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Rating

Credit rating of the region – LC	**BB**
Outlook	**Stable**
Credit rating of the region – FC	**BB**
Outlook	**Stable**

Main Economic Indicators of Krasnodar Region

Macro indicators	2014	2015	2016
Total reg. debt, RUB bn	157,1	164,2	170,3
Nominal GRP, RUB bn	1784,8	1946,8	2194,2*
Real GRP growth, %	0,7	-1,6	1,1*
Total reg. debt/own cons. rev., %	78,6	82,1	74,2
Deficit (surplus)/ own cons. rev., %	-13,5	-8,6	1,1
Total reg. debt/GRP, %	8,8	8,4	7,8*
Deficit (surplus)/GRP, %	-1,5	-0,8	0,1*
External debt, USD bn	0,0	0,0	0,0

Development indicators	2015
GRP per capita, RUB th	355,0

Default indicator	13.10.2017
7Y Gov Bond Yield, %	8,1

Source: RAEX (Europe) calculations based on data from Krasnodar Region, Ministry of Finance of the Russian Federation, Rosstat.
*Forecast for 2016 by the government of Krasnodar Region.

Summary

The confirmation of the credit rating of Krasnodar Region at 'BB' in foreign currency and the assignment of 'BB' in local currency were driven by the stable performance of the key rating drivers. The rating remains positively supported by the fiscal performance in 2016 and 1H 2017, the current structure of government liabilities – with a high share of budget loans, as well as by the favorable structure of budget revenues showing a reduced share of transfers from the central government and a high level of tax revenues diversification. In addition, the large and well diversified economy of the region as alongside the positive performance of key industries contributed favorably to the creditworthiness assessment. However, the rating was restricted by high debt load and moderately low level of capital expenditures.

Key industries' performance keeps improving, while personal income shows a negative trend. As mentioned in our previous report[1], Krasnodar has a large and well-diversified economy with a high share of "defensive" (non-cyclical) industries which affects positively the performance of key industries while undergoing an economy recovery process. This is shown by positive metrics as compared to the country's average trend within the 1H 2017: industrial output grew by 2,5%, agriculture and retail sector by 1,8% and 0,5% as compared to a national average of 2,0%, 0,2% and -0,3% for each industry, respectively (see graph 1).

In addition, after several years of slowdown, the dynamics of investments in fixed assets returned to a positive trend showing a 0,7% growth in 1H 2017 as compared to a country average of 4,8%. The Agency expects a higher growth figure of investments by end-2017 due to the sharp increase in construction activity within the 1H 2017 by 16% as compared to 1H 2016 related to new infrastructure, residential and sport related projects in the region.

At the same time, personal income dynamics keeps showing a strong negative trend declining by 2,8% in 1H 2017 as compared to the same period of 2016. In our view, such a negative trend is related not only to the macroeconomic conditions, but also to the increasing share of "shadow" revenues as was mentioned in our previous research report. Together
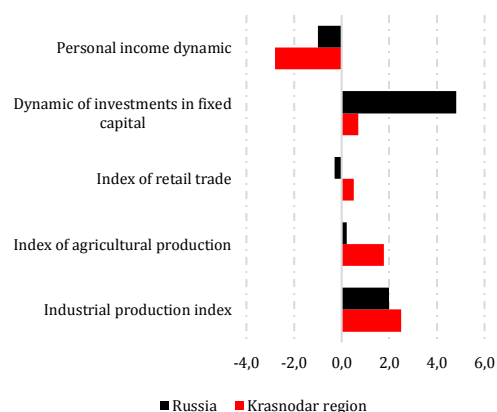
[1] https://raexpert.eu/reports/Research_report_Krasnodar_Region_14.04.2017.pdf

Graph 1: Dynamic of the key economic metrics in real terms in 1H 2017 (to 1H 2016), %
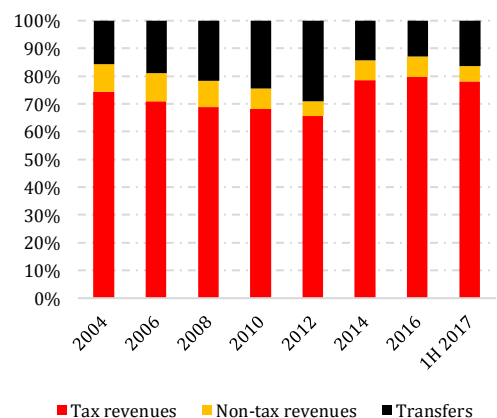

Source: RAEX (Europe) calculations based on data from the Rosstat

Graph 2: Dynamic of the key components of consolidated budget revenues in nominal terms in 1H 2017 (to 1H 2016), %

Source: RAEX (Europe) calculations based on data from the Ministry of Finance of the Russian Federation

Graph 3: Krasnodar Region's consolidated budget revenues structure, %

Source: RAEX (Europe) calculations based on data from the Ministry of Finance of the Russian Federation

with the long-term demographic risks, this creates a strong adverse effect on the personal income tax base and, therefore, the creditworthiness assessment.

Budget revenues dynamics and structure are favorable. Krasnodar keeps showing better dynamics on key items of the consolidated budget revenues in 1H 2017 as compared to the overall trend for Russian regions. Tax revenues increased by 16,2% y-o-y in nominal terms as compared to 9,3% for all Russian regions (see graph 2) mostly due to the growth of corporate profit tax which formed around 21% of the consolidated budget revenues at that period. Such a positive dynamics fully correlates with the recovery of the key region's industries described before. In addition, growth of tax revenues was supported by property tax, which increased by 23%, as well as personal income tax, which showed a growth of 9% in the 1H 2017.

