned to increase in 2010-2011, but this motion is subject to structural reforms that Ukraine has yet to begin. Currently investment is very modest, representing only UAH 22 bn, or close to 11% of country's GDP. It is well below emerging markets average of 30-40% GDP.

Ukrainian economy operates very limited stock of modern equipment. It is possible to increase productivity substantially, provided that necessary capital is there. Apart from direct industry need, demand for investment is huge in infrastructure: roads, electric grid lines etc.

The key reason of under-investment is lack of access to international markets over the last year, especially as Ukraine was widely rendered (for a good reason) as one of the worst credits worldwide in times of economic downturn.

Local banking system was unable to offer alternative source of funding since Ukraine has run a gap between local deposits and loans for some time already. Furthermore, Ukrainian banking system is primarily foreign owned so dramatic surge in risks was automatically translated to banking sector inability to issue new loans.

Given that a) capital markets have been unfreezing for more than three quarters by now b) Ukrainian exports are picking up given favorable developments in exchange rate c) Ukraine to enter a period of relative political stability (see below), we expect access to capital to be substantially easier in 2H2010 and beyond.

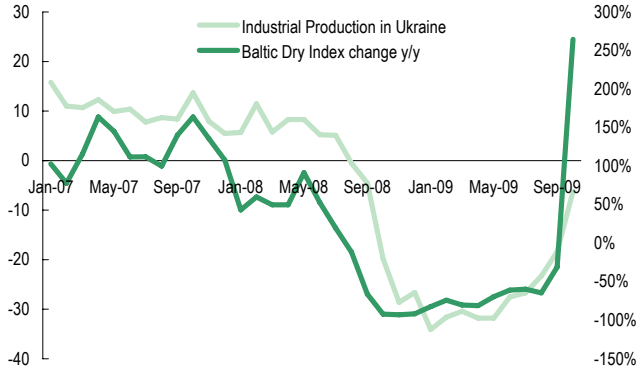
Furthermore, after going through transition period, domestic banking system is to start pumping internal savings to the corporate sector in 2H2010, supporting investments of small and medium businesses.

However, some serious obstacles are on the way, including tax&legal reform, land reform etc. Sustainable growth story in Ukraine has yet to be written and therefore investment is unlikely to fully uncover its potential in the nearest years.

INDUSTRIAL PRODUCTION

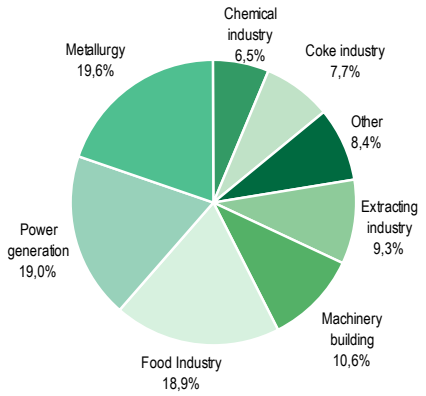
Industrial production recovers across the board, albeit from very low levels. IP recorded contraction of just -6.2% in October 2009 comparing to nearly 30% decline earlier this year. There are two fundamental factors driving the industrial recovery – an improvement in global demand and weakness of Ukrainian currency which allows domestic companies to reap more benefits from global growth.

Change in Industrial Production, y/y



Source: SSC, Bloomberg

IP composition breakdown

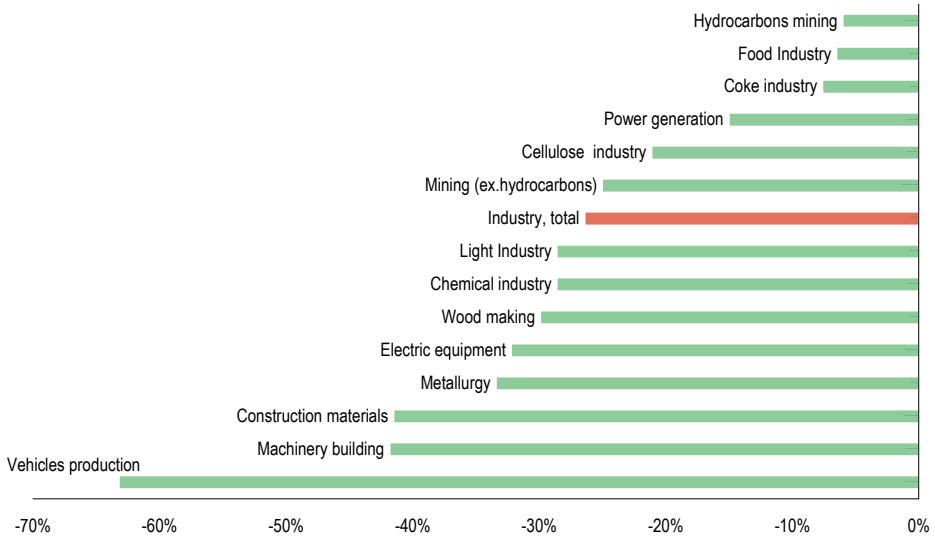


Source: State Statistics Committee

Metallurgy, currently representing about 20% of Ukrainian IP has been the key recovery driver so far, creating demand for coke, ore and electricity. It will remain the backbone of local economy in the mid-term, but also the most dependent on global trends.

Food industry is a bright spot both from perspective of export capacities and strong local demand. The sector offers brilliant prospects provided that necessary capital and technology would arrive there on time. Local currencies of Ukraine's neighbors appreciated vs UAH, creating exports opportunities to EU and Russia, large market with population over 150 mn. Food industry key problems are painful de-leveraging which froze investment projects across the industry and some delays with certification of Ukrainian foodstuffs resulting from insufficient quality of inputs.

Industrial Production, 10M, cross-industry



Source: State Statistics Committee

As energy price advantage is gone chemical industry has quitted the role of "locomotive" and would stay on the backstage. There are several fundamental problems with Ukrainian chemical producers. First, they operate outdated equipment and are not able to compete without lower energy prices. Cost of capital is high, inserting pressure on

margins. Finally, internal customer is weak and does not enjoy abundant government support as in developed countries. Recovery in chemical industry should be viewed as a derivative of structural reform in agriculture, allowing for more Capex and more fertilizers

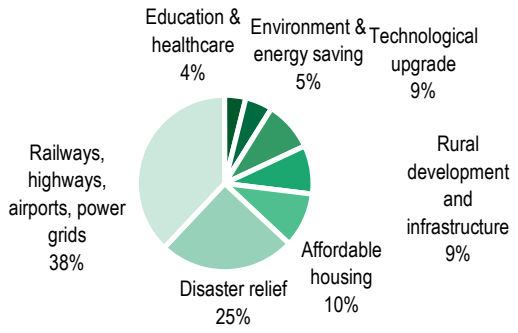
consumption. Unlocking agriculture's potential could drive up production in the industry in physical terms.

Mechanical engineering: segmented growth. The best performance we expect to persist in energy machine building, which showed the most moderate contraction across the industry. Producers of city transport are expanding their export activities along with domestic contracts attraction. Revival in cars production could be expected not earlier than in the end of 2010 - 2011. Aircraft engineering have got a record orders portfolio in 2009, exceeding industry's capacity and thus contracts execution would extend for several years. Ukrainian state railway announced its plans to place orders for railcars by the end of 2009, which most likely would be produced next year.

STEEL STORY – ALREADY WRITTEN

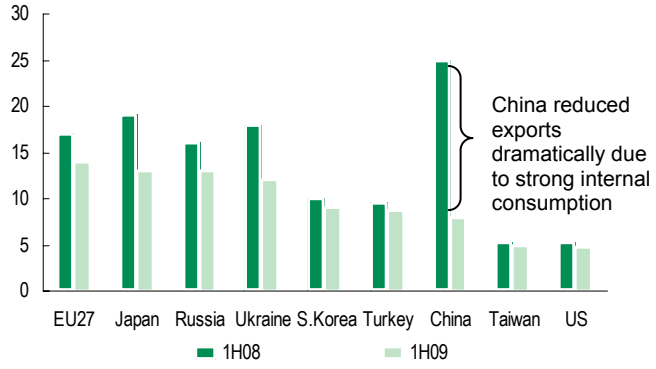
Developments in steel sector – vital Ukrainian export market – have been favorable comparing to what one could expect. Nearly 70% of steel consumption is related to investment, which declines more dramatically than the rest of the business cycle components. Earnings end capacity utilization in steel companies has fallen across the globe, with notable exception of China. Chinese $586bn worth stimulus package is probably much more infrastructure related than anywhere in the world. As a result, average utilization rate in steel sector is 90% in China versus 50% in the US and 60% in EU.

