Access to External Finance by Industrial Companies under two scenarios: Westward vs. Eastward Integration

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1. Motivation and scope of the briefing

- Starting point: Huge need for modernisation of Ukraine's economy
- In particular: Modernisation of often outdated capital stock
- How? Through investment by industrial companies in their capital stock
- However, this requires high volumes of finance
- To some extent: Domestic financial sources can be utilized
- But: Not enough, also external sources of finance are needed

- Thus: Modernisation of economy only possible if external finance is readily available for industrial companies

- Topic here: Comparison of access to external finance by industrial companies under two scenarios

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2. Description of two scenarios (1)

Scenario 1: Association Agreement and IMF-programme ("westward integration")

- Assumption: Ukraine signs an Association Agreement (AA) with the EU
- However: This will not solve the short-term imbalances in the Ukrainian economy, especially with regard to external accounts (i.e. current account deficit)
- Thus: External financial support will be needed
- Only possibility under this scenario: IMF programme
- Thus: Scenario combines the signing of the AA and an IMF deal

Scenario 2: Joining of Customs Union formed by Russia, Belarus and Kazakhstan ("eastward integration")

- In this case, external financial support as well as reduced gas price would be provided by Russia
- Thus: No IMF programme will be concluded (similar to Belarus' experience in mid-2011)

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2. Description of two scenarios (2)

- For each scenario, we analyse the different sources of finance that Ukrainian industrial companies can obtain from private external sources :

1. Equity Finance

- Foreign direct investment (FDI)
- Portfolio investment, i.e. share listings via international stock exchanges

2. Debt Finance

- Bond issues
- Bank loans

- Furthermore, the activities of international financial institutions (IFIs) will be evaluated, both in terms of equity and debt finance

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3. Access to external finance under scenario 1 (1)

1. Equity Finance

Foreign direct investment (FDI)

- EU is already the major source of FDI into Ukraine: Total stock of FDI from EU (excluding Cyprus) was **USD 27 bn** in June 2013 while Russia invested **USD 4 bn** directly (Total FDI stock: **USD 74.5 bn**)
- This development will likely increase after AA signature, as many investors will step up their investments
- Example: Total FDI stock in Poland was **USD 0.4 bn** in 1991 (when Poland's AA was signed with the EU); in 2004, when Poland joined the EU, FDI stock amounted to **USD 86.8 bn**

Portfolio investment, i.e. share listings via international stock exchanges

- Some of Ukrainian corporates are listed abroad in the UK, Poland and Germany, where respective initial public offerings (IPO's) were conducted
- Market capitalization of Ukrainian companies listed in Poland is about **EUR 1.6 bn,** while UK-listed companies had a total capitalization of **EUR 3.2 bn**
- Stock exchanges in the EU are extremely broad and liquid with **EUR 8 trillion** capitalization and **EUR 6.5 trillion** annual turnover
- Advantage: Diversified institutional investor base that is already invested in and familiar with Ukraine; AA will further accelerate this process

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3. Access to external finance under scenario 1 (2)

2. Debt Finance

- A major factor for the access to external debt finance by companies is the sovereign rating of the country, as this is a proxy for the overall risk premium and also a ceiling for any corporate rating
- Impact on sovereign rating
  - Commitment to institutional reform agenda under AA will support long-term credit quality through better investment climate and more capital inflows, but AA but will not alleviate immediate liquidity problems by itself
  - Agreement with IMF is necessary to provide viable scenario of financing external liabilities in the near-term, while preserving the already limited FX reserve cushion
  - In total, a positive impact on the current country rating can be expected
  - However, lack of further EU integration (in case AA is suspended) will be credit negative in the medium-to-long term given that it will constrain access to the EU market and limit improvements with regard to competition, the rule of law and energy efficiency (Issuer Comment by Moody's from November 22, 2013)

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3. Access to external finance under scenario 1 (3)

Bond issues

- The rating of industrial companies is determined by the country ceiling to a large degree (see last slide), i.e. any likely improvement of the country rating will translate into corporate rating upgrades
  - For example, out of 13 issuers rated by Fitch (the agency with the largest number of nonfinancial corporate ratings in Ukraine), 11 are rated at the same level as the sovereign
- But additional factors can play a role, as better access to EU market will be likely reflected in corporate credit ratings due to improved profitability and diversification
- A better investment climate will also support corporate ratings in the medium term

