



Russia

Country Report March 2019

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1.0 Executive summary

Russia's economy put in a modest 0.7% growth in January y/y, as expectations for this year remain subdued, despite a [controversial upgrade to 2.3% growth](#) by Rosstat for the whole of 2018.

Russia's economy is growing again, but that growth is way below potential. The forecast for growth in 2019 is 1.3-1.8% and the same again for 2020 before growth starts to respond to the extra RUB2 trillion of spending a year being invested as part of president Vladimir Putin [May Decrees](#) spending programme on infrastructure and the social sphere that is supposed to “transform” Russia. Analyst say that even 3% growth in 2021 is a “very ambitious” target.

But growth has not been the Kremlin's priority. With new US “crushing” looming, **the Kremlin has focused sanction-proofing the Russian economy.**

External debt has been driven down to 15% of GDP, one of the lowest levels of any major economy in the world. The central bank sold off its US treasury bills holds and has been stockpiling gold since 2007 (so it's reserves can't be seized). A payment system has been set up (to counter the threat of cutting Russia off from SWIFT). **A crackdown on corruption and improvements to tax collection system has seen the tax take soar by 20%** in 2018, while the tax burden stayed the same saw the breakeven price of oil needed to balance the budget tumble from \$115 in 2008 to \$49 now – less than the \$65 average price of oil in 2018. And a tax hike to VAT went into effect in January while retirement ages will be raised to further shore up the government finances (so Russia doesn't need international investors to buy its bonds).

This campaign continues. This spring the Russian government is **experimenting with setting up its own Internet** in case it gets cut off from the global one. The Kremlin has already insulated Russia to the point the where there is very little the US sanctions can do to hurt Russia's economy.

But this has come at the cost of stifling growth. Investment, both domestic and inbound, remains very low. Russia's should be using its rock solid fundamentals to boost growth rather than build a financial fortress. While the corporate and banking sectors are back in profit real incomes fell again in 2018 for the fifth year in a row.

The plan is to use the surplus and go it alone in the form of massive investment as part of the May Decrees and under the 12 national projects.

The discontent from the Kremlin's fortress mentality and the **falling living standards it has caused has lead to growing discontent** and falling popularity ratings for Putin personally, which threatens him politically.

Putin attempted address these concerns during his [state of the nation](#) speech in February announcing a Santa's sack list of social spending increases that are designed to make people's lives feel better and head off social unrest. Of all the initiatives he announced, across the board public sector wage increases are probably going to have the biggest effect has half the population are either

directly or indirectly benefiting from budget spending.

The speech also represented a **major shift in the Kremlin's thinking, away from modernising the army and back to towards creating more prosperity** for the Russian people. While military reforms needed to be able to face down Nato will continue, between 2012 and 2018 the budget was wholly focused on military modernisation at the cost of the public's standard of living. Putin clearly thinks that the external threats have been countered and it's time to switch back to deal with the internal political threats to his rule.

But the jury is still out if the Kremlin can lift Russia up by its bootstraps.

Minister of Economy Maxim Oreshkin admitted in February that the 2.3% GDP growth result for 2018 – a six year high —was “[not sustainable](#)” and “due to one-off factors.”

The macroeconomic results from the start of this year were poor.

Industrial production was down from 2.3% in 2018 to 1.1% in January. The PMI manufacturing index fell again to 50.1 from 50.9 in December to just above the 50 no-change mark.

Retail sales growth slowed to 1.6% y/y from 2.9% in 2018. This was tied in with nominal wage growth easing to 5.2% y/y in January from 7.3% in December, and partly caused by an increase in inflation to 5% from 4.3% over the period. Indeed inflation is going to be a key number in 2019. After it fell to a post-Soviet record low of 2.3% in the middle of 2018 it finished the year at 4.3%, above the Central Bank of Russia (CBR) target rate of 4%, and is expected to rise to around 5-6% in the middle of this year, before falling off again in the second half of the year.

But despite this slowdown **Russia is running a triple surplus again** in the trade, current account and federal budget accounts – the budget and current account surpluses are currently at record highs – which gives it some wiggle room. Oil prices are expected to average \$65 this year and there is a key OPEC meeting in April where the production cuts to keep oil prices at this level are almost certainly going to be prolonged.

This year will see the launch of many of the 12 national programmes as the government starts to push some flesh on the bones of the plan. Putin mandated [RUB25.7 trillion \(\\$390bn\) of investments planned for the 12 national projects](#) and named a handful of infrastructure modernisation programmes to be implemented during 2019–2024, although infrastructure will account for a third of the overall spending. The twelve national priority areas comprise 69 federal-level projects that will cost approximately 4.5% of 2018 GDP. While 70% of funding is supposed to come from budget, it is still unclear how much of an increase in budget spending, if any, will be required to cover the costs.

Geopolitically the big event will be the completion of a series of new big gas pipelines: the Power of Siberia pipe linking Russia to China is finished; Nord Stream 2 pipeline linking Russia to Germany is ahead of schedule and will be completed in the fourth quarter; and Turk Stream linking Russia to Turkey and on to southern Europe is well underway and should be finished next year. This trident of pipes will improve Russia's cash flow and its geopolitical capital.

The bottom line is even if the Kremlin misses all the ambitious goals laid out in

the May Decrees (as seems likely) Russia's economy remains in an extremely robust state and it will continue to muddle through and make progress. The danger is that growth falls below the global rate of growth and that the **economy slowly, but inexorably, falls behind the rest of the world in a Brezhnev-esque slow-moving stagnation.**

2.0 Politics

2.1 Government to take direct control of SOE investment programmes, dividend payments

Fed up with SOEs, the Russian government proposes taking direct control over their investment programmes

Fed up with the wastage and on a campaign to improve the efficiency of state spending, the Russian government has proposed forcing all the state-owned enterprises (SOE) to submit investment programmes for approval and tightening the reigns of control over its companies.

The decision was made at a meeting with Prime Minister Dmitry Medvedev on January 24, a federal official and a person familiar with the meeting participants told Vedomosti.

The new direct may include the government taking direct control over the decision on setting dividend payments. The Ministry of Finance ordered all state-owned companies to pay 50% of earnings as dividends as a way of collecting more revenue for the budget. However, the order has been widely ignored or dodged by some of the biggest SOEs.

"A new proposal to strengthen state control over Gazprom's capital expenditures suggests that a significant faction of interests are looking to exploit the company's frequent failures to improve revenues and effectively guarantee Novatek's dominance for future export growth, barring an expansion of pipeline capacity to China. This is significant given that Gazprom just failed to secure financing from the China Development Bank (CDB) for the construction of the Amur Gas Processing Plant, instead resorting to two-year bridge loans. China likely wanted to avoid angering the Trump administration, but it has, in effect, tightened the screws on Gazprom," Nick Trickett of BMB wrote in a note.

Though Gazprom can finance the project itself, its bloated Capex for inefficiently designed projects kills its dividends, and by extension draws the ire of MinFin and others looking to use state control to improve returns to the state budget.

"So while Germany may be helping out Nord Stream 2, it does so from a very strong negotiating position. In short, these geopolitical plays for influence many have touted for years are still blowing up in Alexei Miller's face. Any meaningful shift in oversight over spending aimed at improving dividend returns for the state's shares should influence future spending plans if adopted," adds Trickett.

2.2 Russia's austerity taking the wind out of economic sails

Both consumer and producer activity weakened in December 2018, confirming our expectations of declining support of local demand to GDP growth at least at the beginning of 2019. This year will be a test to Russia's conservative approach to fiscal and monetary policy, writes Dmitry Dolgin, the head of ING's Russia research, in a [note](#).

Consumption no longer supported by income or leverage

With the exception of the unemployment rate, which remained at a low level of 4.8%, the household activity data for December 2018 was a disappointment.

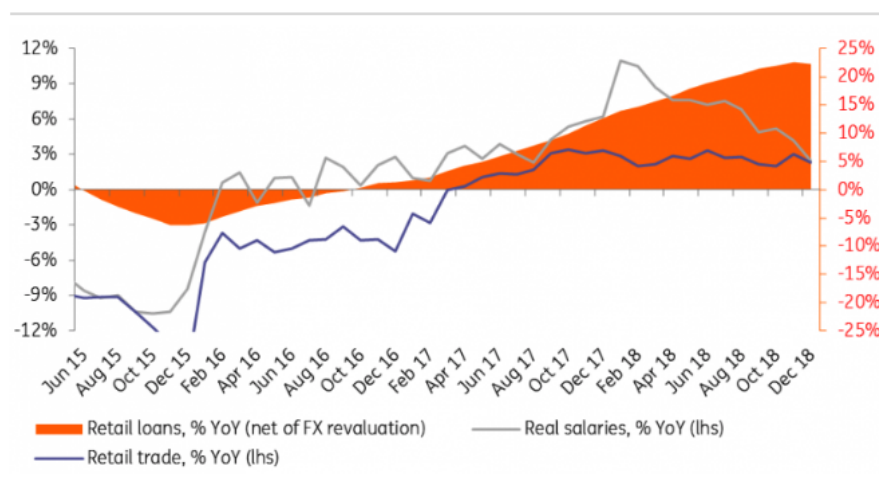
While we expected a pre-VAT hike spending splurge to keep the retail trade figures close to 3.0% y/y, the actual result was only 2.3% y/y, putting the full-year result at 2.6%. Admittedly, this number may underestimate the consumption volumes due to the growing share of cross-border internet trade (eg, AliExpress), which may not be fully accounted for in the flash statistics, however, we are more concerned with other indicators of deterioration of the income and consumption trend coming from various sources:

- The real salary growth decelerated to 2.5% y/y in December 2018 (vs 4.4% y/y consensus) from 4.2% y/y in November, which is a result of both acceleration in the CPI growth from 3.8% to 4.3% y/y and the slowdown in nominal salary growth to 6.9% y/y from 8-10% y/y in the previous months.
- Weaker income trend is confirmed by the slowdown in retail deposit growth (adjusted for FX revaluation effect) to a mere 5.5% in December 2018 vs 6-8% y/y in the previous months, as reported by the Bank of Russia (CBR).
- The retail lending growth, also reported by CBR, slowed down (for the first time in 3 years) to 22% y/y in December 2018, which might indicate declining confidence in the higher-income households.
- Consumer confidence indicator reported by inFOM pollster dropped to 89 points in December from the 91-93 range seen throughout most of 2H18 and 106 at the beginning of last year.

Consumption is expected to further deteriorate in 2019 for the following reasons:

- VAT has been increased from 18% to 20%, excise on a number of products, including gasoline, have also been increased, and the ability of retailers to sacrifice margins in favour of consumers is under question.
- The amount of duty-free imports for individual consumption has been halved to EUR500 per month, making bargain non-food purchases from cross-border e-shops (eg, AliExpress) more expensive.
- Real salary growth is unlikely to repeat this year's good result of 6.8% y/y in real terms due to the end of the electoral cycle and the likely acceleration of the average inflation of 2.9% in 2018 to 5%+ in 2019F.
- The increase in the retirement age effective this year should boost Russia's officially employed population by 2mn people (+3%), but as according to official statistics around 9mn Russians above the current retirement age had remained employed, the effect on total household income (official and unofficial) should not be large.
- The support to consumption from retail lending growth should decline due to CBR's further tightening in risk requirements starting 1 April.

Key indicators of the Russian consumer trend



Source: State Statistics Service, Bank of Russia, ING

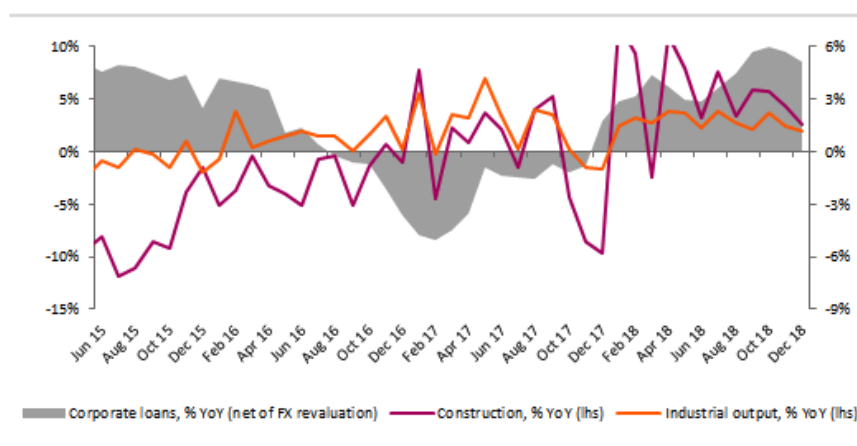
State investments fail to translate into broad-based corporate activity

Corporate activity also disappointed in December.

- Industrial output showed surprising deceleration to 2.0% y/y in December, down from 2.4% y/y in November and below the 2.5% y/y consensus. As we had predicted, industrial production managed to receive support from commodity extraction and energy distribution sectors, however, this was offset by stagnation in the manufacturing sector.
- Construction growth, which is an indirect indicator of investment activity (which is now reported only on a quarterly basis), was reported at 2.6% y/y in December, down from 4.3% y/y in the previous month and below 3.3% y/y consensus forecast.
- We note that the State Statistics Service (Rosstat) has significantly upgraded the previous 2018 dataset for construction, resulting in +5.3% growth in 2018 vs just 0.5% y/y reported earlier for 11M18. Given the 5.5% share of the construction sector in the Russian GDP, such an upgrade may statistically add up to 0.3 pp to the 2018 GDP growth, likely resulting in outperformance of our 1.6% forecast for 2018. However, the upgrade seems to reflect the completion of large state-sponsored infrastructure projects at the beginning of last year, which does not improve the 2019 expectations, if not worsening it due to the higher base effect.
- The weakening of corporate activity at the year-end is also confirmed by the slowdown in corporate lending growth (adjusted for FX revaluation effect) to 5.1% y/y in December from ~6% in the preceding months.

Overall modest performance of industrial and construction at the year-end, as well as weak corporate lending growth, suggest that large investment projects in 2018, including construction of infrastructure for the Football World Cup 2018, construction of the Kerch Bridge and Power of Siberia pipeline fail to translate in a broader-based recovery. For 2019, we expect producer activity to remain restrained by higher taxation in the oil and non-oil industry, extension of the OPEC+ agreement prescribing further cuts in oil production, worsening in the global growth outlook, persistent sanction risks and tightening in the monetary policy.

Key indicators of the Russian producer trend



Source: Bank of Russian, State Statistics Service, ING

2.3 Sales of newly launched Yandex smartphone flop

Russian Internet powerhouse Yandex has suffered a rare defeat after its attempt to break into the smartphone business fell flat

on its face.

[Launched](#) in December to much fanfare, the Yandex.Phone sold less than 500 units as of January 20, according to the GfK market research company, Vedomosti reported on January 31.



The biggest player in Russia's online ecosystem and the most valuable Internet company in Europe, Yandex was hoping to support its core business by selling smartphones that came with a package of Yandex services and apps pre-installed, including "Alice," the listening smart assistance and Russia's answer to "Alexa."

Real incomes in Russia have been shrinking but the process of people upgrading to better smartphones continues where sales of handsets remain strong.

After investing millions into developing the phone the company reported that it had sold only 450 units through retail chains as of January 20, according to GfK.

The company started offering the phone in its own online stores on December 6 last year and launched it in the major consumer electronic stores the next day at the start of Russia's busiest shopping month.

The cost of a phone was set at a competitive RUB17,990 (\$275).

Yandex also offered other perks such as a six-month subscription to its premium services online, discounts on its taxi hailing service Yandex.Taxi, a subscription to its streaming offering Yandex.Music and films in Kinopoisk, free food delivery, and a 10% cashback on purchases paid via Yandex.Money.

Consumers were not impressed. However, sales may have been a bit higher as the GfK statistics does not take into account the main sales channel, which is Yandex's newly launched Beru.ru that is the first online shop to be launched on [Yandex.Checkout](#), a retail platform the company is developing with Sberbank and will be ramped up this year. Yandex.Checkout is intended to be a Russian amazon.com.

Yandex itself did not comment on the actual number of sales, and the leading consumer electronics stores that carry the phone wouldn't comment either.

Research by Mobile Research Group estimates that some 400 units were sold through Beru.ru and another 1000 units have been sold via the retail outlets by the middle of January, reports Vedomosti.

Experts believe that launching in December was a mistake as other producers typically drop prices at this time of year to catch the New Years shopping rush, whereas Yandex offered its phone at full price. (Orthodox Russia doesn't really celebrate Christmas and New Years Eve is the big winter holiday that includes gift giving.) At the same time the advertising campaign to support the phone ended in January when typically there is a post-holidays wave of smartphone purchases in the annual sales period.

February and March will also be tough months as Chinese manufacturers are due to present their new product lines on the Russian market. To be successful the Yandex phone needed to either compete on price or to offer a unique service or feature and the phone does neither.

This was not the first attempt by a Russian firm to break into the

smartphone market.

Russian internet provider Yota launched its Yota smartphone in 2011, which did have a unique feature: two screens. The front of the phone is a regular phone screen, but the back of the phone was an e-ink screen typical of e-Book readers like Kindle.

The second generation of the phone was launched in 2014 in Europe, Asia and the Middle East and costs around \$500. Its main difference from the previous model is that its second screen is touch-sensitive, can send text messages, respond to calls and perform other basic operations. A third generation of the phone came out at the end of 2017.

However, sales of the Yota phone have also been disappointing and with a price that is twice that of the Yandex phone, they are considered expensive on the Russian market.

Yota [sold a 65% to Hong Kong-based REX Global Entertainment Holdings](#) in the maker of the double-screened for \$100mn in October 2015 and the company is concentrating on building up a customer base in China.

2.4 Russia to spend RUB26 trillion on National Projects

National projects will cost RUB26 trillion. The government has published key indicators for its 12 national projects along with their outlays over the next six years. The total will run at RUB25.7 trillion (\$391bn), of which RUB13.1 trillion (\$200bn) will come from the federal budget, RUB7.5 trillion (\$114bn) from non-budgetary sources, RUB4.9 trillion (\$74.6bn) from regional budgets, and RUB147.8bn (\$2.3bn) from federal extra-budgetary funds.

What is astonishing about the numbers released by the government is just how much money will go toward infrastructure. The two largest national projects, costing 40% of total outlays (i.e. \$170bn), both concern transport infrastructure.

Putin's May decrees in a large part arose from Alexei Kudrin's calls to invest more in developing Russia's human capital. And while demography and health will receive fairly large outlays—the government plans to spend RUB969bn (\$14.8bn) on the fight against cancer—education and R&D both appear somewhat overlooked. The government seems to be prioritizing large-scale investment projects—an easy boost to GDP numbers and a great flow of rents to insiders—over investing in Russia's people.

Russia's National Projects RUB

Comprehensive infrastructure development	6.35 trillion
Safe and high-quality roads program	4.78 trillion
Ecology	4.04 trillion
Demography	3.1 trillion
Health	1.72 trillion

Digital Economy	1.63 trillion
Housing and urban environment	1.066 trillion
International cooperation and exports	956.8bn
Education	784.5bn
Science	636bn
Support for SMEs and entrepreneurship	481.5bn
Culture	113.5bn

2.5 Kiosks are back as SMEs come into focus

In the first years following the collapse of the Soviet Union kiosk sprouted up in cities across Russia like mushrooms after the rain. With most of the big Soviet stores bankrupt the kiosk became the main conduit of retail, stocked by the “suitcase traders” (individuals that flew abroad and filled their suitcase with hard-to-find products in Russia that they sold through a kiosk).

However, as pavements became ever more crowded by unregulated kiosks that of course never paid a penny in tax eventually the authorities turned on them. Mayor Yuri Luzhkov took the first swipe at kiosks in the 90s and even the new mayor Sergey Sobyenin was still bulldozing kiosks only last year.

However, on February 11 Russia’s Deputy Minister of Production and Trade Victor Evtukhov made upbeat comments on the rollout of smaller formats retail formats as part of the government drive to encourage the growth of small and medium-sized enterprises (SMEs). It seems that the kiosk is back.

The government is hoping making it easier to get into retail easing the restrictions on kiosks will increase retail trade turnover, lead to a diversification of distribution channels for suppliers, an increase in taxes, and could create up to 250,000 new jobs, Evtukhov said.

The explosive growth of Russia’s supermarket chains has come to an end as [organised retail starts to run up against structural constraints](#). The leading chains have switched from expansion to grab more market share to improving profitability and have even begun to close some of their more unprofitable stores.