Composition of Chinese stimulus package



Source: BNP Paribas

Steel exports, Mt



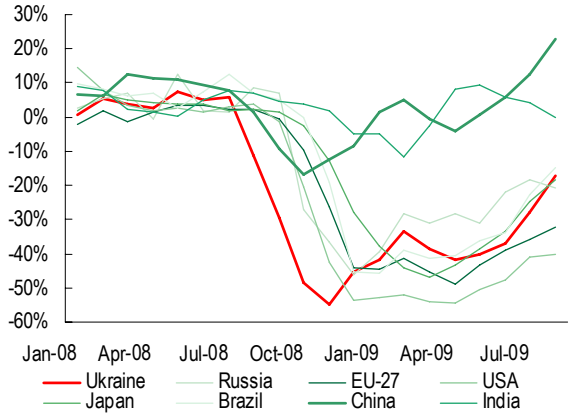
Source: BNP Paribas

We anticipate conjuncture on steel market to remain fairly volatile, with Chinese overproduction probably shaking the markets in 4Q2009 and 2H2010

Export threat from China is an issue. China has cut its exports dramatically in 2009 against the backdrop of increased domestic consumption which created room for other exporters (such as Ukraine). There are several strong arguments to think that China may be back to exports and sell more of its steel abroad. At about 360 tons per capita, average Chinese consumption is already fairly high comparing to 370t in EU and 350t in the US. Average residential floor-space per capita in China has increased by 1m2 per year to reach 30m2, approaching Japanese level (38m2). Investment rate in China is close 50% of GDP which is hardly sustainable while a new economic paradigm based on domestic consumption will take time to emerge.

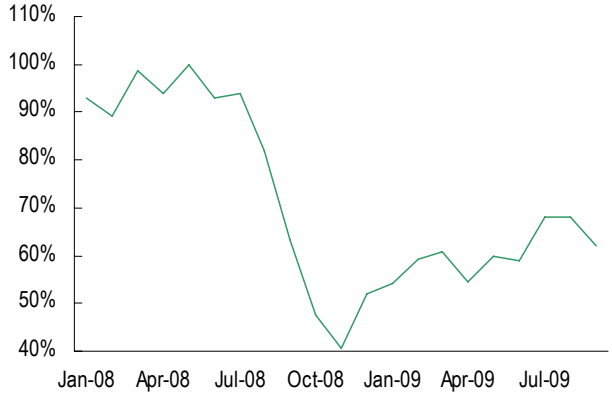
Having said that we anticipate conjuncture on steel market to remain fairly volatile, with Chinese overproduction probably shaking the markets in 4Q2009 and 2H2010.

Change in crude steel production, y/y



Source: Metal Courier

CapU Ukrainian steel sector



Source: Metal Courier

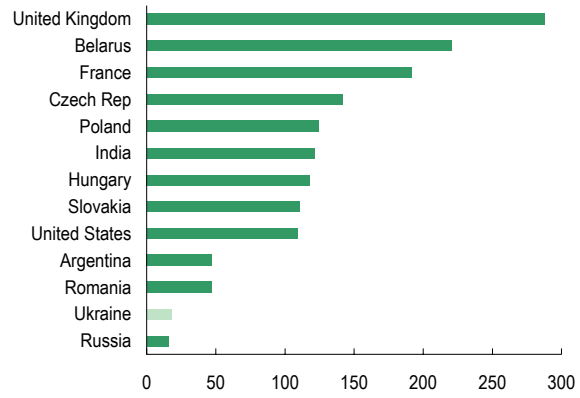
Capacity utilization in Ukrainian steel sector has risen over the course of this year to about two thirds. The rise in CapU is to lose momentum as key competitive advantages (such as devaluation of local currency) have been exhausted by this time. Ukraine demonstrated perhaps the best steel industry performance since Dec08 (in line with China), but **further rise in capacity utilization needs to be supported by heavy investment into equipment and energy-saving technology.** Furthermore, there is plenty of smelting capacity across the globe to step in even if recovery in steel prices is quick.

AGRICULTURE STORY – YET TO BE WRITTEN

Agricultural sector would play the key role in recovery of Ukrainian economy over the next years. Although the sector is developing fast, it is still well below potential. Average crop yield in Ukraine is only 60% of that received in Western Europe, albeit Ukrainian soils are much more fertile.

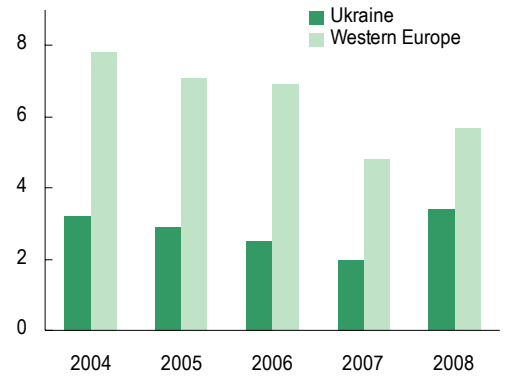
In 2008 the share of agriculture in GDP was 8% and is expected to cross 10% in the course of coming years. Last year's grain harvest was record high (53 mn tones) that allowed Ukraine to export 24,7 mn tones of grain and enter Top-3 grain exporters in the world. In 2008/2009 MY Ukraine was 5th largest wheat exporter and 1st in terms of barley exports. Agriculture Ministry expects Ukrainian grain exports to reach 20 mn tones in 2009/2010 MY, while 2009 harvest is forecasted at 48 mn tones.

Fertilizer Use Intensity, kg/ha



Source: FAOSTAT Online

Crop yields, Ukraine vs Western Europe



Source: UkrAgroconsult

Structural barriers. The absence of land market makes financing attraction quite complicated for Ukrainian agriproducers. The land they cultivate is leased and thus can not be used as a mortgage pledge.

Strong need in infrastructure. Large number of infrastructure projects is expected in the sector as sufficient part of existing storage facilities is obsolete and desperately needs renovation. Many agricultural companies despite economic slowdown and moderate crop expectations announced plans of new storage facilities construction.

Agricultural sector's potential is huge, but serious obstacles still have to be removed: absence of land market, obsolete equipment and lack of infrastructure

Significant consolidation potential. The peculiarity of Ukrainian agriculture is that the **largest agricultural companies hold only around 10% of all country's arable land and the business itself is very fragmented.** Many agricultural market players would seek for their land bank expansion and thus we expect consolidation processes in agricultural sector to activate in 2010. While there are ailing companies overburdened with debts some domestic producers strengthened their positions.

By now 2010 crop prospects look a bit shadowed as winter plantings suffered from drought. In 1Q2010 access to lending resources still might be limited, that could affect spring crops sowing campaign as well. Certain progress could be achieved in 2Q2010 but **the lending would not unwind in large scale.** State support to the sector remains much discussed and pronounced by the government but without material effect. FX rate fluctuations would also have negative impact on agricultural sector as considerable part of costs is made by imported means of production (seeds, fertilizers, equipment etc).

POLITICS

Upcoming presidential elections can turn into a fierce competition, elevating political risks immediately prior to and after the elections. Ukraine is in the midst of transition from tri-polar (Yuschenko-Yanukovych-Tymoshenko) to bi-polar (Yanukovych-Tymoshenko) political setup. Bi-polar setup could guarantee more political stability in the medium term, since the opposition to Prime-minister could no longer appeal to the third center of power and ruling leader would have much more opportunities to take more power and more responsibility for situation in Ukraine. Yuschenko, which served as referee in 2005-2009, has marginal chances to retain President's office via open elections.

