Russia

Industry Research – Corporates

15 December 2016

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Main Economic Indicators of Russia

	2013	2014	2015
Gross gov. debt, RUB bn	9 286	12 723	14 243
Nominal GDP, RUB bn	71 055	77 893	80 413
Real GDP growth, %	1,3	0,7	-3,7
Gross gov. debt/GDP, %	13,1	16,3	17,7
Deficit (surplus)/GDP, %	-1,2	-1,1	-3,5
Inflation rate, %	6,5	11,4	12,9
Current Account Balance/GDP, %	-	-	5,2
External debt, USD bn	-	-	30,6

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

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1. INTRODUCTION

The Russian economy is concentrated in a few industries, namely, real estate and construction, wholesale and retail and oil and gas which, all together, account for a high share of total GDP. These industries have shown mixed results in 2015, as evidenced by the negative growth rates in wholesale and retail as well as construction industries, while the trend in the oil sector remained flat.

Driven by contraction in manufacturing, construction, wholesale and retail, GDP shrank by 3,7% in 2015. The Agency expects GDP growth to reach -0,7% by the end of 2016 as most of the GDP components declined at a slower pace during the first half of the year. In our view, economic activity could grow around 0,4% in 2017 fueled by higher oil prices and stronger internal demand.

Both, manufacturing and services activities, measured by PMI index, accelerated in 2H 2016. Markit Russia Manufacturing Purchasing Managers' Index (PMI) increased to 53,6 in November, compared to 52,4 in October 2016 and services PMI rose to 54,7 as of November 2016 which represents a continuous growth since the beginning of the year. These upturns were mainly driven by larger production, new orders, business expansion and increase in demand of domestic goods.

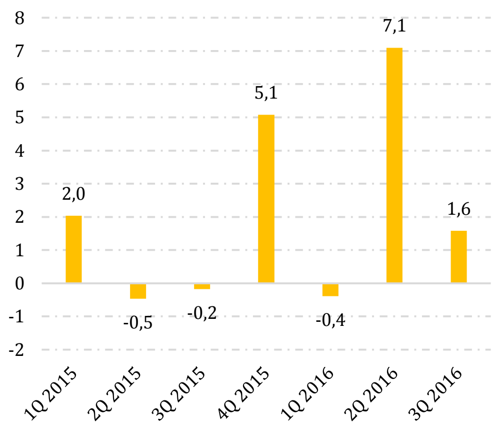
Households consumption declined by 9,7% by end-2015 as a consequence of lower real wages, which followed higher inflation rates. This took a toll on imports, which declined by 36% in 2015. In contrast, exports kept an upward trend as the economy gained competitiveness following the sharp RUB devaluation in end-2014 (see graph 1).

Gross capital formation has followed a declining trend since 2012. This was rooted in poor investment climate, weak consumption, and barriers to access capital, a result of western sanctions and Russian counter-sanctions. Investment in fixed capital has been declining since 2011 and

Graph 1: USD vs. RUB

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

Graph 2: FDI in Russia, USD bn



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

Table 1: Average Financial Indicators of Top Russian Oil Companies

	2012	2013	2014	2015
Debt-to-Assets	0,31	0,26	0,38	0,27
Debt-to-Equity	1,25	0,57	1,11	0,91
Net Profit Margin, %	95,6	48,3	38,8	39,6
Return On Equity, %	25,2	33,4	21,8	24,0
Return On Assets, %	13,4	14,7	15,3	12,4

Source: RAEX (Europe) calculations based on data from Spark Interfax

recorded its sharpest drop in 2014 at around 8,4% y-o-y. Despite this trend turning slightly positive in 3Q 2016, a significant investment increase is unlikely, as the country is going through a fiscal consolidation process.

Based on data from the Central Bank of Russia (CBR), the level of foreign direct investments (FDI) has been picking up. In the first 9M 2016, FDI reached USD 8,3 bn (see graph 2); however, it is still far from the USD 69 bn observed in 2013. As a consequence, investors' confidence is slowly returning as the trend has rebounded in 3Q 2015. In our view, the future trend of Russia's FDI will not only depend on external factors such as the prolongation of western sanctions and oil price level, but also on internal factors such as the implementation of the new CBR policy and improvements in the business climate.

2. OIL & GAS

Oil production is highly concentrated and significantly influenced by government owned companies. The production of crude oil has been constantly growing since 2000 with small seasonal fluctuations in the short run. Therefore, in October 2016 production of crude oil reached a historical record of 47 m tons.

