

Economic & Risks Monitoring Review

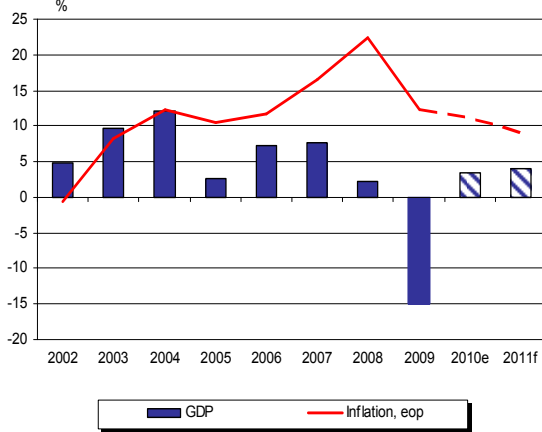
Monthly

Issue 32

May 2010

Highlights

GDP growth and inflation



Source: State Statistics Committee, RB Aval Research

- GDP grew 4.8% yoy in the first quarter of 2010.
- Ukrainian Parliament passed state budget for 2010 with 5.3% of GDP deficit, however, given over-optimistic revenue targets and high financing needs of Naftogas, general government fiscal deficit may reach 7-8% of GDP this year.
- Ukraine's economy and financial markets so far proved resilient to the turmoil in Eurozone thanks to the strong export performance and low intensity of short-term capital flows.
- S&P raised country's sovereign credit ratings against the background of improved policy coordination and stabilization of external liquidity position.
- Political stabilization played an instrumental role in the remarkable improvement of the external accounts as acceleration of capital inflows and tapering off depreciation expectations turned balance of payments positive in March.

Ukraine: Key economic figures and forecasts

	2006	2007	2008	2009	2010e	2011f
Real Sector						
GDP (UAH bn)	544.2	720.7	948.1	914.7	1065.1	1227.3
GDP (USD bn)	107.8	143.3	180.2	114.2	138.3	165.9
GDP (% yoy)	7.3	7.9	2.3	-15.1	3.5	4.0
Domestic demand (% yoy)	13.8	16.5	8.0	-22.2	3.8	4.3
Terms of trade (% yoy)	4.9	10.7	7.2	-6.9	1.3	-1.1
CPI (avg, % yoy)	9.1	12.8	25.2	15.9	10.0	9.0
CPI (eop, % yoy)	11.6	16.6	22.3	12.3	11.0	9.0
PPI (eop, % yoy)	14.1	23.2	23.0	14.4	10.5	10.0
Real disposable income (% yoy)	13.4	12.8	10.3	-8.5	n/a	n/a
External Sector						
C/A Balance (% of GDP)	-1.5	-3.7	-7.1	-1.6	-0.5	-1.4
FDI (USD bn)	5.3	9.2	9.7	4.5	6.0	7.5
Monetary Sector						
Base money (% yoy)	17.5	46.0	31.6	4.4	10.8	11.1
Broad money (% yoy)	34.5	52.2	29.5	-5.5	14.9	14.3
USD/UAH (eop)	5.05	5.05	7.65	8.00	7.70	7.30
USD/UAH (avg)	5.03	5.03	5.26	8.02	7.70	7.40
EUR/UAH (avg)	6.36	6.89	7.73	11.17	10.09	9.25
Fiscal Sector						
Fiscal balance (% of GDP)	-0.7	-1.1	-1.5	-9.0	-6.5	-3.0
Public debt (% of GDP)	15.0	12.5	19.9	34.6	39.0	37.5

Source: State Statistics Committee, National Bank of Ukraine, Ministry of Finance, RB Aval Research

Ukraine: Sovereign ratings

LCY rating	S&P	Moody's	Fitch
Long-term	B+	B2	B-
Short-term	B	—	...
Outlook	Stable	Negative	Stable
FCY rating			
Long-term	B	B2	B-
Short-term	B	...	B-
Outlook	Stable	Negative	Stable
Latest assessment	17.05.10	12.05.09	17.03.10

Source: Reuters, Cbonds

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Macroeconomic Situation

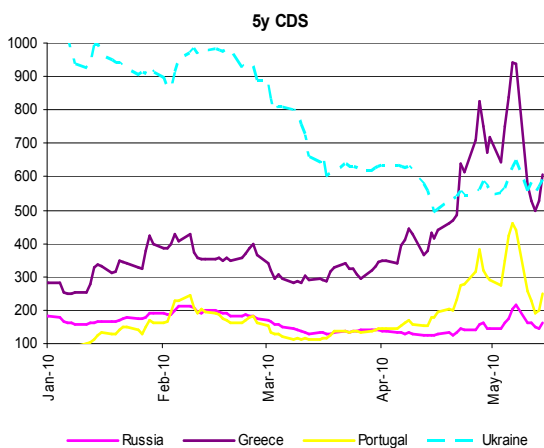
Ukraine's economy and financial markets so far proved resilient to the turmoil in Eurozone thanks to the strong export performance and low intensity of short-term capital flows.

