Rating-Agentur Expert RA confirmed at 'BBB-' the ratings of Russia. The rating outlook is stable.

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

MAJOR FACTORS THAT INFLUENCED BOTH TYPES OF RATINGS:

Positive factors:

- The solid fiscal budget surplus of 2,9% of GDP in 2018 compared with the deficit of previous years was driven mainly by the combination of stable commodity-related revenues with higher oil prices and a weaker ruble. In addition, the fiscal stance was maintained by the growth of the non-oil revenues and conservative expenditure policy. The general government budget is expected to remain in surplus in 2019 in a range between 1,5% and 2,0%, supported by higher than planned oil prices and the increase in VAT revenues. The current adherence to fiscal rule will be a positive impulse to strengthen the budget, however, the beginning of the implementation of national projects might cause the increase in federal spending and shrinking of fiscal buffers. In the long-term run, the successful adoption of pension reform will allow to low age-related fiscal pressures;
- According to IMF real GDP growth surpassed expectations, accelerated to 2,3% in 2018 from 1,6% in 2017, mostly due to favorable global economic growth, higher oil prices, and one-off non-housing construction projects[1]. We anticipate the modest positive growth at around 1,2% in 2019, against the background of a gradual improvement in consumer demand and in the case of stability of the macroeconomic environment and commodity related prices;
- Debt position of the government remained strong with general government debt decreasing to 13,7% of GDP and 38,8% of general government revenues in the end-2018. We consider the debt burdens will remain stable in 2019 supported by prudent fiscal policy and accumulated buffers. Although the share of short-term debt increased in 2018 from a year before, reaching 2,7% of GDP and 7,5% of budget revenues, it bears low risks for the country's creditworthiness;
- Russian foreign position was strengthening, supported by the further accumulation of the international reserves to USD 487,8 bn as of 1Q 2019, mainly due to foreign currency purchases under the fiscal rule framework. This amount covers more than 220% of gross government debt and more than 16 months of 2018 imports;
- The total banking assets in 2018 grew by 10,4% to RUB 94,1 bn, but asset growth lagged behind the growth of nominal GDP, as a result, the ratio of banking sector assets to GDP decreased to 90,6% y-o-y. We assess the banking system profitability and capitalization dynamic as positive factors. The Russian banks show strong improvement of financial results by the end of 1Q 2019 with a ROA and ROE at 1,8% and 15,9%, respectively. Capital adequacy ratio despite a share of distressed banks slightly increased and reached 12,2% in the end-2018, compared to 12,1% at the end of 2017. However we do not exclude the possible deterioration of these metrics as a result of potential harmonization of IFRS 9 and

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

local standards by the end of 2019 and possible international sanctions on the operations of state-owned banks (SOBs);

- Driven by favorable price situation for the main Russian export goods, the current account continued to strengthen in 2018. The trade balance is strengthened at 11,7% of GDP in 2018 as compared to 5,3% in 2017. The increase in the current account surplus has created the conditions for the reduction of external liabilities and the growth of foreign assets, including the accumulation of international reserves.

Restricting factors:

- Following by rising inflation risks and the ruble depreciation, the Central Bank of Russia (CBR) increased the key policy rate twice in 2018 by 25 basis points to 7,75% with the aim to control the inflation on its target of 4% level. Since the beginning of 2019 inflation has been accelerating, the growth rate of consumer prices in April 2019 was 5,2% compared to 4,3% in December 2018, that was driven by VAT increasing effect and the ruble depreciation in 2018. According to the forecasts of the CBR, inflation has reached a peak and in the 1H of 2019 the policy was relaxed by cutting the key rate to 7,5%, however, we expect the annual inflation run at 5%;
- Although in 2018 there was a positive dynamics in corporate and retail lending, the level of private credit to GDP did not rise and fixed at 57,9% in the end-2018 due to higher GDP growth, which is significantly lower than the same metric in its BRIC peers, whose average private credit stands well above 100% of GDP (except India);
- The Russian stock market was more volatile during 2018 compared to the previous year and experienced a significant dropdown of about 14% in the 2Q 2018 due to the introduction of U.S. sanctions against Russian businessmen and officials, as well as the volatility of oil prices. The total capitalization of the stock market at 39,8% as of 1Q 2019 remains significantly lower than the world indicators of developed countries, and the further development of the stock market may be supported by the oil and gas sector and the absence of real actions on the new package of sanctions;
- Economic competitiveness of Russia remains around average world levels as shown by the Index of economic competitiveness from the World Economic Forum (the 43rd place out of 140 countries in 2018), however, the significant footprint of the state and the structural weakness of the economy may slow down a further improvement;
- The net inflow of foreign direct investment (FDI) plunged by more than two times in 2018 compared with 2017 and amounted to about 0,53% of GDP. Since 1997 it was recorded the largest outflow of FDI in the amount of USD 6,5 bn from the capital of Russian companies. Incentives for the FDI to Russia are reduced mostly due to uncertainty caused by geopolitical tension.

Negative factors:

- A high proportion of state ownership in the economy. Government dominates in the key industries of the economy, such as oil and gas. In addition, the banking sector is highly concentrated on large state-owned banks (SOB) with almost 70% of total banks' assets. We expect the concentration on SOBs will increase during 2019 due to the continued private banks' license revocation and M&A process. The excessive footprint of the state creates risks that the government will be forced to provide support to fulfill its contingent liabilities in the event of external shocks and possible further sanctions;
- Despite a stable macroeconomic environment and measures to revitalize the banking system, non-performing loans (NPL) in the end of 1Q 2019 were recorded at the level of 10,4%, which is largely due to the revaluation of the quality of assets of distressed banks. We do not expect a significant recovery in the loan portfolio of banks in 2019, especially given the recent expansion of consumer lending to 8,3% of total assets as of the 1Q 2019, which causes an increase in the credit burden on the population amid a lack of growth in living standards. Besides, from 2019 all Russian banks will begin to apply IFRS 9 with

more strict disclosure of overdue loans and fair valuation of assets, as a consequence, this might have a negative effect on profitability and capital adequacy indicators.

Stress factors:

- High dependence of the economy and concentration of tax revenues on one single industry. The substantial part of fiscal revenues proceeds from oil and gas taxation, and this share increased by end 2018 to 24,4% (moderately weak stress-factor);
- Downside risks to Russia's growth and stability stem from the geopolitical tension and economic sanctions, which have led to shrinking of non-resident investor's activity on the capital market and had a negative impact on prices of imported goods. Moreover, the potential new sanctions can constrain sovereign financial flexibility and banking sector access to international resources (moderately strong stress-factor).

SENSITIVITY ASSESSMENT:

The following developments could lead to an upgrade:

- The further stable fiscal surplus with substantial improvement of the non-oil revenues and the strict adherence to fiscal rule could serve as a basis for macroeconomic resilience;
- 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:

- The strengthening international sanctions with a focus on large state-owned banks may entail materialization of implicit contingent liabilities;
- The weakening of current fiscal policy and the active use of accumulated buffers for the financing of long-running national projects can increase the sensitivity to external shocks.

"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 the 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." – Clarified Vladimir Gorchakov, Associate Director of Rating-Agentur Expert RA.

Research report on Russia is available at:

https://raexpert.eu/reports/Research_report_Russia_14.06.2019.pdf

Next scheduled rating publication: 13 December 2019. The full sovereign rating calendar can be found at Sovereign Rating Calendar 2019

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RATING HISTORY:

Date	Review reason	SGC		Outlook	
		National currency	Foreign currency	National currency	Foreign currency
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 6 June 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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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.