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3. Access to external finance under scenario 1 (4)

Bank loans

- While the market share of EU-banks operating in Ukraine has been decreasing (to about 20% from about 50% four years ago), this development might stop or even reverse in case of an AA agreement
- Reforms required by AA agreement may make some of the Ukrainian companies more “bankable” for EU lenders through harmonization with EU standards; the expected increase in bilateral trade and investment will also positively impact bank lending
  - Access to external loans will also depend on improvements in bankruptcy procedures and corporate governance
- Reforms recently undertaken by the EU (e.g. banking union) will strengthen the banking sector in the EU, so that a diversified and competitive financing landscape for Ukrainian corporates is available
  - The overall size of the EU banking sector is **EUR 46 trillion** (total assets)

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3. Access to external finance under scenario 1 (5)

Impact on external funding by IFIs

Investments by EBRD

- EBRD loans/investments are a good complement for adjustment of Ukrainian corporates to the DCFTA with the EU
- EBRD's total portfolio in Ukraine is **EUR 4.8 bn** and can be expected to increase further
- Maximum country exposure by EBRD is **EUR 12.6 bn** (based on statutory limit of 90% of equity and end-2012 EBRD equity)

Loans from EIB

- EIB financing is another good instrument for DCFTA adjustment and will likely be expanded (with Ukraine as the largest country with a DCFTA)
- After recent increase in EIB capital, annual EIB lending to partner(non-EU) countries may reach **EUR 10 bn** (based on historical information)

Loans from World Bank

- The 2012-2016 country strategy currently does not foresee budget support (development policy loans). Reforms required by AA/IMF may allow World Bank to return to direct budget support of up to **EUR 850 m**
- Reforms required by AA may also allow WB to extend sectoral programs including those required to adjust to free trade with EU

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3. Access to external finance under scenario 2 (1)

1. Equity Finance

Foreign direct investment (FDI)

- Increase in FDI (mainly from Russia) can be expected in scenario 2, but much less in quantity than under scenario 1
  - Example Belarus: FDI stock grew to **USD 14.6 bn** by end-2012 from **USD 6.7 bn** in end-2008. Inflows from Russian federation in 2009-2012 totalled **USD 5.6 bn** bringing FDI stock from Russia to **USD 9.0 bn**
- Furthermore, part of this inflows may be related to political motives, not necessarily commercial ones (Russian FDI in Belarus is mainly done by state-owned companies), and does not bring all the benefits of standard FDI (technology transfers, etc.)
- Often, focus is on politically-motivated joint-ventures, which are difficult to implement and do not offer access to new know-how and technology
- Less room for FDI from outside the CU (e.g. EU): International experience shows that most FDI will flow into the centre of the integration area, i.e. Russia

Portfolio investment, i.e. share listings via international stock exchanges

- The Russian stock market has developed rapidly over the last years, but is still small in comparison to EU markets (capitalization of **USD 0.55 trillion** and turnover of **USD 0.8 trillion**) and does not offer financing alternatives for Ukrainian corporates

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4. Access to external finance under scenario 2 (2)

2. Debt Finance

- Impact on sovereign rating
  - Deal with Russia may allay short-term financing concerns through absence of trade disruptions and likely loans to cover external repayments and/or lower gas price
    - However, concrete impact on the sovereign depends also on structure of the deal – short term lending by Russian banks to Ukraine might be much more expensive than IMF funds: Interest rate on recently attracted USD 750 m syndicated loan from Sberbank/VTB Capital was increased to 9.5% from the initially set 6.5%
  - As a result credit ratings may improve in the short term
  - But further improvement is not very likely:
    - Russian assistance/preferences are not guaranteed by Customs union and may be withdrawn upon short notice (constraining credit rating)
    - So far no capacity for rules-based cooperation was shown
    - No external anchor for reforms
  - Example Belarus: Russian financial support 2011-2013 has not delivered the necessary macroeconomic adjustment; resulting financing gaps have re-emerged, which constrains the sovereign rating
  - **Market sources (i.e. bondholders): Scenario 2 might lead to 100 bp higher sovereign bond spreads compared to scenario 1**

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4. Access to external finance under scenario 2 (3)

