Research Report on Russia

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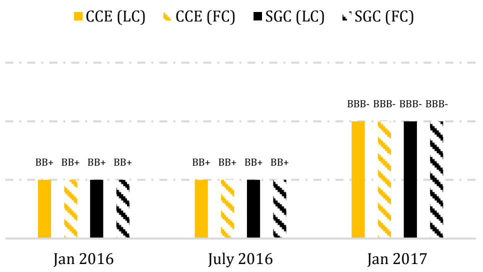
Ratings

Sovereign Government Credit (LC)	BBB-
Sovereign Government Credit (FC)	BBB-
Country Credit Environment (LC)	BBB-
Country Credit Environment (FC)	BBB-

* These ratings are unsolicited

Ratings dynamics



Main Economic Indicators of Russia

Macro indicators	2014	2015	2016
Gross gov. debt, LC bn	12389	13271	14630*
Nominal GDP, LC bn	77945	80804	82815*
Real GDP growth, %	0,7	-3,7	-0,8*
Gross gov. debt/GDP, %	15,9	16,4	17,7
Deficit (surplus)/GDP, %	-1,1	-3,5	-4,0*
Inflation rate, %	11,4	12,9	5,4
Current Account Balance/GDP, %	-	-	3,0*
External debt, USD bn	-	-	35,9*

Development indicators	2015
Inequality adj. HDI	0,71
GDP per capita, USD th	26,0

Default indicator	17.01.2017
5-Year CDS spread, Bp	180
10Y Gov Bond Yield, %	8,1

Source: RAEX (Europe) calculations based on data from the IMF, WB, DB.
* Forecast

Summary

The Agency is upgrading the ratings of Russia from 'BB+' to 'BBB-' mainly on the basis of higher and more stable oil prices, lower inflation rate expectations and a stronger macroeconomic outlook.

The recently signed OPEC agreement to cut oil production stabilized the oil price by the end of 2016. This drove an appreciation of the RUB, which we expect will contribute to lower inflation rates in the short run. Additionally, a higher and more stable oil price will likely reduce pressures on the fiscal budget and prevent the government debt metrics to increase during 2017.

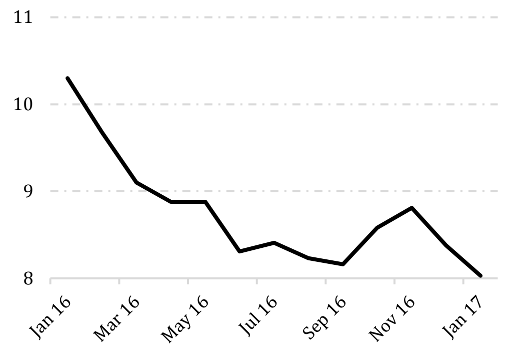
Russian banks' assets remain strong despite having declined slightly, but profitability is still negligible. Despite laying within bearable levels, NPLs to total loans increased in 2016. However, this metric could decline in the back of more encouraging macro outlook for 2017. A lower and less volatile real interest rate and interest rates spread combined with an improving stock market contributed positively to the assessment of the credit climate environment.

Stable government debt load. Russia's government debt load remains low and stable. We forecast, in line with the IMF, that gross government debt will stand around 18% of GDP and 53% of budget revenues in 2016. This would represent a small increase from a year ago, when these metrics stood at 16,4% and 50,1% respectively. In 2015, Russia was the country with the lowest debt load relative to its GDP among the BRICS and with the 14th lowest out of the 185 countries which hold debt in the world.

The Russian government was able to maintain such low levels of debt as a consequence of its accommodative fiscal policy as well as a number of fiscal buffers. The Agency expects the debt to remain subdued in the following years, as economic conditions are likely to reduce pressure on government finances. This has already been digested by market participants and reflected in the steady decline of the 10Y government bond yield through 2016 (see graph 1).

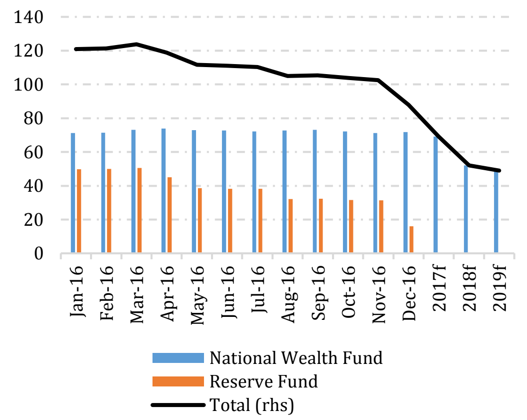
Fiscal balance likely to consolidate. Even though some expenses were cut and others were covered by transfers from the Reserve Fund, the fiscal deficit widened in the first 11M 2016. This was mainly explained by the fact that expenditures were not fully

