Research Report on Azerbaijan

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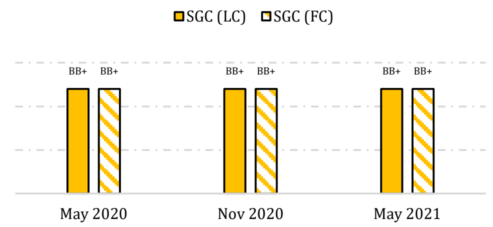
Ratings

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 Azerbaijan

Macro indicators	2018	2019	2020
Gross gov. debt, AZN bn	15	14	15
Nominal GDP, AZN bn	80	82	72
Real GDP growth, %	1,5	2,2	-4,3
Gross gov. debt/GDP, %	18,7	17,7	21,4
Deficit (surplus)/GDP, %	5,5	8,2	-6,4
Inflation rate, %	1,6	2,4	2,7
Current Account Balance/GDP, %	-	-	-0,9
External debt, USD bn	-	-	23,4

Development indicators	2020
Inequality adj. HDI	0,68
GDP per capita, USD th	14,4

Default indicator	07.05.2021
10Y Gov Bond Yield, %	3,41*

Source: RAEX-Europe calculations based on data from the IMF, WB
* Maturity in 2029

RAEX-Europe confirmed at ‘BB+’ the ratings of Azerbaijan. The rating outlook changed from negative to stable.

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 changed from negative to stable, which means that in the mid-term perspective there is a high probability of maintaining the rating score.

Summary

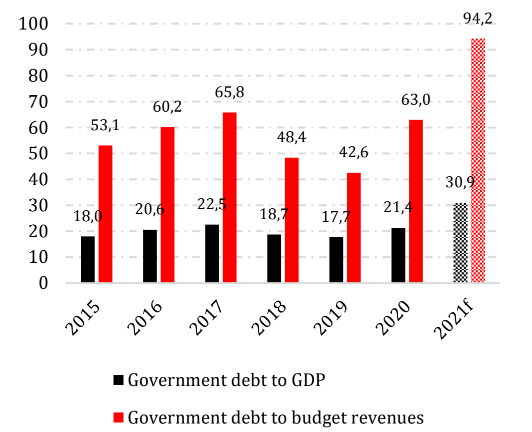
The ratings of Azerbaijan were confirmed at BB+; however, we decided to change the outlook from negative to stable. This mainly reflects the effects of the peace agreement signed last year to temporarily bring to a halt the military conflict in the Nagorno-Karabakh region. This action has eased pressure on potential capital outflows, currency depreciation and public finances. Moreover, the vast and increasing buffers of the State Oil Fund of the Republic of Azerbaijan (SOFAZ) are enough to cover public debt by more than 4x.

On the other hand, the economy remains highly dependent on the oil sector, which increases the risk of economic and public instability in case negative developments in hydrocarbons production or prices were to occur.

Public debt increased in 2020 but remains adequate. The level of gross government debt increased by 4p.p. up to 21,4% of GDP and 63% of government revenues in 2020. The increase was mainly due the nominal increase of 7% in government debt, while nominal GDP decreased by around 11% y-o-y. Despite the steep hike, it remains bearable mainly due to the fact that buffers in SOFAZ are still substantial.

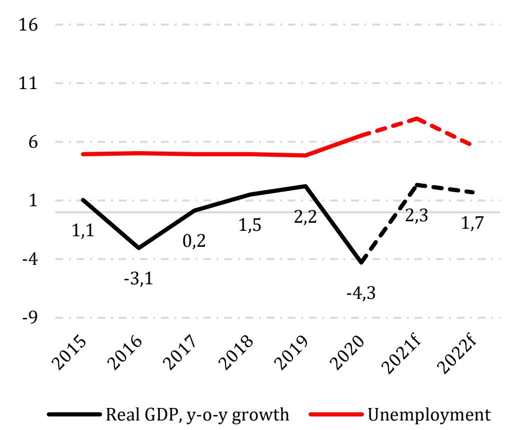
In regard to the debt structure of the government, it remains mixed. While short-term debt remained manageable at 3,5% of overall public debt, the level of FX-denominated debt stood fairly high at 89% of total government obligations. Despite this, most of the debt is owed to various international financial institutions and foreign banks at adequate terms. Moreover, the level of international and SOFAZ reserves remains quite adequate, and we

Graph 1: Government debt dynamics, %



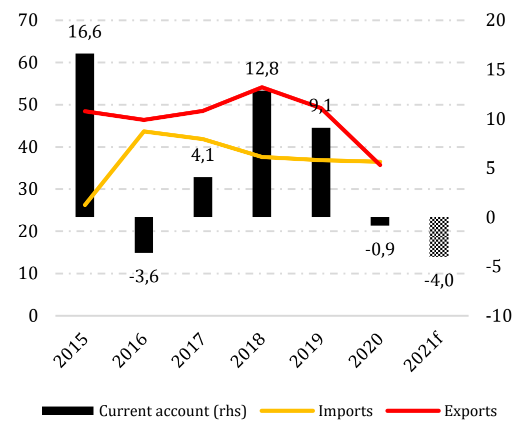
Source: RAEX-Europe calculations based on data from the Ministry of finance of the Republic of Azerbaijan and IMF

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

do not expect a depreciation of the AZN in the mid-term perspective, especially due to the cease fire with Armenia, which would have probably caused a sudden increase in government liabilities.