Bond issues

- Lower gas prices may improve credit ratings of certain sectors (chemical producers, metallurgy), at least in the short term
- But: Overall corporate ratings will be constrained by sovereign ceiling
- Most rated corporates may expand their exports under scenario 1 but will lose this opportunity under scenario 2 – this is a negative rating factor
- Companies that are bought out by Russian investors will benefit from higher parent credit rating of Russia

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4. Access to external finance under scenario 2 (4)

Bank loans

- Subsidiaries of Russian-owned companies will enjoy better access to the Russian banking system
- Russian banks may also be more willing to lend to non-affiliated Ukrainian borrowers, but they hold already a sizable portion of Ukrainian external debt (USD 20-30 bn according to Moody's, December 2, 2013)
- Additionally, Russian banks have on average higher costs of funding due to weaker ratings (BBB for the largest banks, in line with the sovereign) than comparable EU banks – this might increase costs of loans
- In general, size of Russian banking system small in comparison to EU, and less competitive: Total assets of Russian banks stand at **EUR 1.2 trillion**
- Furthermore, main Russian banks share the same owner (the state) and thus do not have a fully independent credit policy based on commercial principles – further risks for Ukrainian corporates

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4. Access to external finance under scenario 2 (5)

Impact on external lending by IFIs

Investments by EBRD

- EBRD will continue to operate in Ukraine but there will be less reforms to support by investments

Loans from EIB

- EIB support will significantly decline due to lower level of EU cooperation

Loans from WB

- WB will still offer sectoral loans but there will be less incentive to comply with financial controls

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5. Conclusion

- Overall, scenario 1 (AA with EU, including IMF) will improve the external access to finance for industrial enterprises in comparison to scenario 2 (CU), especially in the medium term
- While the short-term stabilisation gains due to an IMF program will likely drive down the costs of borrowing in the short-term, the reform commitments due to the AA will become more relevant in the medium term under scenario 1
- Under scenario 1, the EU with one of the biggest capital markets (equity and bonds) and banking sectors in the world, with a highly diversified and professional investor and lending base will offer Ukrainian industrial enterprises very competitive terms of finance – this is the major difference to scenario 2, where financial markets are still under development
  - During the period 2005 – 2008, when the country appeared on the radar screens of Western investors for the first time, Ukraine obtained a total of **USD 82 bn** in capital inflows in a short period of time (FDI: USD 34 bn, debt: USD 48 bn).
  - This sum was almost equal to Ukraine's GDP in 2005 (**USD 86.2 bn**)

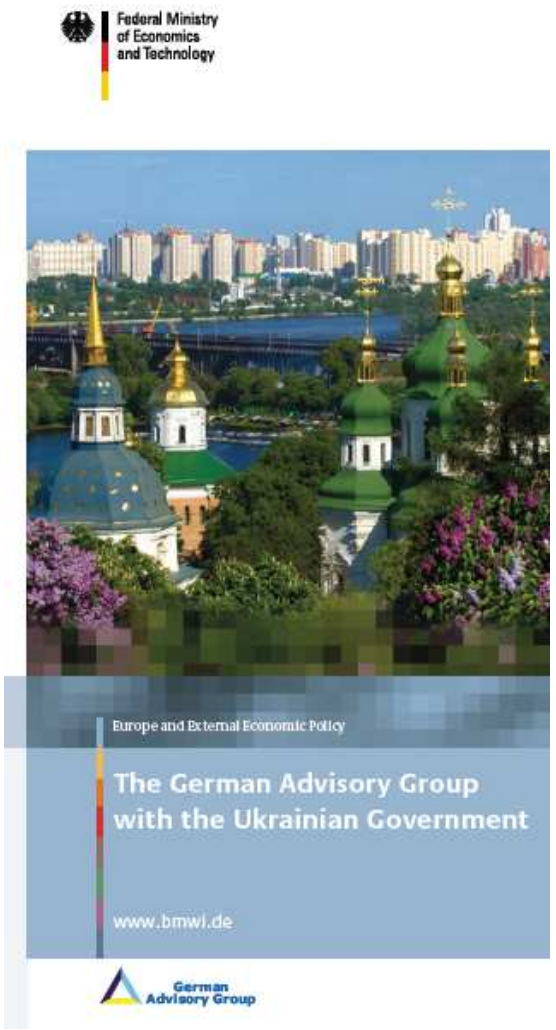
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