Research Report on Russia

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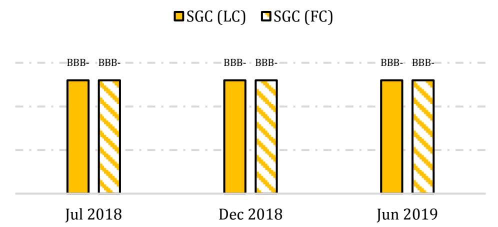
Ratings

Sovereign Government Credit (LC)	**BBB-**
Sovereign Government Credit (FC)	**BBB-**
Outlook (LC)	**Stable**
Outlook (FC)	**Stable**

* These ratings are unsolicited

Ratings dynamics



Main Economic Indicators of Russia

Macro indicators	2016	2017	2018
Gross gov. debt, RUB bn	13 827	14 293	14 258
Nominal GDP, RUB bn	86 149	92 037	103 876
Real GDP growth, %	0,3	1,6	2,3
Gross gov. debt/GDP, %	16,1	15,5	13,7
Deficit (surplus)/GDP, %	-3,7	-1,5	2,9
Inflation rate, %	5,4	2,5	4,3
Current Account Balance/GDP, %	1,9	2,1	6,9
External debt, USD bn	-	-	454

Development indicators	2018
Inequality adj. HDI	0,82
GDP per capita, USD th	29,3

Default indicator	14.06.2019
5-Year CDS spread, Bp	120,39
10Y Gov Eurobonds Yield	4,63

Source: RAEX-Europe calculations based on data from the IMF, WB, Rosstat, CBR, Ministry of finance of the Russian Federation, Ministry of the economic development of the Russian Federation, Cbonds.

Summary

Our confirmation of sovereign government credit ratings of Russia at 'BBB-' with the stable outlook reflects the presence of restricting and stress-factors connected with the structural economic problems and geopolitical tension on the back of improving fiscal stance, the government's deleveraging and strong external position. Excessive concentration of the economy in the oil and gas industry and increased government participation in the banking sector put significant pressure on the rating.

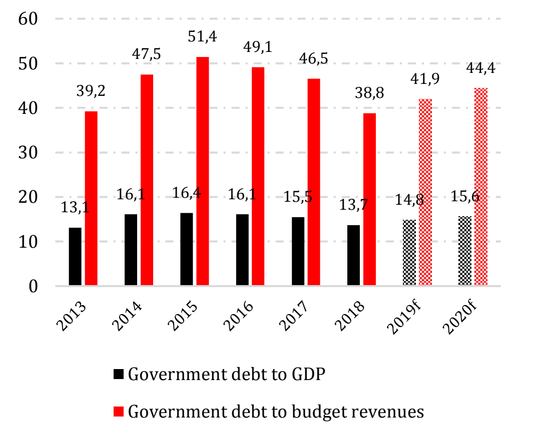
In our view, the stable current account and trade balance, adequate monetary and fiscal policy create favorable conditions for further strengthening of the fiscal buffers and international reserves, which can help to mitigate the feasible external shocks and consequences of potential sanctions. However, implementation of the long-term domestic infrastructural projects can reverse the fiscal achievements.

Deleveraging of the government and accumulation of fiscal buffers add resistance to the external shocks. The level of gross government debt shrank to 13,7% of GDP and 38,8% of budget revenues in 2018 compared to 15,5% and 46,6% in 2017 respectively (see graph 1). The reduction was largely the result of external debt payments during the year and capital outflows from emerging markets, as well as continued decrease of regional debt. The short-term share of the government debt, taking into account the planned repayments up to one year, increased to 2,7% of GDP and 7,5% of budget revenues at the end of 2018, but this level does not represent risks to the country's creditworthiness.

The combination of the budget revenues increasing along with the government expenditures dip resulted in the sound consolidated budget surplus of 2,9% of GDP in 2018 compared with the deficit of previous years (see graph 2). The revenue growth was mainly boosted by higher oil prices and a weaker ruble, as well as improved tax administration. However, this dynamic was mostly attributed to the commodities sector, while non-oil / gas tax revenues increased marginally relative to GDP. The expenditures shrinking reflects the government's adherence to the fiscal rule that based on the benchmark oil price of USD 40 per barrel.

