Aegon Asset Management

UKRAINE BY PROXY

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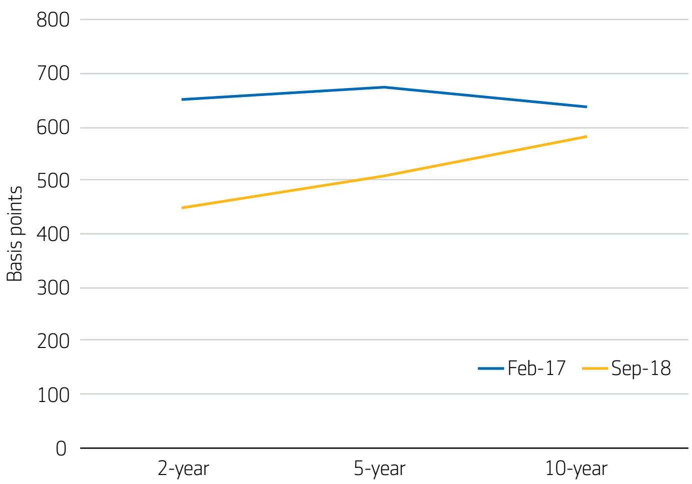
Ukraine has been in and out of the headlines over the last several years. Struggles with war, default and corruption, combined with years of economic mismanagement and accumulation of debt, led Ukraine to again seek IMF assistance in 2015.

Aegon AM US' views and positioning in Ukrainian external debt markets have evolved over the last 18 months. We expected the 2015 sovereign debt restructuring and IMF partnership to provide a degree of stability domestically, and specifically thought the front end of the bond curve needed to reprice tighter. However, considering that the debt restructuring involved only a 20% "haircut" to creditors, as of 2017 Ukraine was still left with a high debt load of 72% debt to GDP, and low GDP growth of 2.5%. With the loss of most of its manufacturing during the Russian invasion and advertised policy programs, we saw little prospect to meaningfully reverse this situation after the IMF support ends.

Our interpretation of the flat/inverted Ukraine sovereign spread curve of 2-year and 10-year bonds in early 2017 was near-term caution and long-term optimism. In our view, we saw short-term fundamentals stabilizing yet long-term prospects still questionable, which appeared to be at odds with market pricing. After further review of the full credit fundamentals and market pricing, we thought short duration Ukrainian credit looked notably more attractive than long-term Ukrainian credit.

Fast forward to the fall of 2018. The credit curve of Ukraine sovereign bonds has changed substantially due to many factors we had anticipated, such as IMF-related economic and governance-related successes, and others that we had not, such as the broad market credit rally of 2017. The whole credit curve is now lower and steeper with a near 150 basis point difference between 2-year and 10-year bonds (Exhibit 1).

Exhibit 1: Ukraine sovereign yield curve spreads over 10-year US Treasury yields



Source: Bloomberg

More recently, we saw the curve shape as roughly appropriate. The long-term story is largely unchanged—credit and governance dynamics long-term suggest little improvement. However, under the watch of the IMF, foreign currency reserves and capital flows are supporting near-term cyclical dynamics. Consequently, we looked for ways to stay involved in the near-term positive sentiment—anchoring short-term credit spreads—while underweighting our overall Ukraine sovereign exposure.

We think an answer to these objectives is the credit of a Ukraine food industry company, which in our view has much better credit quality and long-term prospects than Ukraine sovereigns. The company has maintained its profitability by channeling its products to the most profitable markets, and it maintains one of the strongest credit profiles in emerging markets among protein producers.

The company issued its first USD bond in 2006 and has repaid in full three bonds, including those that matured during the Russian invasion. It also has demonstrated resilience to economic shocks and a military conflict in Ukraine by suffering little impact to its profitability. Moreover, it is in a government-friendly industry that receives subsidies and tax breaks, and thus has a low probability of being subject to harmful controls.

We believe the country factor is the dominant pricing component in most emerging market investment decisions. Unsurprisingly, we view the key factor that is holding the company's spreads high, relative to industry peers, are the near- and long-term challenges facing Ukraine. The company is aware of this factor and it is expanding outside Ukraine to lower its cost of capital. It is expanding its capacity by 45%, using internal cash flow to increase its exports to 70% of sales (from 56% in 2017) by 2021. It also plans to acquire distribution and production capacity in Western Europe to enhance its competitive position in the region.

If the company is successful in its strategic plans of becoming more geographically diversified, we think it should trade tighter to industry peers than at present given its better credit metrics. We would expect it to start to price more like a western European credit and less like a Ukrainian one, and that the bonds will trade substantially tighter than equivalent Ukraine sovereign bonds. Absent a re-escalation of armed conflict toward Western Ukraine—an unlikely scenario in our opinion—the company's bonds should increasingly decouple from Ukraine's sovereign bonds as its credit trajectories diverge.

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