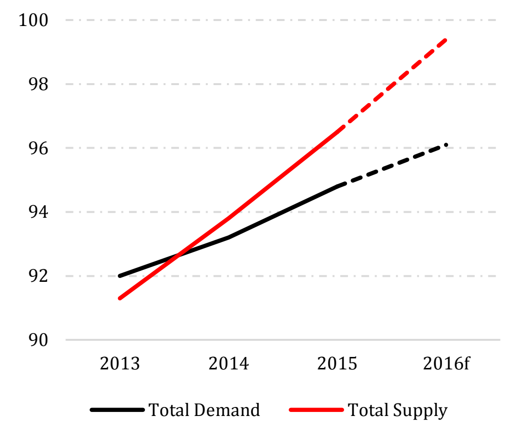
As of 2015 the top seven Russian companies[1] accounted for around 80% of Russia's total oil production. However, the concentration has been shrinking since 2013, when the share of the top seven companies was 83,3%. Furthermore, three out of seven decreased their level of production in 2015 compared to the previous three years. In 2015 the profitability of top oil producers remained positive with the exception of Russneft. The average ROA and net profit margin for these companies stood around 12% and 40% respectively in 2015. In addition, the amount of leverage declined in 2015, when the debt load equaled 27% of the assets and debt-to-equity ratio stood around 91% (see table 1).

Following the deceleration of major world economies and the increase in shale oil production (see graph 3), the world oil prices declined sharply in 2014. Such a drop had a significant impact on Russia's economy as GDP declined by 3,7% and the RUB depreciated by 22% through 2015. The world price for Urals oil has decreased since May 2015, reaching a minimum of USD 46,6 per barrel in January 2016. Since then, the price has been slowly increasing but remains far below the levels observed before 2014.

The International Energy Agency (IEA) forecasts the global oil consumption to grow up to 1,2 million barrels per day until 2021. The

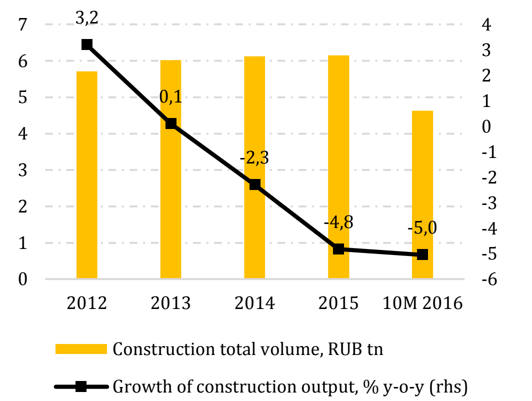
[1] Rosneft, LUKOIL, Surgutneftegas, Gazprom Neft, Tatneft, Bashneft and Slavneft.

Graph 3: World oil demand and supply, M bpd



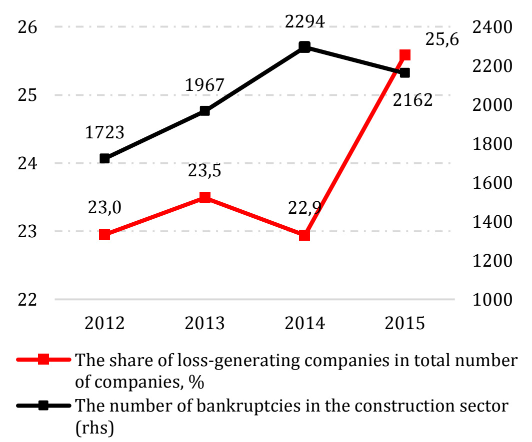
Source: RAEX (Europe) calculations based on data from IEA

Graph 4: Construction activity metrics



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

Graph 5: Profitability and bankruptcy in construction industry



Source: RAEX (Europe) calculations based on data from Rosstat and the Center for Macroeconomic Analysis and Short-term Forecasting

recent agreement between OPEC and non-OPEC countries to cut oil production could stabilize the price and reduce pressure on Russia's public finances and in particular on the 2017 federal budget. In 2016, the share of the federal budget income that came from the oil sector was 5,8% of GDP.

Gas production is highly concentrated among a handful of companies. Gazprom's share in Russia's gas production stood at 64,1% in 2015, compared to 67,5% in 2014. Mostly due to the recent discoveries in other countries, Russia's share in the world's natural gas reserves has been declining since 2005, reaching 19% in 2015. Russia's gas production has also been declining in the past years, accounting for 16% of total world production in 2015. However, the country remains the world's largest exporter of gas, with a volume of 187,9 bcm exported as of end 2014.