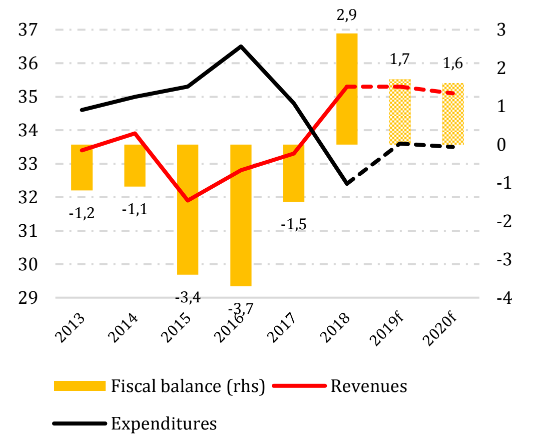
We keep considering the quality of the fiscal policy as a positive factor for the rating assessment. On the back of the state's deleveraging, supported

Graph 1: Government debt dynamics, %



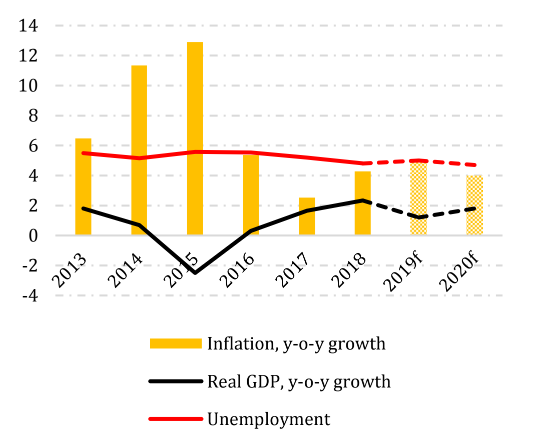
Source: RAEX-Europe calculations based on data from the IMF, CBR and Ministry of finance of the Russian Federation

Graph 2: Fiscal budget dynamics, % of GDP



Source: RAEX-Europe calculations based on data from the IMF and Ministry of finance of the Russian Federation

Graph 3: Macroeconomic indicators, %



Source: RAEX-Europe calculations based on data from the IMF

by the commitment to the new fiscal rule, buffer accumulations to the National Welfare Fund (NWF) continued, reaching USD 58,1 bn (3,8% of GDP) by the end of 2018, and it is expected to continue accumulation along 2019 as well. In addition, the government introduced new measures in order to increase the public expenditures efficiency, including better management of tax expenditures and public procurements.

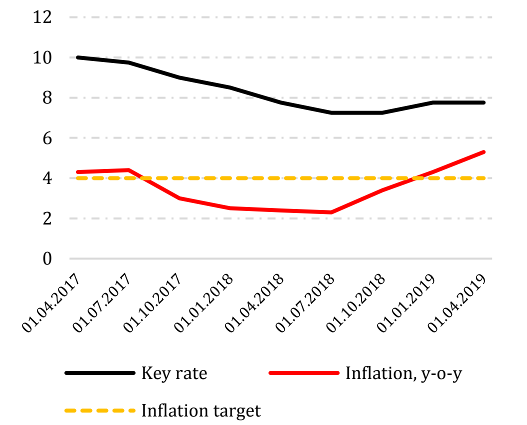
We anticipate the public sector budget to remain in surplus in 2019, as long as favorable oil prices and stable production of energy products exports remain. In addition, the effect from the VAT rate increases, potential improvement of the non-oil revenue and the strict expenditure policy will positively shape the budget. Moreover, the latest data on general government balance shows significant improvement up to 5,4% of GDP in January-March 2019 as compared to 3,2% in the same period in 2018. However, acceleration of ambitious national projects implementation in education, health, and infrastructure could create a pressure on the budget stance. It is expected that the economic effect of the projects realization will be noticeable only in the long term, whereas in the medium term, their financing may lead to a reduction of the liquid part of the NWF.

After higher than expected growth paces in 2018, the economy demonstrates deceleration in the 1Q 2019. Real GDP growth exceeded forecasts in 2018 and surged to 2,3% compared to 1,5% in 2017 (see graph 3). Global economic growth along with favorable pricing conditions in commodity markets and a weaker ruble contributed to the acceleration, while a substantial one-time impetus was the finalization of the energy sector project's constructions. However, the economy demonstrated slowdown in the 1Q 2019 to 0,5% y-o-y amid the tightening of the monetary policy, the subdued consumer demand, and the effect of the VAT rate rise from 18% to 20%.