Concerns over Greece solvency spread the fire across global financial markets causing sharp depreciation of EUR against USD and leading to the general risk re-pricing (i.e. plunging equity indices, higher bond yields, elevated CDS levels) in both Eurozone periphery and Emerging Europe. Moreover, turmoil in Eurozone provoked the massive sell-off of several CEE currencies (notably PLN, HUF, and CZK), which lost 5-10% against EUR just in one week.¹ At the same time, Ukraine so far surprisingly remains the "island of stability" in the raging financial storm. Specifically, hryvnia appreciation trend persists at the FX market amid strong export performance. Domestic equity and bond markets felt some pressure as the most nervous investors rushed to close their positions, however, given the low intensity of speculative capital flows, it did not have a substantial effect on FX trading volumes. Also, despite surging debt costs, Ukrainian entities still have the access to the global financial markets – the metallurgical holding Metinvest has recently placed USD 500 mn Eurobonds with yield of 10.5%, while the government is nursing the plans to issue sovereign Eurobonds in the nearest future (recently selecting the lead managers for the issue). Ukraine's position was also supported by the rating action of Standard&Poor's. On May 17th **S&P raised country's sovereign credit ratings to B/B (foreign currency) and B+/B (local currency)** citing "improved policy coordination, the stabilization in Ukraine's external liquidity position and our expectations of an increase in useable foreign exchange reserves relative to short-term debt, and a relatively moderate general government debt burden" as the main reasons for the upgrade.

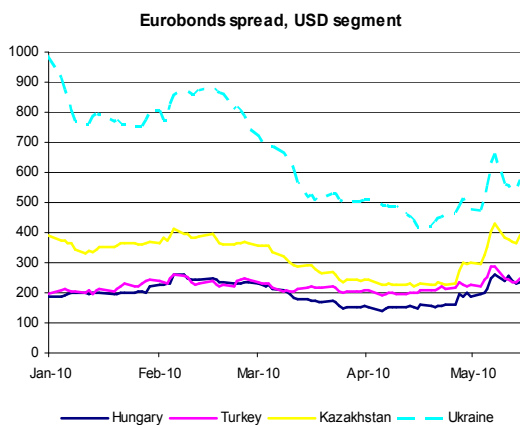
Hence, in our opinion, Ukraine is likely to remain unscathed by the current turbulences in the Eurozone. Specifically, taking into account healthy balance of payments fundamentals (i.e. adjusted trade balance and absence of large external debt repayments), relatively high level of NBU FX reserves (currently covering nearly 5 months of import), and tiny volume of short-term speculative foreign capital (due to the illiquidity of domestic financial markets), we do not expect wild movements in the USD/UAH exchange rate. However, if this financial turmoil spills over to the real sector, Ukrainian economy could be hit severely given high trade openness, subdued domestic demand and absence of room for fiscal stimulus.

Real Sector

According to Ukraine's State Statistics Committee, **GDP grew 4.8% yoy in the first quarter of 2010** after 6.8% yoy decline in Q42009 (in the whole year of 2009 Ukraine's GDP collapsed by 15.1%). Also, we estimate that seasonally adjusted qoq GDP growth rate constituted nearly 1.2% in the first quarter (after growing by 0.4% and falling by 0.8% in the third and fourth quarters of 2009 respectively). In fact, Ukraine has been one of the fastest growers in the region in Q12010 (GDP yoy growth rates in Russia, Czech Republic and Hungary constituted 2.9%, 1.2% and 0.1% respectively) after registering the largest drop in the output (except Latvia) last year. Therefore, on the one side, impressive output recovery should be

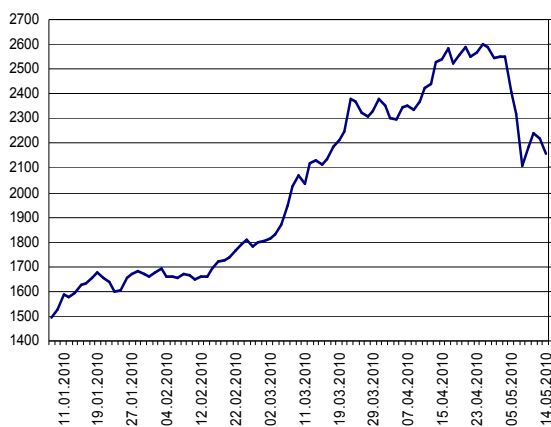


Source: Reuters



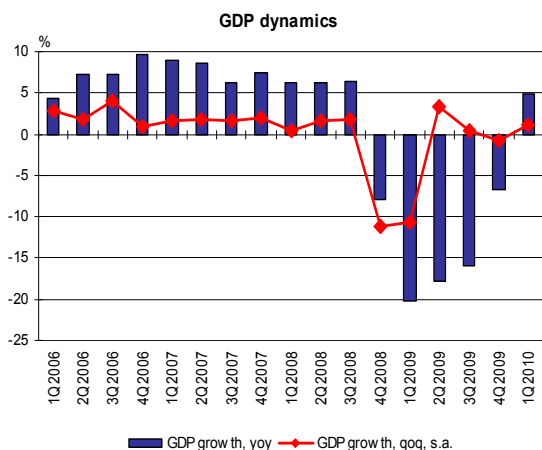
Source: Reuters

Ukraine's equity market index (UX)



Source: Ukrainian Exchange

¹ However, following the approval of unprecedented financial assistance package by the EU, these currencies have regained the ground in the recent days.



