UKRAINE: NAFTOHAZ FOREIGN DEBT LIKELY TO BE RESTUCTURED

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1. (C) Summary. Naftohaz's $500 million Eurobond, due September 30, will likely be restructured into a new $1.75 billion bond instrument backed by a sovereign guarantee. The new instrument would also incorporate $1.25 billion in bilateral debt that Naftohaz owes to four foreign banks that comes due over the next few years. According to the GOU's recently-retained advisor, the proposed restructuring would benefit Naftohaz and the GOU while providing reasonable terms to Naftohaz's current creditors. The proposal allegedly has the support of Naftohaz's bilateral creditors, but a minority group of the Eurobond holders, possibly linked to Dmytro Firtash and Gazprom, has voiced opposition to any restructuring. The IMF has stressed that any restructuring be "voluntary," while the World Bank commented that a restructure deal would depend on a sovereign guarantee and an acceptable coupon rate. The proposed restructure terms would provide cash-strapped Naftohaz much needed room to meet its monthly gas bills in 2009 and 2010. End summary.

POSSIBLE RESTRUCTURING TERMS
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2. (C) Naftohaz and the GOU have hired Cyprus-based Squire Capital to advise on the possible restructuring of Naftohaz's $500 million Eurobond and $1.25 billion bilateral debt. Squire Capital's Robert Grant (protect throughout) told us that the GOU and Naftohaz are working on a bond instrument that would roll over the Eurobond and four outstanding bilateral bonds into a single instrument backed by a sovereign guarantee. Grant explained that cash-strapped Naftohaz would not be able to pay the $500 million Eurobond when it comes due September 30, and that Ukrainian law would prohibit the GOU from covering Naftohaz's debt. The 2009 budget law, however, allows up to $2 billion of Naftohaz debt acquired before 2009 to be restructured and backed by a sovereign guarantee. The new bond instrument, according to Grant, would be structured under this provision.

3. (C) Grant expected terms for the bond restructure to be announced within the next two weeks. One scenario would have the restructuring offer released on September 7, with a 21-day window for noteholders' meetings and a planned close ahead of the Eurobond's September 30 maturity. However, Grant said there is still discussion within Naftohaz and the GOU on when the restructuring offer should be made, with some favoring a mid-September opening date. Under this second timeframe, the offer would close after September 30, allowing Naftohaz to send a strong signal to bondholders that it would not pay the matured Eurobond and would only entertain the restructuring option. Grant also described an "early bird special" being vetted that would incentivize bondholders to sign on to the restructure by giving a more favorable coupon exchange after the offer is released.

4. (C) The restructured bond would have the full sovereign guarantee of the Ukrainian government and would not include any covenants related to Naftohaz. It would also remove the negative pledge on Naftohaz's gas transit revenues by current debt holders, allowing Naftohaz to seek other financing based on the collateral of future transit revenues.

5. (C) Grant told us that the GOU would agree to a coupon rate between 8 and 10 percent, suggesting that it was unlikely Naftohaz would go beyond a single digit rate. He believed the new bond instrument would have enough liquidity to trade 100 basis points above other Ukrainian sovereign debt. The restructured bond would mature in 2014, an advantage for the GOU, Grant noted, as Ukraine has few sovereign obligations coming due that year.

"PLAN B"
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6. (C) Grant stressed that the GOU wanted to mitigate against the possibility of a Eurobond default through the restructuring proposal, but he suggested that the GOU and Naftohaz had developed a "Plan B" in case bondholders would not agree to its terms. Without telling us the exact

details, Grant described the plan as "ugly" and "much more painful," while having the same end result for Naftohaz. Such a plan would likely involve a significant haircut for bondholders after Naftohaz's default on the Eurobond. He stressed that creditors had not been apprised that a "Plan B" had been developed, though its existence would be revealed "at the last minute" if needed.

BILATERAL CREDITORS ON BOARD
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7. (C) Grant told us that Naftohaz's bilateral creditors have, in principle, agreed to the proposed debt restructuring. The four banks (including Credit Suisse, Deutsche Bank, and DEPFA) had been primarily concerned that the new instrument would be backed by a sovereign guarantee. The banks were initially reluctant but came around after being assured they would not take a haircut in the deal. Grant said that three of Naftohaz's bilateral creditors met with Prime Minister Tymoshenko on August 24 to discuss the possible restructuring. Without explicitly mentioning the possibility of default, Tymoshenko reportedly told the creditors that neither Ukraine nor the creditors could afford to miss this "opportunity" to restructure, and that no side wanted to "go down a road" that would be "painful" for all involved.

8. (C) Grant explained that the bilateral debt had been raised at very low rates (between 2.5 and 5 percent), and he suggested that the proposed restructuring terms, while extending the debt's maturity, would also provide the banks larger yields and an instrument with greater liquidity. One of the bilateral creditors, according to Grant, also owns a substantial share of the Eurobonds, bringing the total owed to the bilateral creditors up to $1.4 billion.