We anticipate GDP growth in 2019 will be inferior and not exceed 1,2% with a possibly greater deceleration due to the spillover effects of trade wars and new U.S. sanctions, and if the oil prices will dip amid the uncertainty about the future OPEC+ agreement. Our long-run expectations remain in the range of 1,5-2% due to persistent internal limitations, such as demographic trends, institutional development and low productivity, while national projects can have only one-time effects.

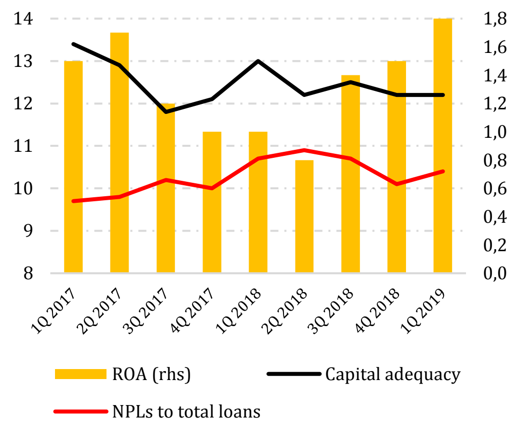
Central bank turned to more loose monetary policy. The elevating of the inflation risks associated with the ruble depreciation and the effect from the VAT rate hike forced the Central Bank of Russia (CBR) to increase the key rate twice in 2018 by 25b.p. to 7,75% with the aim to pull down inflation to 4% target level (see graph 4). Even though the annual

Graph 4: Monetary policy metrics, %



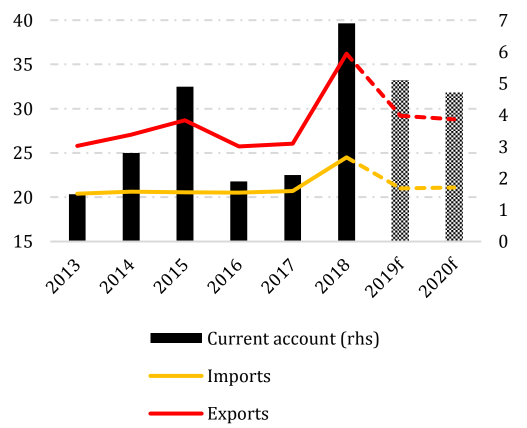
Source: RAEX-Europe calculations based on data from the Rosstat and CBR

Graph 5: Financial soundness indicators, %



Source: RAEX-Europe calculations based on data from the CBR. *The share of loans classified as 4th and 5th quality categories according to the CBR regulation (two categories with the lowest credit quality) was used as a proxy for the indicator "Share of bad loans in total loans".

Graph 6: External sector indicators, % of GDP



Source: RAEX-Europe calculations based on data from IMF and WB

consumer price inflation has been accelerating to 5,1% in May 2019 from 4,3% in December 2018, the CBR authorities cut the key rate by 25b.p. to 7,5% in June 2019, considering that the highest peak was overcome. As long as the macroeconomic environment does not deteriorate, monetary policy can be further relaxed with a gradual move to the key rate of 7% by the end of the year. However, according to our expectations, the inflation in 2019 will be about 5%, as the pro-inflationary risks connected with the geopolitical situation remain high.

Against the back of stabilization, the banking sector increased its concentration and share of the state. According to the results of 2018 and 1Q 2019, the banking system demonstrates stability, positive dynamics of growth of assets and key indicators of profitability and sustainability.

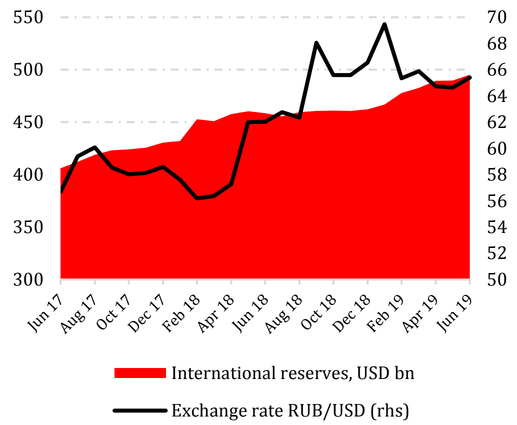
Bank assets increased by 8,4% y-o-y and amounted to RUB 92,4 bn as of 1 April 2019, mainly driven by rocketing households lending and the revival of corporate lending, while SME lending remains stagnated. Meanwhile, the concentration was increased, with the share of the large state-owned banks (SOB) reaching almost 70% of total banks' assets. The excessive footprint of the state creates risks from the great exposure to the possible sanctions against SOBs and the materialization of the implicit contingent liabilities. In addition, the share of three largest banks reached 56,3% by end of April 2019, creating more systematic risks.

