



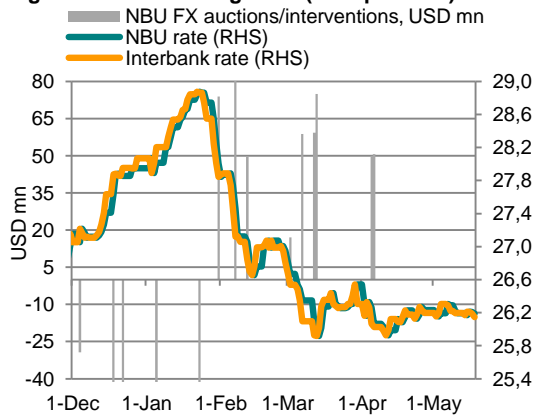
This week in focus: Banks enjoy growing incomes amid steady NPLs

Ukraine's banking system demonstrated improved profitability Q1, against backdrop of improved margins. This comes as result of massive clean-up of the banking sector, providing room for better competitive landscape. Creditor protection and headwinds stemming from rising operation costs are the key headwinds going forward, in our view.

Please see page 3 for more details

FX and interest rates: Verchovna Rada supported currency law

Figure 1. UAH exchange rate (UAH per USD)



Source: NBU, Reuters

USD/UAH closed at 26.15 as of Friday the 18th, down from 26.20 in prior week, as hryvnia were flat during the week.

Average daily FX volumes on the market amounted to the equivalent of USD 250.8mn, USD 24.2mn higher compared to previous week.

NBU interventions resulted in net buying of foreign exchange currency, amounting to USD 1.2bn YTD effective May 18th, 2018. In view of its commitment to principles promulgated recently, namely to buy USD 10mn per day, the central bank overdone that in prior week, buying USD 67mn, beating USD 52mn bought a week before.

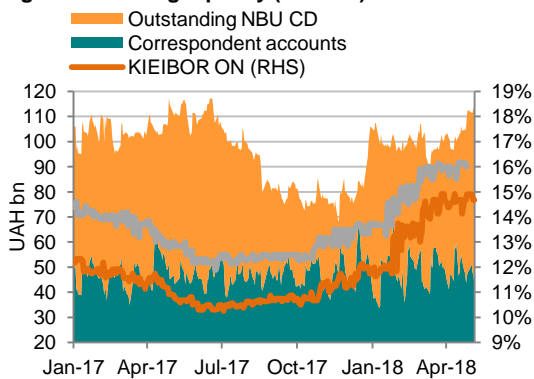
Aggregate banking liquidity amounted to UAH 108.6bn as of Friday the 18th, falling by UAH 4.0bn during the week. In prior week, liquidity declined mainly on the back of tax payments. Having fallen in the prior week, liquidity is to rise again in the coming days. By the end of a prior week, state treasury refunded a modest UAH 1.6bn of VAT cumulatively for the whole month, leaving the largest share of VAT refund to be reimbursed in the current week, and the first half of the next week. In prior month VAT reimbursements accounted for UAH 9.9bn.

Money market rates remained flat: cost of ON funds is around 13.0/15.25, 1 week is 14.0/16.25 while 1M is 15.0/17.0, according to our calculations.

The shortest type of the bonds fell off from investors and primary dealer's radars this time. In general, the auction turned to be less popular, comparing to the previous one. The largest share of demand was spotted out on the bonds with the largest maturity. In particular, 2y bonds beat all other issues by demand and placement size. Having taken a top spot this time, the MoF issued them at a cut off rate 16.15%. In the meantime, the issue with a 6 month maturity was restricted by UAH 0.5bn threshold, which far cry fell short of that level. Two UAH denominated issues totalling UAH 1.1bn and UAH 2.4bn, respectively are to be redeemed this week. Both issues were placed one and two years ago, respectively. In prior week, Verchovna Rada voted in the second reading, supporting a law of nominal holder. This law creates more favourable climate to invest in Ukraine for foreign investors, boosting a demand on local stocks and bonds and in particular on OVDP. At the same time, the term nominal holder was defined in the national legislation for the first time.

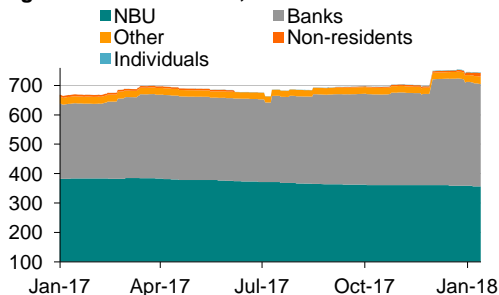
Currently, yields (bids) of local OVDP in UAH at 17.75% (for 6m), 17.70% (for 2Y). 1Y USD bids were at 5.35%, while bids for VAT bonds were at 17.95%.

Figure 2. Banking liquidity (UAH bn)



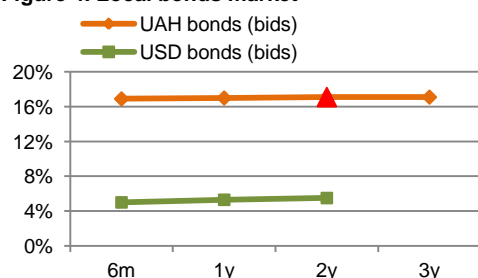
Source: Reuters, NBU, Ukrsibbank, Minfin

Figure 3. OVDP holders, UAH bn



Source: NBU

Figure 4. Local bonds market



Source: Ukrsibbank

Figure 5. OVDP auction combined results, 15th of May 2018

CCY	Maturity	Cut-off rate	WA rate	Max bid rate	Min bid rate	Number of bids	Bids accepted	Bid size	Placement size
UAH	6m	17.20%	17.20%	17.25%	17.20%	8	7	117.4mn	90.0mn
UAH	9m	17.25%	17.19%	17.25%	17.15%	5	5	268.9mn	75.4mn
UAH	1y	17.00%	17.00%	17.05%	17.00%	4	3	60.0mn	54.5mn
UAH	2y	16.15%	16.15%	16.25%	16.15%	5	4	150.7mn	97.9mn

