FitchRatings

RATING ACTION COMMENTARY

Fitch Upgrades Ukraine to 'CC'

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Related Content:
Ukraine - Rating Action Report

Fitch Ratings - London - 17 Aug 2022: Fitch Ratings has upgraded Ukraine's Long-Term Foreign-Currency (LTFC) Issuer Default Rating (IDR) to 'CC' from 'RD' (restricted default).

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

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

EU CALENDAR DEVIATION DISCLOSURE

Under EU credit rating agency (CRA) regulation, the publication of sovereign reviews is subject to restrictions and must take place according to a published schedule, except where it is necessary for CRAs to deviate from this in order to comply with their legal obligations. Fitch interprets this provision as allowing us to publish a rating review in situations where there is a material change in the creditworthiness of the issuer that we believe makes it inappropriate for us to wait until the next scheduled review date to update the rating or Outlook/Watch status. The next expected review date would have been within six months from Ukraine's previous regular sovereign review completed on 22 July 2022 but Fitch believes that developments in the country warrant such a deviation from the calendar and our rationale for this is set out in the High weight factors of the Key Rating Drivers section below.

KEY RATING DRIVERS

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

HIGH

Completion of Distressed Debt Exchange: The upgrade of Ukraine's LTFC IDR to 'CC' follows the execution of consent solicitation on 11 August to restructure external debt, which we deem constitutes completion of a distressed debt exchange (DDE), curing the 'restricted default'. Near USD6 billion of principal and interest on Ukraine's Eurobonds has been deferred by 24 months, alleviating external debt servicing pressure, in the context of weakening international reserves and acute war-related spending needs. The restructuring received the consent of 75% of bondholders (by aggregate principal amount), above the 66.7% minimum required.

Broader Restructuring Probable: Despite this debt servicing relief, the 'CC' rating reflects unresolved debt sustainability risks resulting from Russia's attack and Ukraine's highly stressed public and external finances and macro-financial position. We expect the war to extend well into 2023, driving public debt above 100% of GDP, adding to the already huge costs to infrastructure and economic output, and fuelling inflationary and external pressures, while deficit financing sources remain uncertain. A broader restructuring of the government's commercial debt is therefore probable in our view, although the timing is uncertain. The relief already provided by the two-year standstill on all Eurobonds, and the challenge of agreeing a framework for any such restructuring in such an uncertain macro-environment, could potentially push it into 2024.

Ukraine's ratings also reflect the following rating drivers:

Fundamental Rating Strengths and Weaknesses: The rating reflects 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. The sovereign benefits from strong multilateral and bilateral support, favourable human development indicators, and prior to the invasion, a credible macro-policy framework.

Protracted War: The prospects of a negotiated political settlement over the war with Russia are weak. The Ukrainian government appears unlikely to cede any substantial territory lost to Russia, and we anticipate President Putin will continue to pursue an objective of undermining the sovereign independence of Ukraine. It is unclear either side will have sufficient military superiority to deliver on objectives, which could result in a long-drawn-out conflict.

Economic Cost, Inflationary Pressure: Fitch forecasts the economy contracts 33% this year, with a shallow recovery of 4% in 2023. Net outward migration has risen to 6.1 million people, estimated damage to infrastructure exceeds USD100 billion (75% of GDP), and the government projects 10-year reconstruction needs at USD750 billion.

We project inflation to accelerate from 22.2% in July to 30.0% at end-2022 due to monetary financing, ongoing supply chain disruptions, weak monetary policy transmission and the hryvnia depreciation, and to remain high in 2023, averaging 20.0%.

Declining FX Reserves: International reserves fell USD5.7 billion to USD22.4 billion in the four months to end-July driven by financial account outflows. The current account remained in surplus of USD3.7 billion in 1H22, helped by capital controls and international grants, but Fitch projects it will return to a deficit of 1.7% of GDP in 2023, putting further pressure on international reserves.

Public Finances Severely Stressed: The spike in war-related expenditure will lead to record-high fiscal deficits. Fitch forecasts the general government deficit rises to 28.6% of GDP in 2022 and remains large in 2023, at 21.9%, due to the ongoing war effort and need to replace critical infrastructure. General government debt is projected to rise to 94% of GDP at end-2022 (excluding government guarantees, of 8% of GDP) and 103% at end-2023. Additional contingent liability risks have greatly increased, and our debt projections are subject to exchange rate risk, given 61% of public debt is FC-denominated, and to a high degree of uncertainty more generally.

Financing Sources Highly Uncertain: Pledged budget aid for the remainder of this year totals near USD15 billion, and there will be ongoing need for financing by the National Bank of Ukraine (NBU), which accounted for just above half of deficit financing in 1H22. There is sizeable uncertainty as to whether banks will continue to roll over domestic debt at near 100%, despite the sector's ample liquidity (which has been helped by 16% growth in hryvnia deposits since the war). Ukraine's ability to meet its extremely large financing need into 2023 largely depends on multilateral and bilateral support, which is currently uncertain, and we judge that pre-commitment to commercial debt restructuring is a probable condition of continued budgetary aid support on such a scale.

Local-Currency IDRs Affirmed: We do not consider there has been a material change in the default risk on Ukraine's local-currency debt since we downgraded the Long-Term Local-Currency (LTLC) IDR to 'CCC-' on 22 July. The lower default risk than on foreign-currency debt partly reflects the greater disincentive for the government to restructure local-currency debt, given 47% is held by NBU, a further 40% by banks, and just 6% by non-residents, and the absence of strong international pressure to bring domestic debt into a restructuring process. Nevertheless, there is a high degree of liquidity risk, given uncertainty over the size and sources of deficit financing, and increasing constraints on continued monetary financing at recent levels in the context of rising inflation and external stress.

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.

RATING SENSITIVITIES

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

- The LTFC 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 LTLC 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 announcing restructuring plans that materially reduce the terms of local-currency debt to avoid a traditional payment default.

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

- Structural: 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 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.

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 '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 creditor rights as willingness to service and repay debt is relevant to the rating and is a rating driver which. Given Ukraine's recent deferral of external debt payments which we deem a distressed debt exchange, together with the restructuring of public debt in 2015, 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.

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, either due to their nature or to the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

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RATING ACTIONS

ENTITY / DEBT	RATING			PRIOR
Ukraine	LT IDR	CC	Upgrade	RD
	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	Upgrade	D

VIEW ADDITIONAL RATING DETAILS

Additional information is available on www.fitchratings.com

PARTICIPATION STATUS

The rated entity (and/or its agents) or, in the case of structured finance, one or more of the transaction parties participated in the rating process except that the following issuer(s), if any, did not participate in the rating process, or provide additional information, beyond the issuer's available public disclosure.

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

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Ukraine UK Issued, EU Endorsed

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