Source: State Statistics Committee, RB Aval Research

attributed to the extremely low statistical base of Q12009. However, the robust performance of export-oriented industries (boosted by competitiveness gain following massive nominal depreciation in 2008-2009) has also played the important role in growth rebound.

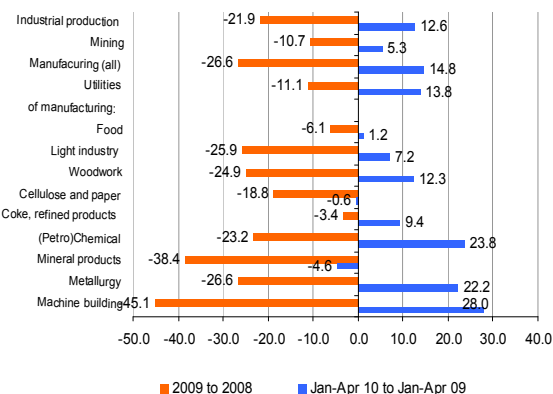
Specifically, strong output growth in steel, chemical and machine building industries (33.4%, 17.3%, and 33.9% yoy growth in April) were the main factors behind industrial output growth acceleration from 13.8% in March to 17.4% in April. In Jan-Apr industrial output grew 12.6% yoy – steel and machine building sectors posted the largest increase (22.2% and 28% respectively), while domestically-oriented industries are apparently lagging behind: the output growth rates in food industry and productions of construction materials constituted 1.2% and -4.6% respectively in Jan-Apr).

The latest growth figures clearly reveal that **Ukraine is emerging out of recession**. However, larger statistical base effect, sharp hryvnia appreciation against EUR, and growth slowdown in the Eurozone are likely to put downward pressure on growth indicators over the next three quarters. Therefore, we leave unchanged our forecast for GDP growth rate in 2010 at 3.5% level, while industrial output is expected to grow 6-7% this year.

Consumer prices dropped by 0.3% mom in April due to the sharp decline in sugar prices coupled with the seasonal effect.

As a result, yoy CPI growth rate fell from 11% to 9.7%. Food prices dropped by 0.7% in April, thus fully explaining 0.3% fall in CPI (consumer price index excluding food prices grew 0.1% mom in April). Specifically, sugar prices plunged by 6.5% mom in April as global prices for this product continue to adjust downwards after the enormous spike in late 2009 – early 2010. Besides, the prices for dairy products, fruits and vegetables fell by 2.5%, 2.2% and 2.1% respectively following traditional seasonal pattern. Finally, the political stabilization has also positively affected households' expectations, thus alleviating inflationary pressures at the food market. At the same time, **producer prices are surging further**. PPI grew 3% mom in April mostly driven by 10.4% increase in the prices in steel industry. Consequently, yoy PPI growth rate went up from 18.7% to 21.7%.