EUROBOND HOLDERS BLOCKING RESTRUCTURE
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9. (C) Grant also discussed efforts of a minority group of

the Eurobond holders to block any possible restructuring.
According to press reports, a group led by Belize-registered
Corlblow, which itself owns $11 million of the $500 million
Eurobond, has consolidated the support of bondholders
representing 20 percent of the Eurobond issue to prevent any
restructuring. Press reports also allege that Corlblow
represents Russian interests. Alexey Olshansky, former head
of Sogaz Insurance, once wholly-owned and now minority-owned
by Russia's Gazprom, has said he is the sole director of
Corlblow and denied any connection between Corlblow and
Gazprom. Grant believes that the minority group could be led
by Ukrainian business tycoon Dmytro Firtash and may have
connections to Gazprom. The minority group would need to
amass support of at least 25 percent of the Eurobond holders
to block the restructuring. Grant suggested the minority
group could be acting solely in its economic interests, but
he expressed concern that it was being guided by political
motives.

POSSIBILITY OF FORCED DEFAULT
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10. (C) Naftohaz might be forced into an "eventive default,"
Grant told us, if it is not able to release its financial
accounts by September 6. On August 6, one of its bilateral
creditors wrote Naftohaz requesting financial accounts.
Grant said that Naftohaz's auditor, Earnst and Young, was
working with Naftohaz to meet the September 6 deadline, but
he said that it would be difficult for them to do so. If the
accounts are not released by September 6, or if they show
that Naftohaz is unable to make its debt servicing payments,
the bilateral creditors could call default and force an
accelerated repayment of the outstanding $1.25 billion in
loans.

IFI OFFICIALS WEIGH IN
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11. (C) Grant told us that IMF resident representative Max
Alier had been reluctant to support the restructuring

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proposal and had urged the GOU to make any proposal
"voluntary." Grant characterized Alier as having his "head
in the sand," refusing to acknowledge the importance of the
GOU's willingness to take on a sovereign guarantee and an
increased coupon, while not demanding a haircut from
creditors. Suggesting that the IMF should "tone down" its
resistance, and that it should not adopt positions that could
ultimately cause the Fund to bail out a state-owned energy

company, Grant said that the government would seek to avoid IMF involvement in the deal. Grant also noted GOU concerns that the IMF official would leak information on the negotiations, pointing to previous statements Alier had made about sensitive discussions with Naftohaz.

12. (C) Although Grant said that he had not spoken directly with other IFIs, World Bank country director Martin Raiser appeared apprised of the negotiation's details on August 27. Raiser told us that creditors had proposed their own terms for restructuring Naftohaz's $500 million Eurobond, and that they would insist on a sovereign guarantee. He said it was still unclear whether the Ministry of Finance would accept the coupon proposed by investors. Raiser speculated that, despite the bad advice being offered by close associates of the Prime Minister, including financier and longtime Tymoshenko associate Oleksandr Ginzburg, who are "buzzing around the honey pot like bees," the GOU would not force investors to take a loss on the Naftohaz debt. "Tymoshenko is unpredictable," Raiser said, "but she is not reckless." Raiser said that having just disbursed its latest $3.3 billion loan tranche in the form of budget support, the IMF would be deeply embarrassed by any restructure arrangement where the GOU would impose punitive terms on investors.

RESTRUCTURING WOULD GIVE NAFTOHAZ MUCH NEEDED RELIEF
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13. (C) If the proposed restructuring goes forward, Naftohaz will gain much needed cash relief. According to the plan outlined by Grant, Naftohaz would postpone payments of roughly $550 million in 2009 and $450 million in 2010, necessary due to its strapped financial position and monthly struggle to make gas payments to Gazprom. Grant noted that the GOU, out of political and economic necessity, would choose to make gas payments before paying foreign creditors. A missed gas payment would trigger harsh sanctions by Gazprom and would be a severe political blow to Tymoshenko. Grant said that the foreign debt restructuring would be characterized by the GOU as the first of a multi-step process to completely reform Naftohaz.

COMMENT
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14. (C) The proposed restructuring could provide a win-win-win opportunity for bilateral creditors, bondholders, and the Tymoshenko government. Naftohaz and the GOU would clearly profit from a reduction and postponement of the energy company's substantial foreign debt servicing, avoiding what analysts had perceived as a possible default scenario. For Naftohaz's bilateral creditors, the plan would yield a

much-desired sovereign guarantee and the potential for higher rates of return in exchange for a few years' extension of maturity. The group with the smallest gain would be the Eurobond holders; they would sacrifice immediate cash for payment in five years. However, they too could benefit, as Naftohaz would likely otherwise fail to repay the full amount of its Eurobond obligations in September.

15. (C) Should Naftohaz not be able to get the support of 75 percent plus one of Eurobond holders, it is not clear that the GOU would resort to "Plan B." Naftohaz has been able to meet its financial obligations throughout this year with creative financing solutions and could resort to some of those same solutions to cover the bond payment, if needed. UkrExImBank Deputy Chairman Nikolay Oudovichenko told us that Naftohaz had incurred "affordable losses" but had enough cash on hand to cover its bond obligations. He pointed to the recent injection of UAH 18.6 billion from a bond issuance approved by the Cabinet of Ministers in July for Naftohaz's statutory capital. This leads us to question if Naftohaz

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would, in the end, default on its Eurobond obligations.
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References to this document in other cables

09KYIV1826 (/plusd/cables/09KYIV1826.html)
09KYIV2219 (/plusd/cables/09KYIV2219.html)

References in this document to other cables

If the reference is ambiguous all possibilities are listed.