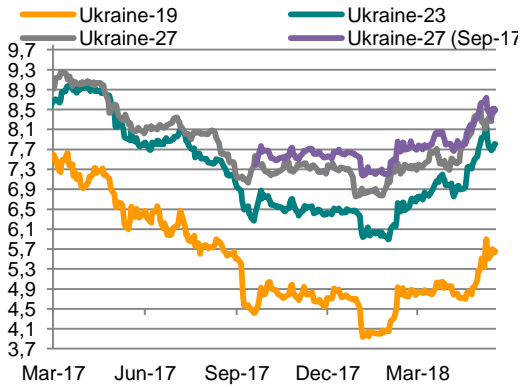
On Thursday, Ukraine's parliament Verchovna Rada voted in the first reading supporting currency bill, developed by the National Bank of Ukraine. Under the new legislation, Ukraine may proceed to foreign exchange operations on a more freely basis. At the same time, bill would allow much faster foreign exchange liberalization, as some old rules are to be cancelled in line with a law adoption. The law would allow households and business to choose freely when and how to conduct currency operations without approval from central bank. The law also aims to be transparent and more simplified comparing to the old legislation.



Global markets:

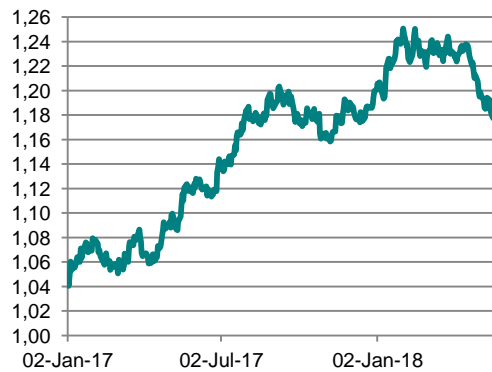
U.S. China trade war was put on hold

Figure 5. Ukraine's sovereign Eurobond yields, bid/ask mid (%)



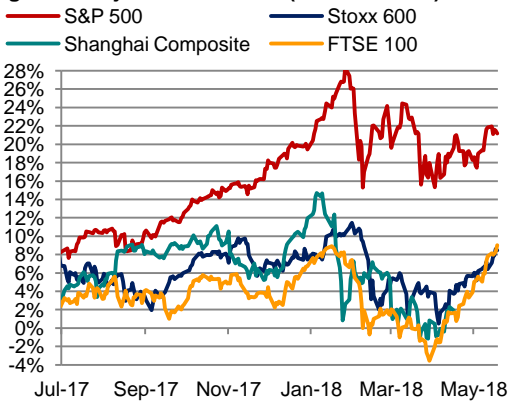
Source: Reuters

Figure 6. EUR USD spot (mid)



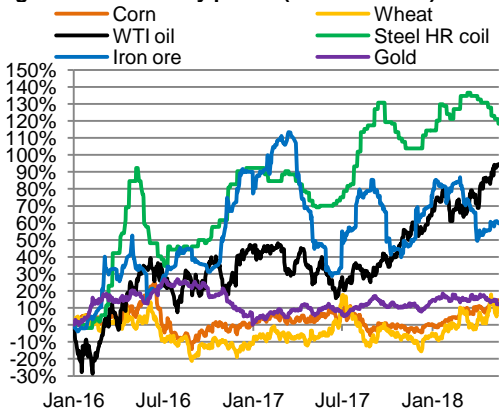
Source: Reuters

Figure 7. Major stock indices (Jan-2017=100)



Source: Reuters

Figure 8. Commodity prices (Jan-2016=100)



Source: Reuters

Trade negotiations and rising yields in U.S. were in the forefront this week. U.S. Treasury secretary, Steven Mnuchin, said that negotiations with Chinese officials resulted in putting on hold trade war. On top of that, yields rose 16bp for week on Thursday, after that meaningful decline brought week-on-week gains by the end of Friday lower. In the meantime, China's economy is likely to grow by around 6.7% in the second quarter of 2018.

Bond benchmarks decreased, with U.S. 10y Treasuries' yield higher by 9bp week-on-week increasing to 3.06%, while German 10y Bunds' yields advanced by 2bp, landing at 0.58%, Japanese 10y bonds yield's ended the week at 0.059. On Thursday, U.S. 10y yields surged 16 basis points for the week, without any information about weak government debt auction or troublesome inflation reading which could push yields higher. After that yields declined meaningfully or the most in six weeks on Friday.

The U.S. stock markets were broadly in the declining mode during the week, as S&P 500 decreased week-on-week by 0.5%, while Nasdaq Composite fell by 0.7%. Stock sell-off during the week was mainly due to increase in 10y U.S. treasuries' yields, which touched 3.128% level during the week. At the same time, trade concerns around U.S. China trade dispute also weighted down the sentiment on the market.

U.S. Treasury secretary, Steven Mnuchin, said that negotiations with Chinese officials resulted in putting on hold trade war, while trying to execute framework. Such a breakthrough was announced after two days of talks between Mnuchin and China's vice-premier, Liu He. At the same time, on Saturday, Beijing and Washington said they would keep talking about measures under which China would import more energy and agriculture from United States to narrow the US 445bn annual US goods and services trade deficit with China.

EUR/USD rate landed at 1.1775 as of Friday the 18th, lower than the last week closing level of 1.1942.

Stoxx 600, a broader gauge of European equity performance advanced by 0.6%, matching the increase in German DAX.

Germany Chancellor, Angela Merkel defended the Iran nuclear deal following its rejection by Washington. A multilateral approach toward Iran was the only option, according to Merkel. She also described the deal as everything other than ideal, arguing that international nuclear authorities mentioned that Iran stoked to its commitments. In a speech to Bundestag the chancellor also called for a strengthening of the euro zone, supporting proposals to transform the European Stability Mechanism into a facility to wind down bad banks.

