MOODY'S
INVESTORS SERVICE

Rating Action: Moody's downgrades Ukraine's ratings to Caa3 and changes outlook to negative, concluding review for downgrade

20 May 2022

London, May 20, 2022 -- Moody's Investors Service ("Moody's") has today downgraded the Government of Ukraine's foreign and domestic currency long-term issuer ratings and foreign currency senior unsecured debt ratings to Caa3 from Caa2. Moody's has also changed the outlook to negative from ratings under review. This concludes the review for downgrade that was initiated on 25 February 2022.

The downgrade of the ratings to Caa3 is driven by the increased risks to Ukraine's government debt sustainability from the invasion by Russia leading to a more protracted military conflict than Moody's initially expected, which increases the likelihood of a debt restructuring and losses being imposed on private-sector creditors. While Ukraine is benefitting from large commitments of international financial support, helping to mitigate immediate liquidity risks, the resulting significant rise in government debt is likely to prove unsustainable over the medium term. Concerns around the sustainability of such a high government debt burden may impede further access to official financing for the purposes of servicing commercial debt. At the Caa3 rating level, Moody's expects a recovery in the event of default of typically in the order of 65-80%.

The negative outlook reflects that there is still a high degree of uncertainty around how the invasion will evolve and its credit implications. A more protracted military conflict following the invasion by Russia would keep financing needs very high for a prolonged period and result in a further rise in the debt burden. Hence, the recovery by investors in the event of default could be lower than 65-80%, which would be consistent with a rating below Caa3.

Ukraine's local- and foreign-currency ceilings have been lowered to Caa2 from Caa1. The only one-notch gap between the local-currency ceiling and the sovereign rating reflects the low predictability of government and institutions and elevated domestic political and geopolitical risks which create considerable policy uncertainty, while external vulnerabilities remain elevated. The foreign-currency ceiling is aligned to the local-currency ceiling, reflecting weak policy effectiveness, already limited capital account openness and elevated external indebtedness with limited foreign exchange reserves.

RATINGS RATIONALE

RATIONALE FOR DOWNGRADING UKRAINE'S RATINGS TO Caa3

The downgrade of the ratings to Caa3 is driven by the increased risks to Ukraine's debt sustainability from a more protracted military conflict, which increases the likelihood of a debt restructuring and losses being imposed on private-sector creditors.

Moody's expects the military conflict will be more protracted than initially assumed and forecasts real GDP will contract sharply by around 35% in 2022 given the heavy human toll, significant damage to Ukraine's productive capacity and infrastructure as well as the very large displacement of the population. Moody's estimates that those regions where fighting is ongoing or that are occupied by Russian troops accounted for around 20% of Ukraine's GDP prior to the invasion, given the concentration of agricultural and industrial activities.

Moody's expects shelling will continue to hold back the return of significant economic activity during the remainder of the year. While Moody's expects the economy to gradually start to recover from 2023, Russia's invasion will likely cause some permanent loss in GDP even if significant external support is provided to help reconstruction.

The more protracted military conflict will act as a drag on the government's financial resources, with Moody's estimating financing needs of around $50 billion (35% of 2022 GDP) for 2022 and forecasting a rise in government debt to around 90% of GDP from around 49% at the end of 2021. The severity of the economic damage from the protracted military conflict will have long-lasting negative implications for the government's finances, increasing risks to debt sustainability.

Moody's expects significant international financing support will help mitigate immediate external and liquidity risks. Moody's estimates that international financial institutions and other donors have committed around $38 billion in financing support, of which $5 billion has so far been disbursed, since the start of the invasion which should cover a large portion of Ukraine's estimated financing needs for 2022. The recent opening of an account at the International Monetary Fund (IMF) to channel donor resources for balance of payments and budgetary needs, including the possibility for countries to transfer Special Drawing Rights, will further increase funding. The challenge for the banking system to absorb significant new sovereign debt and the potential inability to access international markets will likely keep Ukraine dependent on official funding.

Concerns around the sustainability of such a high government debt burden over the medium term may impede further access to official financing for the purposes of servicing commercial debt, increasing the likelihood of a debt restructuring and losses being imposed on private-sector creditors. A proposed bill in the United States (US, Aaa stable) Congress which would require the US Treasury to pursue comprehensive debt payment relief for Ukraine, including from commercial creditor groups, is an indication of such risks.

RATIONALE FOR THE NEGATIVE OUTLOOK

The negative outlook reflects the high degree of uncertainty around how the invasion of Ukraine will evolve and its credit implications. A more protracted military conflict could give rise to a significant further increase in liquidity and external pressures and lead to a higher government debt burden, increasing the likelihood that recoveries by investors in the event of default would be below 65-80%, which would be consistent with a rating below Caa3.

Moreover, a more protracted military conflict would pose further risks to Ukraine's ability to continue to service its debt over the medium term, and its overall debt sustainability, by keeping financing needs very high for a prolonged period. According to IMF estimates, the government's funding needs are around $5 billion for every month the military conflict lasts.