Ukraine is in the midst of transition from tri-polar (Yuschenko-Yanukovych-Tymoshenko) to bi-polar (Yanukovych-Tymoshenko)

The first round is to take place on Jan 17th, followed by second round three weeks later (Feb 7th). An important change in the presidential campaign is that Mr Yatsenyuk (3rd by ratings), young liberal, seems to have fallen out of presidential race. Ineffective election campaign coupled with mixed activity in the mass media and low ratings across Ukraine removed intrigue in the first round.

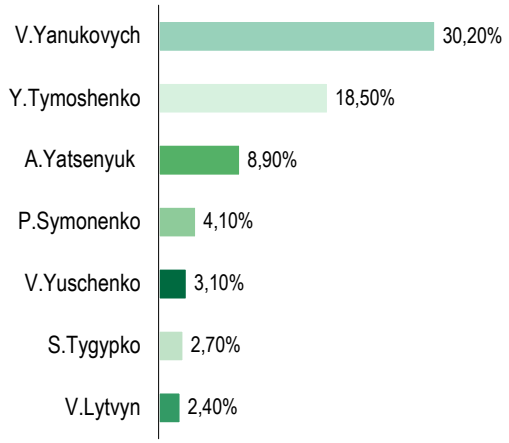
Political Calendar - Ukraine	Date	Importance
First round of presidential elections	17.01.2010	Medium
Second round of presidential elections	**07.02.2010**	**High**
Local council elections	30.05.2010	Medium
Snap parliamentary elections*	**30.05.2010**	**High**
Regular parliamentary elections	2012	High

**Estimated probability 30%*

Source: UkrSibbank

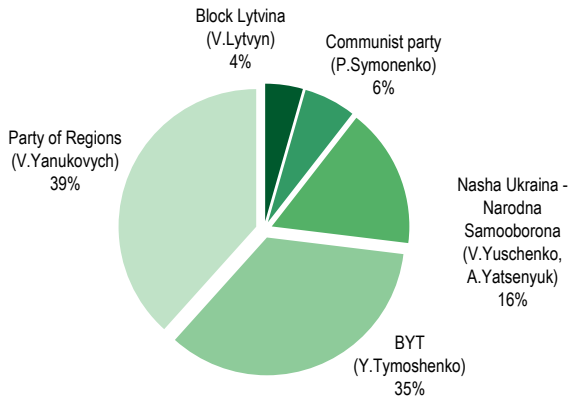
Mrs Tymoshenko, acting Prime-minister and Mr Yanukovych, opposition leader, will make it to the second round and will compete for the President's chair. The most recent poll from R&B Group, local think tank, indicates growing advantage of Mr. Yanukovych in the second round -46% vs 32% of Ms Tymoshenko. It implies that Ms Tymoshenko would have to take decisive steps in order to gain more electoral support over the months to come.

Current presidential ratings



Source: R&B Group

Composition of the parliament



Source: Ukrsibbank

In our central political scenario, the Parliament would create thin majority in order to support the new president. In that case, for the first time since 2005, Ukraine would escape confrontation between Prime-Minister and the President.

There is a material (ca 30%) probability of early parliamentary elections in May 2010. The winner of the presidential race may decide to strengthen his/her presence in the parliament by appointing early parliamentary elections. The most suitable date for this is May, 30th, when elections to local councils should take place. Since the law stipulates 60 days campaigning period, the new President would have to dismiss Parliament within two weeks of its inauguration.

Alternatively, Yanukovych and Tymoshenko could agree to form "wide" coalition, uniting efforts to restore country's ailing economy. In that case lion's share of short-term political risks could be removed.

	Tymoshenko becomes president	Yanukovych becomes President
Politics	BYT takes full control and responsibility	Political noise to remain intensive
Reforms	Higher chances for structural reforms	Slow evolutionary development
Privatization	Quick privatization	Delayed privatization
Relations with the West	Good, but subject to conjuncture	Medium
Relations with Russia	Very good, but subject to conjuncture	Very good
Local currency	Calls for stronger UAH	Weak UAH for protracted period of time
Risk to growth forecast	Strong upside and downside risks to growth forecast, depending on reform	Moderate
IMF	Quick return to IMF track	Complicated return to IMF track

Source: Brokers notes

According to our expectations, the third IMF program review of stand-by agreement reached in November 2008 has been de-facto postponed in order to mitigate risks to program implementation stemming from political cycle in Ukraine. Albeit Ukraine has met quantitative efficiency criteria implied by the second program review, both in terms of floor on FX reserves and ceiling on narrow money, passage of populist law, raising minimum salaries and social benefits has resulted into Ukraine effectively withdrawing from negotiations. Furthermore, insufficient budget revenues jeopardized generous IMF cap on budget deficit (4% GDP + ca 7% GDP in bailout packages).

Ukraine would attempt to return on track of IMF program after presidential elections, no matter who becomes the new President

Ukraine would attempt to return on track after presidential elections, no matter who becomes the new President. The budget execution which was made very difficult on the eve of Presidential elections becomes a heavy burden for any President and/or PM. In case Tymoshenko wins the elections she would try to get back to negotiations as soon as possible, with Ukraine probably seeing the next tranche early next year.

SBA program may be extended, with Ukraine receiving more than initially discussed. Especially if global conjuncture sees a W-shape, IMF might extend its participation, allowing for the size of stand-by loan to be extended or providing other sources of finance. Ukraine might need to replenish its FX reserves not due to the fact that its currency is overpriced (it is not), but because of its high exposure to global economy and dollarized financial system. That would allow the Fund to continue its program, betting on longer term structural effects.

IMF to change role from "cash cow" to "mentor" over 2010, imposing more and stricter requirements. We expect International Monetary Fund to take a proactive position in shaping the growth pattern of Ukrainian economy after president's elections, no matter who of Ukrainian leaders would become the president and/or lead the majority in the Parliament. All major geopolitical players (Russia, EU, US) have had enough of political instability and therefore are likely to establish strong relationship with any leader which could guarantee fulfillment of agreements. Same goes for the Fund, who was actively injecting cash to Ukraine over the last year in order to prevent further decline in GDP and most collapse of financial system which could have strong negative consequences for the whole region.

Ukraine has a positive experience of cooperation with IMF in late 1990s. Ukraine has achieved a broad-based and sustained economic recovery, and has subdued inflation following the 1998-99 financial crisis. Renewed confidence in macroeconomic stability has contributed to the remonetization of the economy, a strong balance of payments, the rebuilding of international reserves, and a significant improvement in the economic outlook.

PUBLIC FINANCE

During 2009, Ukraine (so far) managed to keep its head above the water due to generous support of IMF, which, beyond resources provided to central bank, injected equivalent of UAH 38 bn to substitute falling budget revenues. It allowed to facilitate handling the funding gaps caused by de-facto 12.6% GDP budget deficit, provide help to domestic banks and smooth out decline in consumption. It is not clear to us whether the Fund would continue to contribute to the purse in 2010 (probably yes, but with a substantially higher degree of policy conditionality).

Ballooning public deficit is a key threat for local currency, especially given forthcoming rotation of National Bank's head

Ukraine to face double digit budget deficit for the second consecutive year. State budget project for 2010 stipulates general government's expenditure at UAH 324 bn and revenues at UAH 285 bn. Budget deficit is set at about UAH 40 bn or 4% GDP. This figure does not include UAH 50 bn or 5% GDP to be spent on recapitalization of domestic banks. Given that Ukraine still needs to adjust internal utility tariffs, additional funds might be needed to bail out Naftogaz of Ukraine.

Budget revenues for 2010 were again forecasted under fairly optimistic assumptions. In our baseline scenario we see at least additional 3.5% GDP deficit stemming from lower than expected revenues of general budget. Overall balance would dip to -75 bn. or 7.5% GDP (see below). Below we sketched possible budget revenues for 2010 (MinFin is still working on a final version), but **it is likely that budget would be redrafted next year, probably with participation of IMF technical experts.**

Ballooning public deficit is a key threat for local currency, especially given forthcoming rotation of National Bank's head. Mr Stelmakh, acting NBU governor is to step out of office early next year. While there is a little certainty on who would be possible successor of Mr. Stelmakh, new governor would have to be extremely flexible at least in early 2010 given frozen SBA program and ongoing election cycle.