China's economy is likely to grow by around 6.7% in the second quarter of 2018, according to the State Information Centre. This forecast is a little bit lower than 6.8% growth reached in the previous quarter. According to the latest data released in April, China' economy started to lose traction in recent time. Retail sales, fixed asset investments increased more modestly than expected previously. At the same time, property sales fell for the first time in six months, amid government curbs on speculation and increased mortgage rates.

Crude oil prices increased, as WTI futures rose by 0.8% week-on-week and closed at USD 71.3 per barrel, while Brent 1m futures gained by 1.8% closing at USD 78.5 per barrel.

Gold prices decreased, as NYMEX 1m futures declined by 2.2% week-on-week and finished the week at USD 1290.2 per troy ounce.

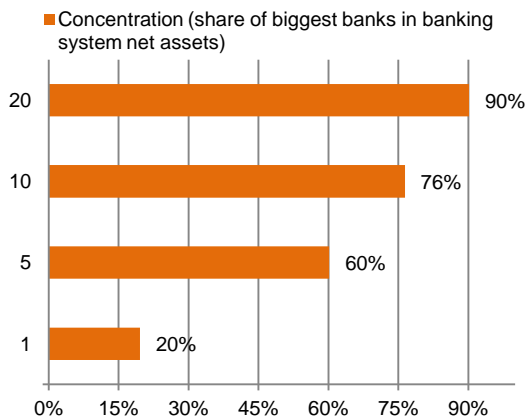
Grains increased, as CBOT Corn 1m futures rose 3.3% week-on-week and closed at USD 402.5 per bushel, while CBOT Wheat 1m futures landed at USD 518.3 per bushel, falling by 5.9%.

Iron ore rose as NYMEX Iron ore 62% Fe 1m futures fell by 0.7% week-on-week and closed at USD 67.0 per ton.



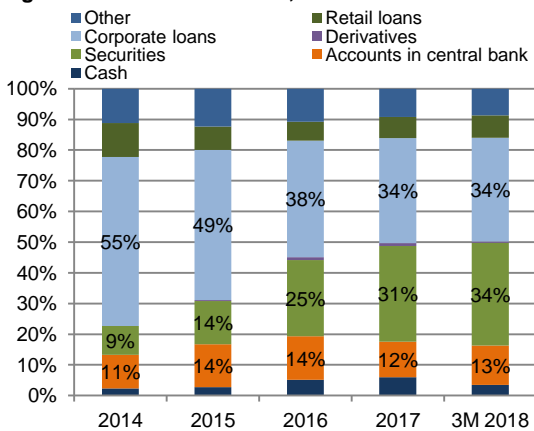
This week in focus: Banks enjoy growing incomes amid steady NPLs

Figure 9. Concentration, as of 01.04.2018



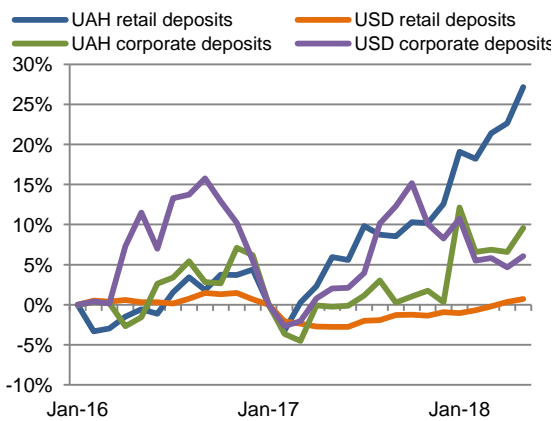
Source: NBU

Figure 10. Banks net assets, %



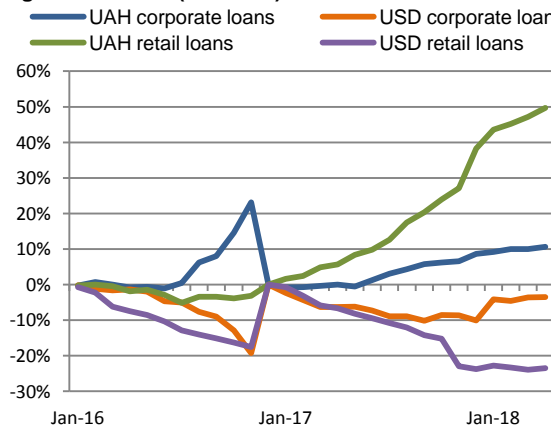
Source: NBU

Figure 11. Deposits (2016=0%)



Source: NBU

Figure 12. Loans (2016=0%)



Source: NBU

The banking system demonstrated some signs of improved profitability, at the same time major loan loss provisions were made in the previous years, allowing banking system to report first profit in 2018 since 2013. The major clean up of the banking system was conducted before, as the number of banks was stable over the latest months. The share of bad debts, albeit being high at 56%, was steady in recent time without strong upswings, while this share was even higher for corporate loan portfolio. As it was previously, the ratio of NPL to total loan was 86% in Privatbank, followed by state and foreign banks. In the meantime, retail deposits on YTD basis gained some ground, while the same deposits of corporate sector decreased somewhat. Banking core incomes, including net interest and net commission income, had increased quite solid in recent time. At the same time, net interest income, the main bank “revenue engine” gained 43% y/y in 1Q2018, while associated general and administrative expenses increased only by 21%. This provides opportunities for higher profits in 2018.

Number of banks has stabilized. As of April 1, there were 82 banks, as opposed to 147 by the end of 2014 year. Private local banks accounted for the major part with a share of 66%. The same share measured by assets, was significantly lower (14.2% in terms of net assets). Foreign banks were trailing behind with a share of 28%, as measured by number of banks.

