Summary

The 'BB' rating of Krasnodar Region was positively supported by the fiscal performance in 2016, current structure of government liabilities with a high share of budget loans, as well as by the favorable structure of budget's revenues showing reduced share of transfers and high level of tax revenues diversification. In addition, the large and well diversified economy of the region also contributed favorably to the creditworthiness assessment. However, the rating was restricted by high and rising debt load of the region, as well as moderately low level of CAPEX in budget expenditures.

Large and highly diversified economy positively influencing the tax base. According to the latest available data for all Russian regions (2015), Krasnodar’s share of aggregated gross regional product was 2,9% and occupied the 5th position among all regions. However, the development level in terms of per capita GRP remains moderate at RUB 355 th per capita (80% of the country average level).

The region has a well-diversified economy with a high share of “defensive” (non-cyclical) industries, such as transport, agriculture and food production, which accounts for more than 30% of total regional output (see graph 1). Such structure creates a broad tax base for the regional budget and supports the positive dynamic of the key industries' performance in 2016 (see graph 2). Most of the indicators exceeded the country's average: industrial output grew by 4,1%, agriculture sector by 6,1% and retail turnover was stagnant as compared with a national average of 1,1%, 4,8% and -5,2% for each industry, respectively. Deeper slowdown in the construction activity is explained by the “base effect” from the finalization of the facilities and infrastructure built for the Sochi Olympics. In addition, the regional economy benefits from its geographical location with access to the Black Sea and high level of infrastructure development underpinned by elevated road density as compared with the country’s average.

Demographics and personal income create fiscal pressures. The current age structure of the region’s population is close to the country’s average with the share of older than working-age people standing at...
Graph 1: Structure of Krasnodar Region's GRP in 2015, % from total

<table>
<thead>
<tr>
<th>Sector</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>16.0</td>
</tr>
<tr>
<td>Construction</td>
<td>16.5</td>
</tr>
<tr>
<td>Wholesale and retail trade</td>
<td>17.1</td>
</tr>
<tr>
<td>Transport and communication</td>
<td>10.9</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>12.4</td>
</tr>
<tr>
<td>Manufacturing (other)</td>
<td></td>
</tr>
<tr>
<td>Other sectors</td>
<td>10.9</td>
</tr>
</tbody>
</table>

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

Graph 2: Dynamic of the key industries in real terms in 2016, %

Graph 3: Investments in fixed capital dynamics in Krasnodar Region, %

Despite negative dynamics, Krasnodar remains one of the main beneficiaries from capital investments in Russia. In 2016 Krasnodar Region received 2.9% of total investments in fixed capital in Russia, occupying the 7th place by this indicator, compared to 4.2% a year before (6th place). The dynamic of this indicator was negative between 2014 and 2016 (see graph 3), after the finalization of the sport and transport infrastructure projects. At the same time, due to the objective characteristics of the economy, Krasnodar Region remains one of the most attractive territories for private investors. According to the latest rating of Investment attractiveness from RAEX-Moscow, Krasnodar occupied the number one position in terms of investment risks (the region with the lowest investment risks).

Budget revenues structure and dynamics are favorable. Being one of the largest Russian regions in terms of total consolidated budget revenues, Krasnodar Region significantly improved the dynamics of this indicator in 2016 with a y-o-y nominal growth rate of 11.2% as compared with a 6.6% increase of all Russian regions (see graph 4). Such a positive dynamic was fully driven by regional own revenues (tax and non-tax in national definition), which increased by 14.9% while transfers from other budget levels dropped by 8.7% in 2016.
Respectively, the share of transfers decreased in 2016 and reached 12.8% of total consolidated budget revenues, which represented the lowest share over the last 10 years and more than 3 p.p. lower than the country average (see graph 5).

In addition, the structure of tax revenues of the consolidated budget is well balanced with no taxes representing more than 50% of total tax revenues (see graph 6). Personal income tax and corporate profit tax form around 60% of total tax revenues, while other tax income is represented mainly by property tax (19%); excises (12%) and taxes on comprehensive income (9%). Moreover, tax revenues of the region are well diversified by industries: 19% of total taxes transferred to the regional budget during 11m 2016 came from wholesale and retail trade companies, 16% is represented by transport, 12% by manufacturing, and 11% by real estate businesses. Such a positive structure reduces the overall volatility of tax revenues and supports the rating assessment.

Fiscal performance improved significantly, but expenditures structure and quality of budget management restrain the region’s creditworthiness. In 2016 the regional government suppressed a sharp increase in spending following the consolidating budget policy. Total expenditures of the consolidated budget of the region increased by only 2.7% in nominal terms as compared with 4.8% increase of all Russian regions. As a result, Krasnodar Region showed a surplus of 0.9% of total revenues or 1.1% of own budget revenues in the consolidated budget, which is a significant improvement from the 2015 deficit equal to 7.2% and 8.6% respectively (see graph 7).

However, the current structure of the expenditures is worrisome, with the share of CAPEX in total expenditures of consolidated budget as low as 5% in 2016 (compared to a country average of 12.6%), and only 3.2% in total expenditures of non-consolidated budget (compared to 10.6% respectively). These shares were one of the lowest among all Russian regions and indicate 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, the quality of the regional budget management also had a strong adverse effect on the rating assessment: Krasnodar was described as a region with “low quality of budget management” by the 2015 results according to the assessment by the Ministry of Finance of the Russian Federation.

Elevated levels of regional debt mitigated by its favorable structure. Within the last five years the total amount of Krasnodar Region’s

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Consolidated debt more than doubled (see graph 8) and reached RUB 170 bn as of end-2016, which is the largest volume among all Russian regions. This indicator continued to grow in 2016 but at a slower pace as compared to previous years: it increased by 3.7% in 2016, compared to 4.5% and 14.2% growth in 2015 and 2014 respectively.

The high level of indebtedness is also evidenced by the ratio of non-consolidated region’s debt to total revenues and own revenues – 73.7% and 88.3% respectively, as compared to average country levels of 27.4% and 33.8%. In addition, the share of debt servicing expenditures remains elevated in relation with the country’s average indicators: 3.5% of total expenditures of consolidated budget of the region compared to 1.5% in 2016.

However, the high debt metrics are mitigated by the creditors’ structure. Around 40% of the debt is formed by the loans issued by the Ministry of Finance of the Russian Federation, which are long term and can be rolled over or restructured with high probability. In addition, all liabilities of the region are denominated in RUB, eliminating any currency risks. Furthermore, the region is characterized by a strict payment discipline, with no overdue payments recorded in the last five years, and a long history of bonds’ issuance on the open market.

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2 Sum of regional debt and debt of the municipalities.