FitchRatings

RATING ACTION COMMENTARY

Fitch Downgrades Ukraine to 'C'

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Ukraine - Rating Action Report

Fitch Ratings - London - 22 Jul 2022: Fitch Ratings has downgraded Ukraine's Long-Term Foreign-Currency (LTFC) Issuer Default Rating (IDR) to 'C' from 'CCC'. Fitch typically does not assign Outlooks to sovereigns with a rating of 'CCC+' or below. Fitch has removed all of the ratings from Under Criteria Observation (UCO).

A full list of rating actions is provided below.

KEY RATING DRIVERS

The downgrade reflects the following key rating drivers and their relative weights:

HIGH

Default-like Process Has Begun: On 20 July, the Ukrainian government formally launched a consent solicitation to defer external debt repayments for 24 months. Fitch views this as the initiation of a distressed debt exchange (DDE) process, consistent with ratings of 'C' for both the LTFC IDR and affected securities. According to Fitch's Sovereign Criteria, a commercial debt restructuring that entails a material reduction in terms, such as the deferral of interest or principal, and is necessary to avoid a traditional payment default constitutes a DDE. The LTFC IDR would be downgraded to 'RD' (restricted default) and the affected instruments to 'D' following the consent solicitation "effective date" should it be accepted, which we view as likely.

MEDIUM

Severe Stresses Necessitate Debt Restructuring: Even if not accepted, Fitch considers that the risk of missed payments or initiation of an alternative DDE process is high as the government seeks to preserve liquidity in the face of acute military spending pressure. More generally, we expect a broader restructuring of the government's commercial debt will be required, although the timing remains uncertain. This reflects severe stresses to Ukraine's macro-financial position, public finances and external finances as a result of protracted war.

Local-Currency (LC) IDR 'CCC-': Following Fitch's recent introduction of +/- modifiers in the 'CCC' category, we have downgraded Ukraine's Local-Currency IDR to 'CCC-', from 'CCC'. The lower default risk than on FC debt partly reflects the government's somewhat greater ability to service LC debt, and greater disincentives to restructure, given that 40% of domestic LC debt is held by banks (and 52% of the sector is state-owned) and a further 47% by the National Bank of Ukraine (NBU). The share of domestic government bonds held by non-residents has fallen to just 6%, and we do not expect strong international pressure for Ukraine to bring domestic debt into a broader restructuring process.

Protracted Military Conflict: The war looks set to continue well into next year, with the prospects of any negotiated political settlement weak. The Ukrainian government, reflecting overwhelming domestic public opinion, appears unlikely to cede any substantial territory lost to Russia, and we judge President Putin will continue to pursue an objective of undermining the sovereign independence of the Ukrainian state. At the same time, it is not clear either side will have sufficient military superiority to deliver on objectives, which could result in a long-drawn-out conflict. The attritional nature of Russian military tactics, which includes the widespread destruction of physical infrastructure, is resulting in huge economic as well as human cost.

Massive Contraction, Gradual Recovery Expected: Fitch forecasts the Ukrainian economy to contract 33% in 2022, with a shallow recovery of 4% in 2023 constrained by ongoing war that limits seaport access and prevents commencement of any large-scale reconstruction. There has been some sequential pick-up in economic activity since the early stages of the invasion, and the share of pre-war output from territory in which there is currently conflict has fallen to an estimated 12%. Net outward migration stands at 5.8 million people, the damage to infrastructure alone is estimated at above USD100 billion (75% of GDP) in mid-June, and the government has projected reconstruction needs over the next 10 years at USD750 billion.

Pressure on International Reserves: Foreign-exchange (FX) reserves fell to USD22.8 billion at end-June from USD28.1 billion at end-March, partly due to USD9.1 billion outflows relating to trade credits and cash withdrawals of refugees abroad in the three months to end-May. The current account remained in surplus, of USD3.6 billion in 5M22, as international grants and the positive impact of capital controls on primary income offset deterioration in the trade and services balances. Fitch forecasts a full-year current account surplus of 2% of GDP, returning to a deficit of 1.6% in 2023, which together with ongoing financial account outflows will put further downward pressure on FX reserves.