2.6 New round of US sanctions looms

Sanctions are back. There were four rounds of sanctions in 2018 that clearly did a lot of damage to Russia’s business and investment case, but ultimately

they failed to produce their advertised goal: force the Kremlin to change its aggressive ways.

As the year came to an end there was a hiatus as the last round of new “crushing” sanctions, due at the end of last year, were postponed due to the US mid-term elections. This week the US government has picked up the ball again and is revving up to target more oligarchs and leading Russian companies in retribution for interfering in the 2016 elections and Russian aggression in the Sea of Azov in November.

Five US senators from both parties on Wednesday evening [announced](#) that they had submitted a bill called the Defending American Security from Kremlin Aggression Act (DASKA). It is intended to increase economic, political and diplomatic pressure on Russia “in response to its interference in democratic processes abroad, its disastrous influence in Syria and aggression against Ukraine, including the incident in the Kerch Strait,” the Senate Foreign Policy Committee said in a press release.

These are the toughest sanctions of all proposed so far, said Republican Lindsay Graham: “Our goal is to change the status quo and introduce significant sanctions and measures against Putin’s Russia. He must stop interfering in the US electoral process, stop cyber attacks on the American infrastructure, withdraw Russia from Ukraine and stop efforts to create chaos in Syria.”

Western diplomats, especially those in Europe, have been disappointed in particular by the Kremlin’s refusal to release sailors from three Ukrainian naval ships that were arrested during [a naval clash between Russian and Ukrainian ships on the Sea of Azov](#) on November 25.

The ruble and equities tanked on February 13 as news broke the US Senate has introduced new sanctions legislation that is due to be heard soon.

Amongst the points mentioned in the bill are sanctions:

- against Russian banks supporting Russian actions to undermine democratic institutions in other countries;
 - in relation to investments in Russian LNG projects outside Russia;
 - in relation to the Russian cyber industry;
- against the Russian government debt;
- against politicians, oligarchs, family members and other individuals who directly or indirectly contribute to illegal and corrupt activities in the interests of Putin.

Sanctions in response to the Kremlin’s aggression in Ukraine include:

- against 24 FSB agents, who are considered to be participants in the attack in the Kerch Strait, - in response to the arrest of 24 Ukrainian sailors who are now being held in Russia;
- regarding the Russian shipbuilding industry in the event that Russia violates freedom of movement in the Kerch Strait or anywhere else in the world;
- in relation to support the development of oil resources in Russia;
- against state-owned energy projects outside of Russia.

The statement also lists other key provisions of the bill. This is NATO support (it will be possible to leave the alliance only with the support of two thirds of senators) and measures to speed up the transfer of weapons to those NATO countries that depend on Russian weapons.

It is also proposed to create several centres that would help fight with Russia and the opponents of the United States in areas such as hybrid and cyber threats. In particular, the National Information Processing Centre will have to confront disinformation and other threats from Russia to counter hybrid threats. The Department of Cyberspace and Digital Economy in the State Department will coordinate diplomatic efforts to ensure international cyber security, Internet

access and Internet freedom, etc. And the Foundation to counter Russian influence will help European countries to resist the intervention of the Kremlin.

2.7 Russia's CBR introduces, expands a P2P payment system designed to reduce Sberbank's dominance

The Central Bank of Russia (CBR) has just introduced a [Rapid Payment System](#) (RPS) that allows Russians to send money to each other using only a telephone number, but already wants to expand the system, Interfax and Finanz.ru reports, citing the CBR's First Deputy Chairperson and Head of the Fintech Association Olga Skorobogatova.

The move maybe the start of a CBR move to reduce the state-owned retail incumbent [Sberbank](#) domination of Russia's banking business and to promote a more balanced sector by introducing more competition.

The plan is designed to be a key competitive pressure to lower the interchange/acquiring costs for merchants, as an alternative to direct capping or regulation of an interchange fees. The CBR has also asked the commercial banks participating in the system to offer the service for free.

The CBR launched a test version of the RPS on 28 January, with 12 banks participating. Peer-to-peer (P2P) payments within the system are to be launched to the public from 28 February. In 2H19, the CBR plans to expand services to payments to business-to-consumer (B2C). These transactions would include a QR code-based solution similar to Alipay in China.

"Interchange fees are likely to start coming under pressure from the CBR, which is evolving as a key competitor to Sberbank (controller of over two thirds of the segment). The extension of the P2P system functionality is logical and would basically see the CBR, through its 100%-owned subsidiary NSPK, which also runs the MIR card payment system and processes all domestic card transactions, launch an 'Alipay of Russia'. Structurally for the market, we believe it means the evolution from a 'Brazil model', with an average acquiring fee of some 1.8%, to a US one, with fees of 0.8% – although not the tightly regulated European model, where fees are capped at 0.2/0.3% (Poland being a recent example). For Sberbank, it would mean a slowdown in F&C growth, to 7% YoY in 2020, on our estimates (vs. mid-teens guidance under current strategy). We have already reflected this shift in our forecasts," Svetlana Aslanova of VTB Capital (VTBC) said in a note.

Analysts say that as part of its clean up of the sector the CBR is becoming less tolerant of Sberbank's dominance – especially in fintech – and wants to broaden the market, introducing more competition.

The plans for changes to the RPS suggest that the CBR's plans for Russia's banking sector are moving into a new phase. The CBR is in the midst of a banking sector clean up that is coming into its end game as the number of banks in Russia [fell below 500](#) in November. The unofficial goal is to reduce the number of banks to around 300 – similar to Germany's banking system – but the emphasis has been on closing down dodgy and undercapitalised banks, as well as to stop the widespread stealing. As *bne IntelliNews* reported in 2017 "Russia's great daylight bank robbery," Russia's banking sector has been plagued by owners helping themselves to depositors' money by making loans to themselves.

The introduction of the RPS seems to be the first volley in a new direction for the CBR where it is concentrating on increasing the competition between the surviving banks and building a more balanced sector, where traditionally the state-owned banks have been dominant.

2.8 Putin's generous social programme launched during the state of nation speech

President Vladimir Putin offered a generous package of benefits and tax breaks to the Russian people during his “homely” [state of the nation speech](#) on February 20 as the Kremlin switches direction away from modernising its army and back to boosting the quality of life of the people.

The speech stood in stark contrast to his “[guns and butter](#)” speech a year ago, but the Kremlin is under increasing political pressure as dissent is rising in the face of stagnating incomes and slow economic growth.

The address focused heavily on supporting Russian families willing to have children and was a follow through on the Kremlin's previously very successful maternity and natal care reforms that has seen the blow to the population numbers from the 90s crisis considerably softened.

In addition the address announced measures dealing with education, healthcare, infrastructure development and other priorities of the new [May Decrees](#).

And the cost of these extra spending is relatively modest. Minister of Finance Anton Siluanov was quoted estimating the costs of the package of new measures at RUB100-120bn (\$1.5bn- \$1.8bn) annually out of total annual budget spending of around RUB16 trillion.

The sources of funding will be, “identified during the execution of the budget,” which, analysts at VTBC Capital (VTBC) believe, means that the Government expects the new spending can be covered simply by further improving tax collection efficiency as well as the reallocation of funds within the budget. Russia tax take has been rising as it clamps down on corruption and makes use of a new IT system; in 2018 tax revenues were up by a whopping 23% despite the fact that the tax burden didn't change.

Economists Alexander Isakov and Petr Grishin at VTBC laid out some of the detail of the promises in a note on February 21 which includes:

- Most of the ‘demographics’ measures will also help achieve goals set for residential construction and the cost of mortgage lending. They are as follows: First, the loosen the eligibility criteria for a means-tested benefit for the first or second birth/adoption, which was introduced in late 2017 in #418-FZ: instead of 1.5x the subsistence wage per person, the threshold has been lifted to 2x the subsistence wage. This, according to the government's estimates, would reach 70% of families having their first or second child.
- Increasing property tax breaks for families with three or more children.
- The period of subsidisation of mortgage interest at 6% for families having a second or subsequent child was extended from up to five years to the whole life of the loan.
- Also, for families having their third child, the President proposed to repay RUB450,000 of the outstanding mortgage loan.
- The wider public would receive the ability to qualify for mortgage payment holidays if a person experiences a temporary loss of the ability to service the debt consistently.
- For healthcare and educational private sector companies, the President proposed setting the 0% profit tax permanently.

- These measures are only the initial batch from a demographic support package, and might be extended in future.

2.9 Russia gets second female billionaire, Wildberries becomes the new Russian e-commerce poster-child

Moscow has more billionaires per square kilometre than any other city in Europe, but they are almost all men. Almost. But not quite.

Until this year Russia has had only one female billionaire – Elena Baturina, who made her money in Moscow's construction sector in the wild 90s.

An impressive figure and astute businesswoman, but an odd coincidence her husband was Moscow mayor Yuri Luzhkov, who also was in charge of handing out building permissions in the capital and managed a city budget the size of New York for more than decade.

Luzhkov was replaced by Sergei Sobyenin in 2010 and has since retired to Latvia where he keeps bees.

Now there is a second female billionaire, who has needed the sort of luck that made Baturina rich.

According to the calculations of the Russian issue of Forbes, the owner of Russia's largest online store of [Wildberries](#) Runet Tatyana Bakalchuk has seen her fortune rise from \$600mn last year to break the magical barrier and top \$1bn this year.



It should be emphasised that the valuation is only an estimate by the magazine as Wildberries is not a listed company (yet) and so the writers at Forbes are still guessing. But it is unlikely they are far off the mark.

The online retailer is doing very well indeed in Russia's burgeoning e-commerce sector with an audience of over 60mn people a month, \$1.7bn in revenue, and is investing into a 150% expansion of its pickup point network in 2018.

Founded by Bakalchuk in 2004 with her husband Vladislav, the company has ridden the wave of Russia's ballooning volume of online sales. Last year [Wildberries was the biggest online retailer in Russia for the third year in a row.](#)

Wildberries is expecting to earn RUB120bn (\$1.8bn) in 2018, a surge of 74% year-on-year, *Kommersant* daily said on December 17 citing the representatives of the company.

"This figure would make Wildberries the leading e-commerce operator in Russia for the third consecutive year and the largest online retailer overall," VTB Capital commented on December 17. The store focuses on non-food categories and covers 1.5mn SKUs from 10,500 suppliers, the bank said.

Wildberries expects the number of orders to almost double to 80mn in 2018, attributing the growth to expanding the assortment, including with premium brands. Analysts surveyed by *Kommersant* link the fast expansion of the online retailer to the creation of the federal delivery chain, increasing the assortment, and engaging new audiences, including TV ads.

Like many other retailers in her niche, Wildberries started out selling women's clothing from the German Otto and Quelle catalogues, but has since branched out to cover kids clothes, shoes, accessories, books, sport, electronics and home & dacha, to name a few of the categories.

Analysts say that one of the things that keeps Wildberries in the lead is the effort and investment it has put into its distribution system. The company's main rival is [Ozon Holdings](#) where growth is being held back by an inadequate fulfilment system.

And the growth in Bakalchuk wealth is unlikely to stop there. The volume of sales of Russia's e-commerce grew 19% in 2018 to RUB1.15bn (\$17.6bn) in Russian stores and another RUB348bn (\$5.3bn) that was spent in foreign online stores, up 29%.

Russia's e-commerce is only starting to mature now and still has plenty of growing room. According to research conducted by the global market research company Nielsen, [90% of Russians have made at least one online purchase in the last ten years](#) as a result of a growing consumer trust in online stores.

And according to the Russian Association for Electronic Communications, almost two thirds of the domestic e-commerce increase last year was delivered by growth at Wildberries and Ozon (might increase 70-80% in 2018) between them.

2.10 Moody's mentions "unorganized regime change" for the first time

Moody's mentions "unorganized regime change" for the first time in Russian ratings note.

For the first time, Moody's Investors Service named "unorganized regime change" as one of the risks for the Russian economy in a ratings note on February 23.

Russians are becoming increasingly disgruntled as the standard of living continues to slide. The problem is that despite a [controversial upgrade to 2.3% growth](#) upgrade and a return to profit for the leading [banks](#) and [companies](#), none of this has filtered down to street level. [Real incomes were down again slightly in 2018](#) for the fifth year on the trot.

A pessimistic mood has settled over regular Russians, who have suffered from four years of austerity as the Kremlin sanction-proofs the economy and sacrifices prosperity for security. [Trust in Putin fell to 33.4% in January](#) – a 13-year low – while those that think Russia is going in the "wrong direction" is now in the majority for the first time in years. 53% Russians said in December that they [want the government to resign](#), up from 33% in November, according

to the most recent poll by independent pollster the Levada Center.

To head off potential social protests Putin just delivered a [homely state of the nation speech](#) on February 20 that was replete with social spending problem – largely targeted at families with young children, but not only, in an effort to make a visible difference to ordinary people's lives. However, analysts remain sceptical that the Kremlin can hit any of the targets it is proposing, summarised in the [May Decrees](#) and more disappointment could threaten the incumbents.

Moody's agency analysts noted the growing dissatisfaction of Russians with the political system and possible problems with the transfer of power due to "Putin's dominance" when (if) he steps down in 2024 as the Constitution demands.

But they added a violent change of regime is a long-term risk, and in the near future Russia will be more harmed by stagnation due to state domination in the economy and new US sanctions, the introduction of which Moody's does not doubt.

The transfer of power to the new leadership will complicate the dominance of Putin in Russian politics, analysts of the agency write, as cited by The Bell. Russians are dissatisfied with the current political system: this is indicated both by the results of opinion polls and the results of the last regional elections, where even the presidential appointees were hard to mobilize the electorate, according to a Moody's report.

The dominance of the public sector, which Moody's estimates at 40–50%, impedes the growth of investment and productivity, creates unequal conditions for business activity, aggravates the situation with the right of ownership and the rule of law. The state's pre-eminence is especially noticeable in public utilities, mining, transport, finance, electronics and equipment manufacturing. A separate problem is the low quality of Russian institutions: endemic corruption and the weak rule of law, an ineffective judicial system and a significant influence of the authorities on the business environment.

Moody's notes separately the risks for the strong Russian IT sector, which from 2008 to 2018 enjoyed a 2.5-fold increase in exports of computer and IT services. According to analysts, "government intervention, which ranges from the alleged involvement of cybersecurity firms in espionage to the forced transfer of control over successful startups to people close to the government, threatens its viability.

Moody's has no doubt about the introduction of new "crushing" sanctions against Russia that were delayed by Washington last year. These may include sanctions against specific oligarchs close to the Kremlin, their enterprises, structures involved in the construction of the Nord Stream 2 gas pipeline, the new and existing sovereign debt and dollar settlements of Russian state banks.

Sanctions could disrupt the auctions by the Ministry of Finance of its workhorse OFZ bonds and impair the government's ability to finance itself. That would lead to a "structural gap" on the public debt market and the depreciation of securities. If public finances deteriorate due to unexpectedly harsh sanctions, Moody's could lower Russia's credit rating, the agency said. But the negative effects will be temporary, experts say: sanctions will can damage the key elements of the Russian loan portfolio, which is in a robust state. Putin announced, for example, in his February speech that Russia can cover its external debt dollar-for-dollar with cash now for the first time ever.

The consequence of fears of external shocks is capital outflow, which Moody's calls the main external risk. [Russia has seen over \\$500bn leave the country](#) since 1994 and enjoyed net inflows for only two years – in 2006 and 2007 at the height of a boom.

In the last few years Russia has been losing a modest \$20bn a year, but in 2018, capital flight began to accelerate again due to investors' fears of external shocks. The current outflow is unlikely to reach the highs of 2014, but new sanctions and other external shocks can accelerate it.

The demographic decline is another key internal risk: a reduction in the number of the working-age population while simultaneously the baby boomers from the 1960s starts to retire, restrains economic growth. In 2018, for the first time in a decade, the influx of migrants did not compensate for the natural decline in population, down by 93,500 people. Labour shortages can be mitigated attracting migrants from Central Asia and Ukraine, attracted because of socio-economic instability and military conflicts at home.

The closer the year 2024 comes, the greater the uncertainty over the transfer of power and the more that will concern business. Moody's first mention of an unorganised change in regime is the signal of the related problems, suggests The Bell: the countdown begins. In the meantime, news of new sanctions will remain the main market-moving news.

2.11 Russia prepares its third tax amnesty

On February 6, 2019, President Vladimir Putin proposed to extend capital amnesty for at least a year. This will be Amnesty 3.0.

As before, its goal is to create conditions for legalizing business and reducing the shadow economy, as well as repatriating capital and increasing investment in the Russian economy.

The first capital amnesty, Amnesty 1.0, was officially held in Russia from July 1, 2015 to June 30, 2016, but in fact was extended until December 31, 2015 and then extended again for another six months.

The initial amnesty required the repatriation of property located in countries that do not share information with Russia, but the requirement for repatriation was subsequently abolished. About 7,200 special declarations were filed during the first stage, which was less than expectations.

There are an estimated 100,000– 150,000 dollar millionaires, which is the “target audience” of the amnesty, [Vedomosti reported](#).

The first capital amnesty was extended for the period from March 1, 2018 to February 28, 2019 by Putin's orders. The conditions of the second version were a repeat of the first with some changes in favour of the declarant.

Amnesty 2.0 allowed individuals to voluntarily declare real estate, vehicles, securities, accounts in foreign banks and controlled foreign companies (CFC), which freed them from tax, administrative and criminal liability for tax evasion and customs duties, as well as for non-compliance with the requirements of legislation on currency regulation and currency control in respect of the property (sources of its acquisition), bank accounts and the CFC indicated in the declaration.

The declarant could be any individual, restrictions on citizenship and tax residency were absent. This amnesty applies to acts committed before January 1, 2018, with the exception of violations of currency legislation.

In addition, taxpayers are exempt from collecting taxes related to the acquisition, use or disposal of property or the CFC, as well as crediting funds to foreign accounts specified in a special declaration (with the exception of taxes payable in relation to profits and assets of the CFC), if the obligation is tax payment has arisen before January 1, 2018 There are no official data on

the number of special declarations submitted under Amnesty 2.0. However, law firms report they saw a significant increase in interest in the declaration from our clients. Ironically the threat of new US sanctions that target commercial Russian firms was driving more Russians to repatriate their money.

Another reason was Russia's accession to the international automatic exchange of information on financial accounts, the first data set for, which has already been received by the Federal Tax Service at the end of 2018. This exchange implies that Russia will receive information not only on personal accounts of Russian tax residents in foreign banks, but also on the accounts of companies whose beneficiaries are tax residents of Russia. In the context of global informational transparency and international cooperation in this area, hiding foreign assets by legal means becomes almost impossible.

To build up trust, the special declarations are transferred for centralized storage to the Federal Tax Service, and the information contained therein constitute a tax secret. Other state bodies are not entitled to access them, and the special declaration and documents attached to it can be requested only at the request of the declarant himself. The fact that the declaration was submitted, as well as the information contained in it, cannot be used as a basis for initiating a criminal case, proceedings in an administrative or tax offense case.

The last day of the Amnesty 2.0 is February 28, 2019.

2.12 More details released on Russia's new hypersonic missiles

In Vladimir Putin's sixteenth State of the Nation address he said Russia is prepared for a present-day version of the Cuban Missile Crisis and heralded a laundry list of capabilities that comprise Russia's "high-tech breakthrough in defence." Less than a week later, a state-sponsored television program broadcast a map of US targets that, in a nuclear conflict, Russia could strike with one of these weapons.

That weapon is the Tsirkon, a hypersonic missile designed for use against land and sea targets. It can be launched from submarines, bombers, and surface naval vessels. With a top speed of 9,800 kilometers per hour—"hypersonic" means travelling over five times faster than the speed of sound—the Tsirkon could hit any of the US targets within minutes. The Tsirkon and the other weapons on Putin's list seem designed to overcome the US missile defence system, which is a source of deep concern to Moscow. That concern has driven Russia's large-scale upgrade of its strategic forces over the past decade.

Here are three weapons that top the list:

Avangard

Avangard is a strategic hypersonic glide vehicle that launches from an intercontinental missile. The system's ability to travel both laterally and vertically will help it defeat missile defences. In fact, US Air Force General John Hyten has said that the United States has no defence system capable of intercepting this type of weapon. Russia likely will begin deploying Avangard in 2020. If that date sticks, Russia would beat out China and the United States to be the first country to deploy a hypersonic, nuclear-capable, boost-glide weapon.