Graph 1: 10Y government bond yield, %



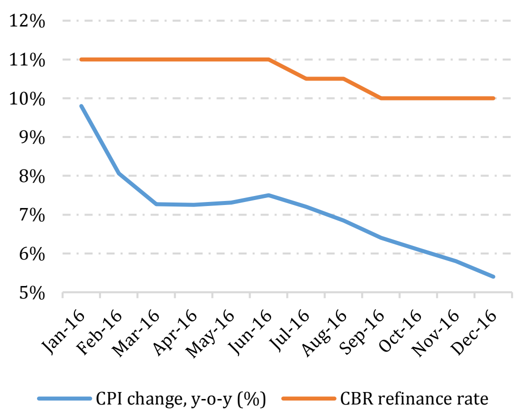
Source: RAEX (Europe) calculations based on data from trading economics

Graph 2: Funds performance, bn USD



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

Graph 3: Inflation rate vs. CBR refinancing rate



Source: RAEX (Europe) calculations based on data from the CBR and GKS

compensated by reduced revenues, which resulted from low oil prices. In our view, the fiscal balance is set to pose a yearly deficit of 4% by the end of 2016, which would represent a decline of 0,5p.p. from a year before.

The Reserve Fund was an important fiscal buffer in 2016, as the total amount of transfers to the treasury equaled USD 18,4 bn by November (see graph 2). As this fund is likely to be depleted in 2017, the government expects to increase the pace of transfers from the National Wealth Fund to the treasury totaling USD 22,3 bn until 2019. This, combined with higher expected oil prices will contribute to further fiscal consolidation in 2017.

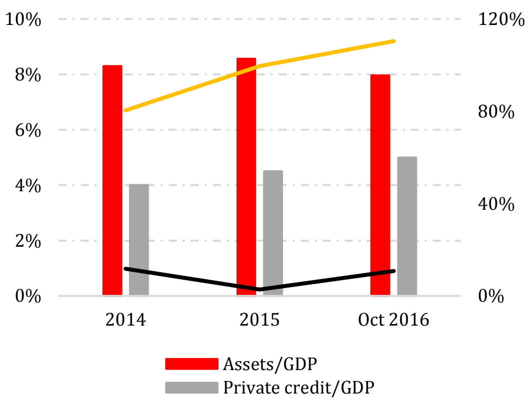
Additionally, the 2017-2019 project of the Federal Budget includes a number of measures aiming at increasing revenues, which range from raising the severance tax rate on oil and gas to redistribution of other taxes among different levels of the budget system. Furthermore, the project considers the possibility of reducing basic and defense expenses until 2019. However, there are a number of off-budget accounts (such as the pension and social security funds) which are ultimately financed by the government and still represent a long-term risk for the fiscal budget.

Encouraging macroeconomic outlook. Russia showed a noticeable improvement in many of its macroeconomic metrics in 2016 with respect to 2015. As a result of a more stable exchange rate and following a base effect, y-o-y inflation rate declined to 5,4% in December 2016 from 12,9% a year before. Additionally, according to the IMF forecast, the real GDP growth rate is set to increase from -3,7% in 2015 to -0,8% in 2016 and we expect it to return to positive ground in 2017. This was followed by a consistent decline of the Central Bank of Russia (CBR) refinance rate (see graph 3), showing adequate responsiveness of the monetary to economic conditions. Despite having increased slightly to 5,9% in 2016, unemployment rate remains low. In our view, a materialization of the macroeconomic outlook could reduce unemployment rate further in 2017.

Mixed results in the banking sector. The Russian banking sector showed mixed results in 2016 with declining assets and increasing private credit as of October. Also, driven by a still declining economic activity, the non-performing loans (NPLs) to total loans ratio kept growing up to 9,2%, while profitability remained sluggish as shown by a ROA of 0,9% in October 2016 (see graph 4).

The license withdrawal process undertaken by the CBR increased the concentration of the Russian banking sector in 2016. The assets of the three largest banks accounted for around 49% of total assets as of October 2016, which represents an increase of 7p.p. from the 2015 figure.

Graph 4: Banking sector metrics, %



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

On the back of forecasted economic recovery, we expect the NPLs ratio to decline and ROA to improve in 2017. Additionally, better economic fundamentals will likely fuel private credit and therefore contribute to refurbish banks' assets.

Sanctions on Russia remain in place. Between the end of 2016 and the beginning of 2017, the European Union and the USA extended sanctions on Russia over the Ukrainian conflict. For this reason the Agency decided to keep a weak stress factor, as we consider that these sanctions are still halting Russia from accessing financing from international markets. However, Trump's administration could potentially have a different approach towards this topic. If any, developments will be observed after the 20th of January 2017, when President-elect Trump will be officially inaugurated as President of the United States.

Improved credit climate environment (CCE). In 2016 we observed some improvement in the CCE, for the first time since our first rating assignment of Russia on the 29th of January 2016[1]. A reduction of the real interest rate and the interest rate spread, combined with an improvement in the quality of investor's protection triggered an increase of our CCE rating score.

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://www.raexpert.eu/reports/Press_release_Russia_20.01.2017.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.

[1] http://raexpert.eu/reports/Research_report_Russia_29.01.2016.pdf