Rating-Agentur Expert RA confirmed at 'BBB-' the ratings of Russia. The rating outlook changed from stable to positive.

Rating-Agentur Expert RA confirmed the sovereign government credit rating (SGC) of Russia at 'BBB-' (Moderately high level of creditworthiness of the government) in national currency and at 'BBB-' (Moderately high level of creditworthiness of the government) in foreign currency. The rating outlook changed from stable to positive which means that in the mid-term perspective there is a high probability of upgrading the rating score.

MAJOR FACTORS THAT INFLUENCED BOTH TYPES OF RATINGS:

Positive factors:

- The Central Bank of Russia (CBR) carries out an effective monetary policy keeping inflation in line within the target of 4%. Against the backdrop of the RUB weakening and increased inflationary risks, the CBR tightened the policy at the end of 2018, raising the key rate to 7,75%. From 2H 2019, the situation has changed, and there is a slowdown in inflation amidst the strengthening of the RUB and restrained domestic demand. The annual inflation as of October 2019 decelerated to 3,8% and, as a result, the CBR eased the policy. The key rate since June 2019 has been gradually reduced by a total of 150b.p. down to 6,25%. We expect the relaxation will create conditions for further reduction of deposit and credit market rates that support the growth of lending to the real sector;
- We assess the banking system's profitability dynamic as a positive factor. ROA and ROE have improved to 1,9% and 17,4% as of September 2019, respectively. The capital to asset ratio slightly decreased to 9,7% as of the same date due to a reduction in accumulated profit, which resulted from the harmonization of IFRS 9 and local standards. At the same time, regulatory capital adequacy metrics showed improvement, as IFRS 9 standards are not yet taken into their calculation;
- GDP growth in 2018 exceeded forecasts, and despite the restrictive fiscal and monetary policies, it accelerated to 2,3%, mostly due to temporary factors as one-off construction projects[1], recovering export prices for energy-related products and RUB depreciation. However, in 2019 the economic growth pace was restrained to 0,5% in 1Q and 0,9% in the 2Q y-o-y amid weakening of real income and a decline in external demand for exports and lower commodity prices. Besides, there are still weak dynamics of investment activity, despite ambitious national programs. We expect economic growth to reach 1,1%-1,2% in 2019 fostered by monetary easing, acceleration of government spending, which will also stimulate the economy and private consumption in the mid-term, whereas the slowdown in the global economy will continue to have a restraining effect;
- The record current account surplus at almost 7% in 2018, which was caused by the favorable price situation for the oil and gas exports, has strengthened the Russian external position and created conditions to further accumulate FX reserves. We anticipate that in the mid-term horizon, the surplus will remain with a strong trade balance; however, it will narrow as the exports will gradually shrink with lower oil prices. In contrast, imports will widen fostered mainly by capital investments in the government structural projects;
- The Russian external position is robust with rising resistance to external shocks, supported by a free-float exchange rate regime, ongoing external deleveraging of the private sector and the significant accumulation of international reserves during the last

[1] One of the biggest is YAMAL LNG - an integrated project encompassing natural gas production, liquefaction, and shipping.

years. During the first ten months of 2019, international reserves grew to USD 542,9 bn as of October 2019, mainly due to the purchase of foreign currency within the budget rule with the purpose to sterilize the excess of oil-related revenue;

- The strong government debt position is confirmed by the deleveraging trend during the last four years: the general government debt decreased to 14,6% of GDP and 41,1% of budget revenues as of the end of 2018. The favorable maturity and currency debt structure bears low risks for the country's creditworthiness and lowers exposure to currency risk. The share of short-term obligations does not exceed 2% of GDP and the share of foreign currency in external government debt decreased to 44% as of June 2019;

- The overall budget balance turned into a surplus in 2018 posting a figure of 2,9% of GDP as compared to deficits recorded in previous years. This was mainly as a result of the combination of stronger oil revenues and tighter expenditures. We anticipate the general government budget surplus in 2019, however, to be modest at around 1%-1,5%, and in the mid-term, it will decline gradually, as the commodity-related revenues will also reduce amid lower prices and demand. Support for public finances will be provided by further strengthening of the non-oil revenues and conservative expenditures, although this will be balanced between the need to adhere to the fiscal rule and the acceleration of funding for priority national projects.

Restricting factors:

- The level of private credit to GDP is declining and stood at 53,9% in the end-2018, which is significantly lower than the same metric in BRIC peers, whose average private credit stands well above 100% of GDP (except India – 72,1%). Even though bank lending has grown steadily in 2018, we anticipate this metric will not progress in the mid-term, as corporate lending dynamics are insufficient and retail lending is slowing down in 2019. As a result, the ratio of the banking assets to GDP continues to decline amid a slowdown of lending and RUB appreciation. Over the last 10 months, banks' assets grew only by 1,8% compared to 6,3% over the same period last year. We expect the ratio of banking assets to GDP to fall below 90% in the end of 2019;

- The total capitalization of the stock market remains at 38,2% of GDP in 2018, thus significantly lower than the world indicators of developed countries. However, the stock market stabilized in 2019 after the last year's volatility and the main stock indices show stable growth (in particular, the MOEX Russian index for 11 months increased by 20% since the beginning of the year) and the total capitalization of national stock market companies as of September 2019 increased by almost 13% in nominal terms. The improvement of the domestic capital markets will be supported by the oil and gas sector, and further progress will depend on the absence of new sanctions;

- The economic competition and business efficiency in Russia is primarily limited by the weakness of its institutions and the significant footprint of the state. According to the Index of economic competitiveness from the World Economic Forum, Russia stands at the 43rd place out of 140 countries in 2018. However, positive signals are the reforms undertaken by the authorities. In particular, pension reform and increasing investment in human capital aim to offset negative demographic dynamic and rise of labor productivity;

- The dynamics of foreign investment inflow in 2018 was negative, as demand for Russian assets is restrained by sanctions. Net FDI inflow in 2018 more than halved compared to 2017 to 0,53% of GDP. In the 1H 2019, FDI inflows grew by 62% y-o-y, mainly due to the investments in debt instruments, although on the scale of the economy this amount is still insignificant.