Sarmat

Sarmat is a new silo-based, liquid-fuel intercontinental ballistic missile (ICBM) designed to replace two retiring Russian ICBMs. Equipped to carry over ten multiple independently targetable reentry vehicles (MIRVs), and with a virtually unlimited range, Sarmat is aimed at thwarting US missile defence systems.

Russia will deploy two missiles starting in 2021, and will possibly fit the missiles with the Avengard warhead. If that happens, it would make Sarmat even more powerful against missile defence.

Poseidon

Poseidon is the first of its kind and the largest torpedo ever built. Designed as a second-strike capability, the Poseidon is known (terrifyingly) as the 'tsunami apocalypse torpedo'—perhaps because of its almost unlimited range and high explosive power. The weapon is an intercontinental, underwater attack drone that is nuclear-powered and nuclear-capable. Poseidon's top speed is 80 miles per hour, making it almost impossible to intercept with defensive capabilities. Thirty-two Poseidons will deploy in the late 2020s.

2.13 Watcom Shopping index off to a slow start in 2019

Watcom shopping index starts 2019 on a low note, outlook for shopping in malls remains subdued

Russia's Watcom Shopping index got off to a lacklustre start in 2019, repeating the lower levels of foot traffic in Moscow's leading shopping malls that were seen last year. If the trend continues then the index suggests there is a permanent reduction in volumes of shoppers visiting big malls as other distribution channels eat into traditional organized retail's share of the market.

The holiday shopping season gave Moscow's leading malls a boost in December, but overall traffic in the leading malls in 2018 was the lowest since the index was established in 2014.

Malls are having to make more of an effort to attract customers, using events and targeting families with offers of childcare and entertainment to pull the punters in. Having picked the US Thanksgiving "Black Friday" idea, in Moscow this was extended to "Black December" with a whole month of discounts and specials, that lifted traffic somewhat. But overall the Watcom Shopping Index in 2018 was down by 5.2% compared to 2017.

In the first week of this year the index, which uses mall's security cameras to count the number of visitors in real time, was 476, slightly down from 2018 and 2017 (495, 496) but well down on the numbers of visitors in 2014 and 2015 (665, 608).

Traffic in the malls is traditionally very weak in January as Russians enjoy a holiday season that runs until January 14 when they celebrate "Old New Year" according to the Gregorian calendar, which is used to calculate religious holidays. As the Watcom index shows shopping picks up again as Russia moves into a series of spring holidays, including Maslenitsa ("Butter/Pancake week", or the spring rites of Shrovetide), International Woman's Day (March 8), the long May Day holidays (May 1-8) and Orthodox Easter, a moveable feast.

The shopping Index in January ends in Moscow with a slight increase +0.7%, while the growth in St Petersburg was strong, up 2.6% in the same period.

Watcom's CEO Roman Skorokhodov said: "The shopping index normally decreases after Christmas spending, where it rose by 3.3% in Moscow on the eve of the New Year, and by 5.9% in St Pete. But this slight growth in January that didn't even reach 1%, does not change the whole picture of the consumer behaviour. Growth by 2.6% in St Pete is due to the touristic traffic as all significant malls are in the centre of the city. Still this growth can be explained by the fact that many Russians did not go abroad on holidays, but stayed at home and went to the shopping centres to spend leisure time instead."

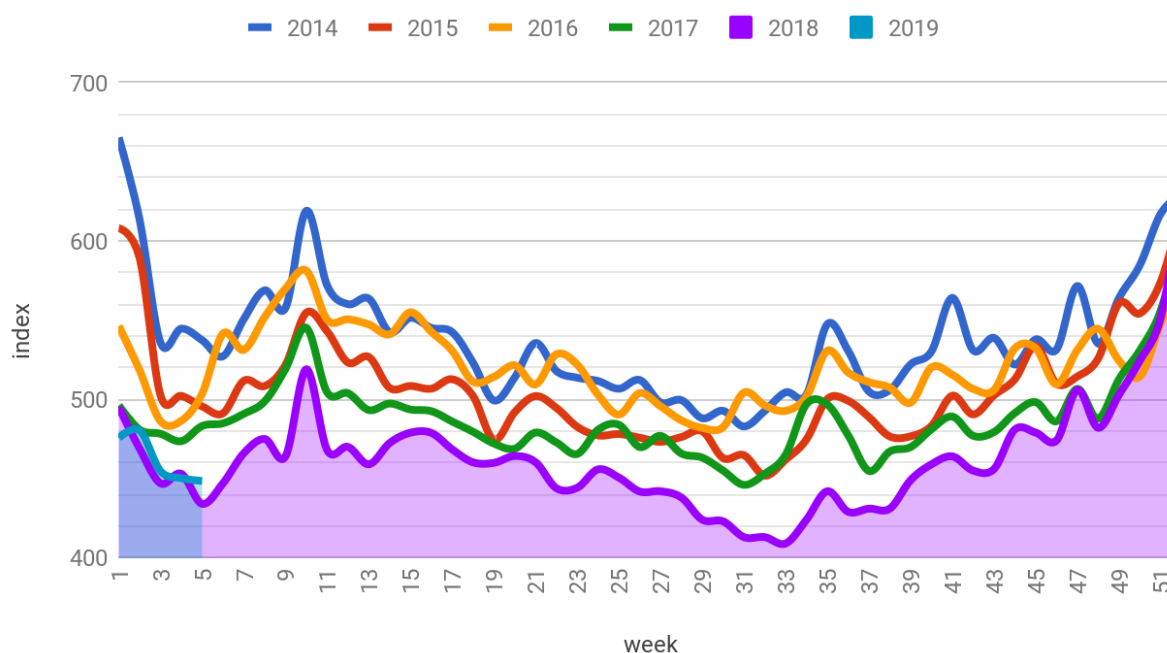
"On the whole, the decrease in traffic is dramatic since 2014 – almost 18% in Moscow and 11% in St Pete. This trend is still in force due to the continuing

decline of real incomes of Russians. Besides that, the share of online shopping in 2018 grew by 32.2% according to Romir,” Skorokhodov said.

[The volume of Russian e-commerce sales was RUB1.5 trillion \(\\$22.8bn\) in 2018](#), according to the estimates by Data Insight cited. Sales in Russian online stores increased by 19% to RUB1.15 trillion and in foreign by 29% to RUB348bn.

[Real incomes in Russia fell again slightly in 2018](#), down for the fifth year in a row.

Russia Watcom shopping index



2.14 Russian business and consumer confidence

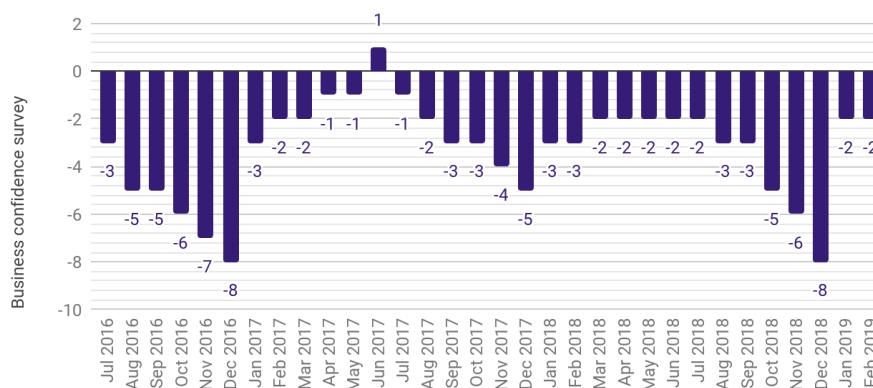
Business confidence crashed at the end of 2018, but has improved at the start of 2019. While economic growth has slowed remarkably at the start of this year business people remain remarkably confident about the rest of the year.

Manufacturers and businessmen are a lot more optimistic about 2019, despite a slow start to commercial activity in January. Russia's manufacturing PMI falls to a five-month low in February, but manufacturers are looking forward to 2019.

Russia's manufacturing sector failed to pick up any momentum and the IHS Markit manufacturing PMI fell to a five-month low in February of 50.1 in February, down slightly from 50.9 in January and just above the 50.0 no-change mark.

Despite a softer rise in new business and intense inflationary pressures, survey respondents remained upbeat that output levels would improve over the coming 12 months. The degree of confidence was the second-highest since May 2013.

Russia business confidence survey



source: Rosstat

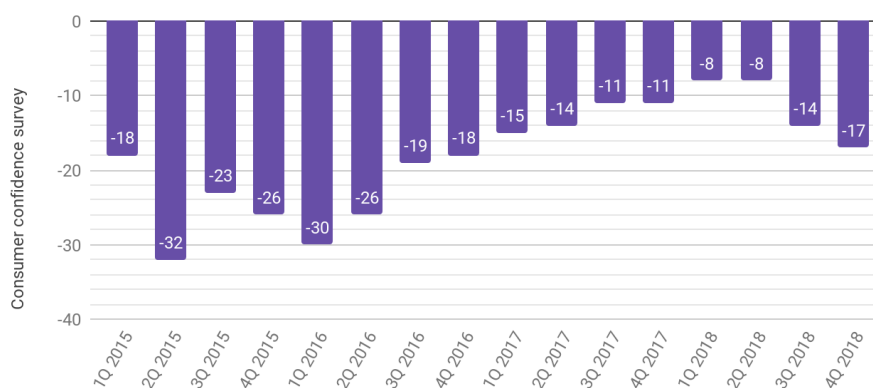
Russian president Vladimir Putin is right to be concerned about rising discontent amongst ordinary Russians. The economy is growing again and both banks and the leading corporates have returned to profit but that is not trickling down as a “feel good” factor to street level. Russia’s consumer confidence in the last quarter of 2018 fell to 17% in Rosstat’s quarterly survey – back to the levels seen during the “silent crisis” years of 2015-2016.

The fall in consumer confidence is reflected in Russia’s low retail turnover. Retail sales growth slowed to 1.6% y/y in January from 2.6% in 2018. This was tied in with nominal wage growth easing to 5.2% y/y in January from 7.3% in December, which was attributable to inflation climbing to 5% from 4.3% over the period. As a result, real wage growth sank to 0.2% from 2.9%.

It is also reflecting in the slow start to the Watcom shopping index in Moscow’s top malls which was off to a slow start in January. And it is reflected in the population’s high inflation expectations.

Putin tried to address the miasma that has fallen over the population in his [state of the nation](#) speech in February where he came with a Santa’s sack of social spending programmes, designed to make a visible impact on regular Russians lives.

Russia consumer confidence survey



source: Rosstat

2.15 Putin & government’s popularity

One in five Russians are prepared to protest with political demands,

according to a new poll by independent pollster the Levada Center released on February 12.

Some 22% of respondents are ready to participate in street protests against 77% who are not. There are fewer potential protestors than those who consider it possible to work in public organizations and political parties (30%) or as a volunteer (24%).

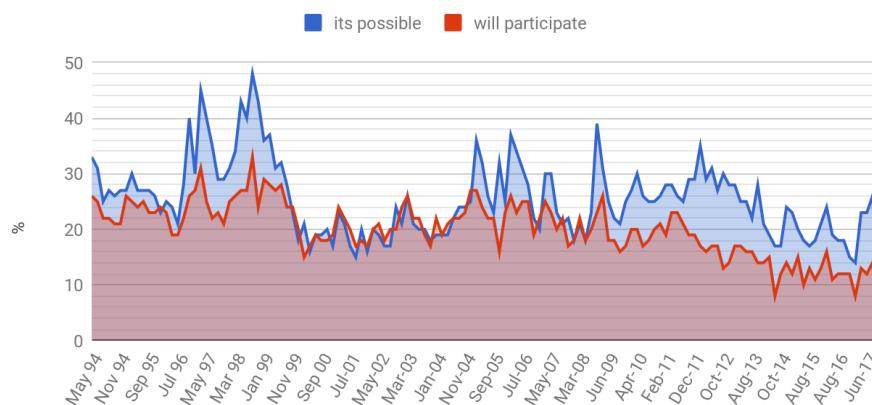
About half of the respondents expressed readiness to sign open letters and petitions (53% and 46%), as well as appeals to the executive authorities (49%). Residents of the capital are more inclined to such actions than large regional cities.

Most prefer to limit their political activity by voting in the elections - 71%, while the 29% are not ready for this, resulting RBC survey data. The survey was conducted at the end of November 2018.

However, Levada also found that the number of Russians that think the country is going in the “wrong direction” has increased again between December and January from 44% to 45%, with 42% and 45% believing the opposite, respectively.

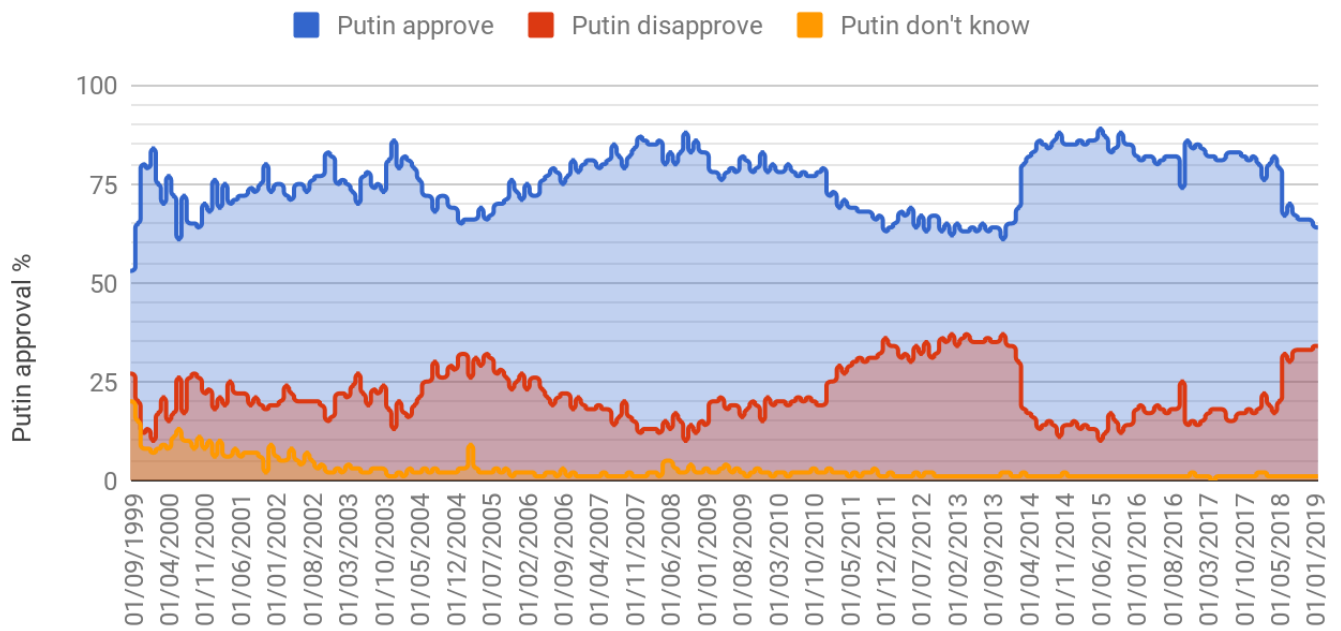
The other metrics on the performance of the government remains largely unchanged, although president Vladimir Putin’s approval rating slipped again slightly from 66% to 64% over the same time period.

Potential for protests - economic demands



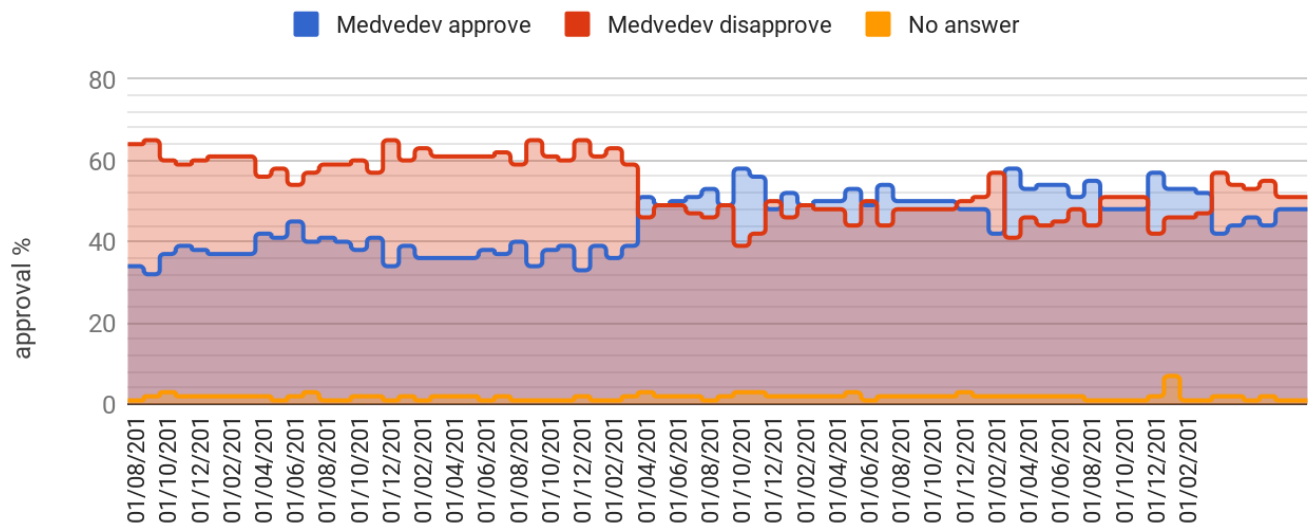
source: Levada Centre

Russia Putin's approval rating %



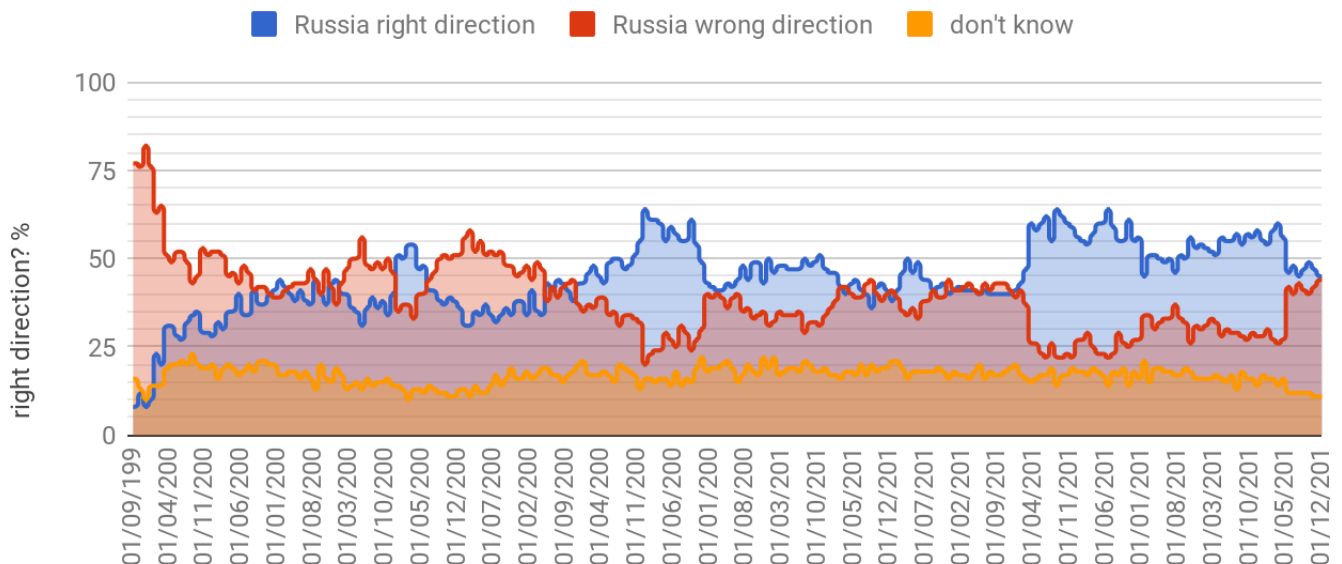
source: Levada Centre

Russia Medvedev's approval rating %



source: Levada Centre

Russia Country going in right direction?



source: Levada Centre

2.16 Politics - misc

State Duma Chairman Vyacheslav Volodin reported on the preparation of a legislative initiative expanding the powers of the Accounts Chamber of the Russian Federation to control the use of funds transferred to subsidiaries, which are created by state corporations and public law companies. The chamber is being beefed up to police the spending of Russia's 83 regions and may also be given powers to over see the state-owned enterprises (SOE) and possibility even the Central Bank of Russia (CBR). Russia's top liberal reformer ex-Finance Minister and co-head of the presidential council Alexei Kudrin was placed in charge of the Chamber last year – a measure of the new status of the organ. "In the near future, we plan to amend the Law on the Accounts Chamber of the Russian Federation and consider them in the spring session," Volodin told Interfax. The current version of the law "On the Accounts Chamber of the Russian Federation" contains restrictions that complicate the full, operational control of the use of funds by subsidiaries created with the participation of the state, Volodin explained. Experts clarified to Interfax that if the amendment is adopted, the subsidiaries of such state corporations as Roskosmos, VEB.RF, Deposit Insurance Agency, Housing and Utilities Reform Fund, public law the company "Russian environmental operator" and several other government agencies

The US Treasury Department (USTD) formally lifted the [April 6 round of sanctions](#) on the companies belonging to Russian oligarch and Kremlin insider Oleg Deripaska, but left those that target the businessmen personally in place. As part of the deal state-owned bank VTB and a big creditor of Deripaska increased its stake in his energy holding EN+ to 22.27% from 7.65%, Vedomosti reported on January 28.

