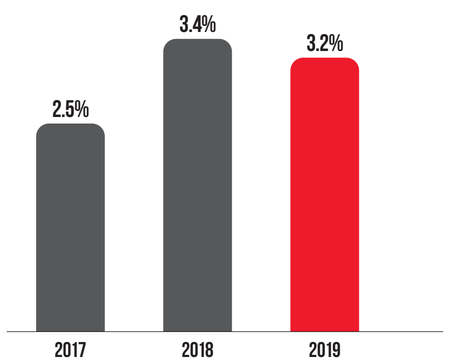
OPPORTUNITY AMID UNCERTAINTY

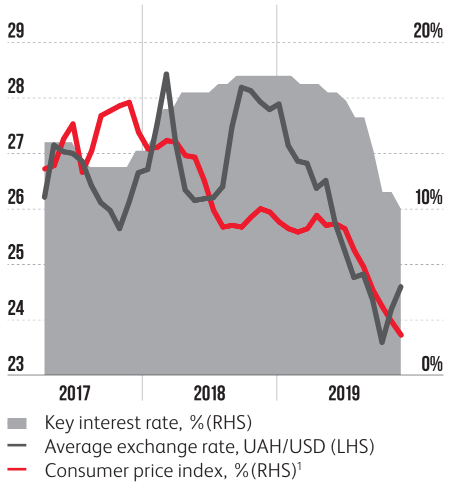
In 2019, Ukraine's economy delivered growth for the fourth year in a row. Real GDP expanded by 3.2% year-on-year, primarily driven by ongoing reforms and improved consumer spending. However, steel consumption fell by 4.0% year-on-year, mainly due to lower demand from pipe manufacturers.

Real GDP growth



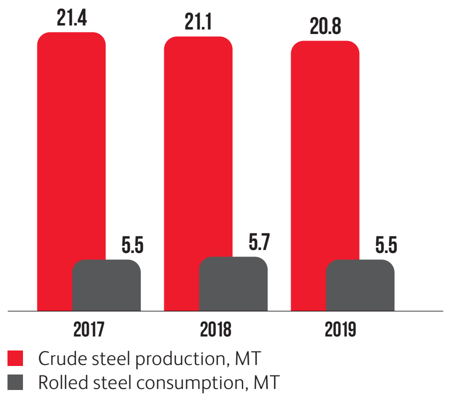
Source: State Statistics Service of Ukraine

Monetary policy



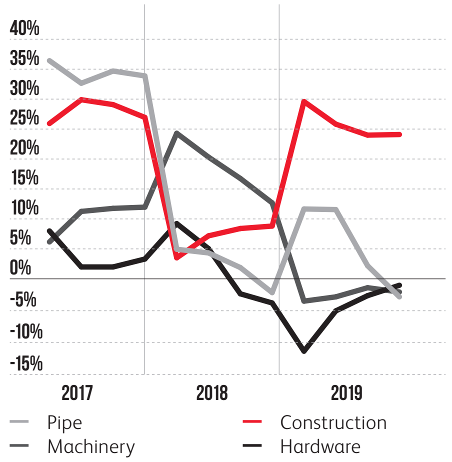
Source: State Statistics Service of Ukraine, NBU

Steel industry



Source: World Steel Association, Metal Expert

Key steel consuming sectors[2]



Source: State Statistics Service of Ukraine, Metal Expert

IMPROVED FUNDAMENTALS

Ukraine's smooth 2019 presidential and parliamentary elections signalled the strength of its democratic institutions. This fostered real GDP growth of 3.2% year-on-year in 2019, propelled by growing consumer spending power and confidence, as well as by a record grain harvest in the agricultural sector.

Still, Ukraine was not immune to external pressures as year-on-year growth slowed from 3.9% in the third quarter to 1.5% in the fourth quarter. This was caused by diminishing industrial production, in part due to Ukraine's manufacturing industries, including steel, feeling the effects of falling global demand.

During the year, the National Bank of Ukraine (NBU) maintained a consistent monetary policy of inflation targeting and kept the local currency floating. In this environment, the interest rate is the NBU's main policy tool. The consumer price index (CPI) descended to below the NBU's target of 5%, slowing in year-on-year terms from 9.8% in December 2018 to 4.1% in December 2019. This enabled the NBU to begin monetary easing. As a result, its key interest rate was cut many times, from 18.0% in early 2019 to 13.5% in December 2019 and, after the reporting period, to 6.0% in June 2020.

In 2019, the NBU also further eased its currency control restrictions. It lifted all limitations concerning the mandatory sale of foreign currency proceeds and the amount of dividend payments that Ukrainian companies can make to non-residents. In addition, it increased the settlement period for import-export transactions in foreign currency to 365 days effective 16 May 2019.

While the key interest rate remained high relative to other countries during 2019, international investors gained easier access to local government bonds in May that year, fuelling a US$4.3 billion inflow of foreign currency into Ukraine during the year, as reported by the NBU. This was the key driver of an unprecedented 18% year-on-year appreciation of the hryvnia against the US dollar from an average of 27.79 in December 2018 to an average 23.61 in December 2019.

