Research Report on Azerbaijan

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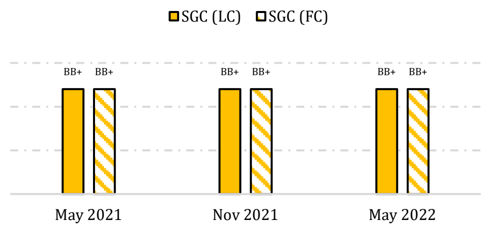
Ratings

Sovereign Government Credit (LC)	BB+
Sovereign Government Credit (FC)	BB+
Outlook (LC)	Stable
Outlook (FC)	Stable

* These ratings are unsolicited

Ratings dynamics



Main Economic Indicators of COUNTRY

Macro indicators	2019	2020	2021
Gross gov. debt, AZN bn	14	15	25
Nominal GDP, AZN bn	82	73	93
Real GDP growth, %	2,5	-4,3	5,6
Gross gov. debt/GDP, %	17,7	21,3	26,4
Deficit (surplus)/GDP, %	9,1	-6,5	4,3
Inflation rate, %	2,4	2,7	12,0
Current Account Balance/GDP, %	-	-	15,2
External debt, USD bn	-	-	8,1

Development indicators	2021
Inequality adj. HDI	0,68
GDP per capita, USD th	15,9

Default indicator	06.05.2022
10Y Gov Bond Yield, %	4,96*

Source: RAEX-Europe calculations based on data from the IMF, WB
* Maturity in 2032

RAEX-Europe confirmed at 'BB+' the credit ratings of Azerbaijan. The rating outlook is stable. The ratings were withdrawn.

RAEX-Europe confirmed the sovereign government credit ratings (SGC) of Azerbaijan at 'BB+' (Sufficient level of creditworthiness of the government) in national currency and at 'BB+' (Sufficient level of creditworthiness of the government) in foreign currency. The rating outlook is stable, which means that in the mid-term perspective there is a high probability of maintaining the rating score. The ratings were withdrawn.

Summary

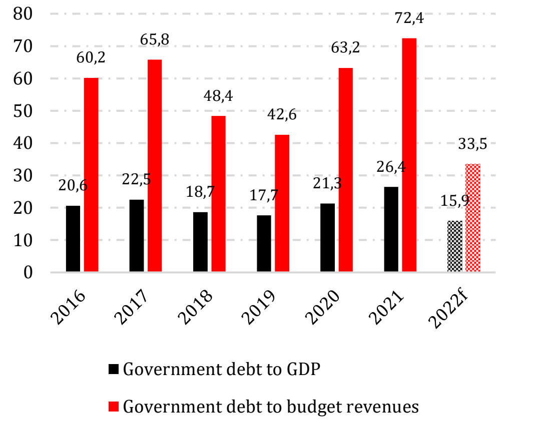
We have confirmed Azerbaijan's ratings at BB+ with a stable outlook. This mainly reflects the effects of the economic recovery in 2021 and 1Q 2022 as a result to higher oil prices, which have also caused external buffers to increase and international accounts to strengthen. Moreover, public finances showed a surplus and are expected to strengthen in 2022 as so will the assets in the State Oil Fund of the Republic of Azerbaijan (SOFAZ).

Nevertheless, the economy remains highly dependent in hydrocarbons production, which, combined with the aging of the fields, could cause a reduction in fiscal revenues and represent a problem for the government. Finally, the banking system, despite slowly recovering, remains weak.

Government debt set to decline in 2022. Gross government debt stood at 2021 up to 26,4% of GDP and to 72,4% of budget revenues, both figures excluding Aqrakredit guarantees. However, we expect debt level to decline in 2022, as the government has pledged to reduce the debt below the 20% threshold going forward excluding Aqrakredit guarantees. Furthermore, the level of buffers in SOFAZ remains quite substantial supporting the creditworthiness of the government. As of March 2022 SOFAZ's assets stood at USD 45,3 bn.