Negative factors:

- The increasing influence and presence of the state, especially in the banking and oil and gas sector, is the main structural weakness of the economy that restrains competition and business efficiency. According to an IMF study[2], the Russian government's share has increased significantly, to almost 40% in the formal sector and up to 50% in employment in the formal sector. Moreover, in the banking industry, where the concentration of SOBs is almost 70%, we expect the footprint of the state to increase due to the continued private banks' license revocation. In the current geopolitical situation, the risks of contingent liabilities are heightened, moreover the external debt of government banks and public corporations was at 10% of GDP in the end-2018 according to the CBR estimations[3];

- The level of NPLs, despite a decrease of 0,7 p.p. in 3Q 2019 y-o-y, remains high at 10%. We do not expect a significant recovery in the loan portfolio of banks next year, as a potentially negative factor may be the deterioration in the quality of loans as the debt burden of the population is increasing whereas real disposable income is declining. On the other side, the preconditions for further reduction of NPL could be a stable macroeconomic situation and further rehabilitation of troubled banks.

Stress factors:

- Despite the economic diversification policy, the concentration of exports in the oil and gas industry remains high, with a share in exports of goods up to 59% in 2018 and 58% in 3Q 2019 (moderately weak stress-factor);
- The threat to the stability of the Russian economy is posed by sanctions risks associated with current and possible restrictions on business and the financial industry. Given continuing geopolitical tensions, there remains uncertainty about the scope and harmfulness of new sanctions, aimed primarily at sovereign debt, state-owned banks, and the energy sector (moderately strong stress-factor).

SENSITIVITY ASSESSMENT:

The following developments could lead to an upgrade:

- Further strengthening of external buffers, accompanied by stable oil prices and commitment to fiscal rules, which will contribute to enhance macroeconomic stability and reduce economic vulnerability;
- Ensuring positive dynamics of capital markets and stability of the banking sector with improvement in the levels of NPLs;
- Relaxation of the sanctions regime could be an incentive to revival of the investment climate and reverse the outflow of the foreign capital.

The following developments could lead to a downgrade:

- Increasing pressure from international sanctions against large state-owned banks and the oil and gas sector, which may lead to materialization of implicit contingent liabilities;
- Significant deviation from current monetary and fiscal policies, which may lead to macroeconomic instability.

"The Agency has decided to maintain the sovereign government credit ratings of Russia at 'BBB-', while the outlook was changed to positive. Our actions reflect the improved macroeconomic stance, increased efficiency of the monetary policy, the robust external position with rising international reserves and continued deleveraging of the private sector, as well as the strengthening of public finances with adherence to the fiscal rule. At the same time, the rating is restrained by the long-standing structural economic problems, the significant footprint of the

[2] https://www.imf.org/en/Publications/WP/Issues/2019/03/09/The-Russian-States-Size-and-its-Footprint-Have-They-Increased-46662

[3] Liabilities of the entities in the banking and other sectors that are public corporations, which are subject to control by government and the Central Bank. Control is established (directly or indirectly) through ownership of more than half of the voting shares or otherwise controlling more than half of the shareholder voting power.

state in the economy, excessive concentration of exports on the hydrocarbon industry and the restrictions imposed by sanctions.

However, in our view, the solid external buffers along with a commitment to the current monetary and fiscal policy can help to mitigate the external shocks and increase resistance to the consequences of sanctions. Moreover, the focus on the implementation of the national infrastructure projects can help to address the existing structural problems and ensure long-term economic growth prospects of the economy." – Clarified Denys Anokhov, Rating Analyst of Rating-Agentur Expert RA.

Research report on Russia is available at:

https://raexpert.eu/reports/Research_report_Russia_13.12.2019.pdf

Next scheduled rating publication: 12 June 2020. The full sovereign rating calendar can be found at Sovereign Rating Calendar 2020

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RATING HISTORY:

Date	Review reason	SGC		Outlook	
		National currency	Foreign currency	National currency	Foreign currency
14.06.2019	Scheduled revision of both types of ratings for the country	BBB-	BBB-	Stable	Stable
21.12.2018	Scheduled revision of both types of ratings for the country	BBB-	BBB-	Stable	Stable
06.07.2018	Scheduled revision of both types of ratings for the country	BBB-	BBB-	Stable	Stable
12.01.2018	Scheduled revision of both types of ratings for the country	BBB-	BBB-	NA	NA
14.07.2017	Scheduled revision of both types of ratings for the country	BBB-	BBB-	NA	NA
20.01.2017	Scheduled revision of both types of ratings for the country	BBB-	BBB-	NA	NA
22.07.2016	Scheduled revision of both types of ratings for the country	BB+	BB+	NA	NA
29.01.2016	First assignment of both types of ratings for the country	BB+	BB+	NA	NA

Minute's summary

The rating committee for Russia was held on 9 December 2019. 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, WB, Central Bank of Russia, Ministry of Finance of the Russian Federation, World Federation of Exchanges, Russian Federal State Statistic Service, International Monetary Fund, World Bank, Trading Economics, World Economic Forum, Doing Business, United Nations, Moscow Stock Exchange (MOEX), Cbonds.

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

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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