The significant foreign currency inflow helped Ukraine to service its debt and reduce borrowing costs. It also allowed the NBU to increase its international reserves to US$25.3 billion in late 2019, the highest level since 2012. The development of the local bond market has led to a higher share of hryvnia-denominated instruments in the government's debt portfolio, which has improved its sustainability. Exchange rate changes and nominal GDP growth brought down the debt to GDP ratio to 50% by year-end, compared with 61% a year earlier. However, the hryvnia strengthening negatively impacted Ukraine's export-oriented companies, like Metinvest, by driving up their costs in local currency.

Ukraine prudently managed its external debt maturity profile during the year, remaining active on international debt markets and placing local bonds. In March 2019, it tapped the Eurobond due in 2028 and printed an additional US$350 million. In June 2019, Ukraine issued its first euro-denominated tranche in 15 years to raise EUR1 billion due in 2026 at 6.75%, unlocking euro financing for Ukrainian borrowers. This encouraged Metinvest to place a EUR300 million Eurobond due in 2025 with a coupon of 5.625% per annum.

To continue managing peak debt repayments in coming years, Ukraine must retain the support of international financial institutions. The ongoing cooperation with the IMF is viewed as a particularly vital source of liquidity and driver of positive change. In June 2020, after the reporting period, the IMF approved a new 18-month, US$5.0 billion programme, under which Ukraine received US$2.1 billion that same month.

In December 2019, Naftogaz and Gazprom finally reached a settlement in their multi-year dispute covering all outstanding matters. A set of agreements was signed, under which all open claims between the two parties were dropped, Gazprom agreed to pay approximately US$2.9 billion to Naftogaz, and the parties agreed to a five-year gas transit agreement including minimum transit volumes, which finally brought clarity to Ukraine's gas transit revenues.

International credit rating agencies recognised Ukraine's progress in 2019. Both Fitch and S&P upgraded Ukraine's sovereign rating by one notch to 'B' in September 2019, while Moody's changed its outlook to 'positive', affirming the 'Caa1' credit rating and 'B3' country ceiling. In addition, Ukraine advanced in the World Bank's Ease of Doing Business Index, rising to 64th place among 190 countries (compared with 71st in 2018).

TOUGH YEAR FOR STEELMAKERS

It was a challenging year for Ukraine's traditionally export-oriented steel industry, especially in the second half of 2019. This was mainly due to unfavourable export markets, while the hryvnia appreciation led to operating cost pressure.

Moreover, domestic apparent steel consumption fell by 4.0% year-on-year to 5.5 million tonnes, primarily due to a 3.0% decrease in pipe manufacturing, which weakened feedstock demand for seamless and welded pipes, a 2.2% drop in machinery output and a 1.1% decline in hardware production. Although construction activity rose by 23.6% year-on-year in 2019, according to management estimates, this was largely driven by the commissioning of new buildings and structures constructed during previous years, as well as by the predominant growth of construction segments with relatively low rates of steel consumption.

While total steel output in the country declined by 1.2% year-on-year to 20.8 million tonnes, Metinvest was able to ramp up production by 3.5% year-on-year to 7.6 million tonnes after launching the new continuous caster at Ilyich Steel.

Metinvest estimates that in 2019, Ukraine's merchant iron ore product consumption dropped by 1.9% year-on-year to 31.3 million tonnes, driven by lower crude steel and hot metal production. Despite weaker demand, the Group's local sales of iron ore products surged by 12.4% year-on-year. Meanwhile, the country's merchant iron ore product output climbed by 5.1% year-on-year to 72.2 million tonnes in 2019.

After a decade of declining Ukrainian coking coal production, latterly due to the situation in the eastern part of the country, Metinvest estimates that this trend reversed in 2019. Ukraine's raw coking coal output rose by 8.8% year-on-year to 6.3 million tonnes, as the Pokrovske coal business, in which the Group bought a 24.77% stake in July 2018, increased its production of raw coking coal by 25.8% year-on-year to 5.0 million tonnes. This helped to reduce the share of coking coal imports in local consumption to 75% in 2019, down 6 percentage points year-on-year.

All told, Metinvest's overall sales in Ukraine fell by 6% year-on-year in 2019, while the country's share in consolidated revenues reached 29%, up 1 percentage point year-on-year.

OUTLOOK FOR 2020

Despite strengthened economic fundamentals, 2020 is expected to be a testing year for Ukraine as the outbreak of the coronavirus in the beginning of the year has significantly disrupted normal life and economic activity not only in the country, but also in all its major trading partners, breaking global supply chains.

It remains to be seen to what extent economic growth in the world and in Ukraine will suffer from quarantine measures to restrict the spread of the virus. Ukraine's export-oriented metals and mining industry is likely to be affected by these events as iron ore and steel consumption could fall worldwide. The Ukrainian government's support will be important in this situation and much will depend on both the efficiency of these efforts and protective measures taken by governments on key markets to which Metinvest exports its products. Ukraine's financial well-being will also depend on its ability to rapidly implement its ambitious reform agenda and to stimulate economic growth.

1 For CPI, the year-on-year change is for the relevant month.
2 All indexes represent the cumulative index from the beginning of the respective year, year-on-year change.