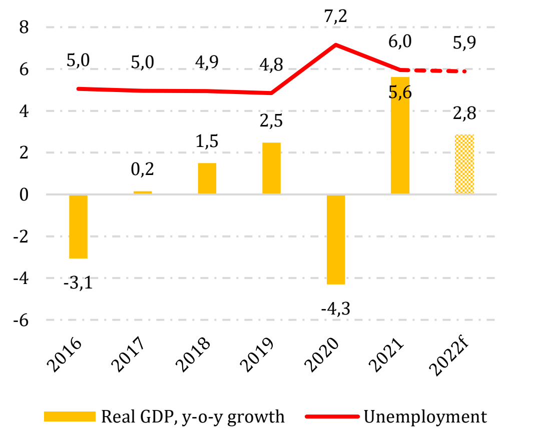
The structure of Azerbaijan's debt has improved. While short-term debt continued to decline down to 1,6% of total public debt by the end of 2021, Azerbaijan's FX-denominated debt decreased substantially down to 56,3% of total debt as of end-2021. Foreign debt remains owed to various international financial institutions and foreign banks at concessional

Graph 1: Government debt dynamics, %



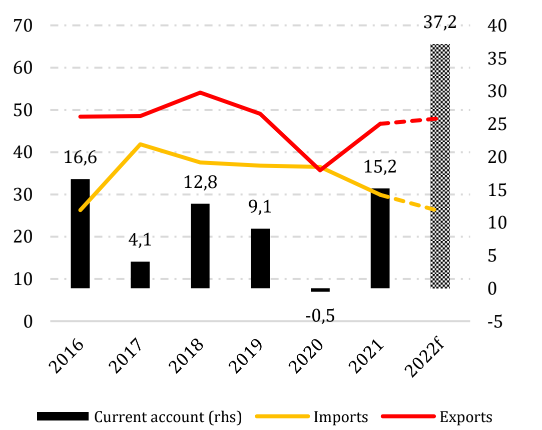
Source: RAEX-Europe calculations based on data from the Ministry of finance of the Republic of Azerbaijan and IMF

Graph 2: Macroeconomic indicators, %



Source: RAEX-Europe calculations based on data from the Statistical Committee of the Republic of Azerbaijan and the IMF

Graph 3: External sector indicators, % of GDP



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

terms. In addition, the level of international and SOFAZ reserves remains quite adequate, and since the AZN is de facto pegged to the USD, we do not anticipate any risk of non-repayment of debt increase this were to increase.

The economy shows strong growth in 2021. By the end of 2021, real GDP grew by 5,6% y-o-y resulting from the recovery from the pandemic as well as higher oil prices. The economy has continued to recover in 1Q 2022 as hydrocarbon prices have surged as a consequence of the Russian invasion of Ukraine. Non-oil gas GDP continues to show strong growth figures as it hiked by 10,3% in 1Q 2022. We expect the economy to grow at a slower pace of about 2,8% y-o-y 2022 mostly as a result of diminishing base effects and increase in inflation.

The concentration of the economy on the oil and gas sector remains high and is still one of the main factors constraining the sovereign ratings, as it makes the economy highly vulnerable to oil demand. Despite decreasing slightly, the oil and gas share in total exports was around 90% in 2021, while it represented 50% of total GDP production as of the same date.

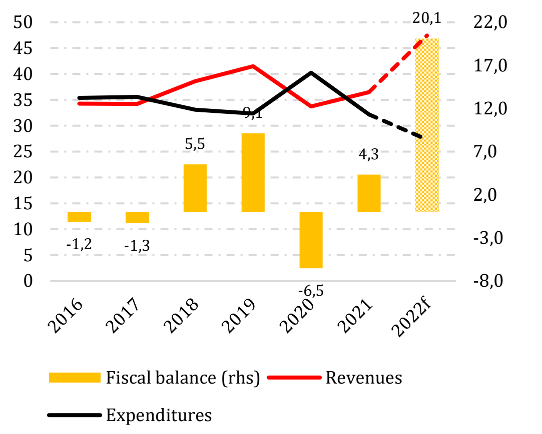
The external position remains strong. The external balance sheet of Azerbaijan remains very solid. The recent increase in oil and gas prices have solidified the current account. After posting a current account surplus of 15,2% of GDP in 2021, we anticipate this metric to increase up to 37% of GDP in 2022. Azerbaijan's trade balance of good and services posted a reading of 5,7% of GDP in 2021, while we expect a stronger figure in 2022 as a result of rising hydrocarbon prices. We consider the trade exposure to Russia and Ukraine to be moderate; thus, not having impactful effect on trade metrics.

Finally, the level of international reserves of the Central Bank of Azerbaijan (CBA) continued to increase steadily and, as of March 2022, it stood at USD 7,136 bn. Further strengthening the external position is the fact that SOFAZ remains with a vast amount of assets.