The economy contracted in 2020. Real GDP contracted in 2020 by 4,3%, mainly in line with the figure we anticipated in our previous review. This was mainly due to the adverse effect from the pandemic, and depressed oil prices in 1H 2020, while the military conflict in the region also had a direct impact on output. Contrary to our initial expectation, the conflict has come to a halt causing our view on the economy to improve going forward. Moreover, oil prices have recovered substantially, and we expect them to remain strong until the end of the year and into 2022. In addition, the unemployment rate increased up to 6,5% in 2020, slightly lower than our previous projection of 7%; however, unofficial figures show that unemployment will be higher in 2021, but still at bearable levels. What is more, the government has expanded measures by increasing social assistance covering more than 4,8 m citizens since the start of the pandemic. Besides, the vaccination campaign started back in January 2021 and as of end-March, around 5% of the population has been vaccinated.

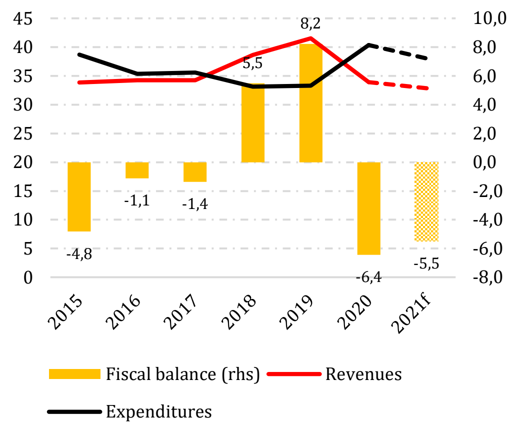
The Azerbaijani economy's concentration in the hydrocarbon sector remains quite high and remains as one of the main factors constraining the sovereign rating, as it makes the economy highly vulnerable to oil demand. Hydrocarbon exports continue to account for around 90% of total exports. However, the easing conflict in the Nagorno-Karabakh region and higher oil prices will relax pressure on the economy. Moreover, non-oil GDP has hiked quite steadily in 2021 by growing by 3,5% in January-March 2020 y-o-y as compared to 1,1% of the overall economy in the same period.

Solid external stance continues. The external position remains strong despite the negative effects from the pandemic. The trade balance and the current account balance stood at -0,77% and -0,9% in 2020 respectively. The dramatic drop was mainly propelled by substantial imports in the non-oil sector while exports declined considerably. Nonetheless, exports from the county have expanded favorably in 1Q 2021. We anticipate the current account balance to turn positive again in 2021.

However, as a result of the stop of the conflict, the recovery from the pandemic, and a solid oil price, the external position will remain strong. Moreover, the level of international reserves of the Central Bank of Azerbaijan (CBA) has remained steady, as of March 2021 it stood at USD 3,6 bn similar to the figure posted at the end 2020. Further strengthening the external position is the fact that SOFAZ remains with a vast amount of assets.

Political risk eased substantially but remains in place. Political risk, albeit remaining fairly elevated, has subdued as a result of the peace accord reached in November 2020. As part of the deal, Russia has sent over 2 000 peacekeepers to Armenia and will remain there for a period of at least five years. Due to this, we anticipate peace to hold for the foreseeable future; thus, rendering stability to both countries in economic terms.

Graph 4: Fiscal balance, % of GDP

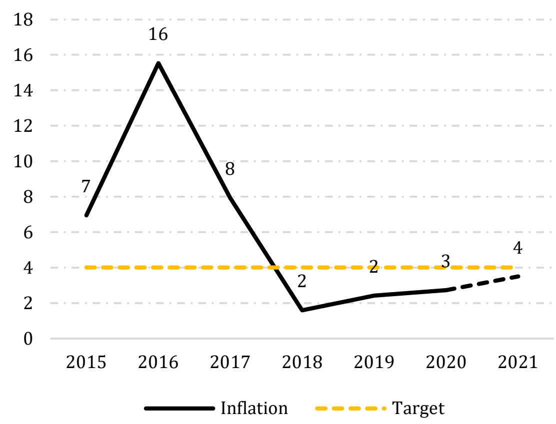


Source: RAEX-Europe calculations based on data from the Ministry of finance of the Republic of Azerbaijan and IMF

Budget balance turned negative but fiscal position remains stable. At the end of 2020, the fiscal budget posted a deficit of 6,4% of GDP as a result of a loose fiscal policy implemented by the government to cushion the negative effect of the pandemic in the economy, combined with depressed fiscal revenues. The measure to support the economy includes increase in healthcare spending, social assistance to unemployed and tax benefits to companies affected by the pandemic, among others. For 2021, the budget allocated another AZN 261 m (0,3% of GDP) to support the economy and fight the coronavirus crisis.

