Research Report on Russia

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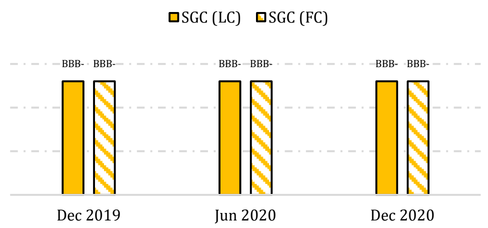
Ratings

Sovereign Government Credit (LC)	BBB-
Sovereign Government Credit (FC)	BBB-
Outlook (LC)	Stable
Outlook (FC)	Stable

* These ratings are unsolicited

Ratings dynamics



Main Economic Indicators of Russia

Macro indicators	2017	2018	2019
Gross gov. debt, RUB bn	14 243	15 171	16 060
Nominal GDP, RUB bn	91 843	104 630	110 046
Real GDP growth, %	1,8	2,5	1,3
Gross gov. debt/GDP, %	15,5	14,5	14,6
Deficit (surplus)/GDP, %	-1,5	2,9	1,9
Inflation rate, %	2,5	4,3	3,0
Current Account Balance/GDP, %	2,1	6,9	3,8
External debt, USD bn	-	-	482*

Development indicators	2019
Inequality adj. HDI	0,74**
GDP per capita, USD th	28,2

Default indicator	11.12.2020
5-Year CDS spread, Bp	75
10Y Gov Eurobonds Yield	1,64***

Source: RAEX-Europe calculations based on data from the IMF, WB, Rosstat, CBR, Ministry of finance of the Russian Federation, Ministry of the economic development of the Russian Federation, Cbonds.
*As of July 2020; **2018; ***with maturity in 2030;

RAEX-Europe confirmed at 'BBB-' the credit ratings of Russia. The rating outlook is stable.

RAEX-Europe 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.

Summary

The confirmation of the sovereign ratings of Russia at 'BBB-' mainly reflects our expectation of the economic stabilization and recovery next years after the severe negative effects from the oil market's volatility and the restrictive response to the pandemic outbreak. Low government debt, a strong external position, and a flexible exchange rate provide resilience in the face of ongoing turbulence, whereas the accommodative monetary policy and temporary easing of the budget rule are aimed at supporting economic recovery.

At the same time, the rating is restrained by the long-standing structural economic problems, the crystallization of contingent liabilities in the massive state corporate and financial sector, excessive concentration of exports on the hydrocarbon industry and the risks arising from sanctions.

GDP dropped dramatically mainly because of the COVID-19 pandemic. GDP growth by 1,6% y-o-y in the 1Q 2020 was followed by a reversal trend in April caused by the restrictive COVID-19 response and lockdown which strongly affected both production and consumer activity. As a result, in the 2Q 2020 the GDP declined by 8% y-o-y. The government implemented three packages of anti-crisis measures that helped slow down the downturn of the economy. They included increased spending on the health care, stimulation of the job market and direct financial aid to the population, as well as support of the business. Despite the easing of lockdown, the negative impact of the OPEC+ deal and depressed consumer activity are dragging down the quick recovery, and we expect the contraction of the economy in 2020 by 4,5% (see graph 1).

In the mid run we anticipate the recovery of the economy with 2,5% growth in 2021 and return to the pre-crisis levels in 2022 in case monetary measures and the nationwide economic recovery plan remain effective and adverse influence of the pandemic flattens. In the long run, the growth of the economy is still constrained by the dominant role of the state and various institutional problems that impede investments and innovations.