	2014	2015	2016	2017	3M 2018
Solvent	147	117	96	82	82
change	-33	-30	-21	-14	0
State	7	7	7	6	5
change	0	0	-1	-1	0
Foreign	25	25	25	23	23
change	0	0	0	-2	0
Private	115	85	65	54	54
change	-33	-30	-20	-11	0
Non-solvent	16	3	4	2	2
change	16	-13	1	-2	0
Under liquidation	21	64	84	95	95
change	19	43	20	11	0

Net assets. Previously, banks’ net assets were skewed toward corporate loan portfolio, the more traditional and familiar structure for banking system. This share shrunk significantly in the midst of banking crisis, effectively running from 2014 up to 2016 (Privatbank nationalization). While the share of securities on the bank’s balance sheets, namely OVDP injected in the recapitalization process, previously was less than 10%, the share of securities, especially fixed income, gained solid ground growing several times (to 31%) by the end of 2017, and amounted more than a third of the banks’ net assets as of end of 1Q 2018. The share of loans to corporate sector slightly fell, as of the end of March, landing at 33.8%.

Figure 17. Banks net assets in nominal terms, UAHbn

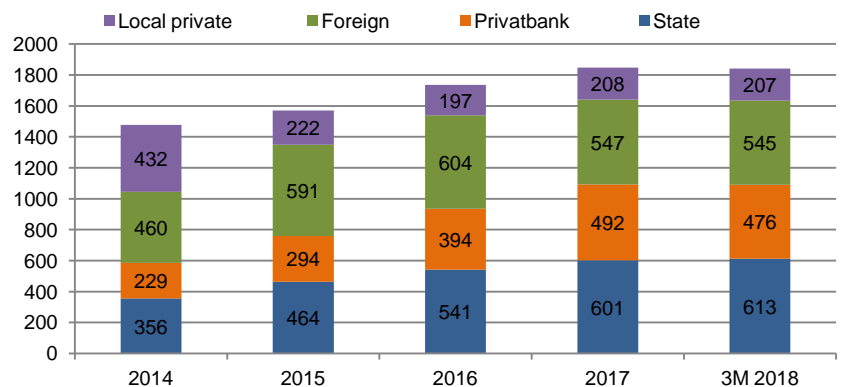
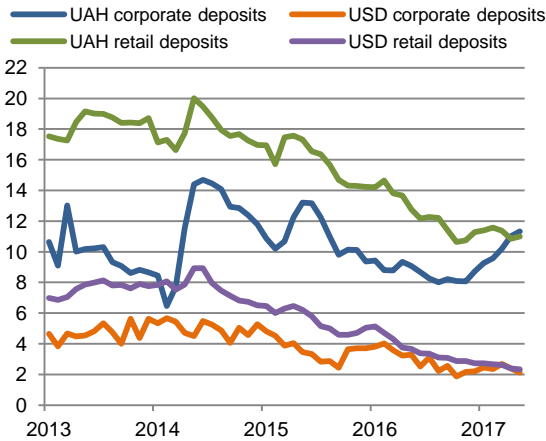


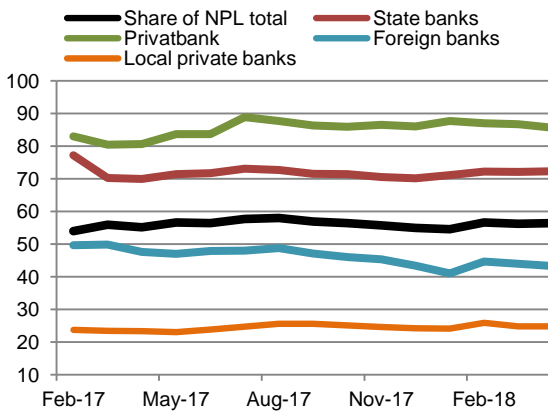


Figure 13. Deposits interest rates, %



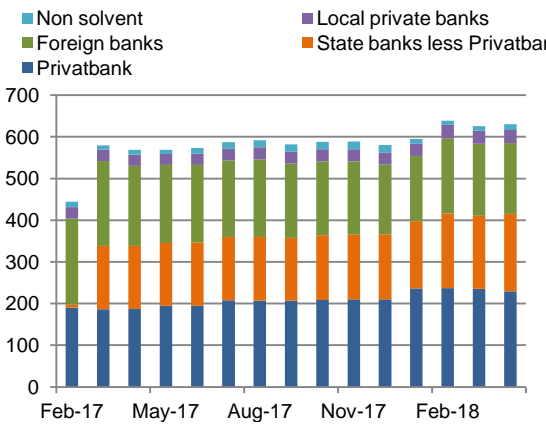
Source: NBU

Figure 14. NPL as a share of loan portfolio, %



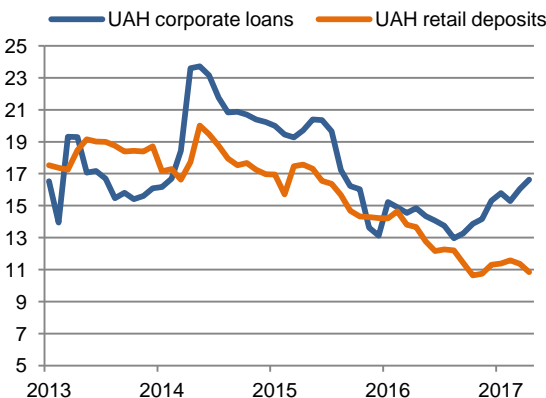
Source: NBU

Figure 15. NPL by banking groups, UAHbn



Source: NBU

Figure 16. UAH rates: firm loans vs household deposits, %



Source: NBU

Deposits were broadly on the rise. The strongest growth was reflected in UAH retail deposits, reaching 27% since 2016. It was followed by UAH deposits of corporate sector (+10%). At the same time, since the end of 2013 only UAH corporate deposits managed to increase by 48%, while other type of deposits remained in the red. At the same time, on YTD basis retail deposits rose, while the same corporate deposits have fallen. In particular, UAH corporate deposits fell by 2.3% YTD, while the same accounts denominated in USD tumbled by 4.2% YTD.