Budget revenues of SOFAZ stood at AZN 3,2 bn, while budget expenditures posted a figure of AZN 2,5 bn in 1Q 2021. Moreover, assets of the fund constituted USD 42,7 bn as of the same date, a decline of 1,8% as compared to the end of 2020. Despite the decline, mainly due to lower gold prices and depreciation of many currencies against the USD, we still consider the fund to have more than enough room to finance the national budget.

Graph 5: Inflation, %



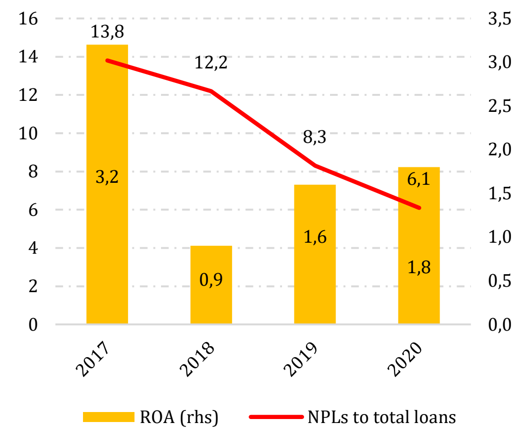
Source: RAEX-Europe calculations based on data from the IMF

Monetary policy to remain prudent. After a number of cuts to the reference rate in 2020, the CBA left the rate unchanged at 6,5%, in April 2021. This is mainly a result of the stability of the inflation level in the country as well as low inflation expectations, which translates in the level of prices being in line with the CBA target of 4%±2%. Moreover, the de facto peg to the USD remains in pace and the Central Bank continues to perform FX auctions alongside the state oil fund, the latest being on 6 May 2021 where USD 24,3 m worth of demand was served.

The CPI index grew by 2,7% in 2020 and we expect it to remain stable in 2021. As of March 2021, the inflation rate stood at 4,1% y-o-y and we expect the metric to end the year at 3,5% showing stability and staying within the target of the CBA.

We still consider that the plan to 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

Graph 6: Financial soundness indicators, %



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

response to the changes in the reference rate remains limited as a result of high dollarization levels.

Banking system showing resiliency. The banking system remains weak; however, it has remained steady in the wake of the coronavirus crisis. As of 1Q 2021, NPLs to total loans ratio continued to decline and stood at 6,1%, according to figure from the Azerbaijan Banks Association (ABA). Moreover, as of the same date, ROA stood at 1,8%, while ROE posted a figure of 12,1%. 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 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.

Nevertheless, despite decreasing, the financial system remains highly dollarized, which makes the stability of the system vulnerable to currency deprecations as the government remains with the USD-peg. The level of financial dollarization in the country stood at 55% of deposits and at 29% of loans as of March 2021. Thus, a sudden devaluation could result in an even harder impact on the market if the government would need to devaluate the currency if pressure from the pandemic, oil prices and an unlikely potential escalation of the Nagorno-Karabakh conflict. As mentioned in our previous review, the CBA took measures to support the economy by signing a USD 200 m swap agreement with the EBRD in order to improve the flow of money into the economy. However, in January 2021, the CBA lifted some measures established in 2020 to ease the banking sector of some burdens. The measures lifted include inspections at banks and the capital requirements in regard to consumer loans went back into place.

The level of domestic credit to GDP is expected to have been at around 15,7% of GDP in 2020, staying fairly stable as compared to a year before. On the other hand, total banks' assets to GDP posted a figure of 44,3%.

Support factors:

- Substantial foreign currency assets on the balance sheet of SOFAZ. The assets of the State Oil Fund of the Republic of Azerbaijan (SOFAZ) recovered in 3Q 2020 but mainly due to extra-budgetary revenues related to the foreign exchange movements and currently stands at USD 43,3 bn, still lower than the figure posted a year before. As of September 2020, AZN 8,9 bn has been transferred to the budget. The fund remains the largest source of current budget expenditures and government debt service (weak support-factor).

Stress factors:

- Increased dollarization level: as of March 2021, 55%% of total deposits and 29% of total loans were denominated in foreign currency (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: 5 November 2021. The full sovereign rating calendar can be found at Sovereign Rating Calendar 2021

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RATING HISTORY:

Date	Review reason	SGC		Outlook	
		National currency	Foreign currency	National currency	Foreign currency
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 7 May 2021. 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 April 2019). 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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Office responsible for preparing the rating

The office responsible for the preparation and issuance of this credit rating is the office of Rating-Agentur Expert RA GmbH in Frankfurt am Main, Germany.

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The European Securities and Markets Authority (ESMA), the EU's direct supervisor of credit rating agencies (CRAs), has registered Rating-Agentur Expert RA GmbH as a CRA under Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies, with effect from 1 December 2015.

Rating-Agentur Expert RA GmbH applies the Code of Conduct Fundamentals for credit rating agencies issued by the International Organization of Securities Commissions (IOSCO Code) and includes the basic principles of IOSCO Code in its Code of Conduct.