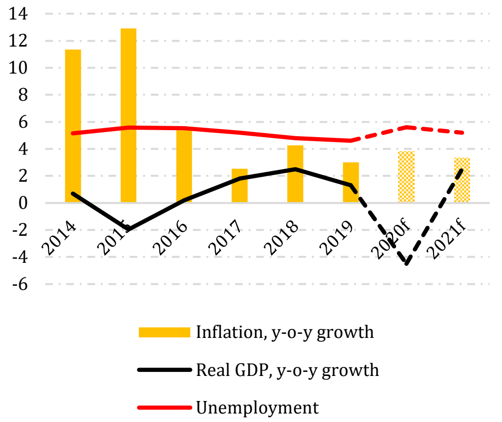
Budget financing of anti-crisis measures amounts to almost 4% of GDP. Along with these additional expenditures, there is a decline in budget revenues due to both the extension of tax deferrals for the most affected businesses, and a reduction in oil related revenues. As such, we expect that the general government budget deficit could reach 6% of GDP by the end of 2020, compared to a surplus of 1,9% of GDP in 2019 (see graph 2). At the same time, we do not see that a significant deterioration of the budget position will affect the creditworthiness of the government. Firstly, it has to do with the fact that the national debt of Russia is significantly lower than that of many developing countries and there is the potential to increase borrowings. Secondly, the government decided temporarily to relax the budget rule for 2021, which will allow redirecting additional oil-and-gas revenues to cover unforeseen expenses using the accumulated safety cushion - the funds of the National Welfare Fund.

The level of government debt remains favorable. The government has space to maneuver and mobilize financial resources to cover the shortfall in budget revenues. Thus, the gross government debt may reach 20% of GDP by the end of this year, due to both economic contraction and revaluation of FX liabilities (see graph 3). At the same time, the share of FX liabilities remains low at 20,3% as of October 2020, which poses low exposure to currency risk. In addition, the debt structure remains favorable by maturity, with the share of short-term liabilities up to one year being 4,6% of gross government debt as of the same date. The main source of new borrowings remains the issue of domestic government bonds, as U.S. sanctions are holding back the ability to issue USD-denominated debt. The volume of domestic bonds in circulation since the beginning of the year increased by 41% and we expect a further borrowings in this market.

Transition from neutral to accommodative monetary policy. Given low inflation risks and the negative impact of the COVID-19 on the economy, from April 2020 the Central Bank of Russia (CBR) returned to an accommodative monetary policy to stimulate domestic demand. This resulted in the reduction of the key rate during the year by 175 b.p. to a record low 4,25% (see graph 4). Due to the effective transmission mechanism, this created conditions for a decrease in market interest rates and yields of government and corporate bonds.

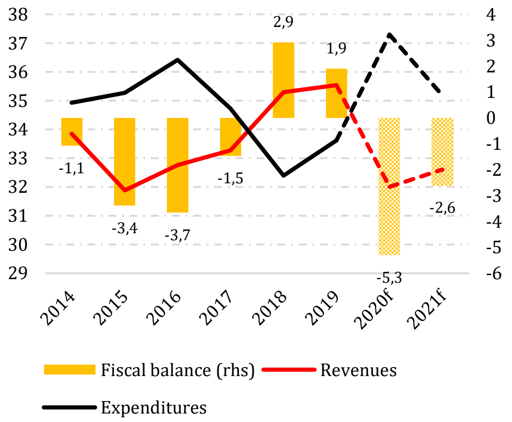
Annual inflation accelerated to 4,4% in November 2020, as consumer prices are under pressure from the weakening RUB. To stabilize the market and support exchange rate flexibility, the CBR switched from purchases to preventive sales of foreign exchange reserves from the National Welfare Fund, including additional amounts in excess of those mandated by the fiscal rule. At the same time, we anticipate the annual inflation close to the

Graph 1: Macroeconomic indicators, %



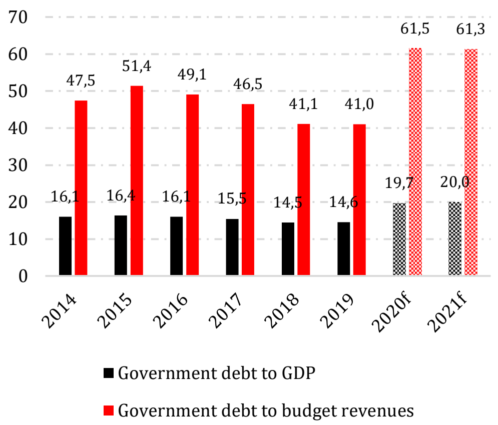
Source: RAEX-Europe calculations based on data from the IMF