Political risk increase slightly due to the Russian invasion of Ukraine. Even though we anticipate that the Nagorno-Karabakh conflict remains controlled and new ways of cooperation have been created, slight uncertainty rose from the Ukraine war. This is mainly due to the fact that Russia broke ties with all nations involved in the Minsk group. However, we still anticipate Russia to retain its peacekeeping forces in the region.

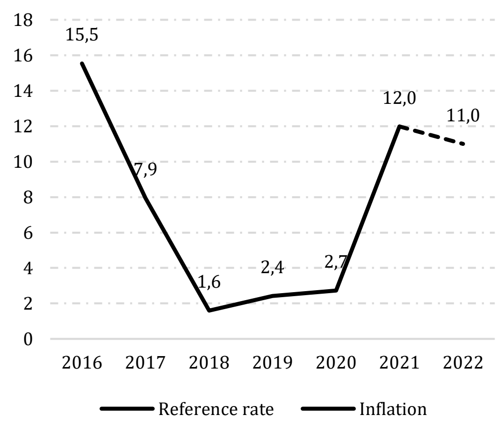
Fiscal position recovered substantially in 2021. The fiscal budget posted surplus of 4,3% of GDP in 2021 as a result of stronger oil prices as well as an increase in non-oil revenues. On the expenditure side, we anticipate Nagorno-Karabakh reconstruction spending will create pressure on the budget. Nevertheless, the high hydrocarbon prices which

Graph 4: Fiscal balance, % of GDP



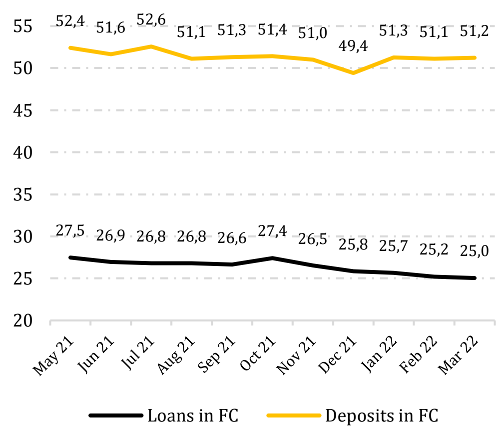
Source: RAEX-Europe calculations based on data from the Ministry of finance of the Republic of Azerbaijan and IMF

Graph 5: Inflation, %



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

Graph 6: Financial dollarization, % of total



Source: RAEX-Europe calculations based on data from the Azerbaijan Banks Association

have resulted from the lack of supply derived from the Russian invasion in Ukraine, will propel the fiscal surplus around 20% of GDP in 2022.

We still consider the SOFAZ to be one of the key strengths for the creditworthiness of the sovereign as it has more than enough room to finance the national budget. As of March 2022, assets of the fund stood at USD 45,3 bn.

Monetary policy tightened slightly. Since September 2021, when the reference rate was 6,5%, the CBA has hiked it four times by 25b.p. up to 7,75% as it stands currently. The tightening has been mainly a response to high inflationary pressures and expectations impacted by increase in food and commodities prices, the overall supply chain crunch and lower imports from Ukraine and Russia. By the end of 2021, the inflation rate stood at 11,9%, while by the end of March 2022 it was 12,2%. We expect inflation to remain high throughout 2022. Moreover, the de facto peg to the USD remains in pace and the CBA continues to perform FX auctions alongside the state oil fund.

We still consider that the plan of transition to an inflation-targeting regime as part of the CBA strategy remains in place but has been delayed due to the current pandemic situation. In terms of effectiveness, the economy's response to the changes in the reference rate remains limited as a result of high dollarization levels.

Banking system remains weak but improving. The banking system posted figures showing better signs of improvement. As of the end of 2021, the ratio of NPLs to total loans stood at 4,2%, a decline of 1p.p. from 3Q 2021. Moreover, as of the same date, ROA stood at 1,6%, while ROE posted a figure of 12,3%. In addition, the estimate of the capital adequacy ratio was at around 22% by the end of 2020. As mentioned in our previous review, the stability of the metrics stems mostly from the capital injection, restructuring process, and subsequent recovery of the state-owned International Bank of Azerbaijan (IBA), as well as from the license revocation of four banks. We anticipate Basel 3 to kick in this year in regard to liquidity and risk management.

Financial dollarization remains high, however, it has not increased further. The level of financial dollarization in the country stood at 51,2% of deposits and at 25% of loans as of March 2022. These levels continue to have a negative effect of the efficiency of monetary policy transmission.

The level of domestic credit to GDP stood at 13,9% of GDP in 2021, while banks' assets to GDP posted a figure of 41,4% as of the same date.