Industrial output growth by sector

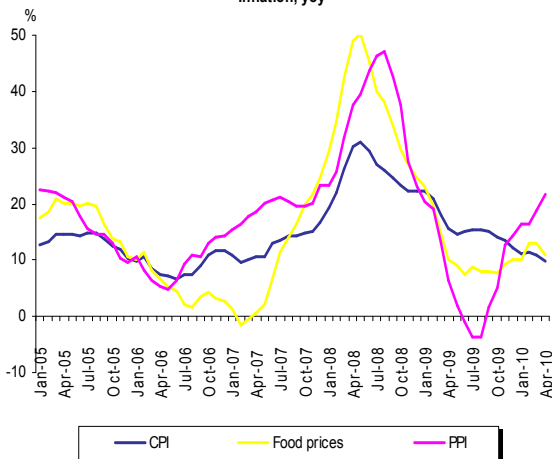


Source: State Statistics Committee

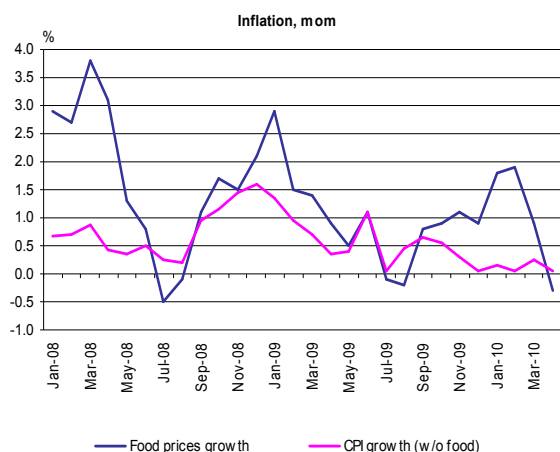
External Sector

Political stabilization played an instrumental role in the remarkable improvement of the external accounts as acceleration of capital inflows and tapering off depreciation expectations turned balance of payments positive in March (for the first time since the onset of the crisis). The deficit of current account widened to USD 239 mn in March (from 57 mn in February) driven by strong growth in merchandise imports' volume. Imports grew 24.6% mom in March on the back of sharp increase in energy imports – the volume of oil and petroleum products imports grew 60% and 40% mom respectively in March (that could be traced back to the rising demand for fuels at the start of the harvesting season), while the import of coke and coal has doubled last month owing to the much stronger demand for inputs from the steelmakers. Merchandize export grew 16.3% mom in March mostly driven by the rebound in global steel prices – as a result, steel exports grew 31.6% mom in March. The deficit of current account constituted USD 69 mn in the 1st quarter of 2010 (narrowing from USD 653 mn in Q12009). While the deficit of merchandise trade balance has widened from USD 956 mn to USD 1369 mn, the reduction in negative balance is mostly attributed to the considerable improvement in services' trade balance (its surplus increased from USD 177 mn in Q12009 to USD 841 mn thanks to the higher revenues from gas transit) and lower deficit of incomes' balance.

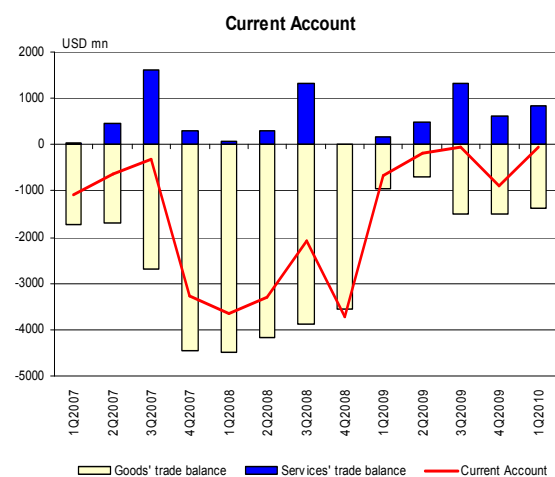
Inflation, yoy



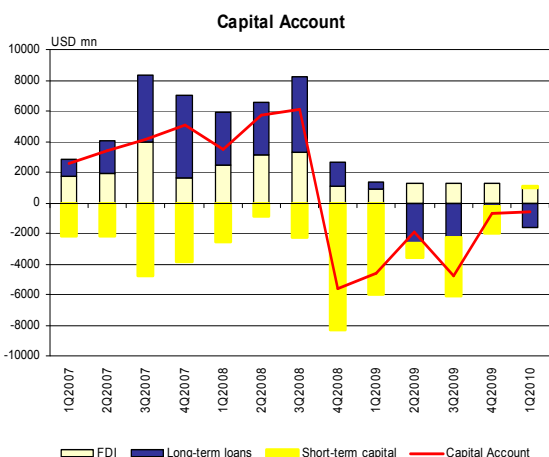
Source: State Statistics Committee, RB Aval Research



Source: State Statistics Committee, RB Aval Research



Source: National Bank of Ukraine



Source: National Bank of Ukraine

Capital account posted a surplus of USD 1271 mn in March (the highest since Aug-08) amid accelerated FDI inflow, higher short-term borrowings by the banking sector, and subdued demand for cash foreign exchange. Specifically, net FDI inflow constituted USD 508 mn in March (up from USD 158 mn and 311 mn in January and February respectively), 57% of which was channeled to the banking sector. As a result, net FDI inflow constituted USD 977 mn in Q12010, 10.6% increase in yoy terms. The balance of foreign borrowings turned positive last month (USD 437 mn) owing to the increase in short-term borrowings by the banking sector (net inflow of USD 470 mn). Finally, long-awaited political stabilization led to the drastic decline in cash foreign exchange demand – the volume of cash FX outside banking system dropped by USD 273 mn in March (after rising by USD 1685 mn in Jan-Feb). Capital account deficit in the 1st quarter of 2010 constituted USD 604 mn, plunging from USD 4571 mn a year ago on the back of reversed capital outflows.

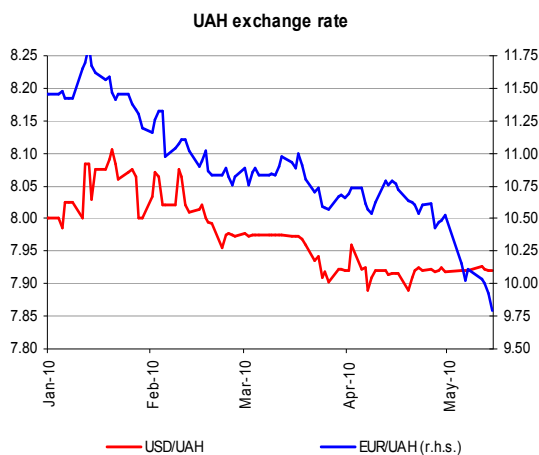
Overall balance of payments deficit reached USD 673 mn in Q12010 (down from USD 5224 mn in Q12009). **We expect external balance to post small surpluses in the next two quarters amid seasonal improvement in the trade balance and continued capital inflows.** The dynamics of external accounts will also be affected by NBU exchange rate policy – if the NBU continues to tightly manage exchange rate, the balance of payments may end up at the positive territory in 2010 (however, at the same time inflation is likely to exceed 15% mark).