Since 2016, only UAH denominated loans managed to rise. While UAH loans of corporate sector increased by 10%, retail loans rose by 50%. In the meantime, since 2013 all types of loans were falling, while only UAH corporate loans were flat since 2013. At the same time, loans were on the rise on YTD basis too. In particular, UAH retail loans registered the strongest gains, comprising 8.3%. It was followed by slightly lower gains posted by USD corporate loans, amounting to 7.4% YTD.

Interest rates. Having been in a downside trend since 2015 year, interest rates of UAH deposits increased in recent time. UAH interest rates on new retail deposits coincided with interest rates on corporate deposits. At the same time, rates for corporates were always lower compared to households historically. USD denominated rates had been falling since 2015, without major upswings in recent time.

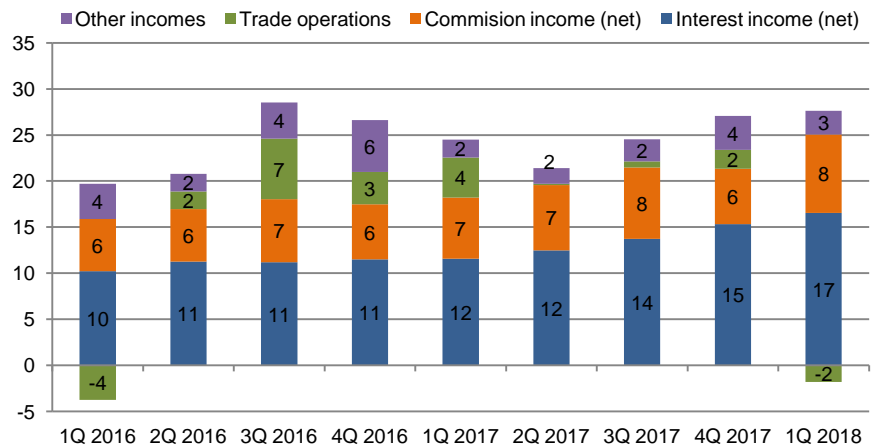
NPL remains steady at 56%. Having started publishing NPL data since February 2017, NBU reported that the share of NPL in the banking system was 56.4% or in line with several preceding months, as of April 1. The share of bad loans in corporate portfolio slightly increased in 1Q 2018 landing at 58.2%, while the same share for household loans portfolio were stable in 1Q 2018 staying at 53.1%.

Since 2012 and up to February 2017, non-performing loans were defined as loans ranged in 4th and 5th asset quality category. Having defined recently the non-performing loans in 10th category under new methodology, NBU also had effectively harmonized local standards with international, as of February 1, 2017.

The largest share of NPL was recorded in state banks, amounting to UAH 415bn or roughly 66% from total, as of April 1. Out of which, UAH 230bn were bad loans of Privatbank, followed by UAH 186bn non-performing loans accumulated in other banks with a state capital. In the meantime, the share of NPL of foreign bank was 27% from total. As a share from loan portfolio, Privatbank non-performing loans amounted to 85.7%, while the same metric for foreign banks were as much as twice less, accounting for 43.3%, as of April 1. The same share for local private banks was 24.8%.

In 1Q 2018, banking system generated UAH 8.8bn of net profit, while in 2017 banks booked UAH 24bn of losses. The reversal was partly due to rising bank incomes. In particular, net interest income increased by 43% y/y in 1Q 2018 (up from 33% y/y in 4Q 2017), followed by 28% rise in net commission income in the same quarter. At the same time, the main source of expenses, namely general and administrative expenses, increased by only 21% y/y in 1Q 2018. The surge of the main banks income was solely due to the increase in net interest margin, against the backdrop of healthy divergence between the borrowing and lending rates.

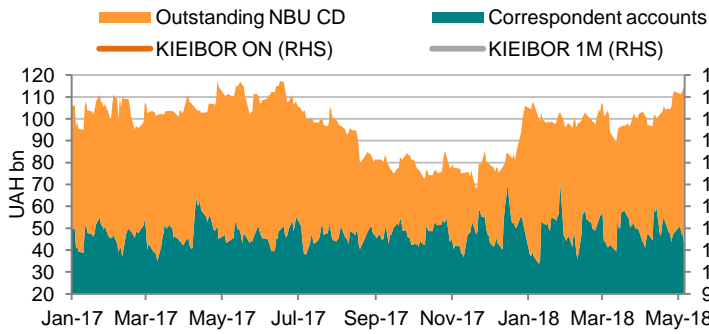
Figure 18. Banks incomes, UAHbn





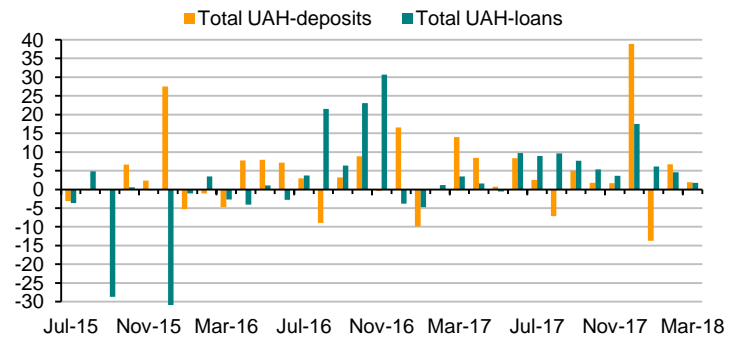
Money market

Banking liquidity vs. money market rates, %



Source: Reuters, NBU, UkrSibbank estimates

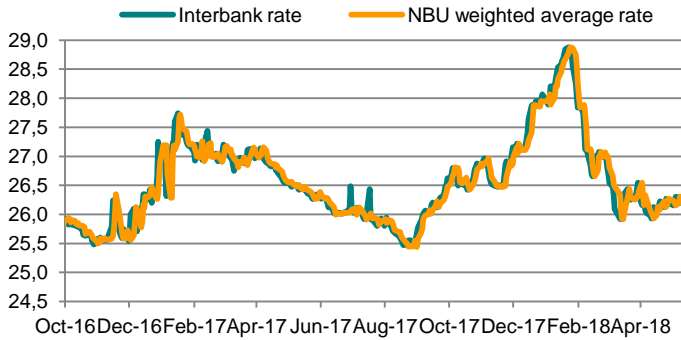
Monthly change in local currency loans and deposits, UAHbn