Bailout money foreseen in the budget (5%GDP) is unlikely to be used earlier than cooperation with IMF resumes. The key priority for the government would be avoiding default on domestic social payments.

Budget performance 2008-2010, UAH bn*

	2008		2009E		2010F	
	All	General	All	General	All	General
Revenue	419.7	231.7	379.3	211.4	445.7	249.2
Tax revenue	358.1	187.5	319.4	166.1	375.4	195.9
Personal income tax	45.9	0.0	42.1	0.0	49.1	0.0
Enterprise profit tax	47.9	47.5	36.4	36.0	43.4	42.9
Payroll tax	107.9	0.0	98.6	0.0	114.8	0.0
Property tax	6.7	0.0	5.7	0.0	6.7	0.0
VAT	92.1	92.1	80.9	80.9	95.2	95.2
Other taxes on goods and services	28.7	25.4	36.5	34.1	44.0	40.2
Taxes on international trade	12.3	12.3	6.5	6.5	7.5	7.5
Other taxes	16.7	10.3	12.6	8.6	14.6	10.0
Nontax, capital revenue, and grants	61.6	44.1	59.9	45.3	70.3	53.3
Expenditure	449.6	256.0	436.0	268.1	520.7	**324.2**
Current expenditures	392.5	215.9	392.6	229.8	-	-
Wages	97.7	43.4	101.8	46.0	-	-
Goods and services	59.5	38.5	60.7	41.2	-	-
Subsidies	34.4	24.8	19.5	10.3	-	-
Transfers	196.0	104.7	196.7	118.9	-	-
Interest	4.9	4.4	13.8	13.4	-	-
Capital spending	52.9	37.4	37.6	32.4	-	-
Net lending	2.8	2.7	5.9	5.8	-	-
Unallocated spending	1.4	0.0	0.0	0.0	-	-
Overall balance	**-30.0**	**-24.3**	**-55.0**	**-55.0**	**-75.0**	**-75.0**

2010 budget is currently being redrafted by Minfin
Source: IMF

INFLATION

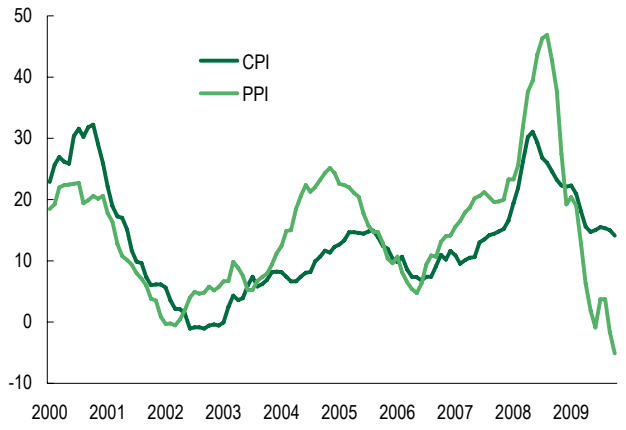
Inflation in Ukraine – nailed down by demand, pushed by supply. CPI pressures have eased significantly over the last 12 months, with headline index falling from 30% y/y to 14.1% y/y. Producers' prices went into negative zone before posting a slight rebound recently.

Producers prices to display moderate growth next year, developing in line with external demand for Ukrainian goods. A slump in internal consumption would keep the prices of domestic market oriented industries broadly stable.

Supply side would prevent Ukraine from slipping into deflation; in fact, CPI would be higher than in neighboring countries

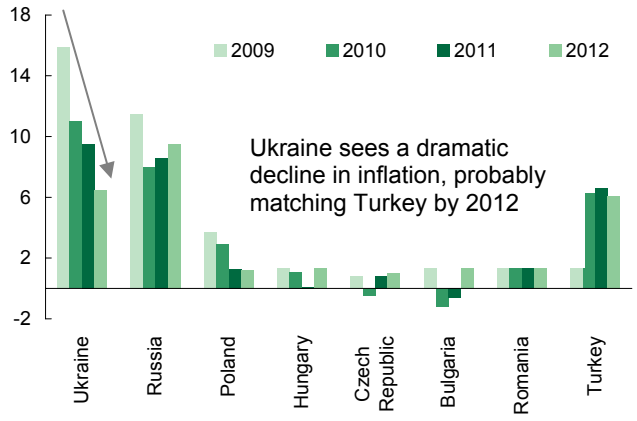
Demand pressures on CPI are gone for a long time. Sharp increases in salaries, incomes and social benefits, sometimes exceeding 40% p.a., were fuelling Ukrainian consumer inflation in 2003-2008. These drivers will be off agenda for at least two years to come. With economy finding itself in a restructuring phase, capacity utilization in some fastest-growing sectors (such as retail, financial sector, vehicle sales etc) edged down dramatically. These sectors are to provide employees to export-oriented businesses with limited or no markup in incomes. Given that retail lending has stumbled for a long time, demand side signals deflationary period.

CPI and PPI



Source: SSC

CPI forecasts, Ukraine vs peers



Source: BNP Paribas, Ukrsibbank

Supply side would prevent Ukraine from slipping into deflation, in fact CPI would be higher than in neighboring countries. Operation costs for local producers are to remain high. First, desperate fiscal situation leads to increases in taxes and tightened tax collection across the board. Second, cost of funding remains incredibly high (at 22-30% in hryvnia or 15-20% in foreign currencies), new lending is not available. Third, weak UAH keeps costs of imported goods, equipment and energy high.

Adjustment of utility tariffs has been postponed for now, but is inevitable after elections. Gas, electricity and public utility tariffs need to be raised in order to improve balance sheet of Naftogaz of Ukraine. Ukraine has already taken commitments to adjust tariffs starting form September this year, but respective decision was blocked by trade unions. Successive talks of IMF local representative with the trade unions brought no results. To some extent, positions of trade unions could be attributed to upcoming elections and we anticipate price adjustments to be implemented after presidential elections, pushing up services.

CPI would decline in the medium term. Easing demand side and passing the peak of supply side pressures (including services) should bring CPI down to 11.5% in 2010, 9.5% in 2011 and just 6.5% in 2012. Lower CPI in 2011-2012 should be supported by UAH strengthening via both USD and currencies of selected neighboring countries.

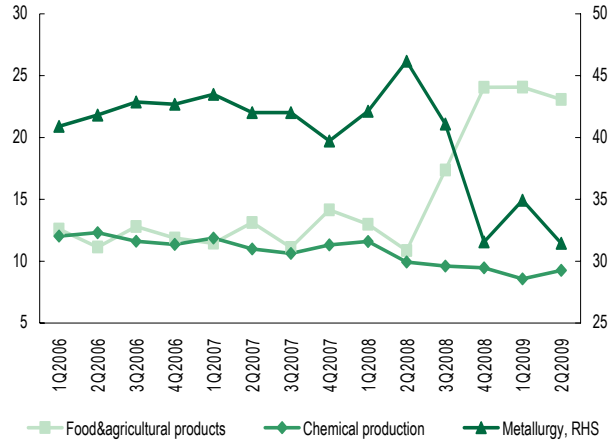
In light of declining consumer inflation we see all reasons for interest rates to go down later in 2010 and early 2011, even in case central bank does not announce formal easing.

EXTERNAL ACCOUNTS

Volume of external trade has contracted over the course of this year. Both exports and imports fell twofold, mimicking contraction of global trade. As of 8M2009, decrease of exports (-48.2%), is much more pronounced than that of imports (-52.6%), reflecting both weakness of Ukrainian currency and retrenchment in domestic consumption.