Russia has performed equally worse in Transparency International's (TI) Corruption Perception Index rankings during recent years. Russia's overall point score has hardly changed since 2012. The 2018 index placed

Russia 138th out of the 180 countries surveyed, on par with Iran, Papua New Guinea, Mexico and Lebanon. Countries at the low end of the TI rankings have typically weak economic and political institutions such as judiciary, media, civil society and public administration. Denmark, New Zealand and Finland have held the top positions in TI's rankings in recent years.

Public sector corruption 2012–2018

	Score 2018	Rank 2018	Score 2015	Rank 2015	Score 2012	Rank 2012
Belarus	44	70/180	31	106/168	31	123/176
India	40	78/180	38	76/168	36	94/176
China	39	87/180	37	83/168	39	80/176
Brazil	35	105/180	38	76/168	43	69/176
Armenia	35	105/180	35	95/168	34	105/176
Moldova	33	117/180	33	102/168	36	94/176
Kazakhstan	31	124/180	28	123/168	28	133/176
Kyrgyzstan	29	132/180	28	123/168	24	154/176
Russia	28	138/180	29	119/168	28	133/176
Azerbaijan	25	152/180	29	119/168	27	139/176
Tajikistan	25	152/180	26	136/168	22	157/176
Uzbekistan	23	158/180	19	153/168	17	170/176

Source: Transparency International.

After being delayed because of the US mid-term elections, the US government is due to resume a debate about imposing “crushing” sanctions on Russia that sent stocks tumbling on February 12. Western nations are close to agreeing new sanctions against Russia in a coordinated push aimed at punishing Moscow for its aggression in Ukraine in the Sea of Azov, according to press reports on February 12. Stocks fell by 2% on the news, having already been dragged down by lower oil prices.

The European Union (EU) has agreed new sanctions against Russia following Moscow's attack of the Ukrainian Navy's boats in the Sea of Azov, Vice President of the European Commission Federica Mogherini told reporters on February 18. "I can confirm that there is political consensus on some further measures to be taken – personal, targeted sanctions," Interfax news agency quoted Mogherini as saying in Brussels. "I believe the formal adoption of the legal acts will be finalised in the coming days."

2.17 Polls & Sociology

The possibility of Russia's war with other countries is considered to be real 56% of those surveyed by the Levada Center, RBC writes, citing a study conducted in mid-December. Doubts about the reality of the military threat were shown by 39% of the respondents. The centre has conducted similar studies since 2000. The peak of fears fell on January 2015, when 68% of respondents believed in the risk of war. The survey was conducted after the annexation of the Crimea, in the midst of the conflict in Ukraine. After this, fears gradually decreased. 88% of respondents believe in the ability of the Russian army to protect the country in the event of a military threat from other states. True, among those who believe in the war, 17% do not exclude the use

of nuclear weapons in it. Three-quarters of respondents are convinced that humanity will not survive this cataclysm.

According to Rosstat, Russia's population was 146.8mn at the end of the year. However, the figure includes the 2.3mn people of the Crimean Peninsula, which Russia illegally annexed in 2014. The Russian population shrank by 0.1% last year. There were 1.6mn births and 1.8mn deaths. Russia's population shrank continuously from the mid-1990s to 2009, when the population began to grow again. 2018 was the first year since 2009 that the Russian population declined. In this decade, population growth has been driven by an increase in immigration and life expectancy. The World Health Organization reports that the current average life expectancy of a Russian woman is 77.2 years and a Russian man 66.4 years. Russia's birth rate has also declined over the past two years. In 2017, the total fertility rate was 1.62, which is typical also for EU countries and China. At the end of 2018, Rosstat forecasted that Russia's population will continue to decline slowly. By their projection, the Russian population would be 144mn in 2036. Last year, net immigration was no longer sufficient to make up for the gap between births and deaths. Rosstat says that net immigration was only about 125,000 persons, down from about 210,000 in 2017. Following the established pattern, many immigrants and emigrants are from former Soviet countries. Last year, the largest sources of net immigration to Russia were Tajikistan and Kazakhstan.

The Levada Center found in 2018, Russians have become more afraid. Fear of a world war jumped 17 points in a year to 57%; fear of stronger authoritarian policies rose 19 points in the same period and reached 36% in 2018; fear of lawlessness soared from 29% in 2017 to 51% in 2018; fear of attack by criminals increased 10 points to 39% in 2018.

For many Russians, the answer still lies in the state: another record figure is the number of people (88%) who believe a great state is "very important," while the percentage of Russians who feel a "strong hand" is always necessary jumped from 40% in 2017 to 58% in 2018.

Five years exactly after the annexation of Crimea, these data are yet another indication that **the "Crimean consensus" is over** -- a period characterized by bombastic expressions of national pride. But it's also a good reminder that we still do not know how this brief era will affect Russian national consciousness on the long term, nor what will come next.

More than half of Russians (62%) do not believe that you can conduct honest business in the country, according to the state owned pollster, the Russian Public Opinion Research Centre (VTsIOM). To the question "Is it possible today to conduct honest business in Russia, without hiding anything and without deceiving anyone," 38% answered "rather not," 24% rejected such a possibility categorically. A positive answer to the question was given by 34% of respondents. In 2017, 41% of respondents believed in the possibility of honest business, 56% experienced doubts. In 2007, these figures were at the level of 21% and 69%, respectively. At the same time, the majority of respondents treat entrepreneurs positively - 89% said so. In 2009, this figure was 79%. At that time, 13% of respondents declared a negative attitude towards businessmen, now - 6%.

3.0 Macro Economy

3.1 Macroeconomic overview

Russia puts in a moderate 0.7% growth in January from mediocre set of monthly macro results

Russia's economy put in a modest 0.7% growth in January y/y, as expectations for this year remain subdued, despite a [controversial upgrade to 2.3% growth](#) by Rosstat for the whole of 2018.

Minister of Economy Maxim Oreshkin admitted that the 2.3% GDP growth result for 2018 – a six year high — reported by Rosstat in January was “[not sustainable](#)” and “due to one-off factors.” The ministry is predicting a very unexciting 1.3% of growth for this year but hopes growth will accelerate to 3% in 2020.

Russia could grow more quickly, but the attempts by the Kremlin to [sanction-proof](#) the economy have depressed incomes, investment and the austerity has depressed economic activity.

The January set of macro data painted a dull picture of meagre or modest gains as the economic growth fails to gather any momentum. After the shock of the 2018 growth result it seems Russia is back to the pedestrian gains of the last few years. Macroeconomic data for January was in line with analysts' expectations.

Retail sales growth slowed to 1.6% y/y from 2.6% in 2018. This was tied in with nominal wage growth easing to 5.2% y/y in January from 7.3% in December, which was attributable to inflation climbing to 5% from 4.3% over the period.

“As a result, real wage growth sank to 0.2% from 2.9%. We expect real retail sales growth of 1.5-2.0% this year, which should correspond with consumption growth of around 1.5%,” Sberbank CIB said in a note.

Construction activity edged up 0.1% y/y in January, but the figure was substantially impacted by the high base effect, as growth reached 12.2% in January 2018.

“The y/y construction figure will be low in February as well, also due to the above-mentioned effect. We expect construction growth and investment activity to accelerate in y/y terms in 2H19, partly thanks to the implementation of the government's investment program,” Sberbank said.

On a promising note, freight transportation volumes expanded 2.4% y/y in January, including 2.3% growth in rail freight and 5.9% growth in the automobile transport segment, which Sberbank ascribes to a possible expansion in foreign trade.

“We reiterate our view that the economy will expand 1.5% this year -- down slightly from 2.3% growth in 2018. This will likely be driven by investment activity and foreign trade,” Sberbank concluded.

Rosstat's first GDP growth estimate for all of 2018, released on February 4, surprised both Russian and foreign analysts. Rosstat estimates Russian GDP last year grew by 2.3%. Preliminary figures for the first nine months of 2018 indicated GDP growth of 1.6%, and available monthly data indicated no significant pick-up in growth.

One factor in the higher-than-expected growth figure was a significant revision of the construction activity data. It appears that a large share of construction work at the massive LNG facility on the Yamal peninsula was only booked in the end of 2018.

Despite the positive surprise, the acceleration in growth has not been broad-based. Growth in private consumption last year slowed to 2.2% (3.2% in 2017) and growth in public consumption remained at just 0.9% (2.5%). Preliminary figures indicate that fixed investment rose last year by only 2.3% (5.5%). The positive surprise in GDP growth in 2018 was largely due to increase in net exports. The growth in the volume of exports rose last year to 6.8% (5.0% in 2017), while growth in the volume of imports slowed to 3.8% (17.4%). First estimates of GDP are, however, still subject to several rounds of revisions.

Minister of Economy Maxim Oreshkin admitted that the 2.3% GDP growth result for 2018 – a six year high -- reported by Rosstat in January was “not sustainable” and “due to one-off factors,” on February 11.

The result raised eyebrows after Rosstat, which is now under the direct control of the Ministry of Economy, [revised the construction output up](#) in 2018 and boosted the overall growth figure dramatically. As *bne IntelliNews* was one of the first to report, when economists checked the construction result against physical proxies like cement production there was little evidence to support the increase and the government has come in for a lot of flak for its “Soviet style” padding the numbers to keep the elites happy.

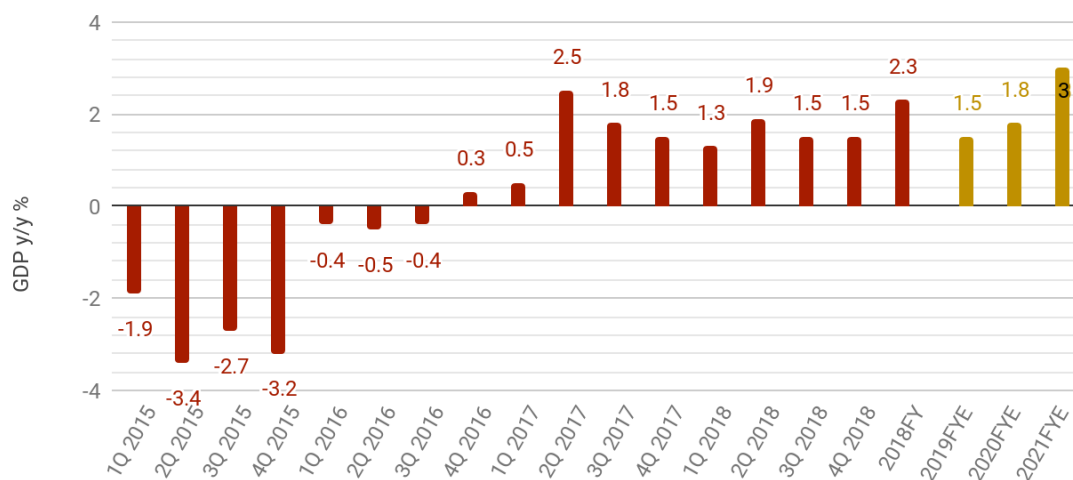
The Ministry of Economic Development acknowledged in its monthly “Picture of the Economy” bulletin that Russia’s 2.3% GDP growth in 2018 does not represent sustainable growth and reiterated its 1.3% growth estimate for this year. The Central Bank of Russia (CBR) has similarly remained bearish on Russian growth, while none of the International Financial Institutions (IFIs) have changed their forecasts.

“Oreshkin cited several one-off factors such as an increase in oil production and a dangerous boom in consumer borrowing as unsustainable sources of 2018 growth. He acknowledges that growth was “not where it can be felt by the population,” and one should not draw “global positive conclusions” from the data. The economy minister, of course, has tried to refocus the discussion on structural reforms that will guarantee Russian growth in the near future. By implementing a [massive \\$390bn investment drive via national projects in infrastructure](#), demography, health, education, and exports, Russia will attain its economic breakthrough (i.e. growth above the global average) in due time. Nevertheless, to the extent that the high 2018 GDP figures were politically motivated, the need for officials to now backtrack on the positive messaging and reaffirm reality has made the endeavour a real flop,” BMB said in a note.

The ministry believes GDP growth will not accelerate above 2% until 2021,

after a 7.6% boost in investment in 2020. Noting that in December, growth rates of industry, construction, real wages, and retail turnover slowed, the CBR reiterated its expectations that 2019 GDP growth will fall between 1.2-1.7%.

Russia GDP (y/y)



source: Rosstat, Ministry of Economy

3.2 Macro outlook

Inflation in Russia on course to end 2019 at 4.7%, says Sberbank.

Russia's inflation ended 2018 above the Central Bank of Russia (CBR) target of 4% as prices surged at the very end of the year. Inflation ended 2018 at 4.3%, jumping from 3.4% in November. However, analysts at Sberbank believe the slowing rise in wheat prices this year, less depreciation of the ruble and depressed consumer demand will hold inflation in 2019 to 4.7%.

In November there was a good chance of inflation coming in under the CBR's 4% target rate, as December's inflation usually comes in below 0.6% m/m. But in the event, it was unusually high, at 0.8%, Sberbank said in a note.

Food inflation reached 1.7% m/m in December - the highest level since February 2015. It appears that a number of inflationary factors in the food segment combined to deal a significant blow in December, Sberbank reports.

Fruit and vegetables (+8.9% m/m), eggs (+15.4%), bread (+1.1%), butter (+1.1%), pasta (+1.0%), meat and poultry (+1.0%) and milk (+0.9%) all saw a significant rise in price. For all of these items, inflation was driven mainly by ruble depreciation and rising producer costs (although the poultry segment also suffered a supply shock).

"As we have mentioned before, a 25% jump in global wheat prices last year was the main reason why food producers' costs increased, as higher wheat prices mean increased fodder costs. We estimate that ruble depreciation contributed 0.4 pp to the 4.3% inflation in 2018, while the surge in wheat prices added around 0.5 pp," Anton Stroutchenevski, Rodion Lomivorotov and Artem Vinogradov of Sberbank CIB said in a note.

At the same time relatively weak household demand affected non-food inflation. In December, for example, non-food inflation was just 0.2% m/m, while in September-November it was 0.4-0.5%.

"We expect \$/RUB to average 67 this year, so assuming that wheat price

inflation returns to the single digits and household demand growth slows somewhat, year-end inflation (adjusted for the January VAT hike) should come in below last year's 4.3%; however, taking into account the VAT hike, which will add around 1 pp, we see the figure at 4.7%," the Sberbank team said.

Fitch Ratings forecasts Russia's economic growth to slow to 1.5% in 2019 and then to modestly accelerate to 1.9% in 2020. "Fitch expects growth to slow to 1.5% in 2019 reflecting the impact of the VAT rate increase on consumption and weaker investment (especially given a higher base effect from 2018). We then expect growth to accelerate modestly to 1.9% in 2020, below the expected 3.2% for the 'BBB' median, supported by recovering private consumption and faster execution of government priority programmes," Fitch said in the report. "Average inflation will increase from the historical low of 2.9% in 2018, to 5.3% in 2019 due to a higher VAT rate, the 2018 ruble depreciation and higher inflation expectations," the credit rating agency added. "Nevertheless, Fitch forecasts inflation to return to the central bank target of 4% by 2020 in the absence of persistent effects from the VAT increase, negative supply shocks and further weakening of the ruble," Fitch noted.

4.0 Real Economy

Russia - Main Macro Indicators	2012	2013	2014	2015	2016	2017	Mar-2018
Annual GDP (y/y, %)	3.41	1.34	0.64	-3.7	-0.5	1.5	1.5
GDP (per capita) (USD)	14,079	15,531	13,873	9,055	8,759	10,743	/
GDP: Private consumption expenditure (USD mn)	1,116,950	1,214,990	1,111,244	720,256	680,455	826,389	207,035
GDP: Public consumption expenditure (USD mn)	391,097	425,831	375,081	244,282	236,063	283,696	79,723
GDP: Gross fixed capital formation (USD mn)	471,337	496,982	428,573	276,240	280,350	342,294	58,303
GDP: Exports (USD mn)	524,697	527,266	497,834	343,543	285,772	357,816	102,956
GDP: Imports (USD mn)	317,177	314,967	286,669	182,719	182,347	227,502	54,820

Source: CEIC

4.1 Industrial production

Russia's manufacturing industry grew by 2.6% in 2018, Industry and Trade Minister Denis Manturov said during the working meeting with President Vladimir Putin on February 25. According to the minister, the fastest-growing sectors were railroad rolling stock manufacturing, first of all freight stock manufacturing, and construction highroad engineering, which soared by 23%. The total growth across sectors of industry ranged from 3% to 12%, he said, adding that chemical process industry and drug production traditionally gain 10% per year.

Russia's industrial output slowed to 1.1% y/y in January from 2% in December 2018, Rosstat reported on February 18.

Despite Rosstat announcing that it would change the base year for y/y comparisons from 2010 to 2017, the data is still based on 2010 prices and is therefore comparable to earlier statistics, according to BSC Global Markets chief economist Vladimir Tikhomirov.

Russia's industrial and manufacturing activity is slowing after a relatively robust 2018, which saw industrial production growth of between 2-3% most months. But industrial activity began to fall off at the start of this year. The results were mirrored by a slowdown in the IHS Markit Russia Manufacturing Purchasing Managers (PMI), which was [only just above the 50 no-change mark in January](#).

However, in a comment for *IntelliNews* Capital Economics argued that the slump in manufacturing would be temporary and was caused by cuts to Russia's defence spending at the end of last year.

"We think that there are two plausible explanations for the weakness in this sub-sector. The first is that a fall in military spending dragged on output. Public finance figures show that consolidated government expenditure on 'national defence' fell to a near three-year low of 2.9% of GDP in December," [Capital Economics said in a note](#). "The second explanation is that the boost from a sharp rise in the production of trains in late-2017 and the first half of 2018 faded. It looks like Russian Railways added new electric trains in this period, particularly within Moscow to meet higher demand during the World Cup."

Industrial weakness driven by the manufacturing sector. All three major industrial segments demonstrated a slowdown in January: the resource industry contracted to 4.8% (from 6.3% y/y in December), manufacturing industry contracted by 1% y/y (v 0% in December), and utilities output expanded by 1.3% y/y (4.5% in December). In seasonally-adjusted terms, industrial growth slowed to just 0.1% m/m (2% y/y) in January from 0.3% m/m (2.9% y/y) in December, BCS reports.

Base factor and VAT rise are the major factors for the slowdown, according to BCS's Tikhomirov.

