Research Report on Russia

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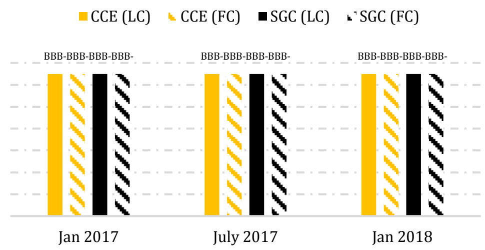
Ratings

Sovereign Government Credit (LC)	BBB-
Sovereign Government Credit (FC)	BBB-
Country Credit Environment (LC)	BBB-
Country Credit Environment (FC)	BBB-

* These ratings are unsolicited

Ratings dynamics



Main Economic Indicators of Russia

Macro indicators	2015	2016	2017
Gross gov. debt, RUB bn	13271	13463	16056*
Nominal GDP, RUB bn	83233	86044	92224*
Real GDP growth, %	-2,8	-0,2	1,8*
Gross gov. debt/GDP, %	15,9	15,6	17,4
Deficit (surplus)/GDP, %	-3,4	-3,7	-1,9
Inflation rate, %	12,9	5,4	2,5
Current Account Balance/GDP, %	-	-	2,8
External debt, USD bn	-	-	46,5

Development indicators	2016
Inequality adj. HDI	0,71
GDP per capita, USD th	27,9

Default indicator	12.01.2018
5-Year CDS spread, Bp	180
10Y Gov Bond Yield, %	6,4

Source: RAEX (Europe) calculations based on data from the IMF, WB, ROSSTAT, Rusbonds. * Forecast.

Summary

The ratings of Russia at 'BBB-' remain underpinned by improving macroeconomic fundamentals, as evidenced by a low inflation rate, acceptable and stable government debt metrics and narrowing fiscal deficit.

The ongoing fiscal consolidation plan, coupled with a low and stable amount of government debt, drove the narrowing of the fiscal deficit in 2017 and is expected to keep this trend along 2018.

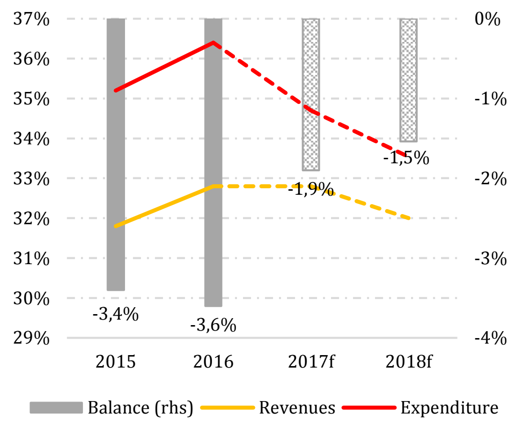
Monetary policy normalization continued with the CBR key interest being cut five times during 2017. The financial sector metrics improved in 2017 as profitability, assets of banks and market capitalization of listed companies increased, while NPLs declined. Sanctions on Russia remain affecting the rating negatively and are still one of the major drawbacks for the country.

Improving macroeconomic stance. The surge of Russia's main macroeconomic indicators in 2017 kept supporting the ratings of the country. Mainly driven by higher oil and gas prices, real GDP grew by 1,8% y-o-y in 3Q 2017 and we expect the yearly growth rate to be around that figure. This shows a significant improvement as compared to 2015 and 2016, when the real GDP contracted strongly following the sharp decline of oil prices and the immediate negative effects of sanctions. Even though economic recovery was evident in 2017, we expect GDP growth to remain rather low in the next years, in line with the IMF, primarily because a major part of the country's economy remains highly driven by the oil and gas industry and private investment in sectors other than these were limited during the past years.

Following the aforementioned encouraging macro conditions, unemployment rate remained low and stable around 5,5% in the last years and is set to reach a similar value by the end of 2017. Additionally, the country's inflation rate declined significantly in 2017 and we expect it to reach the Central Bank of Russia's (CBR) target of 4% by 2018.

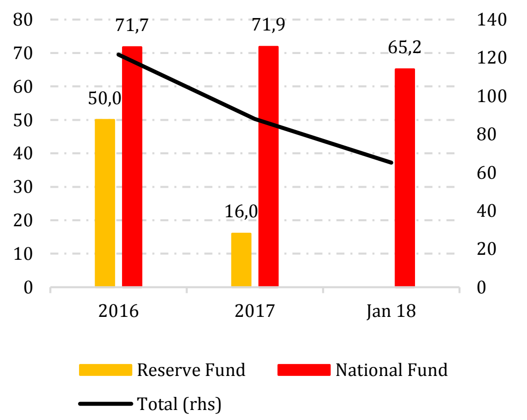
Fiscal consolidation still in place. In 2017 Russia's fiscal deficit is forecast to revert the widening trend it showed in previous year. For the first time since 2012, the deficit is set to narrow and to reach 1,9% in

Graph 1: Fiscal balance, % GDP



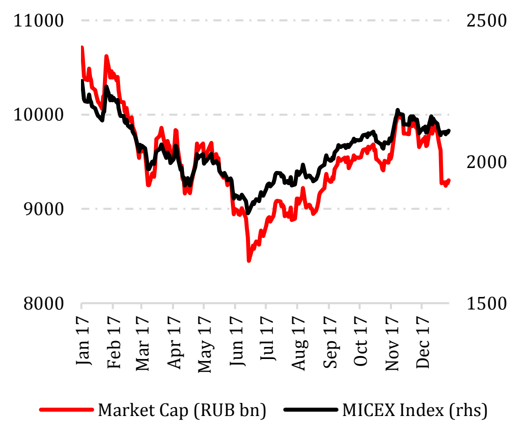
Source: RAEX (Europe) calculations based on data from the IMF

Graph 2: Funds outstanding, USD bn



Source: RAEX (Europe) calculations based on data from the Russian Ministry of Finance

Graph 3: MICEX performance



Source: RAEX (Europe) calculations based on data from MOEX

2017, which represents a 1,7p.p. decline from 2016, when it stood at 3,6% of GDP.