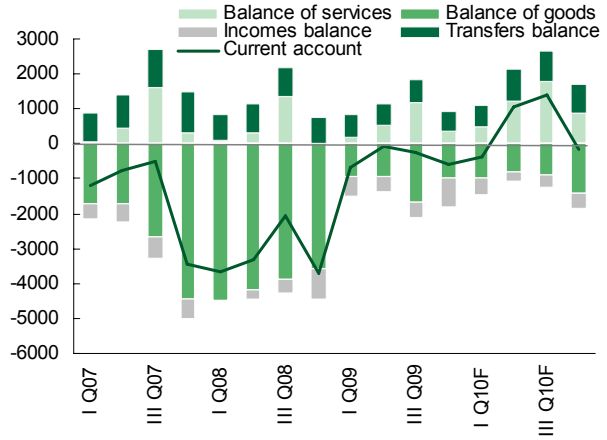
Export mix becomes more diversified across industries, decreasing Ukraine's dependence on steel. Share of metals in total exports fell from over 45% to roughly one third, reflecting both soft patch in steel market and strong demand for Ukrainian agriculture products and processed food. Share of food&agriproducts have recently risen to over 20% of total exports and is poised to climb up in the medium run. Ukraine is currently leading world exporter of sunflower, barley and wheat and expected to enhance its capacities given that local producers are well positioned on the cost curve.

Ukraine's key export categories, share in total exports, %



Source: NBU

Current account



Source: UkrSibbank

9M2009 current account deficit contracted to -$1bn (0.8% GDP) vs -$9bn one year earlier. Cumulative 9M trade balance deficit of -$3.6 bn and incomes item deficit of -$1.6 bn are nearly covered by positive services balance of $1.9 bn and strong transfers ($2.3 bn). Energy imports nosedived recently due to the fact that Ukraine has pumped up (and paid for) the gas into storages for winter season in summer.

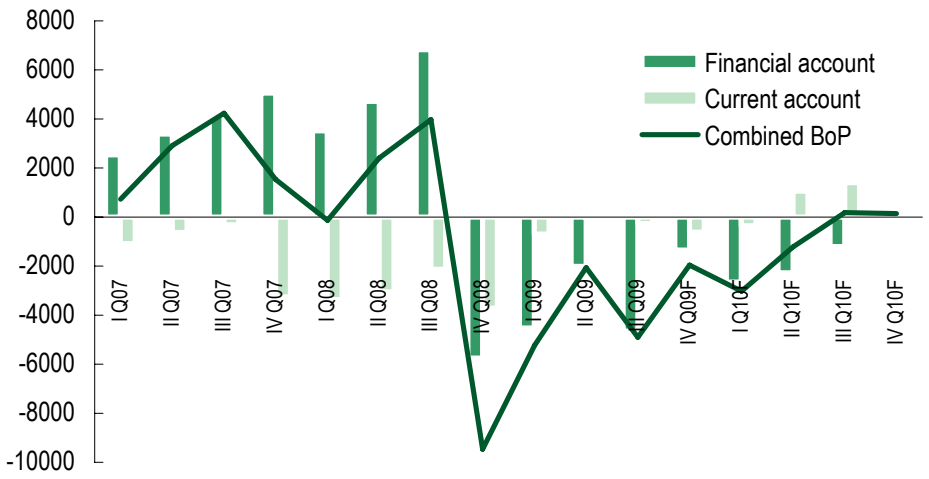
…but is expected to worsen somewhat by year end on stuttering exports, services and transfers - we expect C/A deficit to reach -1.3% GDP in 2009. Outlook for exports in 4Q2009 is weak since conjuncture on key export markets worsened. Payments for services are mostly received for gas transit and Ukraine has already got the most part of payments in advance. Sale of a part of CO2 quota for $560 mn to Japan contributed into c/a for 9M2009, but other significant proceeds are unlikely this year. The inflows through transfers are expected to be moderate till the end of 2009.

In 2010 current account balance would pass into positive zone and cross $1.9 bn mark due to services balance running high. The latter is expected to reach $4.4 bn fully covering -$4 bn trade deficit and supported by moderate improvements across other C/A items. The main driver for services balance increase would be gas transit payments as renewing industrial production in Europe would create greater demand for Russian gas. Effect from the transported gas volumes increase is likely to be multiplied by price hike. According to Naftogaz head O. Dubyna, gas transit tariff would be lifted from current $1.7/tcm for 100 km to $2.7 in 2010. Traveling receipts contributing 1/4 of services export would grow on the back of business activity revival. Incomes balance would continue previous years' story remaining below zero (-$1.5 bn) as debt servicing payments remain high. Transfers are expected to improve their dynamics slightly as a part of Ukrainians who previously worked abroad would return to their workplaces.

In 2010 current account balance would pass into positive zone due to growing services surplus

Merchandise trade deficit would slightly contract to -$4 bn as Ukrainian exporters would continue to benefit from weak UAH and improved external conjuncture in 2010. Utilities are expected to remain the key imports driver as Ukraine would pay much higher gas price next year. Some enterprises have already started to switch to utilities other than gas but the process would take some time so amounts of gas consumption should inevitably grow in 2010. Started modernization of facilities would push up machinery&equipment imports but demand for other imported goods would stay weak. In 2011 strong industrial production would require more utilities and equipment and along with restored domestic demand would result in wider external trade gap of $6.8 bn.

Balance of payments



Source:NBU

Ukraine has to pay a huge price for being highly dollarized economy as flight to cash FX in domestic savings still hurts BoP more than actual flight of foreign capital

Financial account is deeply in red and would remain there at least till middle of 2010. In 9M2009 financial account deficit accounted for -$11.1 bn and we expect it to reach -$12.5 bn in 2009 YE. FX purchases by population continue to be strong destabilizing factor as their volumes ($7.2 bn in 9M2009) almost equal net redemptions. **Indeed, Ukraine has to pay a huge price for being highly dollarized economy as flight to cash FX in domestic savings still hurts BoP more than actual flight of foreign capital.**

In 2010 much would depend on local currency stability. When devaluation expectations would gradually evaporate, FX purchases by population would stop to be significant downside trigger for financial account. We estimate FX volume which would be bought by individuals at $4.5 bn and it is mostly attributed to the 1H2010 (while in 2009 such purchases are expected to be near $9 bn). In 2011 FX cash out of banks would continue to be negative for the reason of FDI outburst and active FX inflows into the country.

FDI surprised on the upside almost reaching our 2009 forecast in 9M (+$3.3 bn) manly due to funds attracted by banks for recap. Though process is far from being completed, banking sector contribution in 2010 FDI is not expected to be of the same large scale. Subordinated loans have played out as the banks having access to such financing had mostly filled the limits established by NBU (subloans should not exceed 100% of additional capital). Most likely channel of capital inflows into banks remain equity injections. These flows would be financed through reinvestment of earnings received in Ukraine, though increasing FDI volume.

At the same time, **we see revival of investors' cautious interest to some industries**, but the scale of investments in real sector is usually smaller comparing to banking. Lending in 2010 would be scarce de-facto restricting real sector from fast recovery. For that reason some companies might choose to sell stakes in their business in exchange for fresh cash. Numerous deals of such fashion are likely to be led by private equity firms. Strategic investors might come in two cases: 1) clear privatization is held 2) large ailing banks are proposed for sale under attractive conditions. Otherwise they would commence to consider entering/reentering Ukrainian market only starting from 2H2010.

Infrastructure projects remain unexplored area for investments as needs in various objects construction is huge (airports, roads, bridges etc.). Public Private Partnership projects, which we expected to appear in this domain in 2009, are likely to be postponed till 2H2010-2011 as investors would like to sign agreements with new established government. Basing on these assumptions **we expect FDI volume to land at $4.4 bn in 2010 as there is a significant time lag between investment decision and its implementation.**

In 2011 FDI would almost double and become F\A driver into positive zone as somewhat deferred demand for making investments would accumulate.

FDI growth in 2010 would be moderate as there is a significant time lag between investment decision and its implementation

Next year eurobonds redemptions schedule would be tight for corporate and banking sector, while sovereign sector has a year-long pause till Dec 2010. **Total volume of redemptions in 2010 would be approx. 1/3 less than in 2009 that would result in -$6.3 bn of net repayments.** According to "Fundamentals of monetary policy for 2010" published by NBU, total payments on external debts in 2010 are estimated at $20.3 bn, more than $18 bn would make payments on corporate debts, around $2.3 bn payments on state and state-guaranteed debts. External debt breakdown has been changing during last 4 quarters: sovereign and quazi-sovereign sectors' debts were growing on IMF financing, increasing their share, while private sector's loans demonstrated the opposite dynamics. In banking sector there is a clear trend of long-term financing share enlargement in total breakdown on the back of short-term debt's decline (due to redemptions, and prolongations which shift a portion of ST debt into LT category).