Monetary and Exchange Rate Policy

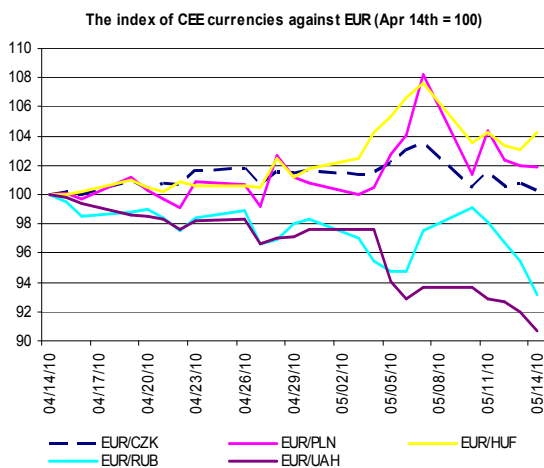
Despite all of the ups and down on the global FX markets, USD/UAH exchange rate remained under appreciation pressure amid improved trade balance and subdued cash FX demand. Ukrainian FX market has barely reacted to the turbulences in Eurozone as hryvnia remained under appreciation pressure – interbank USD/UAH rate is fluctuating in a narrow range of 7.91-7.93 thanks to daily NBU FX interventions. The balance of NBU interventions constituted USD 1318 mn last month, the highest monthly volume since Jul-08. Consequently, NBU gross FX reserves increased from USD 25.1 bn to 26.3 bn in April. According to the NBU, FX market trend is mostly driven by improved trade balance and subdued depreciation expectations (in April net demand for cash foreign exchange by households dropped to USD 62 mn (from USD 711 mn and 302 mn in February and March respectively), and it expects this trend to persist in the near future that will allow the Central Bank to accumulate FX reserves further.

Persistent weakness of Europe's single currency led to the **sharp appreciation of EUR/UAH exchange rate**: since the beginning of the year hryvnia has already gained more than 15% against EUR, moving from 11.50-11.60 levels to 9.75-9.80 range. Substantial nominal effective appreciation (hryvnia has also strengthened by 5% against RUB year-to-date), coupled with elevated inflation, is steadily eroding Ukraine's competitiveness gain emerged from the massive nominal depreciation in 2008-2009. Consequently, we would like to stress once again the importance of structural reforms and improvement in the macroeconomic framework, aiming at reducing inflation to sustainably low levels and boosting productivity, for maintaining country's competitiveness.

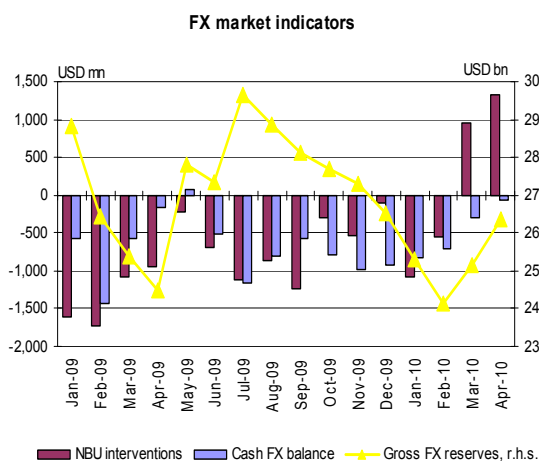
The increase in money supply via FX interventions channel in April was partially offset by the active sterilization operations of the NBU, tighter fiscal stance of the government and reduction in NBU securities' portfolio. Base money grew 1.8% mom



Source: Reuters



Source: Reuters, RB Aval Research



Source: National Bank of Ukraine

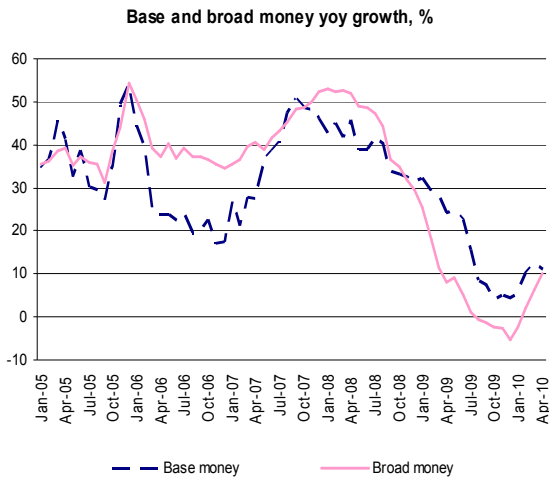
in April (yoy growth rate currently stands at 11%), while broad money grew 3.4% mom (10% yoy growth as of end-April) driven by strong build-up in the domestic deposits. The NBU has been actively sterilizing excess liquidity (it continues to fluctuate near UAH 6-10 bn levels) by selling CDs to the banks – the total turnover of these operations constituted UAH 25.1 bn in April (up from 16.3 bn and 23.4 bn in February and March respectively). These sterilization efforts were also supported by tighter spending policy of the government – the balance of Single Treasury Account grew by 17% (UAH 0.9 bn) last month. Finally, additional UAH 3.2 bn have been sterilized via the reduction in NBU OVDP portfolio (from UAH 72.9 on April 6th to UAH 68.7 bn as of May 5th). Following the news on deflation in April, the National Bank cut its overnight refinancing rates by 25-100 basis points, albeit this decision will have no effect on the markets given weak interest rate transmission mechanism and zero demand for NBU refinancing facilities at the moment (the turnover of NBU refinancing operations constituted mere UAH 390 mn in April amid ample liquidity conditions in the banking system).

