FINANCIAL TIMES

Financial Times. – 08.01.2016

John Dizard

Ukraine: dismal economic prospects, great sovereign bond

Country's external bonds had the highest returns of any sovereign debt last year, says John Dizard

Україна: похмурі економічні перспективи, великий державний борг

Зовнішні облігації країни мали найвищу прибутковість серед суверенних боргів в минулому році, говорить Джон Дізард

В додаток до всіх бід України, її зовнішні облігації в минулому році мали найвищу прибутковість серед суверенних боргів. Оптимісти, які зробили ставки на ці папери в умовах продовження громадянської війни, депресії, девальвації, реструктуризація, і, нарешті, в кінці грудня, вибіркового дефолту, заробили би 41 відсотків прибутку від їх номіналу, пише автор публікації. Далі він аналізує стан з українськими державними облігаціями, в тому числі аналізуючи ситуацій з 3-мільярдним боргом Росії. Швидше за все, Росія і Україна зрештою погодяться на компромісне рішення в рамках більш широкої комплексної угоди, яка включатиме врегулювання "громадянської" війни, прогнозує автор.

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For all Ukraine's troubles, its external bonds had the highest returns of any sovereign debt last year. The optimists who actually held on to the paper through continued civil war, depression, devaluation, restructuring, and, finally, at the end of December, selective default, would have made a 41 per cent profit on their position.

Or perhaps I should say "alleged default", since an arcane court battle over a $3bn Ukraine bond issue held by the Russian government is looming in the coming months. This is not only a bond, but an extremely cleverly done piece of geopolitical manoeuvring.

The $3bn two-year, 5 per cent Eurobond was not completed under the most auspicious circumstances. The prospectus is dated February 17 2014, and the final bits of documentation were only completed on February 19. Just to refresh your memory, what the present Ukraine government would call the Euromaidan revolution and the Russian government a coup d'état, took place between February 18 and February 23. Shootings in a public square, collapse of state control, head of state fleeing with henchmen and family; altogether not the usually desired background for a closing ceremony.

Yet the customers of VTB Capital, the sole lead manager, were nothing if not contrarian. Also, they had some very good documentation on their side. I have gone over the 219 page prospectus, which is a credit to the names of counsels White & Case and Clifford Chance, as well as Citibank, not to neglect the local counsel and the Law Debenture Trust Corporation.

The prospective holder of the notes is given good disclosure of the dismal economic prospects for Ukraine and the widespread allegations of government corruption, along with a briefing on the nation's not entirely happy history. Ukraine's sovereign immunity is explicitly waived (except in the US), and the duly elected government accepts English law and arbitration. The "use of proceeds" is given as "general budgetary purposes", which in Ukraine were pretty open ended.

Along with the standard Eurobond clauses and financials, there were a couple of innovative conditions. One was a clause allowing the holder (Russia or its successors) to declare a default if Ukraine's government debt to gross domestic product exceeded 60 per cent. The other allowed the holder to "cross-default" the Ukraine bonds on any indebtedness owed to the noteholder or to any entity majority owned or controlled by the noteholder. Such as, say, Gazprom.

So the bonds, which were listed on the Dublin stock exchange, were both well documented and prospectively enforceable market instruments and bilateral sovereign debt. That has meant that for the past two years Ukraine has faced not only territorial seizure, violent separatism and economic collapse but the possibility of Argentina-like grinding international litigation.

Which is now a reality. On January 1, the Russian Ministry of Finance announced that "Ukraine is now legally in default on the Eurobond", and that it "has initiated procedures… with a view to commencing legal proceedings as soon as possible".

Whitney Debevoise, an experienced sovereign debt lawyer at Arnold & Porter in Washington, says: "Arbitration like this can be done in six months, but Ukraine may try to delay. Ukraine is likely to throw up some trial balloons, perhaps say they were invaded or they have been under duress, but at the end of the day, those arguments are not likely to succeed."

The Russians have not been entirely unyielding on the Ukraine Eurobond. The ministry added in its January 1 statement: "The commencement of legal proceedings does not preclude a constructive dialogue with a view to reaching an acceptable solution."

Also, Russia has, arguably, had some openings to allege a default on the Eurobond's covenants before it matured on December 20. But rather than accelerate the due date of the principal, it just waited for the more outright event of default. The Russians did not, however, go along with the haircut that Ukraine's private sector bondholders accepted in the autumn.

Even Ukraine's friends among academic lawyers do not think Cristina Kirchner-style bluster about "odious debt" would work in fending off the Russian claim. Anna Gelpern, professor of law at Georgetown University and senior fellow at the Peterson Institute of International Affairs says: "I think Russia did a very, very smart thing. Do I think it is good for the system? No. If I represent Russia, then I am pleased and proud."

Most probably Russia and Ukraine will eventually agree a negotiated solution as part of a broader package deal that would include a settlement of the "civil" war. As Mr Debevoise points out: "[President] Putin has already suggested a willingness to accept payment in instalments, which implies a net present value reduction."

The significance of the Ukraine-Russia Eurobond goes far beyond the $3bn or the particulars of the dispute. As Prof Gelpern says: "What people keep missing [about the bond] is that when governments have the market tools at their disposal, while at the same time having access to all the multilateral institutions, there are huge arbitrage opportunities for them. The governments can come in when they want ahead of your claims. Your readership should wake up to that big time.”