FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Ukraine at 'CC'

Fri 08 Dec, 2023 - 17:02 ET

Fitch Ratings - London - 08 Dec 2023: Fitch Ratings has affirmed Ukraine's Long-Term Foreign-Currency Issuer Default Rating (IDR) at 'CC'.

Fitch typically does not assign Outlooks to sovereigns with a rating of 'CCC+' or below.

A full list of rating actions is at the end of this rating action commentary.

KEY RATING DRIVERS

Foreign-Currency Debt Restructuring Likely: The affirmation of Ukraine's Long-Term Foreign-Currency IDR at 'CC' reflects Fitch's expectation of a further commercial debt restructuring before the two-year standstill on Eurobond payments expires on 1 September 2024. The authorities plan a single comprehensive debt restructuring next year, but if agreement on this with commercial creditors cannot be reached, potentially due to security-related uncertainty, we would expect an intermediate step of further deferral of Eurobond payments. Either case would trigger a distressed debt exchange (DDE) under Fitch's sovereign rating criteria, as with the Eurobond payment deferral effected in August 2022.

'CCC-' LC IDRs Affirmed: The higher rating for local-currency (LC) debt reflects our expectation that it will be excluded from next year's restructuring, partly because only 3% of it is held by non-residents, compared with 45% held by National Bank of Ukraine (NBU), limiting any such benefit to Ukraine. In addition, 40% is held by the domestic banking sector, half of which is state-owned, the restructuring of which could impair the domestic debt market and financial sector stability. Nevertheless, the rating reflects still substantial credit risk on LC debt over a longer horizon, partly due to uncertainty over financing sources for a potentially prolonged period of very high fiscal deficits.

Detail of FC Restructuring Unclear: The Group of Creditors for Ukraine has already agreed to extend the standstill on official sector repayments to 2027, with final debt treatment once there is lower macro-uncertainty stemming from the war, within the framework of Ukraine's four-year USD15.6 billion IMF Extended Fund Facility (EFF). The Ukrainian authorities have committed to seeking comparability of treatment with commercial creditors, and burden sharing is likely to be required by official creditors in light of their ongoing financial support for the war. Without further restructuring, external sovereign debt service would rise to a relatively high USD8.1 billion in 2025, further reinforcing expectations of a DDE next year.

Protracted War: Fitch anticipates the war will continue throughout 2024 within its current broad parameters. In our view, Ukraine still has some strategic military advantage, underpinned by strong resolve and Western military support, but its counteroffensive has made limited gains so far, and in our central scenario there is insufficient superiority to decisively deliver objectives.

We also consider there is an absence of politically credible concessions that could result in a negotiated end to the war, potentially leading to a very protracted conflict. Over a longer horizon, we anticipate some form of settlement, but view a 'frozen conflict' as more likely than a sustainable peace deal, at least for a significant period.

Return to Economic Growth: Fitch forecasts GDP growth of 5.1% in 2023, following a 29.1% contraction in 2022, an upward revision of 1.6pp since our last review in June, on further business adaptation to war conditions, improved consumer confidence, and agriculture growth. The number of Ukrainian refugees has been relatively stable in 2023, at 6.3 million in November, on UN data. We project slowing sequential economic recovery towards year-end, and full-year GDP growth of 3.8% in 2024 and 4.5% in 2025, with upside risks from abating intensity of the conflict, sizeable return of migrants, and greater restoration of Black Sea port export capacity.

Fiscal Deficit to Remain High: We forecast the general government deficit increases 1.6pp in 2023 to 17% of GDP (near 23.5% of GDP excluding international grants), on higher full-year military expenditure, balancing strong revenue growth (including from a 23% rise in consolidated tax revenue in 10M23). Fitch projects a deficit of 16.9% of GDP in 2024, as increasing tax-take is offset by higher social expenditure, with similar levels of military spending and budget aid, followed by a deficit of 16.3% in 2025. Over a longer period, large reconstruction needs will also weigh on public finances, with damage to infrastructure alone estimated at 80-90% of GDP.

Near-Term Financing Adequate: Fitch anticipates 2024 budget aid support will be only slightly below the USD43 billion estimated for 2023, despite political risks to approval of pledged finance. Longer-term proposals include a EUR50 billion EU Ukraine Facility to 2027, and more general official sector funding assurances that underpin the IMF EFF. IMF conditionality in the first phase of the programme is light and we see limited risk it prevents Fund disbursements next year. The domestic rollover rate of government debt has recovered to above 100% in 2023, supported by strong banking sector liquidity due to 20% growth in LC deposits in 9M23, and changes allowing sovereign debt to contribute to bank reserve requirements.