Fiscal Policy

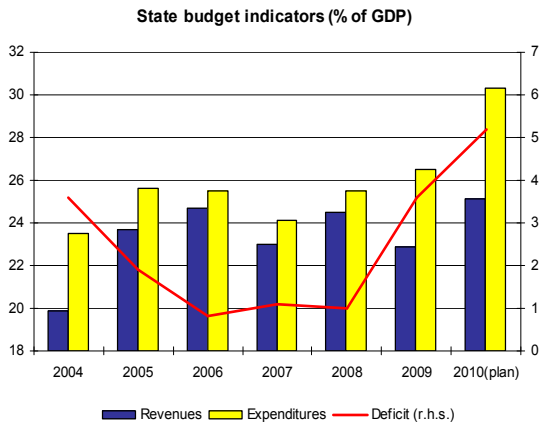
Ukrainian Parliament passed state budget for 2010 with 5.3% of GDP deficit, however, given over-optimistic revenue targets and high financing needs of Naftogas, general government fiscal deficit may reach 7-8% of GDP this year. The revenues and expenditures of the state budget in 2010 are planned at the level of UAH 267.5 bn and 323.6 bn respectively (27.5% and 33.6% increase comparing to the outcome of 2009), implying state budget deficit of UAH 57.7 bn (which is nearly equivalent to 5.3% of GDP).

Tax contributions are expected to be the main source of budget revenues - the plan for 2010 is set at the level of UAH 202.9 bn, including VAT revenues of UAH 119 bn and UAH 40.4 bn contribution from enterprise profit tax (27% and 20.6% yoy increase respectively). According to the government's statements, **gradual economic recovery and improved tax administration will be the main factors contributing to the growth in budget revenues** this year. Moreover, the authorities plan to get additional UAH 16 bn from a number of tax initiatives, including the increase in excise taxes and certain fees, the amendments to the taxation procedures of bank profits, the optimization of VAT and corporate tax administration etc (the corresponding law is yet to be passed by Verkhovna Rada). Also, the budget law envisages UAH 10 bn profit transfer from the NBU (up from UAH 5.1 bn last year).

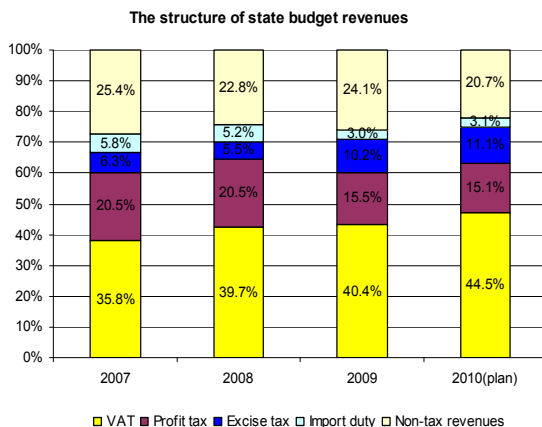
On the expenditure side, the government budgeted the increase in minimum wage and minimum subsistence level this year (however, this decision will have only minor impact on budget accounts as it will not affect directly the salaries and pensions of public servants). At the same time, the hike in public wages (which was envisaged in the law adopted by the Parliament last fall) will be conditional on the available budget resources (according to some estimates, full wage decompression will require additional budget expenditures of nearly UAH 80 bn). Since the new authorities so far did not take any efforts to curb the unsustainable growth in pension expenditures, **the deficit of Pension Fund will grow even bigger this year** - to UAH 30 bn from UAH 13 bn in 2009 (and has to be covered by the transfer from the state budget). Consequently, given the large share of recurrent social expenditures, the government has apparently no room to boost public capital spending (which collapsed last year to 2.1% of GDP from 4.3% in 2008), but hopes to finance certain capital expenditures (first



Source: National Bank of Ukraine



Source: Ministry of Finance, RB Aval Research



Source: Ministry of Finance

of all those related to EURO 2012) via stabilization fund mechanism and loans from international financial institutions. Finally, according to the budget law, the expenditures for bank recapitalization (via the issuance of government bonds) are planned at the level of UAH 30 bn (2.8% of GDP) this year (bank recapitalization costs are not included into the headline budget deficit).

Domestic and external borrowings and privatization revenues are expected to be the main budget deficit financing sources.