Source: the NBU

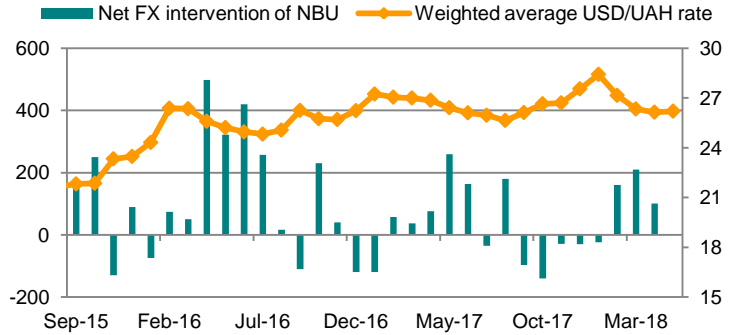
Currency market

UAH exchange rate, UAH/USD



Source: Reuters

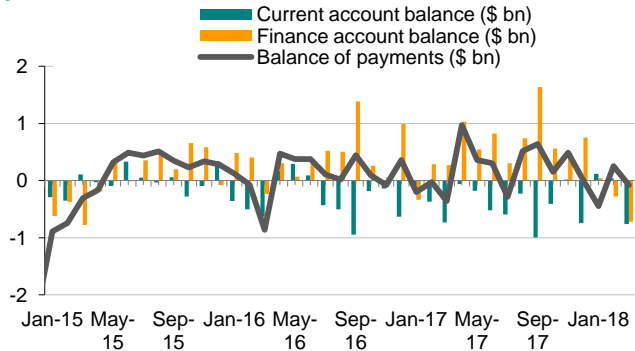
Net retail FX interventions of the NBU in 2015-2017, USDmn



Source: NBU

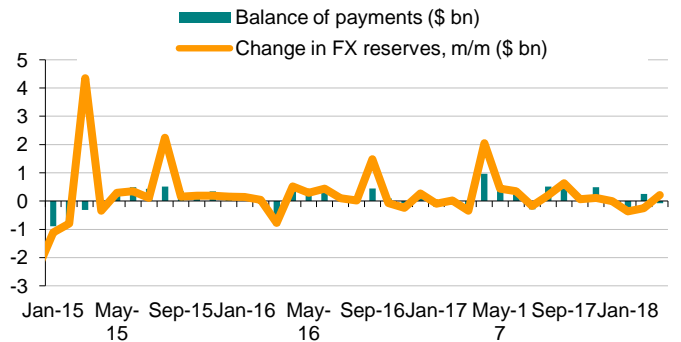
Balance of payments

Major BoP accounts, USDbn



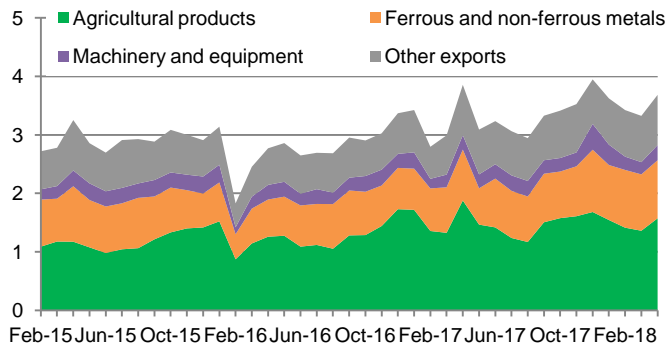
Source: NBU

BoP vs change in foreign reserves, USDbn



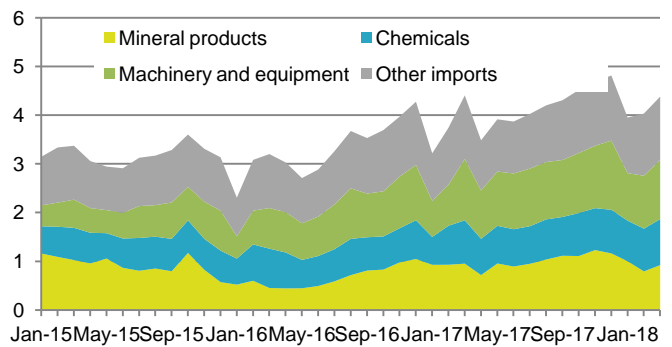
Source: NBU

Exports components dynamic, USDbn



Source: NBU

Imports components dynamic, USDbn



Source: NBU



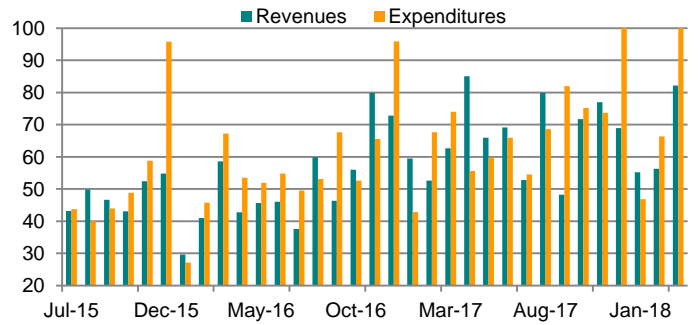
Budget performance

Budget performance, UAHbn

	Jan – Feb 2017	Jan - Feb 2018
Budget revenues	112,0	111,4
VAT proceeds	35,3	36,0
Corporate income tax	8,8	7,4
Budget expenditures	110,6	113,2
Deficit / Surplus	1,5	-1,8