The banking system showed moderately high profitability in 2018 and the further improvement of ROA and ROE to 1,8% and 15,9%, respectively as of the 1Q 2019 (see graph 5), although the major contribution was from Sberbank. Capital adequacy ratio despite the presence of distressed banks remained almost unchanged at 12,2% as of the 1Q 2019 as compared to 12,1% at the end of 2017.

The relative financial stability of banks could potentially be threatened by the recent expansion of household consumer lending to 8,3%[1] of total assets as of the 1Q 2019, which induces an increase in the credit burden of the borrowers amid low disposable incomes. In the case of the deterioration of the macroeconomic situation, credit risks can widen the already large NPLs, which reached the level of 10,4% of total loans as of 1Q 2019, however, the CBR reacted promptly by increasing risk weights on unsecured consumer loans. Besides, the main bank's metrics can be reassessed with deterioration, if the CBR will make steps towards harmonization of IFRS 9 and local standards.

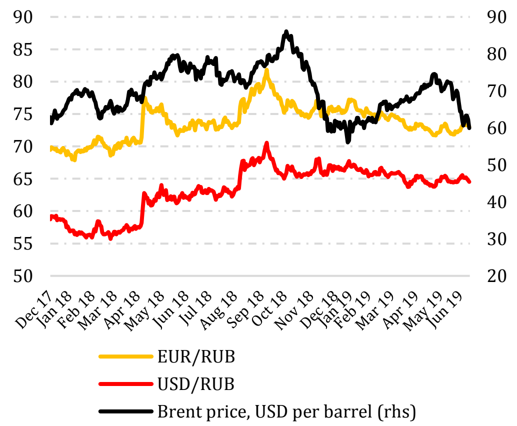
[1] "Other consumer loans" according to the CBR's classification.

Graph 7: International reserves and FX-rate



Source: RAEX-Europe calculations based on data from CBR

Graph 8: FX-rates and oil price



Source: RAEX-Europe calculations based on data from CBR and Finam

The low external debt position along with the international reserves strengthening improve resistance to external shocks. The external debt of Russia is gradually continuing to decline. The overall reduction in external debt by 2% to 30,4% of GDP at the end of 2018 was mainly due to the shrinking of the share of government bonds and debt burdens of the private sector, including banks. Along with that, the current account surplus increased to 6,9% from 2,1% of GDP in 2017 fostered by the strengthening of the trade balance to 11,7% of GDP in 2018 due to the stable export and higher commodities prices (see graph 6).

International reserves, supported by the accumulation of foreign currency under the new fiscal rule, increased by 8,3% and amounted to USD 468,5 bn at the end of 2018 (see graph 7). Moreover, in 2019 the CBR is continuing FX accumulation, what led to the further strengthening of reserves to USD 487,8 bn in the 1Q 2019 covering more than 17 months of goods and services import and more than 220% of gross government debt.

At the end of 2018, the ruble weakened against the USD by 20,6% and against the EUR by 15,4% as compared to end 2017. The tightening of U.S. monetary policy, the increased likelihood of trade wars, and the strengthening of sanctions expectations were the main factors weakening the ruble. Under these conditions, the CBR in the 2H 2018 suspended active purchases of foreign currency on the FX market within the framework of the fiscal rule. Along with the increase of the key rate in 2018, these measures contributed to the stabilization of the exchange rate and the gradual strengthening of the ruble, which continues in 2019 (see graph 8).

Potential risks stemming from the new US sanctions persist. The hidden risk from the potential expansion of the new round of sanctions discussed in the U.S. Senate still limits the credit rating of Russia and increases uncertainty. A possible tightening may affect the public sector, including large SOBs. Investors' sentiments and fears are reflected in the current negative dynamics of foreign direct investments and outflows from the sovereign securities market, therefore, we assess the threat from the international sanctions as the moderately strong factor. However, a solid fiscal and external position, as well as low public debt, can partially mitigate these risks and help to weather external shocks.

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:

https://raexpert.eu/reports/Press_release_Russia_14.06.2019.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.