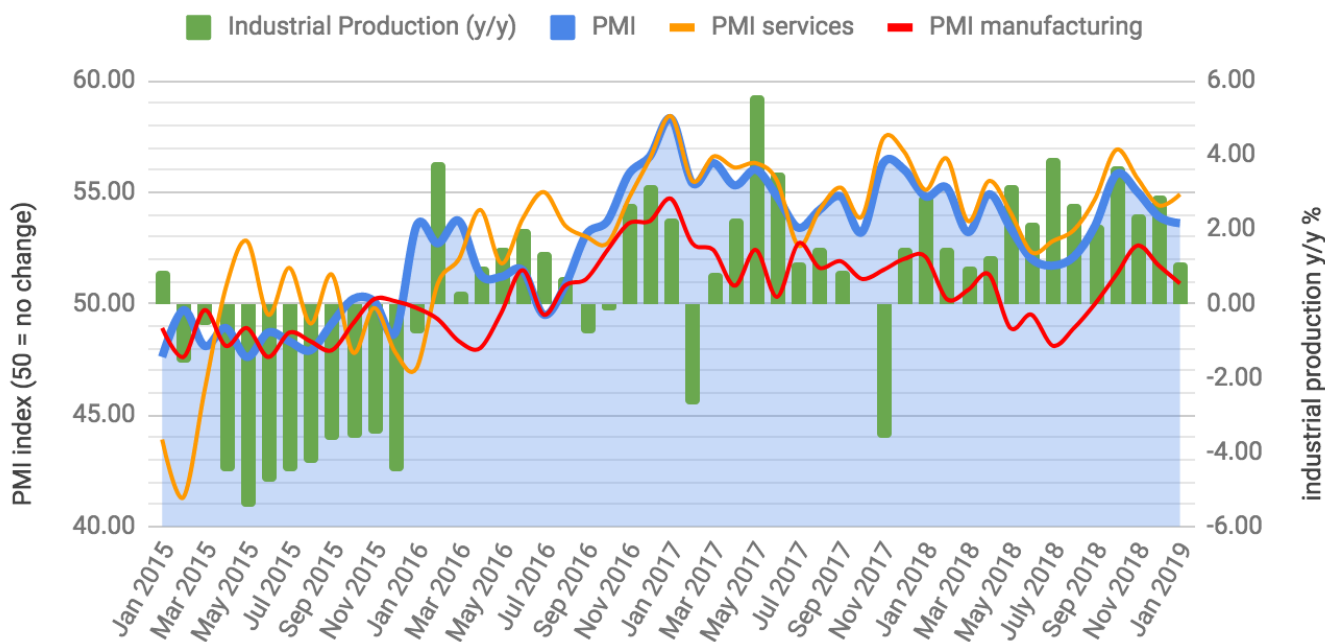
The slowdown was expected due to weaker domestic demand following the VAT hike at the start of the year. The base factor also added to industrial weakness and was triggered by OPEC+ cuts in oil output, a warmer winter and cuts in defence procurements. Softer output was seen in the food industry (meats, dairy), construction materials (which confronts Rosstat's take last year on an acceleration in construction dynamics), electronics, chemicals and automotive (car production fell by 0.1% y/y – the first decline in many months, driven by a rise in new car prices after the VAT hike). At the same time, metallurgy and locomotive production demonstrated solid gains last month.

"The first indicator of expected 1H19 weakness in the Russian economy due to the VAT rise, base factor, warmer weather and OPEC+ oil cuts. However, we expect growth in the economy to gain pace in 2H19," said Tikhomirov.

Industry is expected to accelerate in 2H19. After a rather weak start to the year, Tikhomirov expects industry to gain pace in 2H19 and to grow by an average of 2.7% y/y in FY19 (2.9% y/y in 2018).

“These estimates are based on the previous data sets; if/when Rosstat updates its statistics to include 2017 as the base year, as promised, I will have to revise my estimates as well,” Tikhomirov added.

Russia industrial production vs PMI index



4.2 Inflation

Russia's inflation in 2019 will be higher than the official forecast of the Economic Development Ministry at 4.3%, but will remain below 5%, Economic Development Minister Maxim Oreshkin said in February.

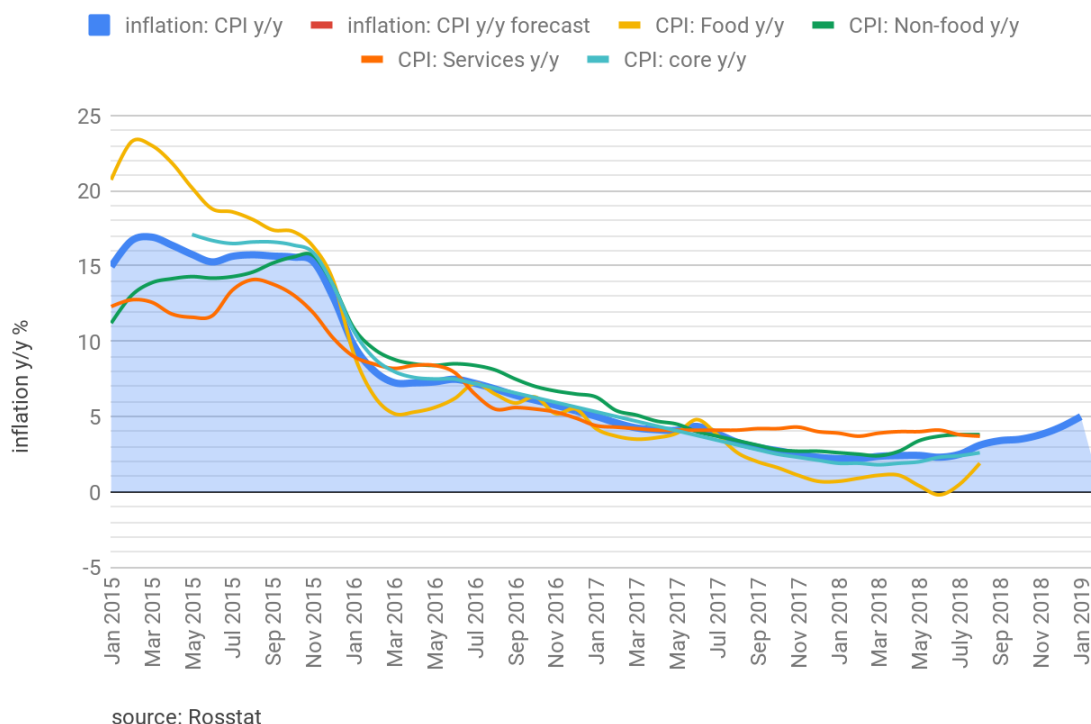
The Ministry's forecast stated that inflation in Russia in 2019 will be below 5%, while maintaining the current ruble exchange rate.

Earlier the Ministry said that inflation in Russia was expected to reach 0.5-0.6% in monthly terms in February 2019, and to accelerate to 5.2-5.4% in annual terms. The Ministry suggested that inflation would slow down to below 5% by the end of 2019 if the ruble's exchange rate remains stable.

In January 2019, inflation amounted to 1% in monthly terms, below the ministry's projections, while in annual terms it reached 5%, according to the note.

In 2018, inflation in Russia accelerated to 4.3% against 3.2% projected by the ministry in August. According to its official outlook, inflation is expected to total 4.3% by the end of 2019.

Russia Inflation components



4.2.1 CPI dynamics

Consumer price inflation rose 5.0% y/y in January. In particular, higher food prices since last summer appear to be driving inflation. Rosstat reports that core inflation, which excludes prices of food, energy and administratively regulated prices, was up 4.1% in January.

The hike in the value-added tax (VAT) at the start of this year from 18% to 20% had a lower-than-expected impact on consumer price inflation in January. It seems that the effects of the VAT hike will gradually pass-through to consumer prices over coming months.

As 12-month inflation is currently running near the lower bound of the Central Bank of Russia's (CBR) inflation forecast for this year (5–5.5% at the end of this year), the CBR left the key rate unchanged (7.75%) at its rate review meeting on February 8. The CBR expects annual inflation to settle back to its target level of 4% in the first half of 2020. However, real interest rates in Russia are still rather high as the nominal average rate for corporate loans for over 12 months hit 9.2% in December.

4.2.2 PPI dynamics

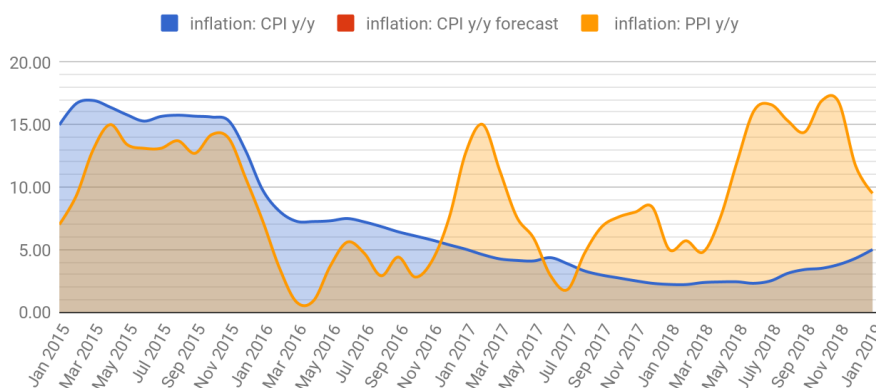
The notable development in June was the increase in the producer price index that spiked to 16.1% y/y from a years worth of single digits, a pace unseen since 2015. This uptick was driven by the rise in oil prices, as prices of oil-linked goods made up 11pp of the headline growth, according to bankers. .

Ruble-denominated oil prices started to add more visibly in April, with +45.4% y/y, while in June they surged +74.5% y/y. Given that gasoline makes up 4% of the consumer basket, and taking into account the retail price structure, bankers estimated the total effect on consumer inflation in May at about +0.5pp.

However, the basket structures of CPI and PPI are completely different. While,

for CPI, Rosstat applies the consumption structure, in the case of PPI, it uses the amount of goods produced. Given this, in a sense the PPI basket is closer to that for IP, with the weight of oil-linked industries in the basket close to 28%. It implies the contribution of oil-triggered inflation at about 11pp out of the +16.1% y/y total growth.

Russia inflation: CPI vs PPI y/y



source: Rosstat

4.3 Industrial sectors and trade

4.3.1 Producers PMI

Russia's manufacturing PMI falls to a five-month low in February, but manufacturers are optimistic about 2019

Russia's manufacturing sector failed to pick up any momentum in January and the IHS Markit manufacturing PMI fell to a five-month low in February of 50.1 in February, down slightly from 50.9 in January and just above the 50.0 no-change mark.

"Russian manufacturing firms registered broadly unchanged operating conditions in February, with the headline PMI dipping to a five-month low. Although output growth picked up slightly, the upturn in new business softened and was the slowest since last September. Moreover, foreign client demand fell further and new export orders contracted at the quickest rate since April 2017. Nonetheless, firms remained upbeat and optimism reached its second-highest since May 2013," Markit said in a press release.

Russia's industrial sector has been spluttering in 2018 and while it has made gains they are far below potential. The results have been weighed down by a number of factors, despite a [controversial upgrade to 2.3% growth](#) in 2018, the lack of private investment, soggy commercial borrowing and [real incomes in Russia fell again slightly in 2018](#), down for the fifth year in a row.

Russia's manufacturing industry grew by 2.6% in 2018, Industry and Trade Minister Denis Manturov said during the working meeting with President Vladimir Putin on February 25. And the results didn't improve in January when industrial output slowed again to 1.1% y/y from 2% in December 2018, Rosstat reported on February 18.

Production was hit again in January by a hike in VAT rates from 18% to 20% that has continued to push up input costs for manufacturers. Firms were able to partly pass higher expenses onto clients, as output charges rose at the quickest rate for almost four years, according to Markit.

On the price front, survey **respondents registered a quicker and marked rise in output charges in February**. Factory gate prices increased at the fastest pace since March 2015 as firms endeavoured to partly pass on a sharp rise in raw material costs, exacerbated by the recent hike in VAT. However, the rate of input price inflation softened from January's recent high, but was above the long-run series trend.

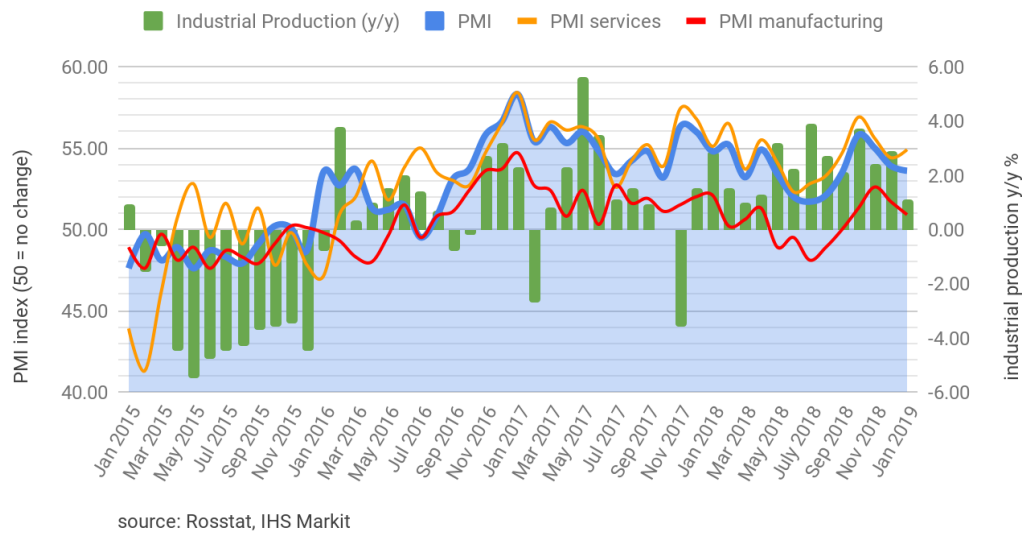
After reaching record lows in 2018 **inflation was creeping up again in the last months of 2018**, causing the Central Bank of Russia (CBR) to hike rates twice as inflation finished 2018 at 4.3%, above the CBR's target rate of 4%, and is expected to rise further in the first quarter of this year to [approximately 5%](#) before [easing again](#) in the second half of this year.

Despite a softer rise in new business and intense inflationary pressures, survey respondents remained upbeat that output levels would improve over the coming 12 months. The degree of confidence was the second-highest since May 2013.

Meanwhile, backlogs of work decreased sharply and at the quickest rate for six months. Nonetheless, manufacturers increased their workforce numbers.

Finally, contractions in buying activity and inventories quickened amid a slower increase in new orders and sharp rises in input costs Siân Jones, Economist at IHS Markit, which compiles the Russia Manufacturing PMI survey, commented: "Weaker global demand conditions and the impact of the recent hike in VAT dented growth across the Russian manufacturing sector. Although the upturn in output quickened, the rise was only fractional and operating conditions were broadly unchanged in February. New export orders took a further tumble, and declined at the fastest pace since April 2017 as weaker demand from foreign clients took hold. Meanwhile, inflationary pressures remained strong following the rise in VAT. Notably, factory gate prices increased at the fastest rate in almost four years as firms sought to pass on higher costs. Nevertheless, manufacturers were expectant of an upturn in output over the coming 12 months. Business confidence was the second-highest since May 2013, despite softer demand conditions."

Russia industrial production vs PMI index



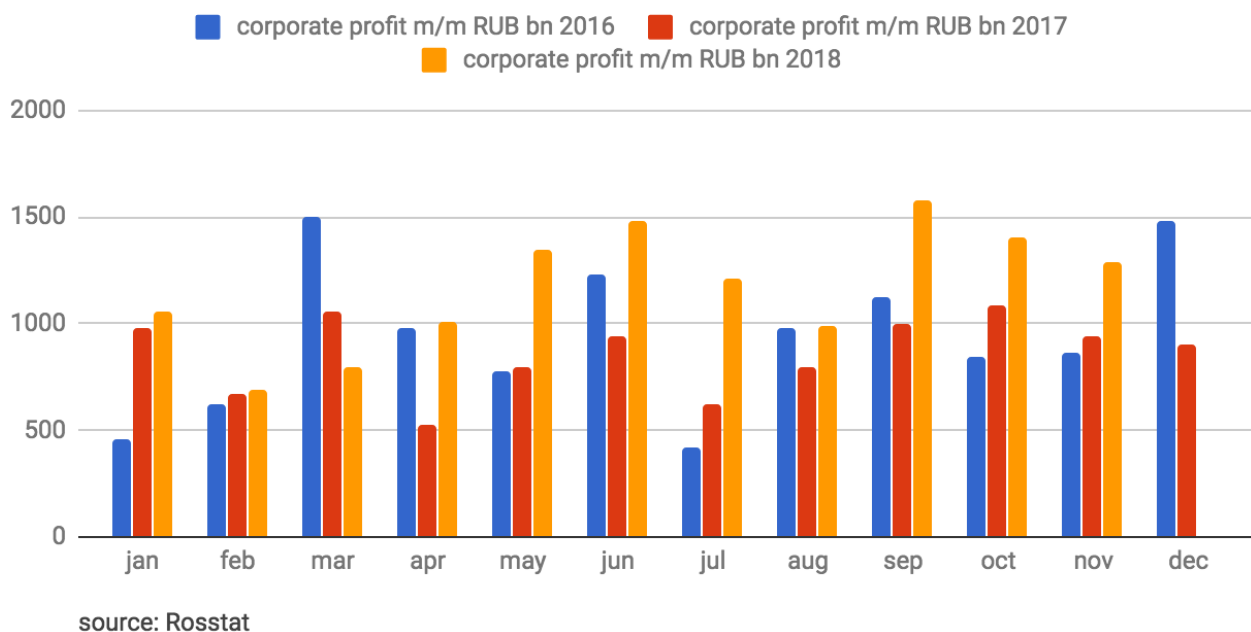
4.3.2 Corporate profits dynamics and M&A

Cumulative Russian corporate profit hit a three year high of RUB12.8 trillion (\$194.8bn) in November, or a monthly profit of RUB1.3 trillion (\$19.7bn), according to Rosstat.

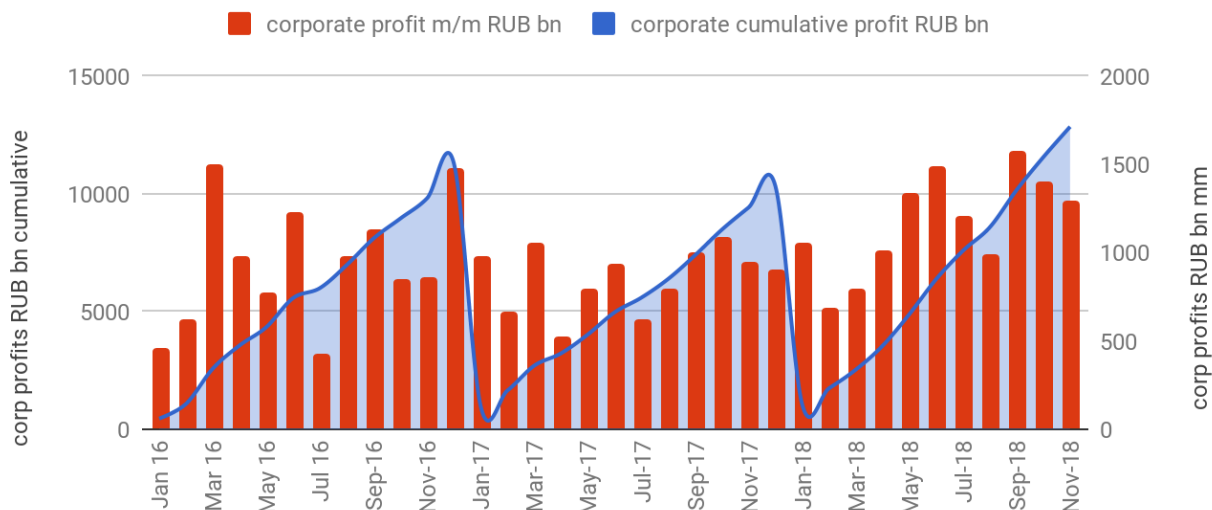
Russian companies reported better profits in 2018 than in 2017 every month of the year other than March and August.

Russia's corporate sector net profit was down 8.5% in 2017 y/y, according to Rosstat. The trend runs counter to GDP growth, which hit 1.5% last year after contracting by 0.2% in 2016.

Russia corporate profits RUB bn



Russia corporate profits RUB bn m/m vs cumulative



source: Rosstat

Ministry of Economy promises SMEs \$152bn in preferential lending The Ministry of Economic Development will restart the program of preferential lending for small- and medium-sized enterprises under the national project for the development of small business. Entrepreneurs can receive loans with a 7.75-8.5% annual interest rate as part of the scheme. Stimulating small business is a key priority of Putin's [May Decrees](#). The Russian economy remains dominated by large SOEs. The ministry's program is designed to promote SMEs – but the government has been chasing this will-o'-the-wisp for years without much luck. Part of the problem is that large companies have the means to either fight off venal officials looking for bribes, or can simply afford to pay them. Small traders operate on narrow margins and so corruption often kills their business off as they effectively become graft-slaves to whoever is in a position to extract the bribe, so they quickly give up. A recent Central Bank of Russia (CBR) reports found that state programs for preferential lending have helped decrease average rates for SMEs on the open market. However, preferential lending is not a fix-all. Truly boosting the small-business sector of the Russian economy requires structural reforms. The ministry previously ran a similar program starting in 2015, which offered preferential annual rates ranging from 9.6-10.6%. The ministry has selected 70 banks to participate in the new program, almost five times more than in its earlier version. The government will subsidize part of the rate, by 1.5-2.5% for systemically important banks, and by 1.75-2.75% for others. The maximum loan amount for a fiscal year will be RUB1bn (\$15.2mn), and the maximum loan term will be ten years. The ministry expects to issue more than RUB10 trillion (\$152bn) worth of loans under the new program by 2024; RUB1 trillion (\$15.2bn) will be offered in 2019.