Source: NBU

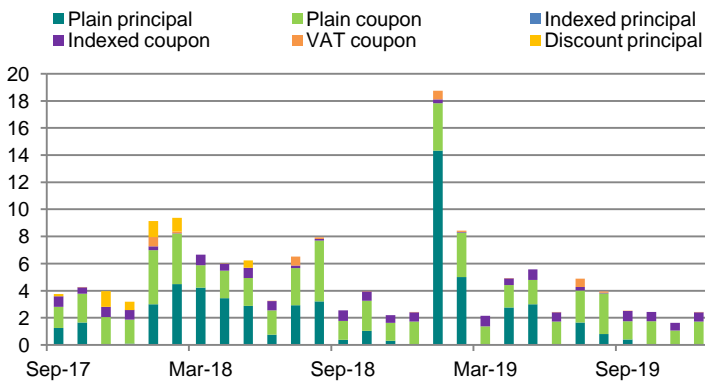
Monthly change in budget revenues and expenditures, UAHbn



Source: NBU, State Treasury

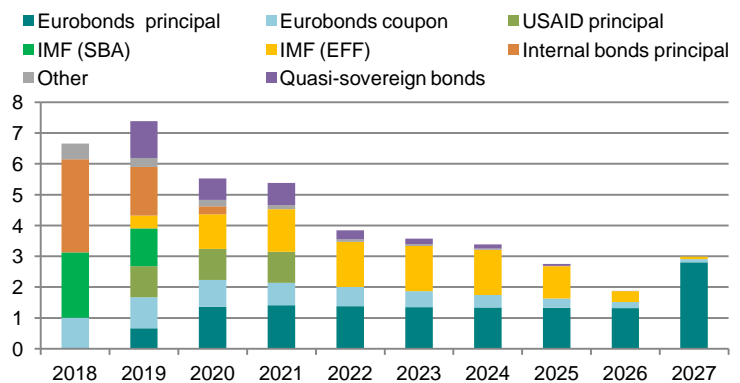
Sovereign debt

UAH-denominated debts' repayments schedule, UAHbn



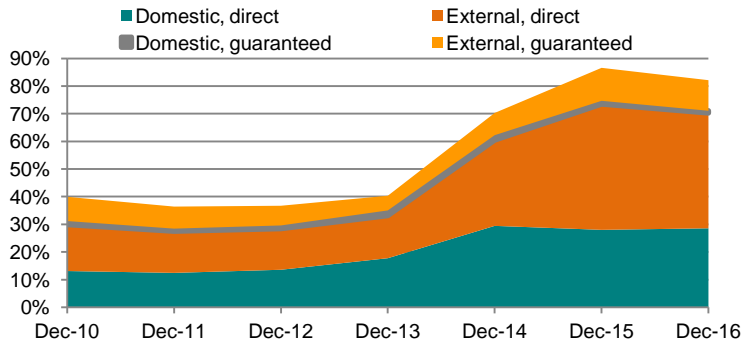
Source: NBU, UkrSibbank estimates

FX-denominated debt repayments schedule, USDbn



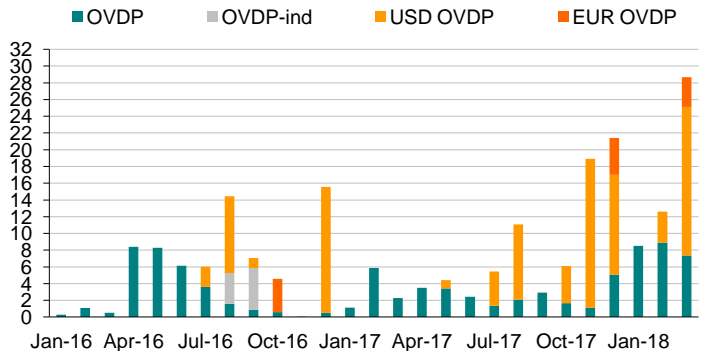
Source: Reuters, IMF, UkrSibbank estimates