Specifically, the government plans to issue local government bonds for UAH 66 bn this year (including recapitalization bonds, but excluding VAT bonds, which parameters are not yet defined), while external borrowings are planned at the level of UAH 34 bn (USD 4.1 bn), including USD 2 bn from IMF, 0.5 bn from the World Bank, and USD 1.3 bn from Eurobonds' placement. As a result, Ukraine's public debt is expected to surge further – assuming the fulfillment of budget borrowings plan, the resumption of IMF program, VAT bonds issuance and full execution of government guarantees' plan (the budget law envisages the provision of state guarantees in the amount of UAH 45 bn), the total public debt may reach UAH 490 bn at the end of this year (up from UAH 317 bn at end-2009), jumping from 34.6% of GDP to 46%. The plan for privatization revenues for 2010 is set at the level of UAH 10 bn that, on the one side, looks over-optimistic given repeated failure of privatization programs in the last few years: in 2006-2009, against the background of persistent political quarrels, total privatization revenues constitute UAH 5.7 bn. On the other side, if the full-scale privatization program is re-launched, the government may easily meet privatization target for 2010 (given a number of lucrative assets still owned by the state – Ukrtelecom, Odessa Seaport Plant, Luganskteplovoz etc).

In our opinion, the adopted budget law has few major drawbacks. First, despite highlight declarations, **the authorities so far failed to deliver their earlier promises of implementing necessary fiscal measures** (i.e. to reduce Pension Fund gap, raise retail gas tariffs, streamline simplified taxation system etc). Second, **government's fiscal targets for this year look questionable**. For example, it expects tax revenues to increase by 36.3% in 2010 comparing to the outcome of previous year, while nominal GDP is projected to grow 18% this year. Moreover, in the first quarter of 2010 tax revenues of the state budget grew only 7.3% yoy from the extremely low base of Q12009. Consequently, given sluggish economic recovery, **we expect budget revenues to fall below the plan by 1-1.5% of GDP** this year (even taking into account additional revenue mobilization due to the hike in excise taxes and higher taxation burden on the banking system). Additionally, despite authorities' claims on full sustainability of Naftogas finances (thanks to 30% discount on import gas price), its financial difficulties are apparently far from to be resolved – the experts project **at least 1% of GDP deficit in Naftogas accounts** in 2010 (as gas tariffs for households and communal enterprises remain far below cost recovery level). As a result, **total fiscal deficit (w/o bank recapitalization costs) may substantially exceed government's target and reach the level of 7-8% of GDP**, thus breaching IMF limit of 6%. In fact, the delay in Ukraine-IMF negotiations (the discussions in Washington in late April did not bring any visible result, and the next visit of IMF mission to Kiev (to continue negotiations) is not yet confirmed) is probably signaling on Fund's skepticism regarding government's estimates of budget deficit this year.

Financial Sector

Banking Sector

Assets and Liabilities

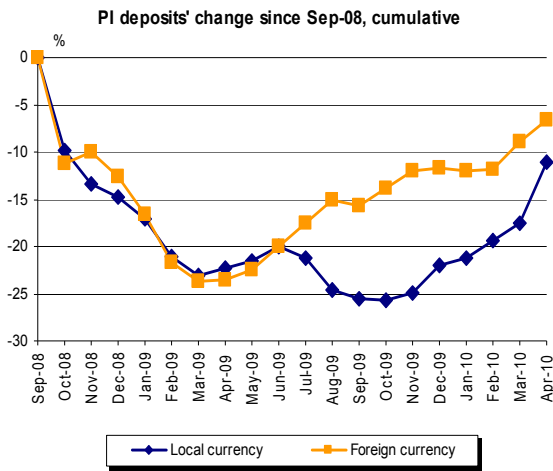
Total deposits grew 3.6% mom in April, while yoy growth rate jumped to 12.1%. PI deposits grew 5.1% mom (local currency deposits leapt by 7.8% driven by improved hryvnia sentiment, while PI FX deposits grew 2.6%), which, in our view, should be mostly attributed to the de-shadowing of cash savings. Thus, following the improvement in economic and political conditions, the banks are slowly regaining the confidence of the depositors – as of end-April 2010 the volume of PI deposits is just 10% below pre-crisis level of end-September 2008 (the peak of outflows was reached in Mar-09 – 24%). Moderate but steady growth in corporate deposits (0.8% in April, 2.3% year-to-date) also signals on certain economic recovery, probably reflecting increased cash flows of the exporters.

At the same time, **lending activity still remains extremely subdued amid weak demand for loans**. Total loans grew 0.2% mom in April, since the beginning of the year loan portfolio of the banking system shrank by 2.7% (UAH 19.5 bn). Specifically, in Jan-Apr 2010 the banks reduced loan portfolio in both corporate and retail segments: CO loans' volume fell by 1.1% year-to-date (after growing 4.7% in 2009 driven by directed lending activities of state-owned banks), while PI loans' portfolio shrank by 6% so far in 2010 (at the top of 14% reduction last year). On the one side, the banks enjoy excess liquidity and thus willing to restart lending, however, there are simply not enough clients to disburse the loans – despite certain signs of economic stabilization (first of all in export-oriented sectors) most of the corporates are still financially constrained, while loan interest rates remain prohibitively high, albeit falling (hryvnia corporate loans for good clients are priced in 21-24% range at the moment). Also, for example, in the agricultural sector (which has been the only "bright spot" in the domestic economy during the crisis) most of the enterprises are cash-rich thanks to the bountiful harvest last year, thus they simply do not need new loans.