Graph 2: Fiscal budget dynamics, % of GDP



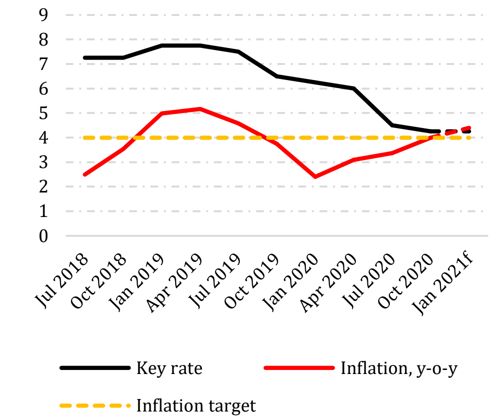
Source: RAEX-Europe calculations based on data from the IMF and Ministry of finance of the Russian Federation

Graph 3: Government debt dynamics, %



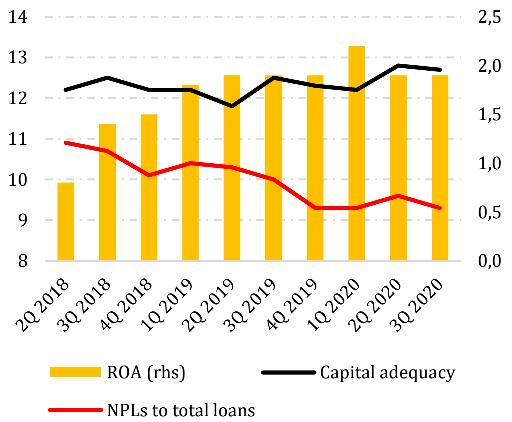
Source: RAEX-Europe calculations based on data from the IMF, CB and Ministry of finance of the Russian Federation

Graph 4: Monetary policy metrics, %



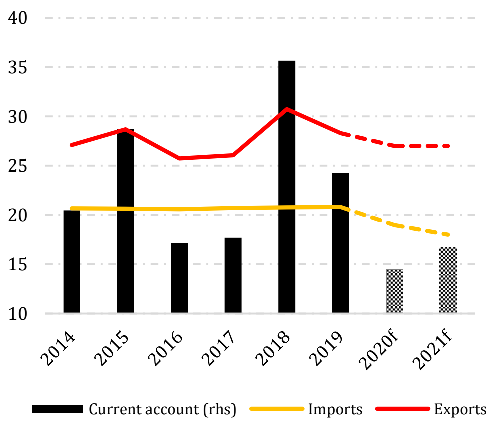
Source: RAEX-Europe calculations based on data from the Rosstat and CBR

Graph 5: Financial soundness indicators, %



Source: RAEX-Europe calculations based on data from the CBR. *The share of loans classified as 4th and 5th quality categories according to the CBR regulation (two categories with the lowest credit quality) was used as a proxy for the indicator "Share of bad loans in total loans".

Graph 6: External sector indicators, % of GDP



Source: RAEX-Europe calculations based on data from IMF and WB

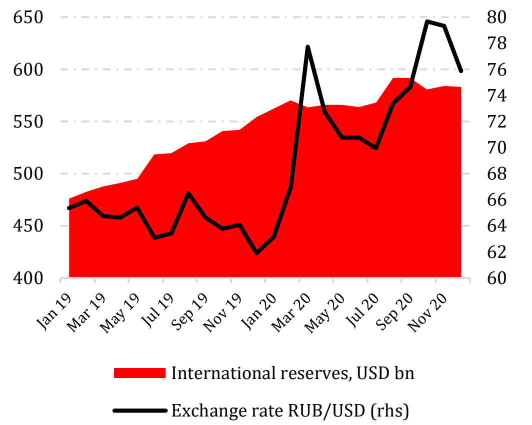
regulator's target of 4% due to the disinflationary impact of slack aggregate demand.