After two years of reduction, the federal government of the Russian Federation provided more transfers to all Russian regions in 1H 2017 as compared the same period of last year. Incoming transfers of the Krasnodar region's consolidated budget increased by 58,6% in this period, which led to the elevation of the transfers' share in total revenues of the region (see graph 3).
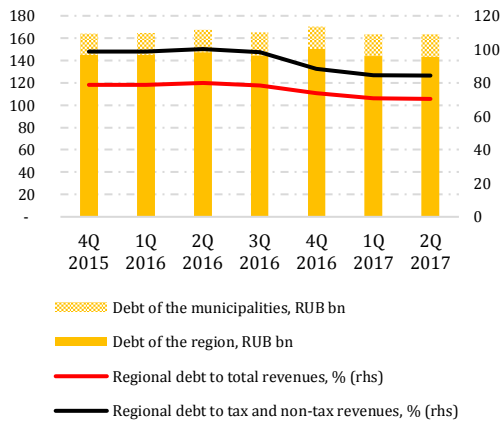
In addition, the structure of tax revenues of the consolidated budget keeps positively affecting the regional creditworthiness with no taxes representing more than 50% of total tax revenues. Personal income tax and corporate profit tax form around 60% of total tax revenues, while other tax income is represented mainly by property tax (18%); excises (10%) and taxes on comprehensive income (10%).

Fiscal performance keeps improving, but expenditures structure and quality of budget management still restrain the region's creditworthiness. The regional authorities' consolidating fiscal policy continued to restraining expenses' growth in 1H 2017 when it stood at 2,2% y-o-y in nominal terms. This figure is below inflation levels and the country's average of 6,3%. Combined with a significant increase in revenues, this led to an outstanding fiscal surplus at 15,7% of total revenues or 18,7% of own budget revenues in 1H 2017 as compared to -0,04% and -0,05% respectively in 1H 2016. Due to the regions' usual practice of increasing public spending towards the end of the year, we expect the fiscal surplus of Krasnodar region in 2017 to be significantly below the mid-year results, but higher than the 2016 surplus at 0,9% and 1,1% of total and own budget revenues respectively.
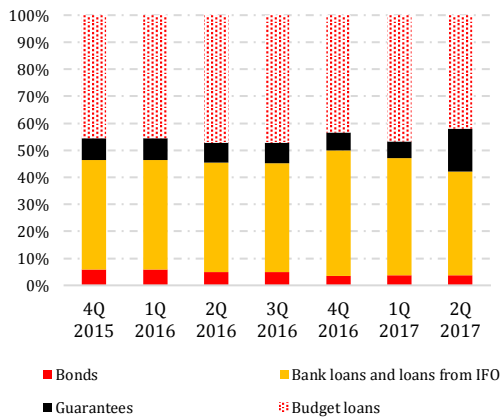
Graph 4: Krasnodar Region's debt metrics

- Debt of the municipalities, RUB bn
- Debt of the region, RUB bn
- Regional debt to total revenues, % (rhs)
- Regional debt to tax and non-tax revenues, % (rhs)

Source: RAEX (Europe) calculations based on data from the Ministry of finance of the Russian Federation

Graph 5: Krasnodar Region's debt structure

- Bonds
- Bank loans and loans from IFO
- Guarantees
- Budget loans

Source: RAEX (Europe) calculations based on data from the Ministry of finance of the Russian Federation

As mentioned in our previous report, the structure of expenditures has an adverse effect on the region's creditworthiness. The share of CAPEX in total expenditures of consolidated budget was as low as 2,7% in 1H 2017 (compared to a country's average of 8,4%). This share indicates that there is a very narrow space to cut expenditures in case of a drop in revenues and, therefore, creates an additional risk of further growth in debt levels.

In addition, according to the recent results of the assessment by the Ministry of Finance of the Russian Federation regarding the quality of the regional budget management for 2016, Krasnodar was described as a region with "proper quality of budget management". This assessment is an improvement as compared to a year ago when it was categorized as "low quality". However, Krasnodar region was included in the list of territories which violated the Russian budgetary regulation within the last year in regard to the new debt issuing: the total amount of raised debt during 2016 exceeded the amount of debt redemption within the same year.

Debt load remains elevated despite the positive dynamics, while the structure remains favorable. As of 1 July 2017, the total amount of consolidated debt of the region (the sum of debt of the regional and municipal authorities) stood at RUB 163 bn, which remains the highest level among all Russian regions. However, the Agency noticed a positive dynamics within 1H 2017: the total amount of consolidated debt decreased by 4,4% as compared to the beginning of the year or by 1,9% as compared to 1H 2016 (see graph 4).

Key indicators of indebtedness remained high as compared to the country's average despite the slight improvement during 1H 2017. The ratio of non-consolidated region's debt to total revenues and own revenues stood at 70% and 84% respectively, as compared to average country levels of 26% and 32% as of the end of 1H 2017, while the share of debt servicing expenditures stood at 3,6% for 6M 2017 (against 1,5% average for Russian regions).

These levels of indebtedness remain mitigated by the currency and creditors' structure with more than 40% of it formed by loans issued by the Ministry of Finance of the Russian Federation (see graph 5), and absence of FX-debt. However, the Agency will keep on watch the debt level and its structure due to the high probability of raising new debt in the 4Q 2017.

Important note for sovereign ratings

This Research Report shall be treated as a supplementary part of the published Press Release included in the following link:

http://raexpert.eu/reports/Press_release_Krasnodar_Region_13.10.2017.pdf

Both documents shall be treated as essential parts of each other.

For further information on the factors, their weights, methodologies, risks and limitations of these ratings, and other regulatory disclosures, please refer to the Press Release and the website of the Agency.