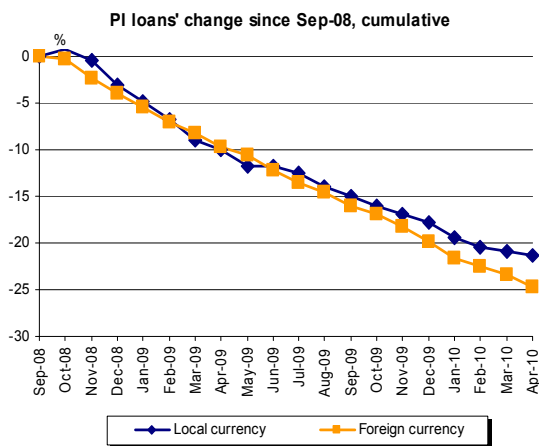
As a result, **the strong rebound in deposit base and continued reduction of loan portfolios put the pressure on banks' financial accounts** (which are already damaged by the high level of non-performing loans). Consequently, the banks are looking for other earning opportunities, for example stepping up investments into the government bonds. In Jan-Apr 2010 the total volume of OVDP in banks' portfolios has risen by UAH 6.3 bn (30%) and its share in total assets of the banking system grew from 2.3% to 3%. However, this earning opportunity is apparently vanishing following the dramatic decline in OVDP yields (from 25-30% in late 2009 to 11-14% at the moment), albeit the forthcoming issuance of VAT bonds could become an attractive investment option for the banks.

Financial Performance

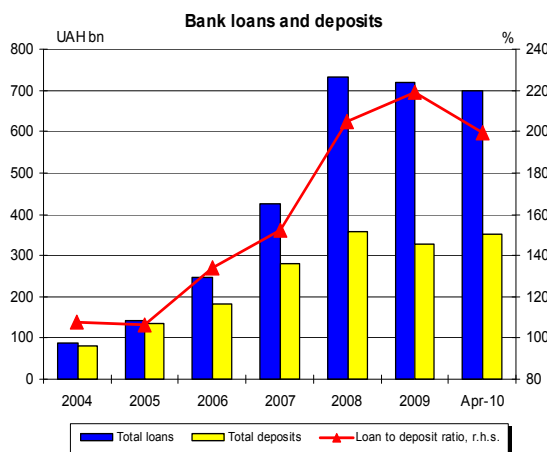
The deceleration in pace of new NPLs formation improved banks' financial indicators in the first quarter of 2010. Total loss of the banking system constituted UAH 4.4 bn in Q1 2010, declining by 37% in yoy terms. Moreover, 72% of this amount (UAH 3.2 bn) is attributed to the loss of state-turned Rodovid Bank. Thus, excluding the result of Rodovid the financial picture is even better - the total loss of the banking system without Rodovid dropped by more than 80% in yoy terms in Jan-Mar 2010. The return on equity ratio has risen from -32.5% at end-2009 to -14.8% as



Source: National Bank of Ukraine, RB Aval Research

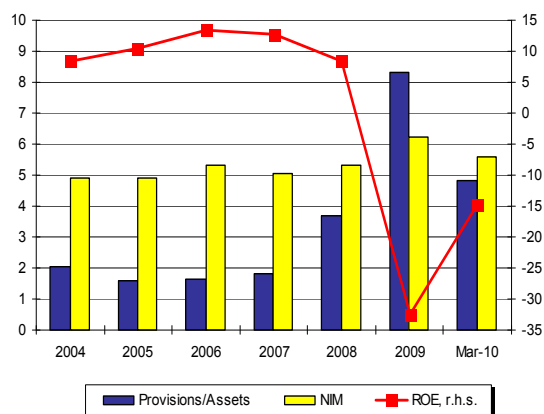


Source: National Bank of Ukraine, RB Aval Research



Source: National Bank of Ukraine, RB Aval Research

Profitability indicators, %



Source: National Bank of Ukraine, RB Aval Research

of end-March, while return on assets improved from -4.4% to -2.1%. The visible improvement in banks' profitability indicators should be mostly attributed to the sharp decline in loan-loss provisions (45% reduction in yoy terms as of end-March, the ratio of provisions to customer loans dropped from 8.3% to 4.8% in Q12010), which is explained by the substantial deceleration in pace of new NPLs formation.

The freeze of loan business is negatively affecting banks' interest earnings: net interest income fell by 16.3% yoy in Q12010, while net interest margin decreased from 6.2% to 5.6% in Jan-Mar. Banks' commission income is declining as well – 15.2% fall in yoy term, non-interest margin dropped from 1.5% to 1.3% since the beginning of the year. Finally, the stability of the exchange rate had a negative effect on banks' FX trading income – it fell by 64% yoy in the first quarter.

Economic & Risks Monitoring Review Monthly

Acknowledgements

This report was prepared by Raiffeisen Bank Aval on 19th May 2010

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