3. REAL ESTATE & CONSTRUCTION

Construction output in nominal terms has been increasing since 2009 to reach 6,1 trillion RUB as of end-2015. In real terms, however, 2015 was a weak year for the construction market as the levels of output registered a record decline of 4,8% compared to a year before. Furthermore, the negative output trend continued during the first 10M 2016 (see graph 4).

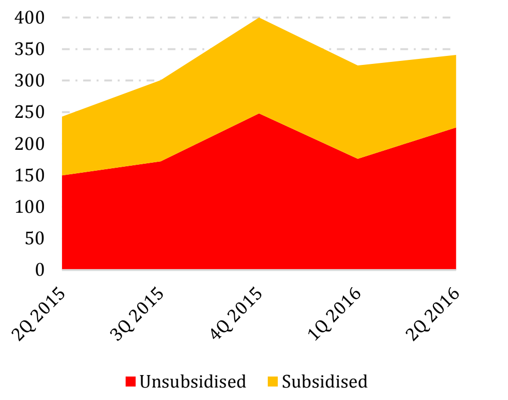
The sluggish performance was mostly driven by the lower overall investment levels, especially in fixed assets, due to the high devaluation of RUB and lower investment in the oil and gas industry. The sector's unattractive environment is reflected by the fact that the investment level in construction dropped by almost 7% in 2015.

The profitability in the sector was also harmed as evidenced by the share of loss generating companies which jumped to 25,6% in 2015 (see graph 5). Also, compared to other industries and economic activities, the construction sector has the largest share of overdue loans at around 25% of the total loan portfolio as of the beginning of 2016.

After several years of growth, the number of new granted mortgage loans contracted by 31% in 2015. Despite this, the total value of the outstanding portfolio picked up during that year and the trend continued in 2016. This increase was driven by the government's mortgage interest subsidies program approved in March 2015 (see graph 6). As a result of this program, the share of government subsidized loans has been increasing in the total mortgage loans portfolio.

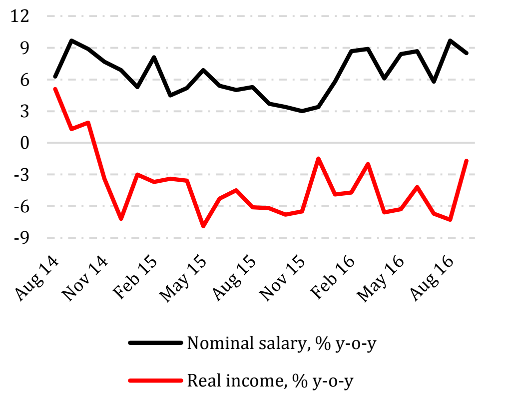
Fluctuations in the exchange rate combined with higher uncertainty in other sectors of the economy, still hinder the investors' confidence in the real estate market. Additionally, the three rental segments (offices, high streets and logistics), showed a negative performance. Rental oversupply

Graph 6: Value of granted mortgage loans, RUB bn



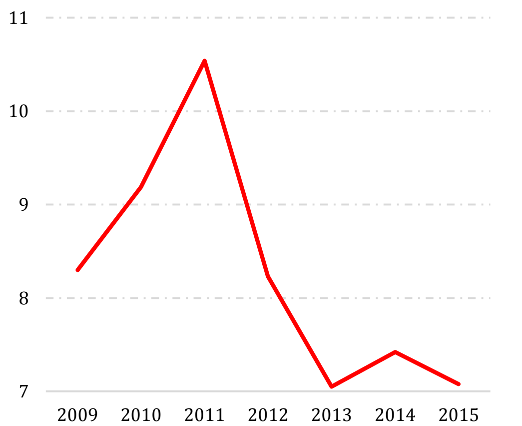
Source: RAEX (Europe) calculations based on data from PMR and Agency for Housing Mortgage Lending

Graph 7: Average real income vs. nominal wage



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

Graph 8: Gross profit to COGS ratio



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

still exists, and the demand is mostly driven by the existing tenants, rather than new participants.

4. WHOLESALE AND RETAIL

Low domestic demand limits economic activity and in due course, retail sales turnover. The sharp decline in domestic demand caused a drop in retail turnovers since January 2015 and the trends of both indicators remained in a similar path in the months which followed. Furthermore, the average purchasing power has been declining as evidenced by the downward trend in the real average income since April 2014 (see graph 7).