Record High Fiscal Deficit: The monthly fiscal deficit averaged USD4 billion in 2Q22, driven by war-related expenditure, and we forecast a full year general government deficit of 29.1% of GDP, a record high for Ukraine. Given urgent spending pressures, we view the size of monthly expenditure as largely a function of available finance. We project the deficit to remain large in 2023, at 22.4% of GDP due to the ongoing need to fund the war and replace critical infrastructure.

Uncertain Financing Sources: Pledged multilateral and bilateral budget aid support for 2022 totals near USD30 billion (USD14 billion of which has been disbursed) but there remains a need for further financing by NBU (which accounted for just above 50% of deficit financing in 1H22). We assume the rollover rate on domestic debt will be just below 100% for the remainder of the year, helped by ample banking-sector liquidity and capital controls that encourage non-residents to roll over debt, but there is sizeable risk to this. The ability to meet Ukraine's extremely large financing need into 2023 largely depends on multilateral and bilateral support, which is currently uncertain; and we judge that debt restructuring is a probable condition of continued external support on such a scale.

Huge Rise in Public Debt: Fitch forecasts general government debt to rise 48pp in 2022 to 92% of GDP, and to 103% at end-2023 (excluding government guarantees, of 8% of GDP on latest data). The majority of bilateral and multilateral loans are highly concessional, partly offset by the shorter tenor and expected rise in yields on domestic debt following the NBU policy-rate increase to 25%. There is a high degree of exchange rate risk, with 61% of public debt FC-denominated, and uncertainty over the debt trajectory generally. Additional contingent-liability risks have also greatly increased.

High and Accelerating Inflation: Inflation quickened to 21.5% in June, and we forecast rises to 30% at end-2022, due to weak monetary policy transmission, further supply chain disruptions, monetary financing, and ongoing high global commodity prices. Inflation is projected to remain high in 2023, averaging 20%, partly due to hryvnia depreciation.

Ukraine's ratings also reflect the following rating drivers:

Fundamental Rating Strengths and Weaknesses: The rating is supported by strong multilateral and bilateral support, favourable human development indicators, and prior to the invasion a credible macro-policy framework. Set against these factors are heightened geopolitical and security risk, low and falling external buffers, very weak public finances, the huge economic and human cost of the war, high inflation and macro-volatility, which also complicates IMF-programme support.

Regulatory Forbearance Supports Banks: An extended period of regulatory forbearance will help banks contain the near-term impact of asset-quality deterioration, but ultimately a large government recapitalisation of the sector is inevitable. Domestic confidence in banks has held up well, supporting liquidity, with hryvnia retail deposits rising 16% since the Russian invasion, although those in FC fell by 7% and term deposits by 13%.

ESG - Governance: Ukraine has an ESG Relevance Score (RS) of '5' for both political stability and rights and for the rule of law, institutional and regulatory quality and control of corruption. These scores reflect the high weight that the World Bank Governance Indicators (WBGI) have in our proprietary Sovereign Rating Model (SRM). Ukraine has a low WBGI ranking at the 32nd percentile, reflecting the Russian-Ukrainian conflict, weak institutional capacity, uneven application of the rule of law and a high level of corruption.

ESG - Creditor Rights: Ukraine has an ESG Relevance Score of '5' for creditor rights as willingness to service and repay debt is highly relevant to the rating and is a key rating driver for Ukraine, given the announced consent solicitation.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to negative rating action/downgrade:

- The LTFC IDR would be downgraded to 'RD' and the affected securities to 'D' following the consent solicitation "effective date" should it be accepted, or agreement to any alternative proposals that entail a material reduction of terms, or if there is failure to make a payment on a Eurobond in line with the original terms and within the applicable grace period

- The LTLC IDR would be downgraded to 'CC' if Fitch assesses that default of some kind on LC debt appears probable, or to 'C' on announcing restructuring plans that materially reduce the terms of LC debt to avoid a traditional payment default