Medium-Term Financing Uncertainty, High Debt: We see greater financing uncertainty from 2025, partly due to the US electoral cycle, the potential for greater donor fatigue, residual risks over EU financing plans, and the possibility that the domestic banking sector does not further increase its holding of government debt. Fitch projects general government debt rises to 94.5% of GDP at end-2024, from 84.1% at end-2023 (and 48.9% at end-2021), well above the median for 'B'/'C'/'D' rated sovereigns, of 70.7%. Our projections do not incorporate potential debt stock restructuring treatment, the parameters of which remain uncertain.

International Reserve Position Strengthens: We project the current account deficit steadily widens from 4.1% of GDP in 2023 to 7.1% of GDP in 2025 (from a surplus of 5% in 2022), driven by recovering imports and ongoing logistical barriers to exports. International reserves rose USD10.8 billion in the 12 months to November to USD38.8 billion, supported by large official sector loans, capital controls, and a lower drain from refugee spending abroad due to their ongoing economic integration. We forecast international reserves end 2025 at five months of current external payments, from 4.8 months at end-2023, above the current 'B'/'C'/'D' rating group median of three months.

Inflation Falls Sharply: Inflation fell to 5.3% in October, from 12.8% in June, with core inflation of 6.8%, helped by lower food and energy prices and exchange rate stability. We project inflation rises to average 9.1% in 2024-2025, partly due to base effects, moderately higher wage growth, and ongoing domestic supply chain disruptions, above the projected median for the 'B'/'C'/'D' rating category of 5.5%. NBU has cut the policy interest rate to 16% from 25% in June, and introduced an exchange rate policy of 'managed flexibility'. Fitch anticipates continued FX interventions to support broad hryvnia/US dollar stability in the near term, alongside relatively gradual capital account liberalisation.

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 29th 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 given Ukraine's 2022 deferral of external debt payments which Fitch deemed as a distressed debt exchange, and that another DDE is probable, in our view.

RATING SENSITIVITIES

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

- The Long-Term Foreign-Currency IDR would be downgraded on signs that a renewed default-like process has begun, for example, a formal launch of a debt exchange proposal involving a material reduction in terms and taken to avoid a traditional payment default.

- The Long-Term LC IDR would be downgraded to 'CC' on increased signs of a probable default event, for example from severe liquidity stress and reduced capacity of the government to access financing, or to 'C' on announcement of 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

- The Long-Term Foreign-Currency IDR would be upgraded on 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.

- The Long-Term LC IDR would be upgraded on reduced risk of liquidity stress, potentially due to more predictable sources of official financing, greater confidence in the ability of the domestic market to roll over government debt, and/or lower expenditure needs.

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 LT FC IDR. Fitch's QO is a forward-looking qualitative framework designed to allow for adjustment to the SRM output to assign the final rating, reflecting factors within our criteria that are not fully quantifiable and/or not fully reflected in the SRM.

COUNTRY CEILING

The Country Ceiling for Ukraine is 'B-'. For sovereigns rated 'CCC+' and below, Fitch assumes a starting point of 'CCC+' for determining the Country Ceiling. Fitch's Country Ceiling Model produced a starting point uplift of zero notches. Fitch's rating committee applied a +1 notch qualitative adjustment to this, under the Balance of Payments Restrictions pillar, reflecting that imposition of capital and exchange controls since Russia's invasion of Ukraine has not prevented some private sector entities from converting local currency into foreign currency and transferring the proceeds to non-resident creditors to service debt payments.

Fitch does not assign Country Ceilings below 'CCC+', and only assigns a Country Ceiling of 'CCC+' in the event that transfer and convertibility risk has materialised and is affecting the vast majority of economic sectors and asset classes.

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. As Ukraine has a percentile below 50 for the respective governance indicator, this has a negative impact on the credit profile. The invasion by Russia and ongoing war severely compromises political stability and the security outlook.

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 '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 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 creditor rights as willingness to service and repay debt is relevant to the rating and is a rating driver for Ukraine, as for all sovereigns. Given Ukraine's 2022 deferral of external debt payments which Fitch deemed as a distressed debt exchange, and that another DDE is probable in our view, this has a negative 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.

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/topics/esg/products#esg-relevance-scores.

RATING ACTIONS

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

senior unsecured	LT	CC	Affirmed	CC

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Sovereign Rating Criteria (pub. 06 Apr 2023) (including rating assumption sensitivity)

Country Ceiling Criteria (pub. 24 Jul 2023)

APPLICABLE MODELS

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

Country Ceiling Model, v2.0.0 (1)

Debt Dynamics Model, v1.3.2 (1)

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

Sovereign Rating Model, v3.14.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Ukraine	UK Issued, EU Endorsed

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The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Fitch also provides information on best-case rating upgrade scenarios and worst-case rating downgrade scenarios (defined as the 99th percentile of rating transitions, measured in each direction) for international credit ratings, based on historical performance. A simple average across asset classes presents best-case upgrades of 4 notches and worst-case downgrades of 8 notches at the 99th percentile. Sector-specific best- and worst-case scenario credit ratings are listed in more detail at https://www.fitchratings.com/site/re/10238496

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