The share of loss-generating companies has been increasing since end of 2013 and reached maximum of 20% as of January 2016. Gross profit to cost of goods sold (COGS) has been dropping since 2012; nonetheless, in 2014, the downward trend slowed down and for the past three years it stood around 7% (see graph 8).

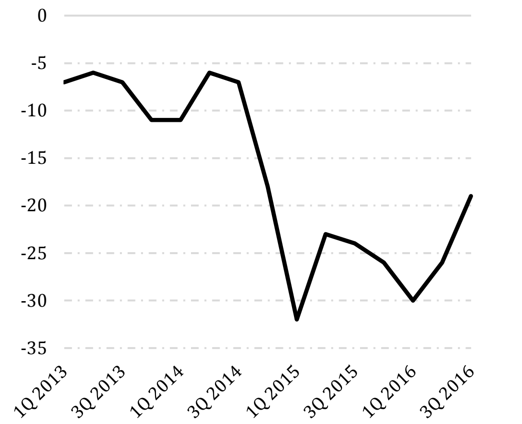
Despite an increase in 2016, the consumer confidence remains low as shown by the Rosstat consumer confidence index. The slight improvement in the unemployment rate alongside recent increase of the real wages growth rate and the increasing economic activity stand as the key drivers of the increase of the consumer confidence in 2016 (see graph 9). Consumers are more optimistic than at the beginning of the year.

The number of newly opened shopping centers in Moscow has been augmenting. The increase started in 2011 and, despite a small drop in 2015, we expect this trend to continue in 2016. The main factors which limit the retail sector growth, are the drop in purchasing power, low real wages as well as the cost of credit resources which hinders the investment capabilities in the sector.

5. OUTLOOK

Apart from the world balance of oil demand and supply (see graph 3) and the actions of the main oil producers (especially Iran and USA) the oil and gas industry outlook for 2017 is mainly affected by Russia's commitment, along with OPEC, to control oil production and by so called "tax maneuver". Taking into account potential price stabilization due to recent OPEC agreement, Russian oil companies can improve its financial metrics in the mid-term perspective. However, the "tax maneuver" implemented by the government is expected to increase the burden on the sector, especially for low-tech refineries. Given the expected increase in oil prices for 2017 (Urals future contracts for April 2017 are now at 54 USD per barrel) due to the reduction on production, the authorities are likely to

Graph 9: Consumer confidence index



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

Table 2: Consolidated outlook for Brent and Urals price, USD per barrel

Source	Date	2015*	2016	2017
IMF (WEO)	Oct 2016	52,4	44,5	52,6
EIA (STEO)	Oct 2016	52,4	43,3	51,0
EIA (AEO)	May 2016	52,4	37,5	50,0
IHS	Nov 2016	52,4	43,3	51,8
WB**	Oct 2016	50,8	43,3	55,2
OECD	Jun 2016	52,4	41,8	45,0
Reuters	Oct 2016	52,4	44,7	57,3
Consolidated		52,4	42,6	51,8
Consolidated, growth %		-	-18,6	21,6
Urals***		51,2	41,7	50,7
Urals’	Oct 2016	-	41,0	48,0

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

*Fact; ** Forecast for WTI price; *** Calculated on the basis of the fact prices for Urals and growth based on consolidated growth. Urals’ – Price of Urals oil (USD per barrel) in accordance to the official forecast of the Ministry of economic development of Russian Federation (base case scenario).

continue with the “tax maneuver”, which means increasing the mineral extraction tax and reducing the export duties.

We expect a further decline in consumer demand which will cause a continued decrease in residential construction. Furthermore, the still depressed investment climate alongside with the consolidating fiscal policy of the federal government (see Research report on Russia[2]) will continue to take a toll on non-residential construction. Also, the contribution from this sector to GDP has been declining and we estimate it will continue to do so in the coming years. Finally, the Russian government is looking for PPP type agreements alongside offering incentives in order to spur infrastructure projects.

Expected declining consumer demand, sustained inflation, lower purchasing power and depressed consumer confidence will directly affect the retail sector in a negative way. Additionally, attractive savings rates (even with inflation staying high, the real interest rates are positive) will encourage people to choose savings over consumption. The negative outlook for the wholesale and retail sector is supported by the lower than initial GDP growth projections from several institutions, such as HSE, which estimated this metric at 0,4%.

[2] Research report on Russia from 22 July 2016 (http://raexpert.eu/reports/Research_report_Russia_22.07.2016.pdf)