Support factors:

- Substantial foreign currency assets (expected above 100% of GDP by end-2022) on the balance sheet of SOFAZ. As of March 2022, the fund had around USD 45,3 bn in assets (weak support-factor).

Stress factors:

- Increased dollarization level: 51,2% of deposits and at 25% of loans were denominated in foreign currency as of March 2022 (moderately weak stress-factor);
- Budget revenues are highly dependent on the oil sector. (weak stress-factor);
- Escalation of the frozen conflict over the Nagorno-Karabakh territory continues to constrain the structural transformation of the country, despite the peace treaty, we still consider the situation as a stress factor (weak stress-factor).

SENSITIVITY ASSESSMENT:

The following developments could lead to an upgrade:

- Continued increase in oil prices higher than our base scenario to support GDP growth and the external trade position;
- Increased economic diversification and lower share of budget revenues from the oil industry.

The following developments could lead to a downgrade:

- Further deterioration of economic activity which will have a direct impact on public finances and external buffers;
- Renewed escalation in the military conflict with Armenia.

ESG Disclosure:

Inherent factors

- Quality of fiscal policy; quality of monetary policy; natural resources; natural and climatic threats; environmental threats; level of corruption, CPI; Government Effectiveness Index; quality of the business environment; position in Doing Business Ranking; level of investment in human capital, adjusted for inequality; Rule of Law Index; transparency of government policymaking Index; level of information transparency of the government; Political Stability and Absence of Violence/Terrorism Index; natural disasters, constant exposure to difficult natural conditions.

Drivers of change factors

- None

Next scheduled rating publication: N/A. The full sovereign rating calendar can be found at [Sovereign Rating Calendar 2022]

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RATING HISTORY:

Date	Review reason	SGC		Outlook	
		National currency	Foreign currency	National currency	Foreign currency
05.11.2021	Scheduled revision of both types of ratings for the country	BB+	BB+	Stable	Stable
07.05.2021	Scheduled revision of both types of ratings for the country	BB+	BB+	Stable	Stable
06.11.2020	Scheduled revision of both types of ratings for the country	BB+	BB+	Negative	Negative
08.05.2020	Scheduled revision of both types of ratings for the country	BB+	BB+	Negative	Negative
08.11.2019	Scheduled revision of both types of ratings for the country	BB+	BB+	Stable	Stable
10.05.2019	First assignment of both types of ratings for the country	BB+	BB+	Stable	Stable

Minute's summary

The rating committee for Azerbaijan was held on 5 May 2022. The quorum for the rating committee was present. After the responsible expert presented the factors, which influenced the rating assessment, the members of the committee expressed their opinions and suggestions within the framework of the Sovereign methodology. The chairman of the rating committee ensured that every member of the committee expressed his/her opinion before proceeding to the voting.

The following methodology was used for the rating assessment: Methodology for Assigning Sovereign Government Credit Ratings – Full Public Version (from August 2020). Descriptions and definitions of all rating categories can be found under the Rating scale section. The user of the rating shall read the methodology in order to have a full understanding of the rating procedure.

The definition of default can be found on the Agency's website in the section for Internal policies.

These ratings are unsolicited. The rated entity did not participate in the rating process.

Main sources of information: IMF, World Bank, Central Bank of Azerbaijan, National statistical office of the Republic of Azerbaijan, Ministry of finance of the Republic of Azerbaijan, WEF, The State Statistical Committee of the Republic of Azerbaijan, Transparency international, open sources.

ESG Disclosure

We consider Environmental, Social, and Governance (ESG) risks and opportunities in the creditworthiness analysis of our Sovereign entities. The disclosure document can be found on the Agency's website in the section: ESG factors in RAEX-Europe's Credit Ratings

Limits of the Credit Rating

During the rating assignment process, Rating-Agentur Expert RA GmbH (the Agency) used publicly available information that was considered to be reliable, complete and non-biased. The responsible expert performed the rating assessment of the country with information considered as the most reliable and up to date in accordance to the overall position of the country and the Agency's internal criteria for selecting data providers. The information and data used for this specific assessment can be considered as of sufficient quality.

Regulatory use

SGC ratings can be used for regulatory purposes according to the ESMA definition.

Conflict of interest

The responsible expert was neither influenced nor biased by third parties during the rating assessment. All employees involved in the rating assessment and revision of the rated entity have reported absence of conflicts of interests before initiation of the rating process.

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Risk warning

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Office responsible for preparing the rating

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