We expect to see debt prolongations where it would be possible, but to lesser extent for public loans because many companies would start to seek for external financing on the back of locked domestic lending. As international capital markets would demonstrate further unfreeze in 2010, opportunities for obtaining new loans might appear for selected Ukrainian companies. Furthermore, we believe a possibility of tapping the market by the government is very high (such intentions have already been mentioned by MoF representatives). Good portion of loans would come from the side of international organizations again through infrastructure loans, banking and agricultural sectors. The topic of Europe's joint loan for gas transportation system modernization seems to be closed by now but might reappear again in 2010-2011. Meanwhile, we do not put these funds in our projections as gas-related issues could hardly be forecasted at the moment. In 2011 short-term loans are likely to come back first preceding healthy long-term financing comeback aimed for development.

Balance of Payments of Ukraine

	2008					2009				2009	2010	2011	2012
$ mn	1Q08	2Q08	3Q09	9M08	Year	1Q09	2Q09	3Q09	9M09				
Current Account Balance	**-3 700**	**-3 313**	**-2 078**	**-9 053**	**-12 933**	**-696**	**-54**	**-258**	**-1 008**	**-1 619**	**1 944**	**-1 200**	**-218**
Balance of Trade in Goods and Services	-4 451	-3 863	-2 527	-10 803	-14 520	-751	-718	-488	-1 657	-2 313	327	-2 234	-2 140
Export of Goods and Services	17 528	23 516	27 253	68 297	85 612	11 282	11 402	14 529	38 268	48 334	62 650	70 372	80 393
Import of Goods and Services	-21 979	-27 379	-29 780	-79 100	-100 132	-12 033	-12 120	-15 017	-39 925	-50 647	-62 323	-72 606	-82 533
Merchandise Trade Balance	-4 670	-4 171	-3 868	-12 529	-16 934	-937	-1 141	-1 684	-3 567	-4 567	-4 082	-6 867	-8 253
Export of Goods	13 960	18 940	21 199	54 099	67 717	8 455	8 488	10 362	28 002	36 221	46 902	52 530	60 409
Import of Goods	-18 630	-23 111	-25 067	-66 628	-84 651	-9 392	-9 629	-12 046	-31 569	-40 787	-50 984	-59 396	-68 662
Services Trade Balance	219	308	1 341	1 726	2 414	186	423	1 196	1 910	2 254	4 409	4 632	6 113
Inflows	3 568	4 576	6 054	14 198	17 895	2 827	2 914	4 167	10 266	12 114	15 748	17 843	19 984
Outflows	-3 349	-4 268	-4 713	-12 472	-15 481	-2 641	-2 491	-2 971	-8 356	-9 860	-11 339	-13 210	-13 871
Incomes (balance)	11	-283	-382	-654	-1 540	-574	-428	-409	-1 673	-2 208	-1 546	-1 623	-1 055
Transfers (balance)	740	833	831	2 404	3 127	629	622	639	2 322	2 903	3 164	2 658	2 976
Capital and Financial Accounts Balance	**3 565**	**5 723**	**6 058**	**15 308**	**9 874**	**-4 529**	**-2 009**	**-4 650**	**-11 188**	**-12 540**	**-5 843**	**5 705**	**10 372**
Capital Transfers		-1	5	4	5	70	5	3	78	85	17	23	35
FDI (balance)	2 430	3 091	3 324	8 845	9 683	847	1 247	1 212	3 336	4 237	4 025	7 325	10 402
Portfolio Investment (equity capital)	208	72	114	394	388	-55	-9	-15	-79	14	366	512	769
Loans and bonds (balance)	3 246	4 595	5 516	13 358	12 489	-1 767	-2 869	-2 939	-7 575	-8 088	-6 324	-288	-250
Medium and Long-Term Loans, Bonds (balance)	3 445	3 491	4 876	11 813	13 520	463	-2 589	-1 871	-3 997	-4 225	358	-889	-951
incl govt	246	-239	-438	-380	-89	-195	-43	-960	-1 198	-1 330	398	-282	-316
incl banks	1 975	2 298	2 779	7 052	7 625	1 193	-2 092	-1 144	-2 043	-2 063	-214	-475	-532
incl other sectors	1 224	1 432	2 535	5 141	5 984	-535	-454	233	-756	-832	174	-132	-103
Short-term loans	-199	1 104	640	1 545	-1 031	-2 230	-280	-1 068	-3 578	-3 864	-6 682	601	701
incl banks	-36	861	371	1 196	-1 559	-2 248	-286	-1 074	-3 608	-3 897	-6 496	327	353
incl other sectors	-163	243	269	349	528	18	6	6	30	33	-186	274	348
Other capital	-2 319	-2 034	-2 901	-7 293	-12 691	-3 624	-383	-2 941	-6 948	-8 788	-3 927	-1 868	-584
incl. FX Cash out of Banks	-2 145	-1 554	-3 997	-7 806	-12 897	-4 205	-197	-2 792	-7 195	-9 138	-4 477	-2 418	-1 112
BoP	**-135**	**2 410**	**3 980**	**6 255**	**-3 059**	**-5 225**	**-2 063**	**-4 908**	**-12 196**	**-14 159**	**-3 899**	**4 505**	**10 153**
IMF resources use	-	-	-	-	4 347					5925	5780	0	-3495
Gross International Reserves	**-**	**-**	**-**	**-**	**31 543**	**-**	**-**	**-**	**28 126**	**27 001**	**28 882**	**31 193**	**27 698**

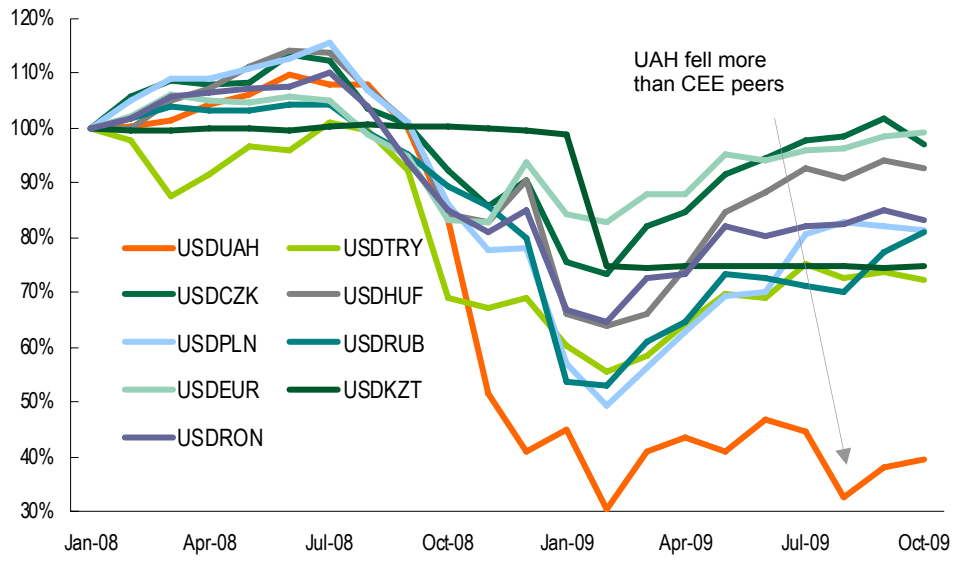
Source: NBU, UkrSib's forecasts

FX FORECAST – CHEAP AND WEAK…

UAH looks cheap comparing to other currencies…

Fundamentally, Ukrainian currency seems to be cheap. The CEE universe has moved down 10-20% vs USD since January 2008, while UAH lost some 60% since that time.