Furthermore, the trajectory of Ukraine's government debt burden will also face risks from the sizeable share (59% at end 2021) of debt denominated in foreign currency once the restrictions on the foreign exchange market are lifted, which the central bank has committed to remove gradually. Ukraine's fiscal sustainability will also face risks over the medium term from the GDP-linked warrants issued as part of the 2015 debt restructuring. Subject to a number of conditions, Ukraine is required to pay 15% of the additional economic output it generates if real GDP growth is above 3% and 40% if real GDP growth is above 4%. In particular, strong reconstruction-led growth in 2024 could trigger large payouts on the instruments from 2026, once the 1% of GDP payment cap no longer applies.

ENVIRONMENTAL, SOCIAL, GOVERNANCE CONSIDERATIONS

Ukraine's ESG Credit Impact Score is very highly negative (CIS-5), reflecting moderately negative exposure to environmental risk, very high exposure to social risks, and a very weak governance profile. The latter, together with moderate wealth levels, helps to explain Ukraine's relatively low resilience to E and S risks.

Ukraine is moderately exposed to environmental risks. These include physical climate risks, carbon transition and the weak preservation of natural capital, reflected in its low agriculture yields despite its abundance of very fertile black soil, which explains its E-3 issuer profile score. Its exposure to physical climate risk is exacerbated by the importance of the agricultural sector (both in terms of economic contribution and employment), which makes the country's exports vulnerable to climate change and adverse weather events. Ukraine's exposure to carbon transition comes from the fact that transit of gas from Russia to Europe via Ukraine has provided a valuable source of foreign-exchange revenue, although the transit of gas from Russia to Europe is now likely to reduce.

Exposure to social risks is very highly negative (S-5 issuer profile score). The on-going invasion and the significant displacement of large parts of the population severely increases risks around health and safety and access to basic services as well as the access to housing. Furthermore, Ukraine's unfavourable demographics and risks related to labour and income, with relatively high youth unemployment, as well as weak health outcomes contributes to social risks. A persistent demographic drag will likely constrain Ukraine's scope for strengthening its economic competitiveness, despite favourable educational attainment.

Ukraine has a very highly negative governance profile score (G-5 issuer profile), reflecting weaknesses in the rule of law and corruption, which hinders the business environment, as well as a track record of sovereign defaults.

The publication of this rating action deviates from the previously scheduled release dates in the UK sovereign calendar published on www.moodys.com. This action was prompted by Russia's ongoing invasion of Ukraine which increases the risks to the sustainability of Ukraine's government debt burden.

GDP per capita (PPP basis, US$): 13,196 (2020 Actual) (also known as Per Capita Income)

GDP growth (% change): -3.8% (2020 Actual) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 5% (2020 Actual)

Gen. Gov. Financial Balance/GDP: -5.6% (2020 Actual) (also known as Fiscal Balance)

Current Account Balance/GDP: 3.4% (2020 Actual) (also known as External Balance)

External debt/GDP: 80.2%

Economic resiliency: b3

Default history: At least one default event (on bonds and/or loans) has been recorded since 1983.

On 17 May 2022, a rating committee was called to discuss the rating of the Ukraine, Government of. The main points raised during the discussion were: The issuer's economic fundamentals, including its economic strength, have materially decreased. The issuer's institutions and governance strength, have not materially changed. The issuer's fiscal or financial strength, including its debt profile, has not materially changed. The issuer's susceptibility to event risks has not materially changed.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

FACTORS THAT COULD LEAD TO AN UPGRADE OF UKRAINE'S RATINGS

The negative outlook suggests an upgrade is unlikely in the near term. The outlook could be changed to stable if the invasion were to end relatively soon, helping to contain Ukraine's financing needs and reducing risks to the sustainability of Ukraine's government debt burden. Furthermore, indications that the recovery for bondholders in the event of default was expected to remain in line with a Caa3 rating could also lead to a stabilization of the outlook.

FACTORS THAT COULD LEAD TO A DOWNGRADE OF UKRAINE'S RATINGS

Ukraine's ratings could be downgraded if a more protracted military conflict or a renewed widening of the invasion were to give rise to a significant further increase in debt sustainability risks, liquidity and external pressures, and further increase the likelihood of a debt restructuring. Furthermore, indications that losses to investors from a restructuring of government debt would likely be in excess of those consistent with a Caa3 rating could lead to a downgrade of the rating.

The principal methodology used in these ratings was Sovereign Ratings Methodology published in November 2019 and available at https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1158631 . Alternatively, please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

The weighting of all rating factors is described in the methodology used in this credit rating action, if applicable.

REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found at: https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_79004.

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Moody's general principles for assessing environmental, social and governance (ESG) risks in our credit analysis can be found at http://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1288235 .

The Global Scale Credit Rating on this Credit Rating Announcement was issued by one of Moody's affiliates outside the EU and is endorsed by Moody's Deutschland GmbH, An der Welle 5, Frankfurt am Main 60322, Germany, in accordance with Art.4 paragraph 3 of the Regulation (EC) No 1060/2009 on Credit Rating Agencies. Further information on the EU endorsement status and on the Moody's office that issued the credit rating is available on www.moodys.com.

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