Russian M&A flat y/y in 2018 on sanctions pressure. Russia had to cope with four rounds of new US sanctions in 2018 as well as unstable oil prices and a general miasma that has fallen over the population as real incomes failed to rise for the fifth year in a row.

All that hurt business sentiment and overall M&A activity in Russia was almost flat in terms of value in 2018, totalling €19.99bn across 153 transactions, compared to €20.2bn (178 deals) announced in 2017, according to Russian

The Russian story was out of step with the rest of Central and Eastern Europe (CEE), which saw M&A volumes rise on the back of booming economic growth.

The slowdown in deal making was particularly bad in the second half of 2018, which put in the lowest second half deal value result and deal count since 2002, reports Mergermarket with only €5.8bn (29% of total annual activity) across 74 deals.

Unsurprisingly the Energy, Mining & Utilities was the most active sector for deals in 2018, accounting for just under a third (29.8%) of all deals, although it too declined sharply compared to previous years, with the second-lowest annual value (€6bn) and the lowest deal count (19) since 2002 (€3.1bn, 12 deals).

The biggest deals in this sector included the Qatar Investment Authority's acquisition of Glencore's 9.18% stake in Rosneft Oil Company for €3.7bn, which accounted for 18.5% of the overall M&A value. Glencore and Qatar Investment Authority jointly bought a 19.5% in Rosneft for €10.5bn in December 2016.

Outbound deals grew to €2.27bn from 17 deals, up 169.3% by value y/y with five more transactions compared to 2017 (€843m, 12 deals).

Russia has always exported more capital than it imports as Russian businesses invest in the so-called "near abroad" countries. The majority of outbound investments were made by corporates and private investors (10 deals) while almost 60% of deals conducted by local institutional investors outside the region (seven deals) targeted the technology sector (four deals), reports Mergermarket.

Western sanctions appeared to have taken their toll on foreign investments, with inbound M&A deal count dropping to 22 in 2018, less than half the equivalent figure in 2017 (48 deals) and the lowest level since 2002 (11 deals). In particular, investment from the US and Europe has fallen to just 16 transactions, down from 36 a year prior. The largest foreign investments in 2018, including the aforementioned Rosneft deal, were conducted by Asian and Middle Eastern investors totalling €6.1bn across five disclosed deals, compared to Western companies contributing instead only €1.1bn, just over 15% of the total inbound activity.

Another function of the sanctions is the Russian state remains by far the biggest player in the M&A business. The three biggest deals, representing over 50% of the value of the top 10 biggest transactions in Russia in 2018, were all conducted by state-run companies.

Given that the share of Russia's state-owned companies in the GDP is around 50%, and the government has no plans for massive privatisation in the near term, Mergermarket says it expects the government to play an even more important role on the M&A market in 2019.

Mary Tasouli, Research Coordinator (EMEA) at Mergermarket commented: "Amid ongoing uncertainty due to high geopolitical and trade tensions, the number of deals targeting Russia declined in 2018, hitting the lowest figure

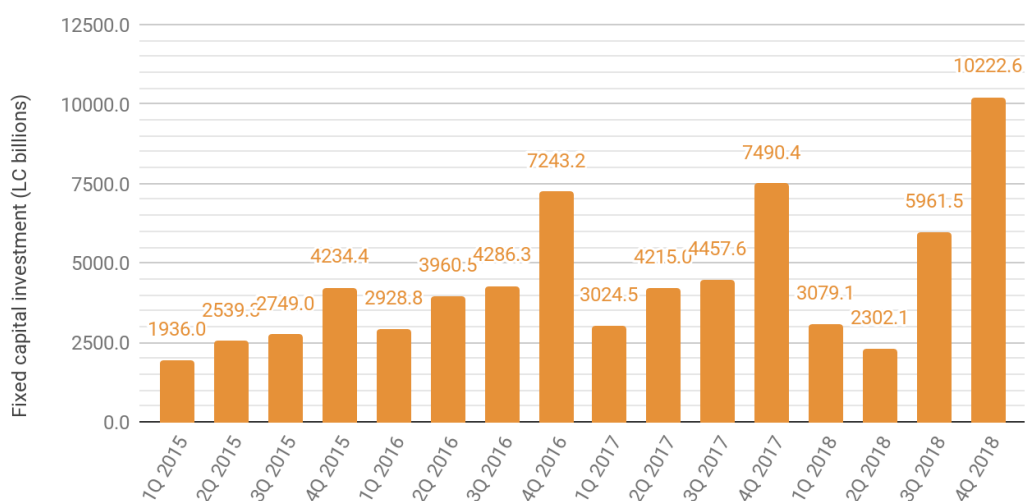
since 2003 (111 deals). Deal value however, remained steady compared to 2017 following a strong performance in the first half of the year.”

4.4 Fixed investment

Russia -Fixed capital investment	2012	2013	2014	2015	2016	2017	Mar-2018
Investment (% of GDP)	24.3	22.9	22.0	21.4	22.5	23.5	15.3
GDP: Gross fixed investment capital formation (USD mn)	471,337	496,982	428,573	276,240	280,350	342,294	58,303
source: CEIC							

Fixed investment remains low in Russia and is being mainly driven by the state owned raw materials companies and their mega-projects.

Russia fixed capital investment cumulative q/q (LC bn)



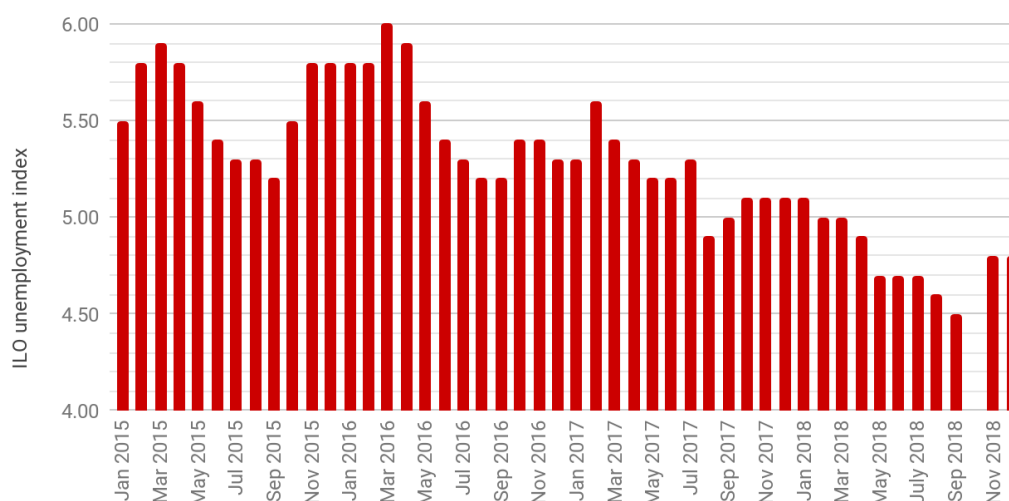
4.5 Labour and income

4.5.1 Labour market, unemployment dynamics

In the first two months of 2019, more than 33,000 people registered as self-employed, the head of the Federal Tax Service Mikhail Mishustin told the Federation Council, reports TASS. This status allows you to use the new tax regime with a reduced rate: 4% - when working with individuals and 6% - when working with legal entities. The experiment, which began on January 1, is taking place in four regions - Moscow, Moscow region, Kaluga region and Tatarstan. Citizens who do not have an employer and employees and who create a product or service independently, without intermediaries, can take advantage of the special regime. Moreover, their income should not exceed 2.4mn rubles. in year.

The number of registered unemployed Russians increased 2.3% to 746,910 people from January 30 through February 6, the Labour and Social Protection Ministry said on Monday. Unemployment grew in 80 regions, the ministry said. The number of people working part-time, in dead time or on not fully paid vacations amounted to 143,066 as of February 6.

Russia ILO unemployment index



4.5.2 Income dynamics

Real disposable incomes contracted 1.3% in January, according to Rosstat. The median of 9 economists forecast a decline of 0.9%. Wages, after adjusting for inflation, rose less than expected at 0.2% in January. Retail sales grew 1.6%, the weakest since July 2017.

“People are increasing their debt because incomes are not growing, they support consumption habits by taking out loans, the situation is close to overheating,” said Natalia Orlova, an analyst at Alfa-Bank in Moscow. “Trends for wages and incomes don’t look good.”

Real disposable incomes crept up 0.3% in 2018 after four years of declines. Retail sales rose 2.6% in 2018, as consumers boosted borrowing by 23%.

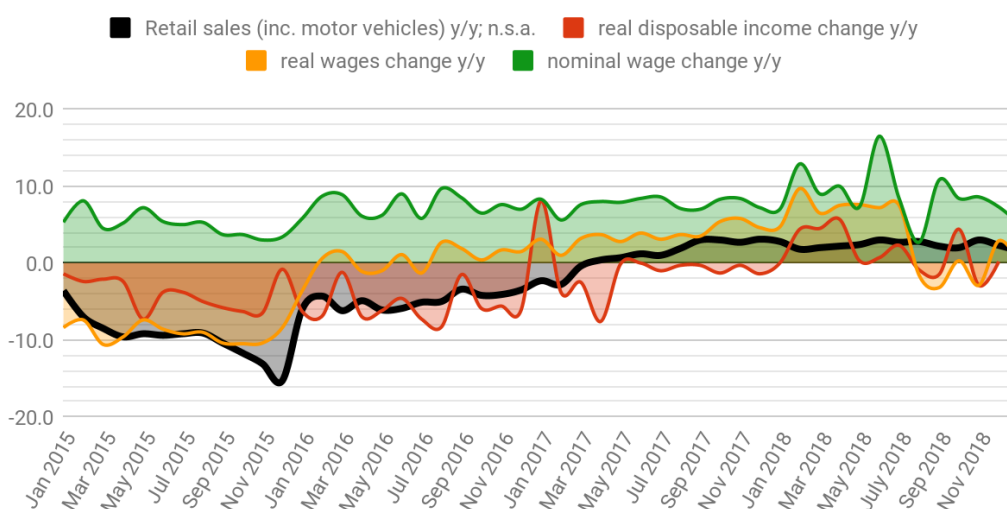
Sberbank PJSC, the country's biggest bank, reported new consumer loans hit a record last month.

Annual performance	January	December
Retail sales	1.6%	2.3%
Real wages	0.2%	2.9%
Unemployment	4.9%	4.8%
Real disposable income	-1.3%	0.1%

Source: Rosstat

The average salary in Russia in 2018 rose 10% to RUB43,400 (\$660.24), but real disposable incomes, or money adjusted for inflation that households have after paying taxes, declined 0.2% in 2018 after falling 1.2% in 2017, according to Rosstat.

Russia income vs retail sales



source: Rosstat

4.5.3 Retail sector dynamics

The volume of retail sales grew by 2.6% y/y in 2018. The pace of growth varied during the year, however, slowing to 2.3% y/y in December. After several years of contraction, Rosstat reports that the volume of retail sales increased by roughly 5% in the time period of 2017–2018.

The volume of food sales rose by 1.7% last year. The volume of retail sales increased despite lower household disposable incomes. This may be partly explained by the rise in sales of inexpensive goods as well as a distinct increase in household borrowing. The stock of household borrowing increased by 22% last year. However, most of the increased borrowing came from

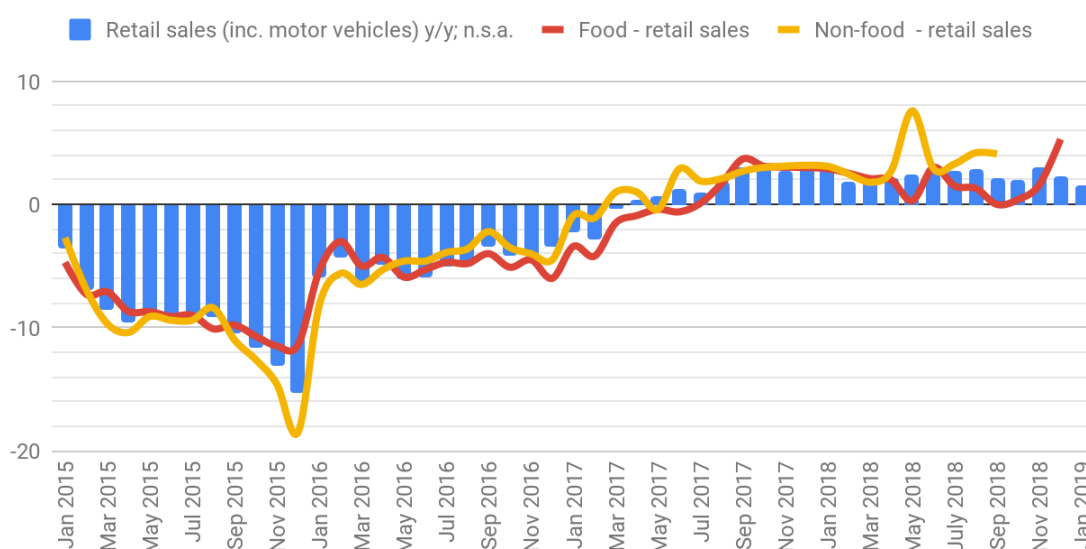
housing loans.

In January 2019, retail sales volume growth was dragged down by a general increase in the value-added tax (VAT) rate from 18% to 20%. January retail sales volumes rose by 1.6% y/y, while growth in sales of non-food goods slowed sharply to just 1.2%. The VAT rate on food was unchanged, however, and growth in food sales picked up slightly last month.

Retail sales growth slowed to 1.6% y/y in January from 2.6% in 2018. This was tied in with nominal wage growth easing to 5.2% y/y in January from 7.3% in December, which was attributable to inflation climbing to 5% from 4.3% over the period. As a result, real wage growth sank to 0.2% from 2.9%.

Sberbank expects real retail sales growth of 1.5-2.0% this year, which should correspond with consumption growth of around 1.5%.

Russia retail sales and components % y/y



source: Rosstat

5.0 External Sector & Trade

5.1 External sector overview

Russian customs reports that in 2018 the country's goods trade surplus climbed to \$212bn, or roughly 12% of GDP. Russia is now running a triple surplus again for the first time in years: trade, current account and federal budget. Both the budget and the current account surpluses are at record levels.

Russian goods exports rose by 26% from previous year. This reflects changes in both quantities and prices. Some of these may prove to be temporary. Energy prices are a major driver of fluctuations in Russia's case, Bank of

The EU accounted for 46% of Russian exports, while 12% went to China. Two-thirds of earnings from goods exports came from fossil fuels. The combination of a slight increase in oil and gas export volumes and higher world prices raised export earnings by a third. In addition to fossil fuels, there were also significant increases in exports of metals and grains. With the bumper crop of autumn 2017, 2018 wheat exports were up by a third from 2017. Russia produces about 10% of the world's wheat. In recent years, about half of Russia's wheat production has gone to exports.

The trend in exports last year was not reflected in imports. Russians spent only 5% more on imported goods in 2018 than in the previous year. Import growth was depressed by ruble depreciation of more than 10% against the dollar and euro.

About 37% of Russia's goods imports last year came from the EU and 22% from China. While half of imports consisted of machinery, equipment and vehicles, growth in the category was modest. Pharmaceuticals and foodstuffs were also important import good categories.

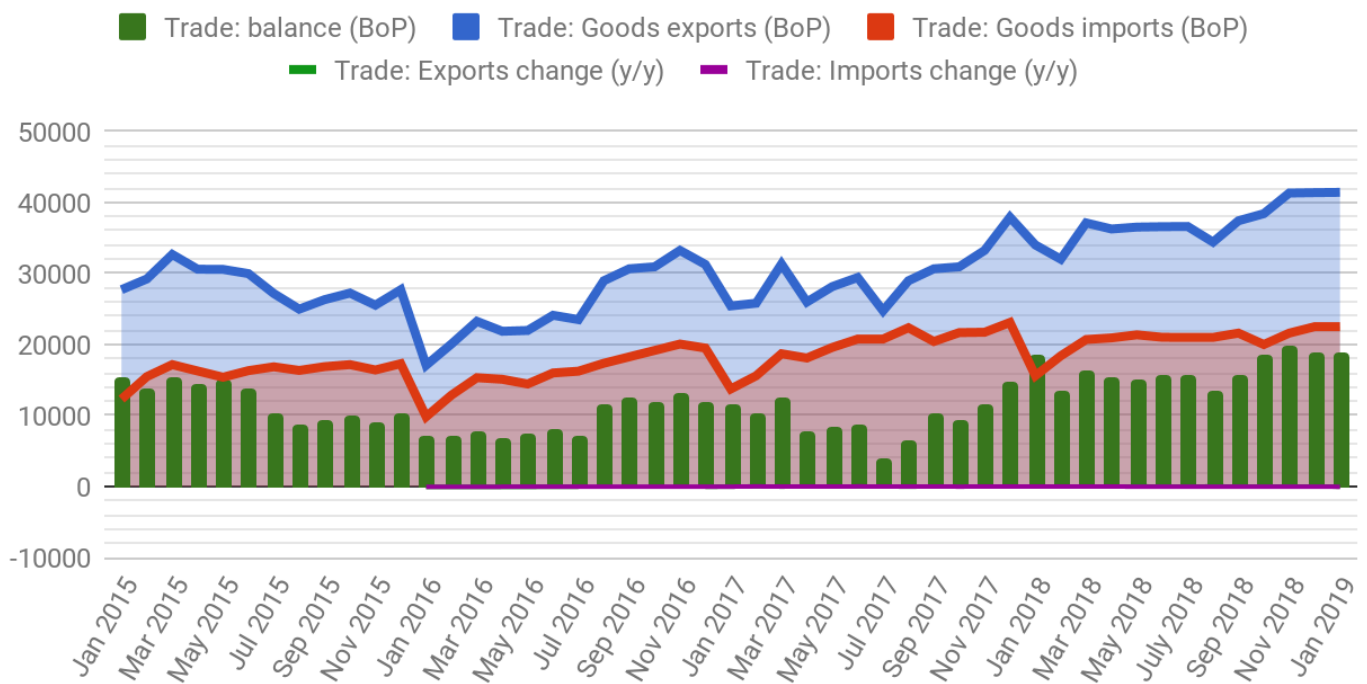
Preliminary balance-of-payments figures for the fourth quarter of 2018 show Russian revenues from exports of goods & services were up nearly 20% y/y even if the growth was no longer as fast as in the previous quarter. For the entire year, export earnings were up by over 20% as revenues from energy exports ballooned by over 30% on strong export prices.

Russia's spending on imports of goods & services in the second half of last year was unchanged from 2H17. For all of 2018, spending on imports was up by a few%. The spending of Russian travellers abroad was up by about 10% for the year although the growth stopped in the fourth quarter. The overwhelming underlying factor was ruble depreciation. Total spending on imports of goods & services in the second half of last year roughly matched 2008 and 2010 levels.