USDUAH vs peers (January 2008=100%)



Source: Bloomberg, UkrSibbank

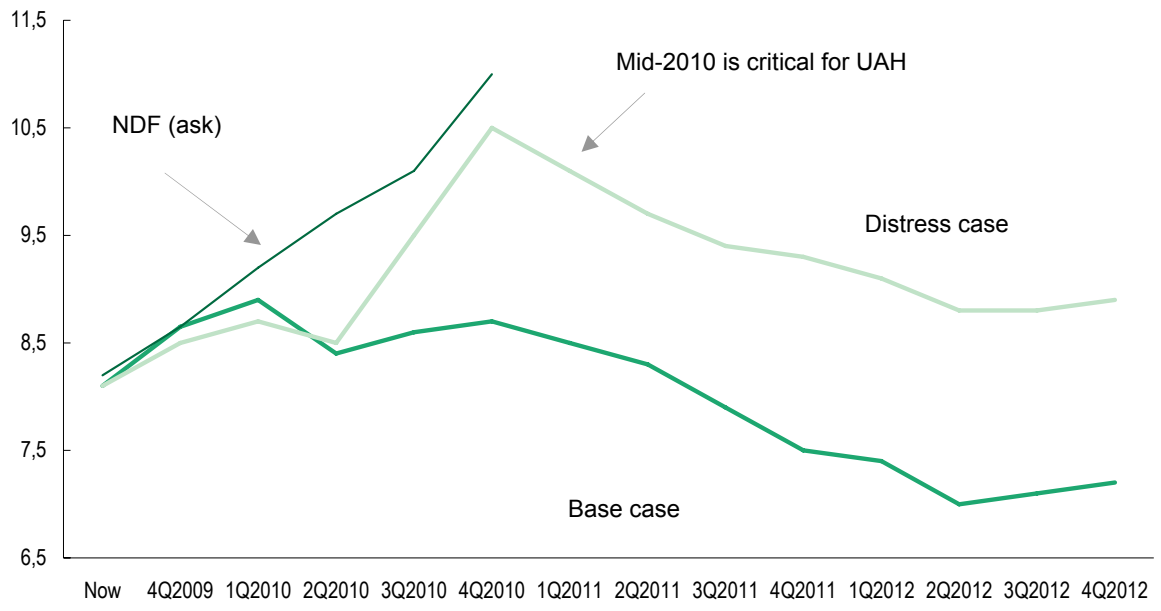
Ukrainian currency is likely to remain weak over 2010, with key risks stemming from probable correction in steel prices coupled with high private sector leverage and significant fiscal deficits.

Ukrainian currency is likely to remain weak over 2010, with key risks stemming from probable correction in steel prices coupled with high private sector leverage and significant fiscal deficits.

Good times for local currency are at least one year away:

- **Albeit some improvement in the export mix is taking place, Ukraine is still highly dependent on steel market conjuncture** which might turn highly unfavorable after China is done with its ambitious domestic stimulus program;
- **C/A adjustment over the last quarters is significant, but not enough to compensate deficits on financial account side.** Capital outflows are to prevail over 2010 and current account needs to go further into positive territory in order to compensate for that;
- **Fiscal deficits are in double digits as a percentage of GDP** and their funding would require participation of National bank in one way or another, probably via buyout of government debt. Banks bailout package worth UAH 50 bn is scheduled for the next year. Part of it would be used to compensate for FX deposits in troubled banks, inducing pressure on local currency;
- **FDI and return of FX denominated domestic savings currently piled under pillows would probably be a key factor, resolving the problem with financial account.** It does not look like it could happen before political mess is cleared out and public finance is on sustainable path;
- **Private sector's leverage remains substantial.** While rollover rates remain high and there are signs that a substantial portion of external debt is held by Ukrainian nationals, debt service costs are growing after restructurings and return of FX cash to Ukraine is subject to significant improvement in animal spirits (Ukraine's attractiveness as investment destination).

USDUAH – risk scenarios vs NDF



Source: NBU

Base case. Hryvnia is weak over 2010, reaches lowest points in 4Q2010-1Q2011, when the global economy passes the second trough in the "W-shaped" recovery. China is busy with transition to domestic consumption paradigm while other regions are turning to display moderate growth. Global investment comes out of the woods and banks resume lending, generating healthy demand for metals in early 2011. Ukrainian public deficits are high over 2010, but then are declining both due to rising revenues and expenditure reduction.

Distress case. Sharp contraction of global demand in 2H2010 followed by growing risk aversion among international investors and wave of de-leveraging. Exports are down. Large fiscal deficits are maintained in order to support domestic demand. Cooperation with IMF is frozen. Financial system is under stress and requires additional bailout packages. Note that if UAH crosses 10, its behavior would be administratively driven, with stricter capital and currency controls taking place.

In both baseline and distress cases we anticipate UAH strengthening in 2011 due to gradual USD devaluation. **Weaker USD is hryvnia's best friend in medium-term.** Both external debt and leverage of domestic households is mostly FX denominated, so USD depreciation both against key currencies and real assets would be very favorable both for Ukrainian currency and local credit risk. In that case financial account would go into positive territory, resulting into steady surplus on FX market and NBU probably intervening in order to prevent UAH from excessive strengthening.

	Now	4Q2009	1Q2010	2Q2010	3Q2010	4Q2010	1Q2011	2Q2011	3Q2011	4Q2011	1Q2012	2Q2012	3Q2012	4Q2012
Base case	8,1	8,7	8,9	8,4	8,6	8,7	8,5	8,3	7,9	7,5	7,4	7,0	7,1	7,2
Distress case	8,1	8,5	8,7	8,5	9,5	10,5	10,1	9,7	9,4	9,3	9,1	8,8	8,8	8,9
NDF quotations	8,2	8,65	9,2	9,7	10,1	11								

Source: UkrSibbank, Reuters

BANKING SYSTEM – SURVIVING THROUGH THE CRISIS

Ukrainian banking system has escaped the horror scenario for now. **One important achievement of domestic banking system is that it has survived bank run and de-facto collapse of three large banks, one of which was the leading financial institution in transactions and cash management.** Consequences of this have been moderate, comparing to what one could expect, perhaps due to low level of financial system development.

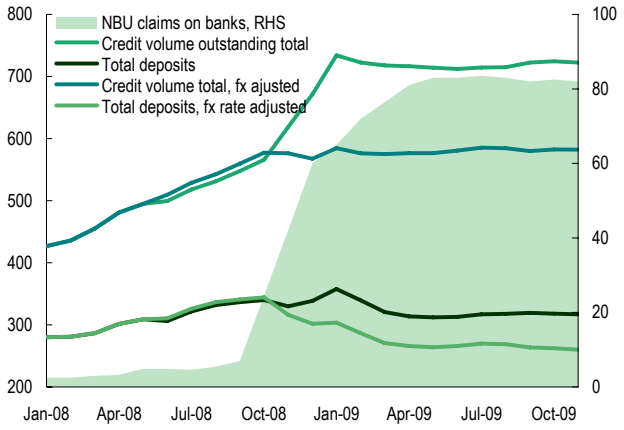
One important achievement of domestic banking system is that it has survived bank run and de-facto collapse of two large banks, one of which was the leading financial institution in transactions and cash management.

Deposit run is over, NBU cuts liquidity provision. Our estimations show that majority of top tier Ukrainian banks have had excessive liquidity over some period of time as deposit run stopped in the summer and willingness of domestic banks to generate new loans have been very limited.

Money market rates have been low for the most of this year, reflecting strong cash preference by domestic banks. To some extent this preference can be explained by a) unwillingness to lend to real economy b) strict conditions of NBU's refinancing loans (central bank often demands additional restrictions) c) there is no wide interbank market. Currently Ukrainian interbank is a multi-tier system. Top banks (primarily international capital) are dealing in one club, while second-tier and third tier deal largely in their own universe.

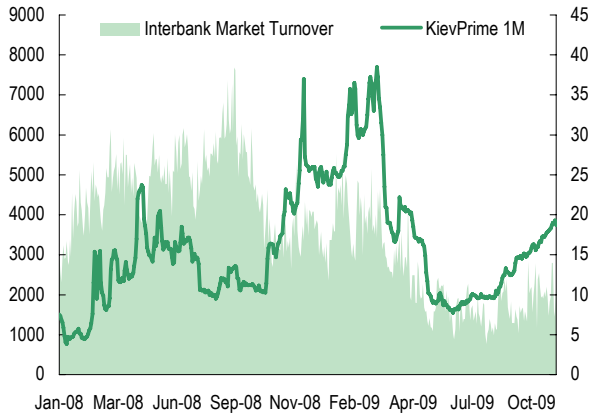
Due to generous offers government bonds (up to 29.5% on 6M note), interest rates have risen somewhat in October, reflecting crowding-out effect. New lending barely exists, and commercial loans are rare and expensive - the interest rates on new 6M-1Y loans are typically ranging from 25% to 30% and there is still very limited number of banks offering lending products.