This improvement is the result of the government's medium term fiscal adjustments outlined in the latest federal budget, as well as the introduction of a new fiscal rule, which decouples expenditures from volatile commodity-based revenues. Under the new rule, fiscal expenditures should not be cut and would flow smoother in case of a wider range of oil price changes. Moreover, the new rule aims to narrow the non-oil & gas deficit, which averaged 10% between 2009-16, and to reduce real federal budget expenditures by 4,5%-5% during the period 2016-2020. If this is achieved, we expect the fiscal deficit to keep narrowing so as to reach 1,5% of GDP by the end of 2018 (see graph 1).

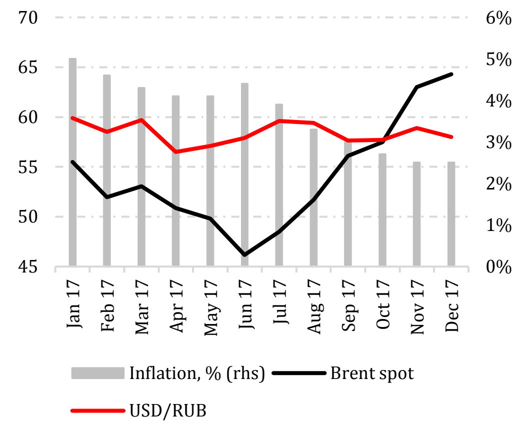
Additionally, the Ministry of Finance (MoF) used the remaining USD 17 bn left in the Reserve Fund by the end of 2017 to narrow the fiscal deficit. Following this, the Reserve Fund will not exist further and the country will be left with the National Fund, which currently stands at around USD 65 bn (see graph 2). We consider that this fund would be sufficiently enough to cover a potential drop of revenues during 2018.

Improving financial sector stance. The Russian banking sector metrics improved after 1Q 2017, with NPLs declining and reaching 8,1% by August (9,8% in April). Additionally, bank's assets grew by 2,5% between December 2016 and August 2017, while ROA remained positive slightly below 2% during the year. These results can be mainly attributed to the lagged effect of the CBR's license withdrawal to "zombie" banks, which aimed at improving the banks' assets quality. This was credit positive for the rating assessment of Russia.

Even though the MICEX market cap showed a downward trend during 1H 2017, it increased steadily during 2H 2017 following the rebound of oil prices (see graph 3). We expect this trend to remain in place during 2018 following better economic conditions and steadily increasing oil prices.

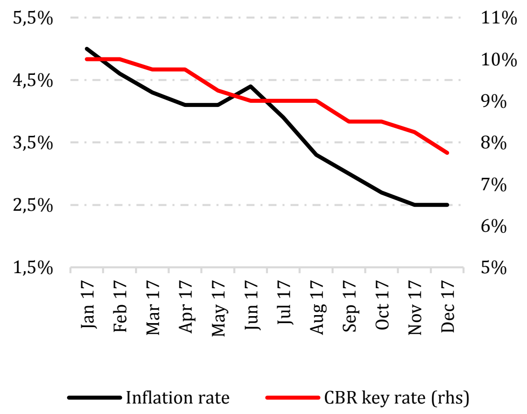
Low and acceptable debt metrics. Russia's government debt load is forecast to remain low and stable at around 17,4% of GDP and 53% of budget revenues in 2017. Despite the share of short-term debt on total debt increasing to 8% through November 2017 (5% in 2016), we consider this amount to be low according to our internal benchmarks. In our view, these metrics are likely to remain subdued in the long term as the fiscal adjustments introduced in the latest federal budget and the introduction of the new fiscal rule are expected to consolidate government finances. Consequently, the yield on the 10Y government bond in foreign currency remained stable around 4% during 2017.

Graph 4: Oil price vs. inflation and exchange rate



Source: RAEX (Europe) calculations based on data from the CBR and FRED

Graph 5: Inflation vs. CBR key rate



Source: RAEX (Europe) calculations based on data from the CBR

Ongoing monetary policy normalization. The recovery of oil prices drove a steady appreciation of RUB in 2016 and contributed to the low volatility observed in the exchange rate during 2017. As a consequence, this supported the decline of the inflation rate, which was reported at 2,5% y-o-y in December 2017 (see graph 4). Such a decline encouraged the CBR to cut its key interest rate five times during the year (see graph 5). However, the CBR's inflation expectations are still relatively high, so we could expect to see interest rates to decrease at a slower pace during 2018.

Uncertainty over sanctions persists. International sanctions on Russia in response to the conflict in Ukraine remain one of the major factors which affect the creditworthiness of the country negatively. These sanctions are expected to remain in place or even become stronger during 2018.

A new set of US sanctions could potentially be imposed on Russia mainly in response to an alleged meddling of the latter country into the 2016 presidential election of the former country. This could not only include direct sanctions to Russian officials and companies but also secondary sanctions, which target third countries actors doing business with targeted Russian enterprises and individuals.

Important note for sovereign ratings

This Research Report shall be treated as a supplementary part of the published Press Release included in the following link:

http://www.raexpert.eu/reports/Press_release_Russia_12.01.2018.pdf

Both documents shall be treated as essential parts of each other.

For further information on the factors, their weights, methodologies, risks and limitations of these ratings, and other regulatory disclosures, please refer to the Press Release and the website of the Agency.