Total government debt, % GDP



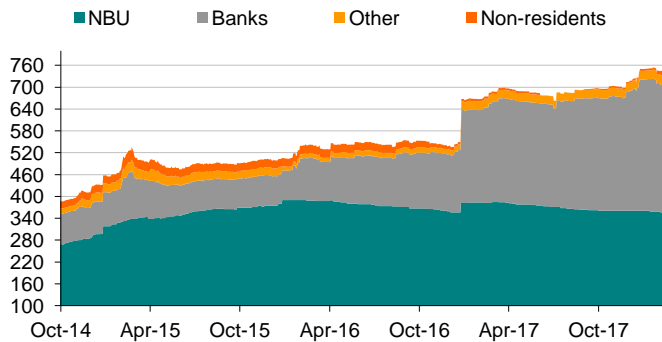
Source: MinFin

Local borrowings, UAHbn equivalent



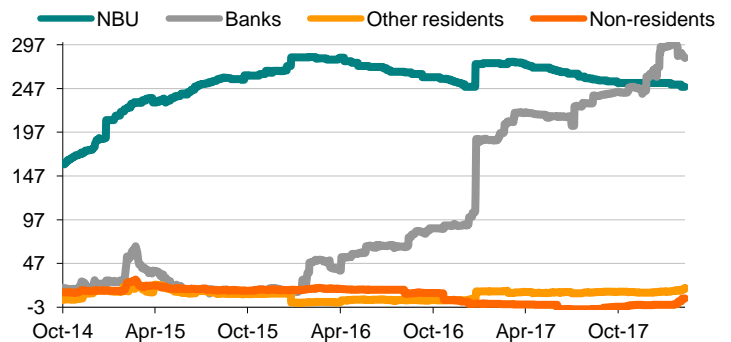
Source: NBU

Outstanding OVDP owners structure, UAHbn



Source: NBU

Outstanding OVDP changes in holding, UAHbn

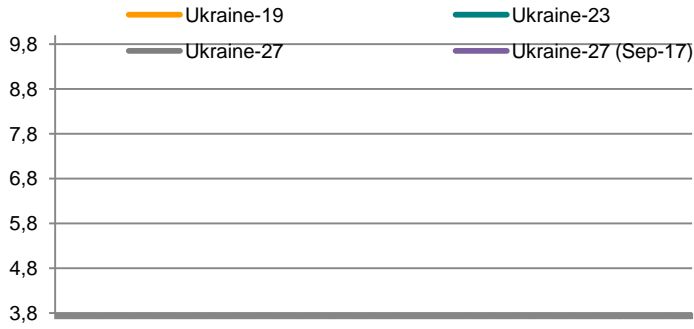


Source: NBU



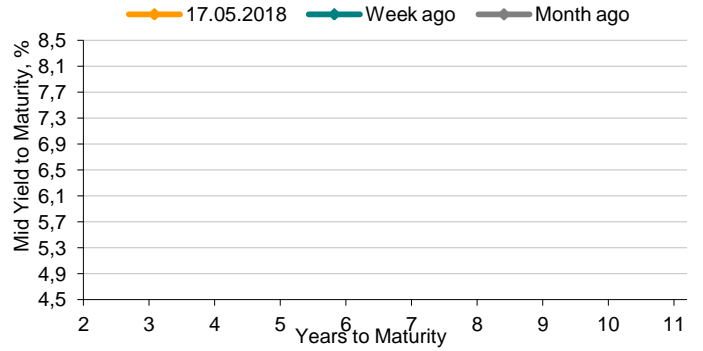
Eurobond market

Ukraine's sovereign Eurobond yields, %



Source: Reuters

Ukraine's sovereign Eurobond yield curve



Source: Reuters

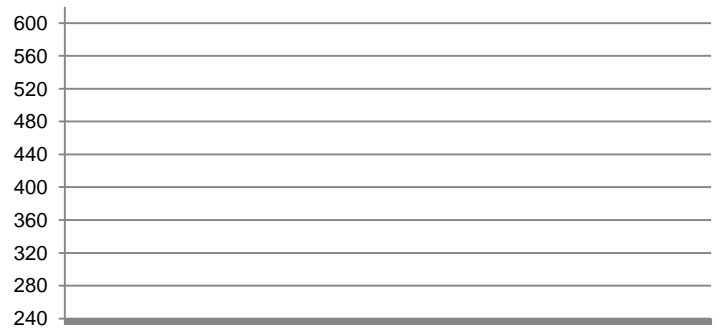
Commodity markets

Iron ore 62% Fe (nearest active future at NYMEX), USD per ton



Source: Reuters

Steel CIS export HR coil, USD per ton



Source: Reuters

WTI oil (nearest active future at NYMEX), USD per barrel



Source: Reuters

Corn and wheat (nearest active future at CBT), USD per bushel



Source: Reuters



Key Macroeconomic Indicators											
Ratings (M/S&P/F) Caa2/B-/B-	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018F
Real sector											
Real GDP (%YoY)	2.3	-14.8	4.1	5.2	0.2	0.0	-6.6	-9.8	2.3	2.5	3.1
Industrial production (%YoY)	-5.2	-21.9	11.2	8.0	-0.7	-4.3	-10.7	-6.0	2.4	-0.1	3.0
Retail sales (%YoY)	17.3	-20.9	10.1	13.2	12.3	6.1	-11.0	-25.0	4.0	8.8	7.0
Unemployment rate end of year (ILO, working age)	6.9	9.6	8.8	8.6	8.1	7.7	9.7	11.5	9.3	8.7	8.5
Nominal GDP (UAH bn)	948.1	913.3	1079.4	1299.9	1404.7	1465.8	1586.9	1979.5	2383.2	2982.9	3239.8
Nominal GDP (USD bn)	178.9	112.8	136.1	163.1	175.8	183.5	133.7	91.2	93.1	112.1	120.0
Prices											
CPI (average %YoY)	25.2	15.9	9.4	8.0	0.6	-0.2	12.1	48.7	16.5	14.4	11.9
CPI (end of year %YoY)	22.3	12.3	9.1	4.6	-0.2	0.5	24.9	43.3	12.4	13.7	10.9
Real average wage growth (%YoY)	6.3	-9.2	10.2	8.7	14.4	8.2	-6.5	-35.0	10.0	18.9	7.0
Fiscal balance (% of GDP)											
State budget deficit (without Naftogaz)	1.3	3.9	5.9	1.8	3.7	4.2	4.9	2.3	2.9	1.6	2.4
Total public debt	20.0	34.8	39.9	36.3	36.7	39.9	69.4	79.4	81.0	71.8	70.0
External balance											
Exports of goods and services (USD bn)	67.7	40.4	65.6	83.7	86.5	81.7	65.4	47.9	46.0	54.0	53.5
Imports of goods and services (USD bn)	83.8	44.7	69.6	93.8	100.9	97.4	70.0	49.6	51.8	60.8	62.3
Current account balance (USD bn)	-12.8	-1.7	-3.0	-10.2	-14.3	-16.5	-4.6	-0.2	-3.8	-3.8	-3.3
Current account balance (% of GDP)	-7.1	-1.5	-2.2	-6.3	-8.1	-9.0	-3.4	-0.2	-4.1	-3.6	-2.8
Net FDI (USD bn)	9.9	4.7	5.8	7.0	7.2	4.1	0.3	3.0	3.4	2.3	2.5
Foreign exchange reserves (end of year)	31.5	26.5	34.6	31.8	24.5	20.4	7.5	13.3	15.5	18.8	22.0
Imports coverage (months of imports of goods)	4.5	7.1	6.8	4.5	3.3	2.9	1.5	4.4	3.7	3.6	4.7
Interest and exchange rates											
NBU discount rate (% end of year)	12.00	10.25	7.75	7.75	7.50	6.50	14.00	22.00	14.00	14.50	17.00*
Exchange rate (UAH/USD) end of year	8.1	8.0	7.9	8.0	8.1	8.2	15.8	24.0	27.2	27.95	29.5*
Exchange rate (UAH/EUR) end of year	10.9	11.5	10.5	10.4	10.6	11.3	23.0	26.2	28.3	33.50	32.5*

Source: UkrStat, NBU, MinFin, UkrSibbank

* Broad estimate



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