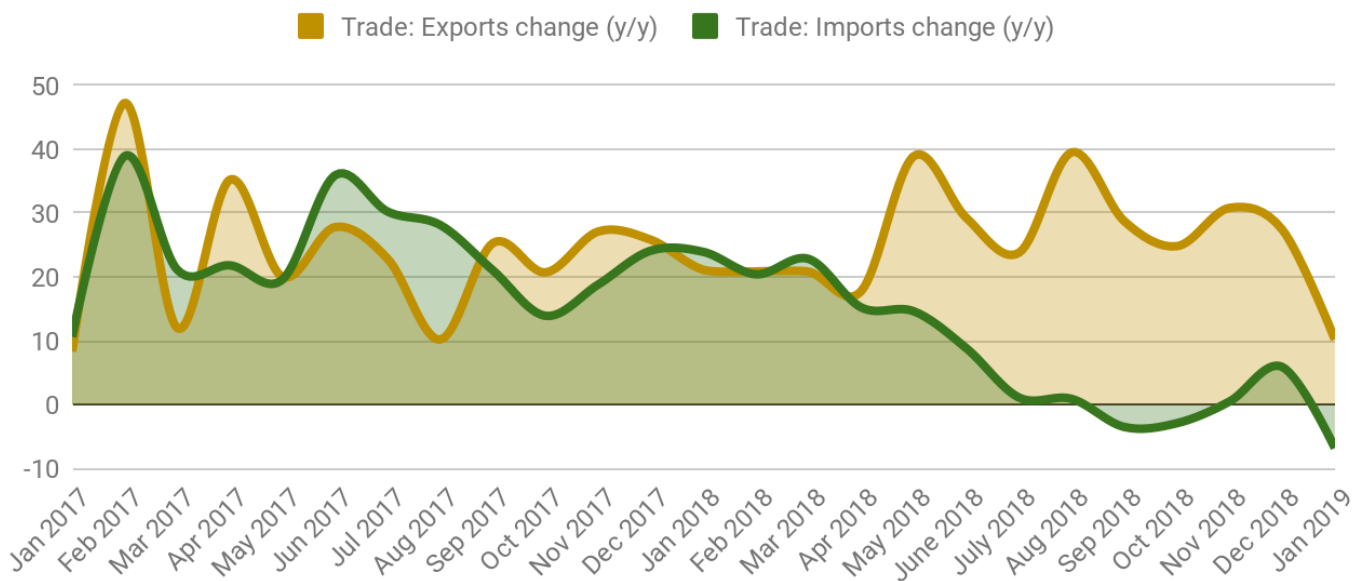
The gap between export earnings and spending on imports widened in 2018 to produce a whopping current account surplus of about 7% of GDP – Russia's largest current account surplus since 2006.

The net capital outflow from the private sector increased substantially in 2018. The flow of direct investments from abroad into the Russian corporate sector (excl. banks) dried up almost entirely, while FDI outflows from Russia remained rather notable. Similar to 2017, banks' capital outflow abroad mostly arose from decreases in their foreign liabilities.

Russia trade export/import goods \$mn (BoP)



Russia trade change in import, export volumes y/y %



source: state customs service

5.2 Balance of payments, current account

Russia -Trade	2012	2013	2014	2015	2016	2017	Mar-2018
Trade: External balance on goods and services (USD mn)	148,023	123,679	134,497	111,638	103,425	130,314	48,353
Trade: External balance on goods and services (% of GDP)	6.66	5.39	6.41	8.04	5.17	5.35	/
Trade: Goods exports (BoP) (USD mn)	527,434	523,275	497,763	341,467	285,772	353,547	101,881
Trade: Goods imports (BoP)	335,771	341,337	308,026	193,952	191,671	237,993	57,000
Trade: Current account BPM6 (USD mn)	71,282	34,801	58,432	68,375	25,664	35,350	18,321
Trade: Current account to GDP (%)	3.20	1.40	2.70	4.90	1.90	2.20	/
source: CEIC, World Bank, CBR							

5.2.1 Import/export dynamics

Exports remain heavily weighted towards hydrocarbons which totalled \$260bn in December – more than half of Russia's exports, with minerals and base metals making up another \$48.7bn from the total of \$461bn.

Imports are half as much as Russia's exports, which has led to the record surplus in 2018. Imports are more evenly distributed but the top four items -- machinery (\$80.7bn) , chemicals (\$32.4), vehicles (\$28.4bn), and base metals (\$18.5bn) – accounting for 70% of the total imports to Russia.

Country-wise, China has become the single most important partner accounting for 12.4% (\$60.6bn) of Russia's exports in December and 22% (\$56.9bn) of its imports. European countries feature heavily as Russian export markets, but the US accounts for only 2.8% (\$13.5bn) of Russia's exports, although it is the third most important source of imports, accounting for 5.3% (\$13.9bn) of Russia's total imports in December.

Russia is much less exposed to Brexit than its peers in Central Europe as the UK accounts for only 2.1% (\$10.4bn) of Russia's exports and 1.7% (\$4.4bn) of its imports in December. That puts the UK on a par with Ukraine which has the same export numbers, but ranks above the UK in terms of imports: Ukraine accounted for 2.3% (\$6bn) in December and continues to run an almost \$2bn trade deficit with Russia.

Russian Federation remained Ukraine's main trade partner in 2018, despite mutual trade restrictions imposed in 2016. In 2018, Ukrainian exports to other countries amounted to \$47.3bn, an increase of 9.4% compared with 2017, according to the figures released by the State Statistics Service on February 19. The biggest share of the country's exports (\$3.7bn) still falls on Russia, despite a

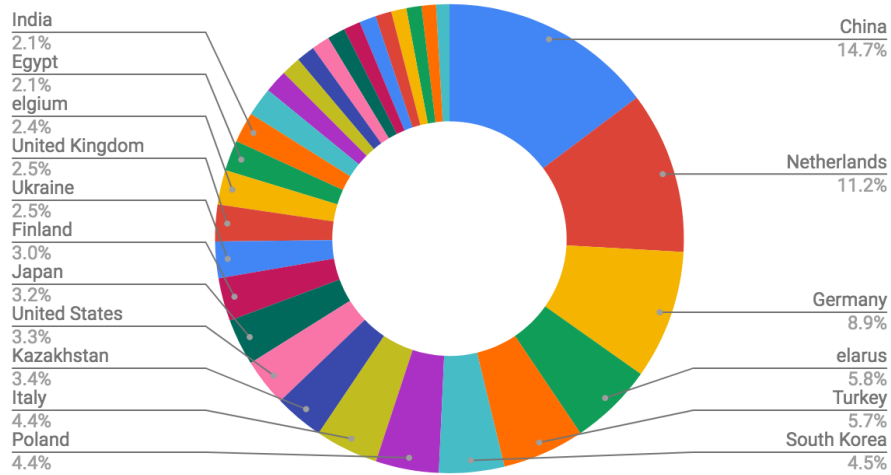
7.2% decrease, which is followed by Poland (\$3.3bn), Italy (\$2.6bn), Turkey (\$2.4bn), Germany and China (\$2.2bn each). All in all, 42.5% of Ukrainian exports (\$20.2bn) fell on EU countries last year. Among importers, Russia also remains the first. In 2018, imports of Russian goods to Ukraine rose by 12.3% compared with 2017 to \$8.1bn. China was the second (\$7.6bn), followed by Germany (\$5.9bn), Belarus (\$3.8bn), and Poland (\$3.6bn). Total Ukrainian imports equaled \$57.1bn last year, an increase of 15.2% compared with 2017, with 40% (\$23.2bn) falling on EU countries.

Russia's imports of meat and meat products plummeted by almost 58% to 800,000 tonnes over the past four years since introduction of sanctions and counter-sanctions, Sergei Dankvert, director of the Federal Service for Veterinary and Phytosanitary Oversight, said in an interview to Rossiya 1 channel released late on Monday. "We have interesting figures to share. Let's take the year of 2014. We imported almost 1.9 million tonnes of all types of meat and meat products then. Now let's have a look at the past year, and we see only 800,000 tonnes. We've replaced almost 1 million tonnes over the four years," he said. "If we look at milk and dairy products, we had 1.164 million tonnes (imported in 2014), and now we have only 790,000 tonnes," he said. He added that imports from Belarus amount to about 350,000 tonnes, and imports of dairy products and milk from all other countries amounts to about 450,000 tonnes. The reduction of imports happened simultaneously with an increase in domestic production, he added.

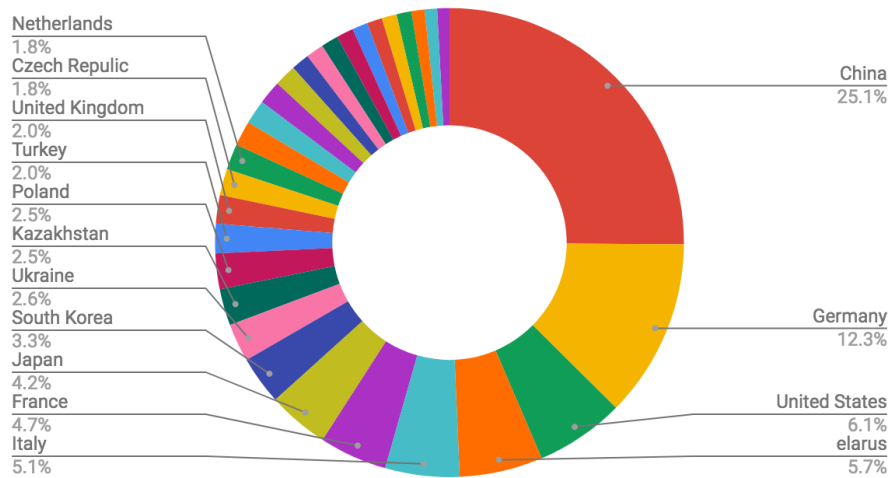
Trade turnover between Russia and China in January 2019 has increased by 10.8% on an annualized basis to \$9.2bn, China's General Administration of Customs said in a report issued on Thursday. China's exports to Russia grew by 11.5% in the first month of 2019 and exceeded \$4.3bn. Russia's exports to China also increased by 10.2% to \$4.89bn. In 2018 trade turnover between Russia and China increased by 27.1% on an annualized basis to \$107bn. Russia and China are hoping to grow trade turnover from \$100bn in 2018 to \$200bn by 2020.

From January to November, 2018 Russia's potato export decreased by 28% and stood at \$13.9mn with a total weight of 132.605 thous. tn. Russia's import of this product was 14.7 times as much as its export. For this period the country imported 550.537 thous. tn of potato for the total amount of \$204.4mn. Potato import volume and value remained almost the same as in 2017. Russia exported potato mostly to Ukraine (89.4%), but also to Azerbaijan (3.5%), Kazakhstan (3.1%), Belarus (1.9%) and other countries. Potato was imported to Russia from Egypt (62.5%), Azerbaijan (14.1%), China (11.4%), Belarus (4.9%), Pakistan (4.5%), Israel (2.3%) and other countries

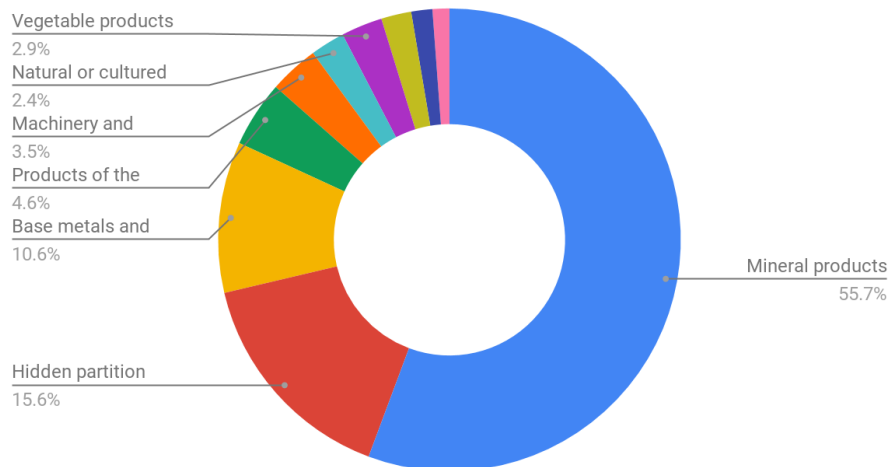
Russia's export partners Dec y/y



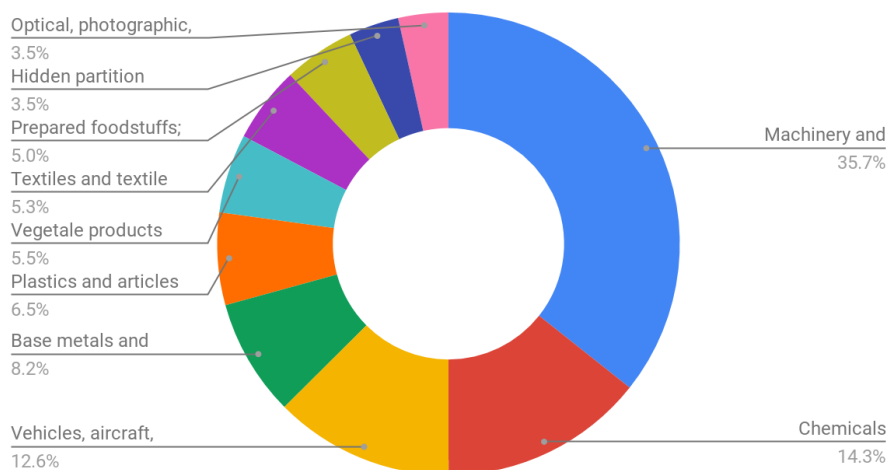
Russia's import partners Dec y/y



Russia major export products Dec y/y



Russia major import products Dec y/y



5.2.2 Current account dynamics

Russian customs reports that in 2018 the country's goods trade surplus climbed to \$212bn, or roughly 12% of GDP. Russia is now running a triple surplus again for the first time in years: trade, current account and federal budget. Both the budget and the current account surpluses are at record levels. The record trade surplus was driven partly by the rise in oil prices in 2018, but falling imports, especially falling food imports, played at least as important a role.

The CBR's estimate of the current account surplus for full year 2018 is a record \$114.9bn, while for 4Q18 it is \$38.8bn, which exceeded the \$33bn surplus in 2017.

"The strength of the current account highlights that it is one of several parts of the Russian economy where sensitivity to oil prices is not reduced by the fiscal rule, but rather amplified," VTB Capital (VTBC) said in a note. "In this case, it was because diminished ruble effective exchange rate (REER) sensitivity to oil eliminated imports' sensitivity to improvements in the terms of trade. As a result, goods imports in 4Q18 were \$65.6bn, but down -\$1.9bn y/y. Were oil prices to average approximately \$70/bbl in 2019, we would expect a current account surplus of close to \$110bn."

The CBR has reported the current account surplus for 4Q18 at \$38.8bn, more than the total surplus accumulated in 2017 of \$33.3bn and up +\$25.3bn y/y.

At the components level, the trade balance has seen the most drastic improvement, of +\$22.0bn y/y. Increased export revenues from oil and petroleum products contributed +\$14.4bn to that, while other types of non-oil & gas exports were up just +\$2.6bn.

Imports declined, in annual terms, for the second quarter. The pace of the decline almost doubled, from -\$1.1bn in 3Q18 to -\$1.9bn in 4Q18. The decline in imports signals modest domestic demand strength.

"To cross-check demand weakness in goods, we refer to the data on trade in services. The balance of this segment of trade continued to improve, in annual terms, for the third quarter in a row, meaning that the growth in exports exceeded that of imports. In particular, the transportation balance was up +\$0.6bn y/y, mostly on the growth in exports," VTBC said.

Both banks and corporates have seen their external debt contract, by -\$8.1bn

and –\$2.3bn, respectively. For the banking sector, this is the 19th consecutive quarter that external debt has contracted, which started in 3Q14.

For the corporate sector, the decline in external debt only restarted in 2H18, and in this sense it is a reversal of the trend of 2017. In 4Q17, the corporate sector attracted around \$2bn on a net basis.

Capital outflow reached \$67.5bn from the private sector and almost \$7bn from the public sector. Apart from this, the CBR bought \$36.1bn worth of FX from the market before these purchases were suspended in August.

In the fourth quarter of 2018, net capital outflow from the private sector reached \$36.5bn, exceeding the figure for the whole of 2017 (\$25.2bn).

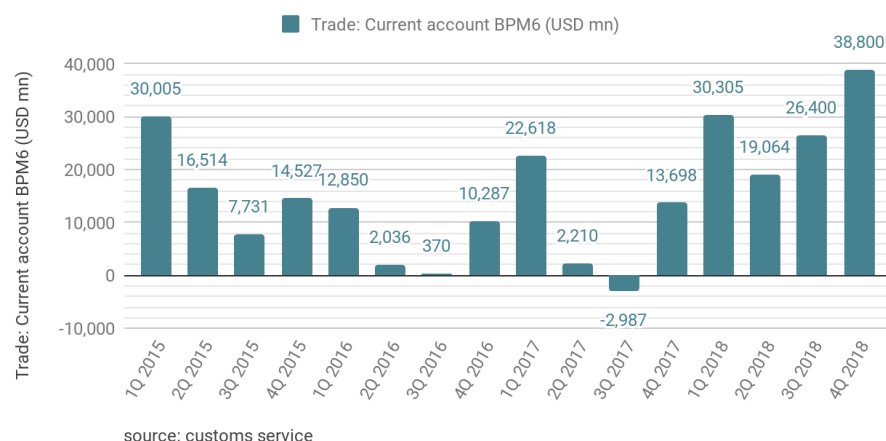
Importantly, net foreign debt redemptions stood at \$10.4bn, so the majority of the capital outflow in the fourth quarter of 2018 (\$26.1bn) was attributable to an increase in foreign assets.

It appears that once the CBR halted its FX acquisitions, residents took the opportunity to accumulate FX liquidity for FX debt redemptions in the future.

VTB Capital (VTBC) argues that now the Central Bank of Russia (CBR) is back in the FZ market capital outflow should drop significantly in 2019 this year.

According to the preliminary figures (which are subject to revision once the CBR has received all the data for December), portfolio investments in Russian sovereign bonds fell by just \$0.6bn in 2018.

Russia current account BPM6 \$mn



5.2.3 Capital flight dynamics

The net export of capital from Russia by the private sector in January reached \$10.4bn, which is almost 1.5 times higher than the figure for the same period last year, according to the Central Bank of Russia (CBR) Vedomosti reported on February 11.

This amount is already half of all the capital flight that the CBR is predicting for the full year under its basic scenario.

In January 2018, the amount of capital flight was \$7.1bn. According to preliminary estimates by the Central Bank, the current account surplus of Russia's balance of payments this January was \$11.8bn, which is \$1.1bn less

than in the same period of 2018.

The key factor in the fall was a decrease in exports of goods amid a reduction in the aggregate negative balance of other components current account balance of payments.

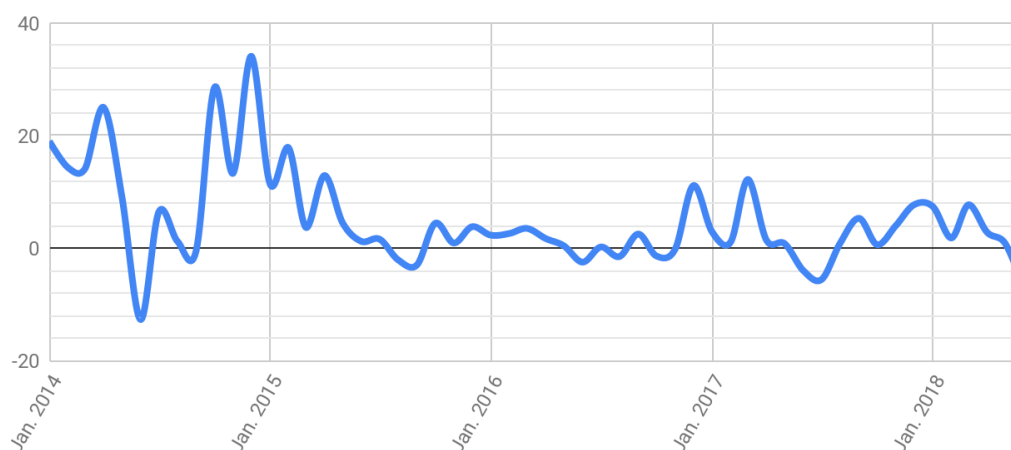
The regulator notes that the current account surplus of the balance of payments caused a slowdown in net lending to the rest of the world by the Russian private sector at the beginning of the year compared to the last quarter of 2018 of \$36.5bn.

At the same time the CBR has started purchasing foreign exchange in the open market again this January on behalf of the Ministry of Finance within the framework of the fiscal rule after a four-month break so reserves increased by \$1.9bn.

Last year, the net outflow of private sector capital from Russia increased by 2.7 times compared to the previous year and reached a total of \$67.5bn.