Loans, deposits and liquidity provision



Source: NBU

Interest rates and interbank volumes



Source: NBU, Reuters

Asset quality has been badly impacted and it will get worse. According to our estimations, "true" NPL should reach 20% over months to come. Recent NBU's estimation of overdue loans landed at 7%. This figure, however, includes only overdue payments while under international standards the principal is also considered to be overdue. Fitch rating agency estimates 90-day overdue loans at 11% of credit portfolio, noting that additional 24% of total loans have been restructured (i.e. impaired). Our working assumption is that NPL would include all overdue 90 days loans plus one third of currently restructured loans, due to the fact that many restructurings were made in order to free up cash flows for consumption (retail) and acquisitions (corporate sector). Domestic banks do not have a tool to spot a troubled customer and therefore have to agree for restructurings.

Asset quality would demand additional capital

As of 3Q2009, total credit portfolio of local banks was at UAH 747.8 bn, while amount of provisions stood at UAH 92.7 bn. It can be said that 12.4% of credit portfolio saw 100% provisioning. Under fairly reasonable assumption that NPLs could reach 20%, **full provisioning would require additional UAH 56.7 bn.** As of 3Q2009, own capital of Ukrainian banks was at UAH 118.0 bn. Subtracting additional provisioning would leave us with UAH 61.1 bn of net equity, which would be an equivalent of ca 6.9% CAR. This compares to healthy 15.6% reported in the beginning of October 2008. Given that some of the banks are extremely well capitalized (e.g. state giant Oschadbank), capitalization of selected banks can be significantly below industry average.

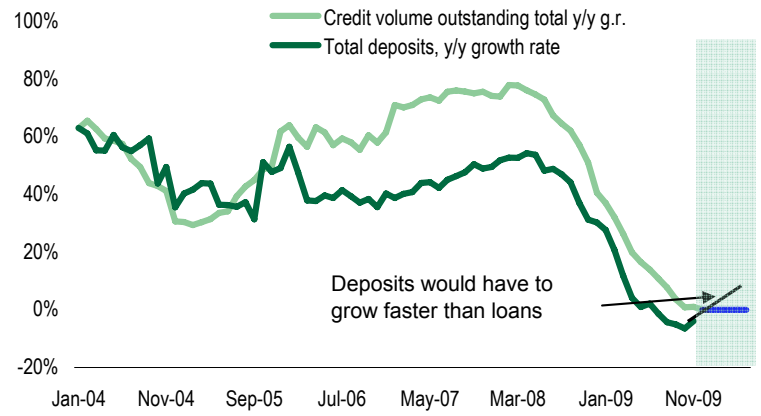
Banking system statistics, UAH thds

Tier	Assets (Oct 1 2009)	Credit portfolio (Oct 1 2009)	Provisions (Oct 1 2009)	Provisions as % of credit portfolio (Oct 1 2009)	Additional provisions needed given 20% NPL assumption	Equity (Oct 1 2009)	Net equity*	CAR*
Tier I	605 209 259	530 872 428	-66 653 533	12,56%	-39 520 953	74 104 999	34 584 046	5,71%
Tier II	145 692 369	114 667 913	-13 161 519	11,48%	-9 772 064	18 038 874	8 266 810	5,67%
Tier III	67 597 024	47 686 592	-6 366 908	13,35%	-3 170 410	12 794 003	9 623 593	14,24%
Tier IV	71 459 880	54 548 526	-6 503 548	11,92%	-4 406 157	13 030 141	8 623 984	12,07%
Total	**889 958 533**	**747 775 459**	**-92 685 508**	**12,39%**	**-56 869 584**	**117 968 018**	**61 098 434**	**6,87%**

*given 20% NPL assumption, CAR calculation simplified, actual CAR 1-2% higher for all groups

Ukrainian banks should be able to clean the mess of troubled assets over the course of 2010, but some serious handicaps are there, including weak local legal system which allows borrowers to delay or even avoid cession of the collateral in some cases. Tier III and Tier IV banks are well positioned to be the first to restart lending as they are better capitalized than Tier I and Tier II financial institutions.

Loans and deposits



Source: NBU

Banks lack resources for the new lending, NBU must invest the way to inject money in the economy

Banks would lack resources for the new lending. Latest version of banking legislation prohibits origination of FX loans for those borrowers which do not have incomes in respective currency. Even if the most optimistic assumptions regarding asset quality hold and banks would be willing to lend, deposits would have to kick off faster than loans given that large gap between loans and deposits is not funded by foreign FX resource anymore.

Growth of domestic deposits will be limited for a protracted period of time as falling real incomes dip into savings. The only supportive factor for domestic deposits is large amount of cash outside the banking system (UAH 150 bn in national currency and approximately $40 bn in FX).

Furthermore, duration of domestic UAH denominated deposits is typically very short, in fact every fifth retail deposits has been placed “on demand” and could be withdrawn at any time. Those banks crediting in UAH would have to take enormous liquidity risks on board and probably apply for NBU funds from time to time.

Key task of central bank is to invent the mechanism of providing banks with long-term resource. This could be done via swap lines, allowing banks to change foreign currencies into UAH, paying some premium. Alternatively NBU could hold auctions, offering 1yr and 2yr UAH loans from the central bank on a competitive basis. Should central bank refrain from the process, Ukraine may see several years of deleveraging.

Interest rate – high in the short term with subsequent decline as central bank would have to ease

Long and medium term interest rates to remain in double digits well into 2010:

- **Supply of government bonds will remain very high**, causing crowding-out effects for domestic businesses;
- **Deposits to display limited growth** due to declining real incomes which should dip into savings;
- **Key foreign financial groups are in the process of decreasing exposure on Ukraine**, it would take a while to reverse that decision even if the developments are highly favorable;
- **NBU's ability to drive down interest rates is limited.** Refinancing mechanism is not working properly and banks cannot rely on receipt of liquidity from the central bank at any time, unless it is a lending of last resort.

Some substantial easing is on the way from 2H2010 onwards:

- **CPI inflation is heading sharply down, real interest rates are surging.** Current real short term rates are about 4%, real rates on government debt are up to 15%. Such high real interest rates would ether kill the economy or force government to run a strong inflationary cycle. In case the government goes for inflation, this would be short-lived and would quickly end up in another currency crisis which is depictured as our distressed scenario;
- **Currency is cheap and high yielding.** Such combination would guarantee influx of foreign capital driving down interest rates after Ukraine passes election period and is back on track with IMF;
- **Government and central bank want to get the economy up and running after elections**, which could be done only via injections of cheap UAH funding. While the mechanism of these injections still has to be invented, incentives to do that are high, especially considering shortages in public finance that are about to become chronic.

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JSIB "UkrSibbank"
2/12, Andriivska st., Kiev, 04070 Ukraine
tel.: +380 44 201 22 54/74,
+380 44 537 49 17,
tel./fax: +380 44 537 50 27
http://www.ukrsibbank.com

CONTACT US

INVESTMENT BANKING TEAM

Head of Investment Banking	Denis Mikhov	(044) 201 22 54 d_mikhov@ukrsibbank.com
Deputy Head of Investment Banking	Oleg Churiy	(044) 201 22 74 oleg.churiy@ukrsibbank.com
Corporate Finance	Ruslan Kilmukhametov	(044) 537 49 17 rk@ukrsibbank.com
Debt origination	Oksana Shveda	(044) 537 49 25 o_shveda@ukrsibbank.com
M&A	Pavel Mishustin	(044) 585 01 32 p_mishustin@ukrsibbank.com
Macro&Fixed Income Research	Serhiy Yahnych	(044) 537 49 17 Serhiy.Yahnych@ukrsibbank.com
Brokerage	Anatoliy Zub	(044) 201 22 74 a_zub@ukrsibbank.com
Sales	Alexey Litvinov	(044) 201 22 74 aleksey.litvinov@ukrsibbank.com