With improving profitability and capitalization, the banking sector is showing resilience. In the first 10 months of 2020, the banking sector's asset growth amounted to 11,5%, supported by active lending, mainly in the corporate segment. Retail lending growth also rebounded in 2Q 2020 after the lifting of restrictive measures and softening of monetary conditions, as well as stimulated by the new government mortgage program. Overall, profitability in the banking sector persists, with ROA and ROE at 1,9% and 17,3% as of September 2020, which supports the banks' capitalization (see graph 5). The regulatory capital adequacy strengthened to 12,7% as of September 2020, due to the outpacing growth of equity compared to the risk-weighted assets. According to estimates of the CBR as of September 2020, a solid capital stock of banks has the potential to absorb losses at about 11% of the system's loans. In order to create additional lending possibilities, the regulator allowed banks to use supervisory capital adequacy buffers, and certain macro prudential capital adequacy requirements were relaxed.

Structural liquidity surplus in the banking sector persists, and regulatory measures to manage liquidity help to maintain a stability. In addition, banks were given the right to postpone the provisioning for borrowers affected by the crisis. The recommendation of the regulator to restructure loans has been extended until the end of the year. Since the beginning of the lockdown, banks have restructured about 10% of total loans. These measures have temporarily delayed the recorded deterioration of loan quality, and the level of NPLs during the year remains at 9,3% of total loans. We consider that the deterioration of loans' quality is still a potential risk to the banking system in the medium term, as well as a risk of materialization of contingent liabilities for the government, as SOBs concentrate almost 70% of banking sector assets.

Russia's external position remains one of the strengths supporting its credit rating. According to preliminary estimates for 10 months of 2020, the current account balance weakened to 2,2% of GDP compared to 3,5% of GDP for the same period last year (see graph 6). The major determinant was a significant weakening of the trade surplus caused by a decrease of export commodities. On the other hand, with the recovery of foreign trade observed in 3Q 2020 after the easing of restrictive measures, as well as a reduction of imports, we do not anticipate a transition to current account deficit by 2020. Amid volatility in oil markets in the 2Q 2020, the CBR sold foreign currency from reserves as part of the budget rule, which helped to absorb external shocks and stabilize the exchange market.

Graph 7: International reserves and FX-rate



Source: RAEX-Europe calculations based on data from CBR

Nevertheless, international reserves have increased since the beginning of the year to USD 583,2 bn as of December 2020, mainly as a result of rising global gold prices (see graph 7). This amount covers more than 210% of gross government debt and almost 15 months of 2019 imports.

Stress factors:

- The high concentration of tax revenues in the oil and gas industry is due to the industry's dominance in exports with a 57% share in 2019. Oil and gas revenues accounted for 20,1% of total consolidated budget revenues in 2019 (moderately weak stress-factor);
- The potential of risks' materialization arising from sanctions as moderately strong, weighing on Russia's credit ratings. The threat of sanctions remains as in late 2019, the U.S. imposed additional sanctions on Nord Stream-2. In addition, sanctions packages for new public debt, state banks and the energy sector are still under discussion in the US Congress (moderately strong stress-factor).

SENSITIVITY ASSESSMENT:

The following developments could lead to an upgrade:

- Increase in the oil prices higher than our base scenario to support GDP growth and the external trade position;
- Faster and stronger than originally anticipated recovery from the current economic crisis with higher non-oil GDP growth and improvement of non-oil fiscal balance;
- Relaxation of sanctions regime could be an incentive for the revival of the investment climate and reverse the outflow of the foreign capital.

The following developments could lead to a downgrade:

- Significant deviation from current monetary and fiscal policies, which may lead to macroeconomic instability;
- Weakening of the banking system, which would materialize contingent liabilities of the government.
- 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.

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.

Next scheduled rating publication: TBD December 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
12.06.2020	Scheduled revision of both types of ratings for the country	BBB-	BBB-	Stable	Stable
13.12.2019	Scheduled revision of both types of ratings for the country	BBB-	BBB-	Positive	Positive
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 11 December 2020. 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.

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

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