Factors that could, individually or collectively, lead to positive rating action/upgrade:

- Continued payment on Eurobonds in line with their original terms that Fitch views as sustainable, for example due to de-escalation of conflict with Russia that markedly reduces vulnerabilities to Ukraine's external finances, fiscal position and macro-financial stability, reducing the probability of commercial debt restructuring

SOVEREIGN RATING MODEL (SRM) AND QUALITATIVE OVERLAY (QO)

Fitch's proprietary SRM assigns Ukraine a score equivalent to a rating of 'CCC+' on the LTFC IDR scale. However, in accordance with its rating criteria, Fitch's sovereign rating committee has not utilised the SRM and QO to explain the ratings in this instance. Ratings of 'CCC+' and below are instead guided by Fitch's rating definitions.

Fitch's SRM is the agency's proprietary multiple regression rating model that employs 18 variables based on three-year centred averages, including one year of forecasts, to produce a score equivalent to a LTFC IDR. Fitch's QO is a forward-looking qualitative framework designed to allow for adjustment to the SRM output to assign the LTFC IDR, reflecting factors within our criteria that are not fully quantifiable and/or not fully reflected in the SRM.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Ukraine has an ESG Relevance Score of '5' for political stability and rights as WBGI have the highest weight in Fitch's SRM and are highly relevant to the rating and a key rating driver with a high weight. The invasion by Russia and ongoing war severely compromises political stability and the security outlook. As Ukraine has a percentile below 50 for the respective governance indicator, this has a negative impact on the credit profile.

Ukraine has an ESG Relevance Score of '5' for rule of law, institutional & regulatory quality and control of corruption as WBGI have the highest weight in Fitch's SRM and in the case of Ukraine weaken the business environment, investment and reform prospects; this is highly relevant to the rating and a key rating driver with high weight. As Ukraine has a percentile rank below 50 for the respective governance indicators, this has a negative impact on the credit profile.

Ukraine has an ESG Relevance Score of '5' for creditor rights as willingness to service and repay debt is highly relevant to the rating and is a key rating driver with a high weight for Ukraine given the announced consent solicitation which, together with the fairly recent restructuring of public debt in 2015, has a negative impact on the credit profile.

Ukraine has an ESG Relevance Score of '4[+]' for human rights and political freedoms as the voice and accountability pillar of the WBGI is relevant to the rating and a rating driver. As Ukraine has a percentile rank above 50 for the respective governance indicator, this has a positive impact on the credit profile.

Ukraine has an ESG Relevance Score of '4' for international relations and trade, reflecting the detrimental impact of the conflict with Russia on international trade, which is relevant to the rating and a rating driver with a negative impact on the credit profile.

Except for the matters discussed above, the highest level of ESG credit relevance, if present, is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity(ies), either due to their nature or to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

Contact:

Sovereigns

+44 20 3530 1000

Media Relations

media.relations.emea@fitchratings.com

RATING ACTIONS

ENTITY / DEBT	RATING			PRIOR
Ukraine	LT IDR	C	Downgrade	CCC
	ST IDR	C	Affirmed	C
	LC LT IDR	CCC-	Downgrade	CCC
	LC ST IDR	C	Affirmed	C
	Country Ceiling	B-	Affirmed	B-
senior unsecured	LT	CCC-	Downgrade	CCC
senior unsecured	LT	C	Downgrade	CCC

VIEW ADDITIONAL RATING DETAILS

Additional information is available on www.fitchratings.com

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APPLICABLE CRITERIA

Country Ceilings Criteria (pub. 01 Jul 2020)

Sovereign Rating Criteria (pub. 12 Jul 2022) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Country Ceiling Model, v1.7.2 (1)

Debt Dynamics Model, v1.3.1 (1)

Macro-Prudential Indicator Model, v1.5.0 (1)

Sovereign Rating Model, v3.13.1 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Ukraine	UK Issued, EU Endorsed

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Sovereigns Europe Ukraine