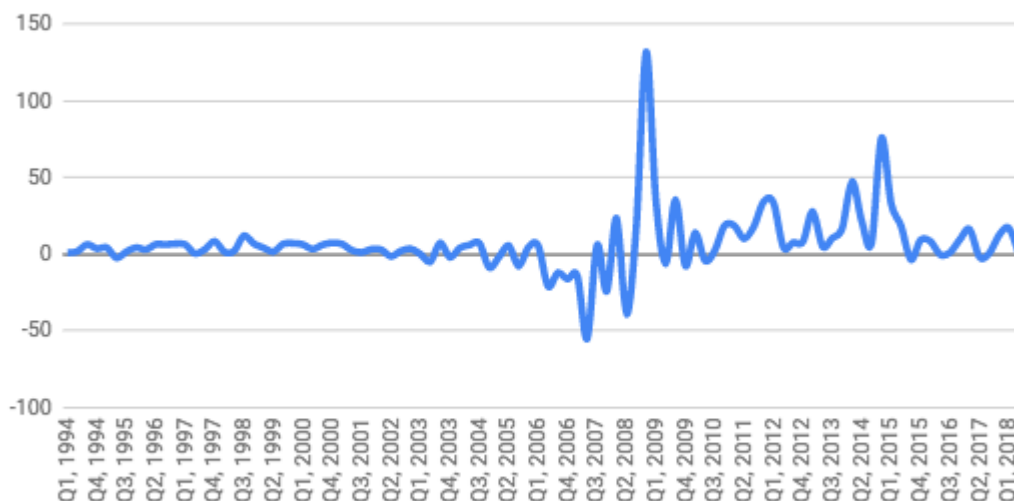
According to the baseline scenario with an average oil price of \$55 per barrel the regulator the net private capital outflow from Russia is expected to be \$20bn in 2019.

Russia private sector net capital inflows (BoP \$bn)



source: CBR

Russia Private sector net capital inflows (BoP \$bn)



source: CBR

5.2.4 Gross international reserves

Russian exports of gold fell by a factor of 3.3 in 2018 compared with the previous year, from 56.6 tonnes (1.82mn ounces) to 17.05 tonnes (548,083 ounces), the Assay Office said on February 19, according to RIA Novosti.

[Russia has been actively building up gold as a share of its gross international reserves \(GIR\) since 2007](#), as *bne IntelliNews* reported previously. The Central Bank of Russia (CBR) has been buying most of the gold produced domestically and [purchased a record amount](#) in 2018.

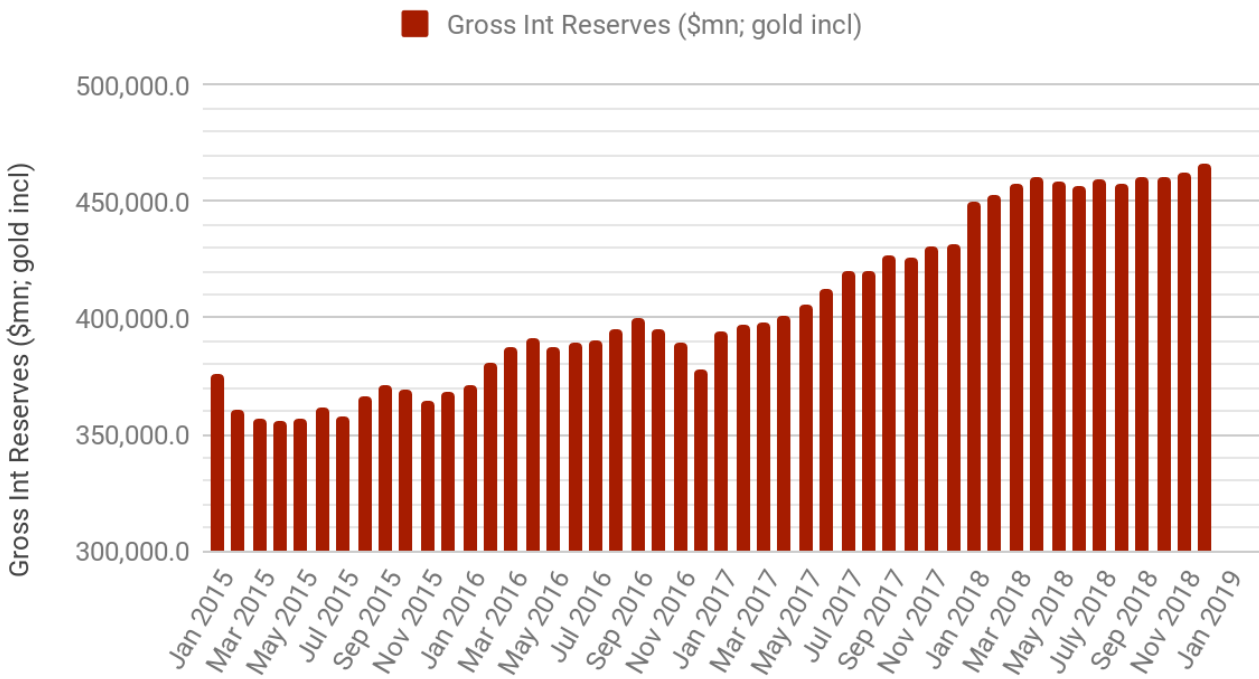
Last year's [gold purchases were financed from the sale of circa \\$100bn of US treasury bills](#) by the CBR, as *bne IntelliNews* reported in November, as Russia begins the long slow process of dumping the US dollar as the current of international trade.

At the same time the government has approved licenses to develop several very large gold fields that have sat fallow for over two decades, with the [Sukhoi Log](#) deposit being the biggest and more important among them.

Russian gold refining plants increased gold production by 2.45% to 314.42 tons (10.1mn ounces) in 2018. Last year a little more than 5.4% of the total gold produced in Russia was exported, while about 273.7 tons of gold was purchased by the Central Bank to replenish gold and foreign exchange reserves. In 2016, 22.39 tons of gold were exported from Russia, in 2015 — 39.41 tons, in 2014 — 75.66 tons, reports Vedomosti.

Earlier, the World Gold Council (WGC) reported that Russia bought a record gold quantity for it in 2018 of 274.3 tons. Russia's gold reserves are growing for the 13th consecutive year and increased over this period by 1,726.2 tons to 2,113 tons by the end of 2018.

Russia Gross Int Reserves (\$mn; gold incl)

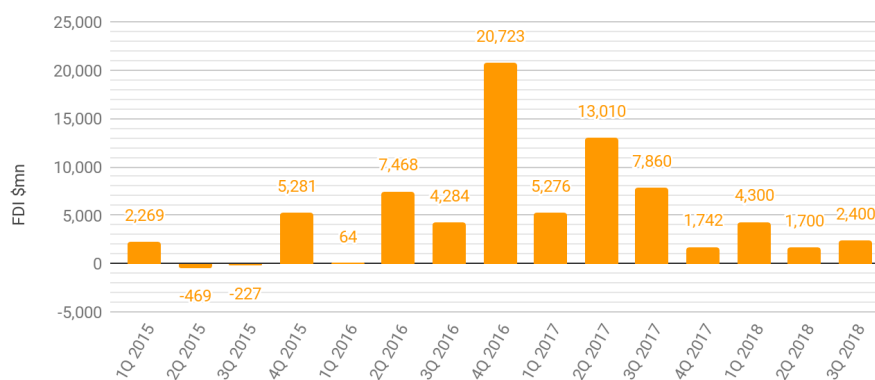


5.3 FDI

Russia -FDI	2012	2013	2014	2015	2016	2017	Mar-2018
Foreign direct investment (BoP) (USD mn)	50,588	69,219	22,031	6,854	32,539	27,886	7,044
Foreign direct investment: % of GDP (BoP)	2.29	3.11	1.05	2.09	2.28	1.85	1.80
Foreign portfolio investment (USD mn)	19,312	748	-23,203	-12,872	3,020	9,330	3,728
source: CEIC							

Foreign Direct Investment (Net Flows) in Russia increased by \$4,300mn in the first quarter of 2018. Foreign Direct Investment in Russia averaged \$5,985mn from 1994 until 2018, reaching an all time high of \$40,140mn in the first quarter of 2013 and a record low of -\$3922mn in the fourth quarter of 2005.

Russia FDI \$mn



source: CBR

6.0 Public Sector

6.1 Budget

Russia's VAT hike boosted Russia's budget revenues in January. The Finance Ministry on February 15 reported that budget revenues climbed 13.9% y/y in January to RUB1.5 trillion (\$22.6bn).

The growth was mainly driven by non-oil and gas revenues, which surged 25% y/y; oil and gas revenues rose just 2.9% y/y.

VAT revenues, which accounted for 69% of all non-oil and gas revenues in January, jumped 21% y/y to RUB556bn following the increase in the VAT rate from 18% to 20% on January 1. Corporate tax receipts soared by 46% y/y, though these revenues represent only 6% of non-oil revenues and are very volatile.

Budget spending rose 8% y/y during the month to RUB1.2 trillion, in line with the government's plans to boost expenditures by 7.7% this year to RUB18 trillion.

The budget surplus reached RUB282bn (\$4.2bn).

The government expects the full-year budget surplus to reach RUB1.9 trillion (\$28.5bn), or 1.8% of GDP. This assumption is based on a Brent forecast of \$65/bbl.

"Since we forecast an average oil price of \$70/bbl this year, we project an even wider surplus of 2.7% of GDP," Anton Stroutchenevski of Sberbank CIB said in a note.

2018 budget revenues were up 29% in 2018. Much of the gain came from higher revenues from oil & gas taxes, which saw a boom especially in autumn. The price of Urals-grade crude oil in early autumn hit 78–79 dollars a barrel, while weakening of the ruble's exchange rate raised the ruble-denominated oil price to an all-time high. Revenues from oil & gas revenues accounted for 46% of all federal budget revenues in 2018, with the ratio of revenues from energy products to GDP rising to nearly 9%. During the 2011–2014 peak period, the ratio was only slightly higher (9.3%).

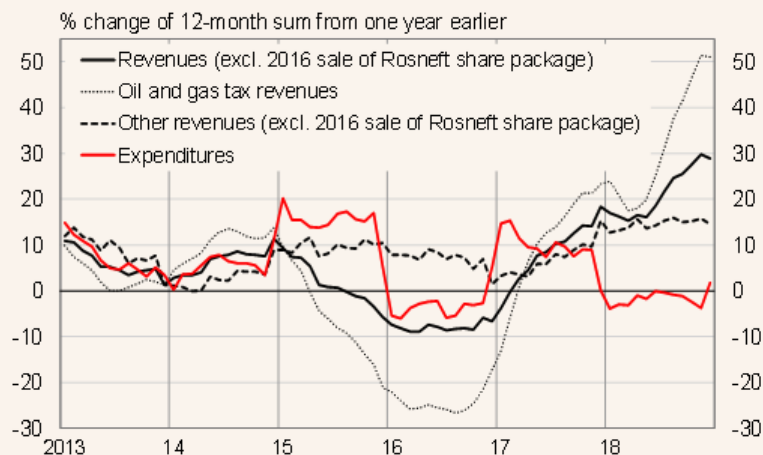
Growth in other budget revenues accelerated to over 14% last year mainly thanks to a 17% increase in value-added tax revenues. VAT revenues accounted for 58% revenues of other than oil & gas revenues. VAT's share of other revenues has not been this high in roughly one and a half decade. Revenues from corporate profit taxes and dividends from state-owned enterprises also increased substantially.

Federal budget spending rose in nominal terms by just 2% in 2018. Defence spending declined slightly. Spending on domestic security saw large increases to the agencies responsible for security, prosecutorial and investigatory functions. The federal budget covers nearly all of these spending items.

The federal budget surplus rose in 2018 to a level equal to 2.7% of GDP. The

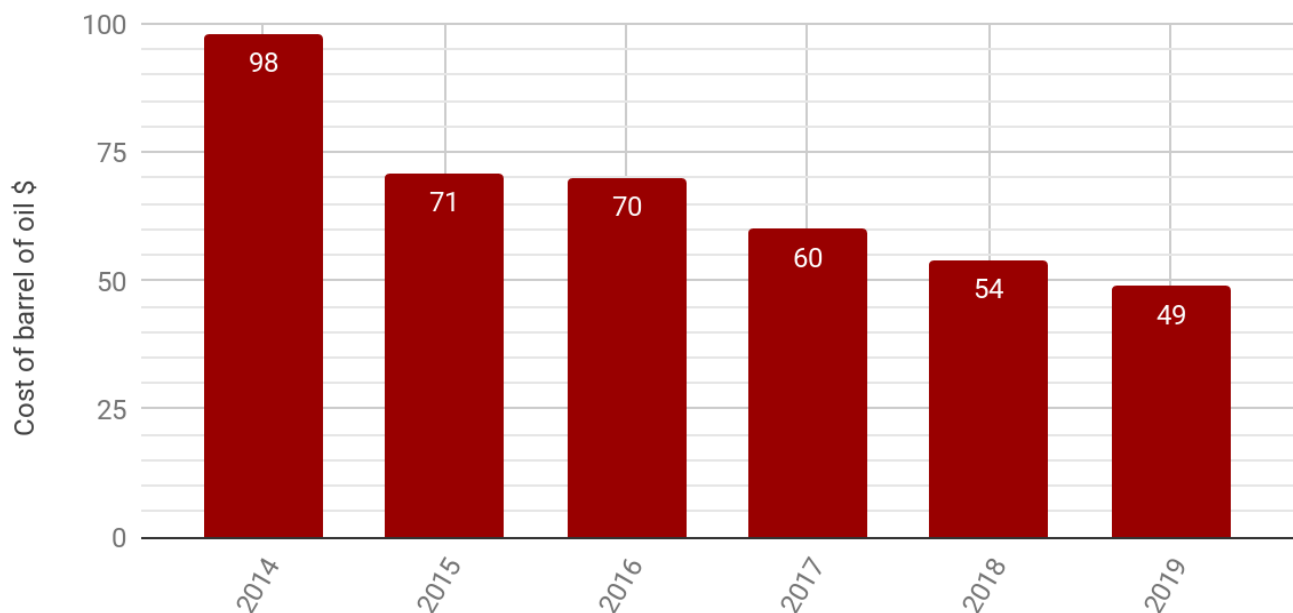
last time the federal budget showed such a large surplus was in 2011. Federal cash reserves also rose significantly in the second half, finishing the year at nearly 10% of GDP. The sum includes liquid reserve fund assets (i.e. National Welfare Fund). The boost in assets was partly driven by oil prices well in excess of the basic calculation price defined under the fiscal rule (last year's calculation price was just under 41 dollars a barrel). The Russian Federation last year issued ruble bonds equivalent to roughly 1% of GDP. Repayments of ruble-denominated bonds corresponded to 0.5% of GDP.

Russian federal budget revenues and expenditures, 2013–2018



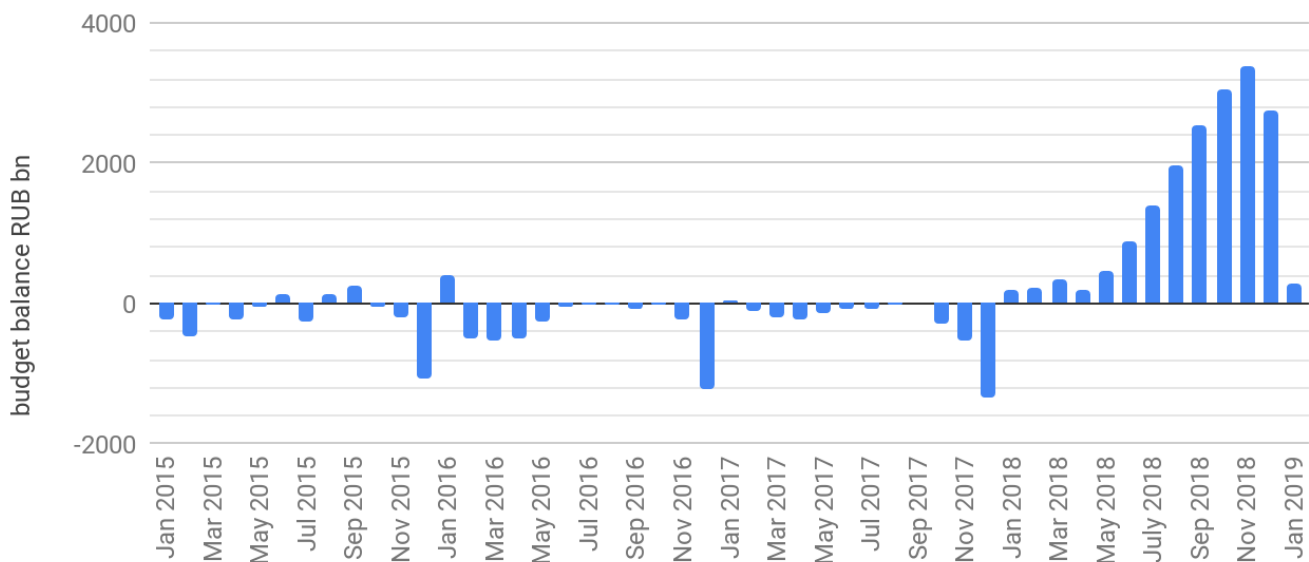
Source: Russian Ministry of Finance.

Russia breakeven Urals oil price for Russian budget



source: Renaissance Capital

Russia budget balance RUB bn



source: MinFin

6.1.1 Budget dynamics - specific issues...

VEB published a macro projection for 2018-2021 with a base case featuring a pension age increase by half a year per year starting in 2020.

The very next day, the projection was deleted from VEB's website. The Minister of Economy announced at the "Russia: New Opportunities" Forum that such an increase is indeed being discussed, with several proposals on the topic already formulated. When prodded by journalists on where such discussions are occurring, he replied "in society." Both stories mark continued paralysis on pension reform, despite an increasingly evident need to do something: the number of workers per pensioner continues to shrink, as do pension benefits in real terms.

Russia's Finance Ministry warned that it would have a RUB204bn (\$3.3bn) hole in budget revenues in it if state-owned enterprises (SOE) don't pay out the 50% of profits they have been ordered to by the government, Interfax and *Vedomosti* daily said on April 23 citing unnamed sources in the government.

MinFin's complaints is the latest in a running battle between the liberal fraction running Russia's finances and the heads of Russia's largest companies, most of whom run their enterprises like personal fiefdoms. MinFin [continues to demand](#) that state-owned enterprises pay the requested 50% of IFRS net profit in dividends, warning the Prime Minister Dmitri Medvedev that 2018 budget will have a big hole in it if they don't.

The 2018 federal budget plans to raise RUB380bn in dividends based on 50% of IFRS net profit, most of the state majors dodge. Gazprom natural gas giant alone will save paying the state RUB78bn by paying 25% of consolidated net profit.

Rosneftgaz holding controlled by influential ally of President Vladimir Putin Igor Sechin is another [long-time rival of the Ministry of Finance in the fight for](#)

[dividends](#), and still holds half of the RUB40.6bn interim dividends for January-June 2017 from Russia's largest oil company Rosneft. Rosneftgaz does nothing other than hold shares and has less than a dozen employees. Sechin is head of both the oil company and the holding.

Also Russian oil pipeline monopoly [Transneft dodged the full dividend payout for 2017](#). It is unlikely that given the favourable oil prices environment the government will manage to create urgency and will to have the oil and gas giants budge.

"It is worth indicating that the amount under discussion is equivalent to around a \$2/barrel increase in annual oil prices, thus the negative effect on the budget in relation to the lower-than-expected dividends payments is clearly not an issue this year given the substantial spike in oil prices," Alfa Bank commented on April 23.

In 2016 Russia faced a crisis as the hole in the budget was not RUB200bn but [RUB2 trillion](#) and had no way to finance it. In the end a 19% of Rosneft was sold in a faux privatisation that turned out to be more of a loan and the government got through the year.

Covering the dividend short fall gap will be a lot easier. The ministry could increase net domestic market borrowing by exactly RUB200bn in 2018, the RIA news agency reported on Monday, Reuters and RIA Novosti said in a separate report citing the head of the ministry's debt department Konstantin Vyshkovsky.

Another survey by RBC business portal showed that 90% of the managers of large Russian companies point to increasing presence of the state in the economy. 50% of the respondents see the state's share in the economy as "extremely high", 23% as "high", and 17% as "rather high".

Previously the Finance Ministry argued that in Central and Eastern Europe SOEs on average pay 70% dividends. It also [sees uncollected dividends as representing an unjustified indirect form of state subsidy](#), giving state companies an unfair advantage over the private sector.

The "subsidy" for the four largest SOEs alone (Rosneft and Gazprom oil and gas giants, Sberbank and VTB bank) is estimated at RUB350bn, or 0.4% of GDP for 2016, and about RUB300bn annually in the past five years.

Russia's oil and gas sectors were a key source of tax revenues in 2017, according to data from the Federal Tax Service (FNS).

The two extractive sectors (that also included the mining industries) provided some 29.2% of all revenue to Russia's consolidated federal budget, which includes both federal and regional budgets. That figure is up over 2016, when it reached 26.5%.

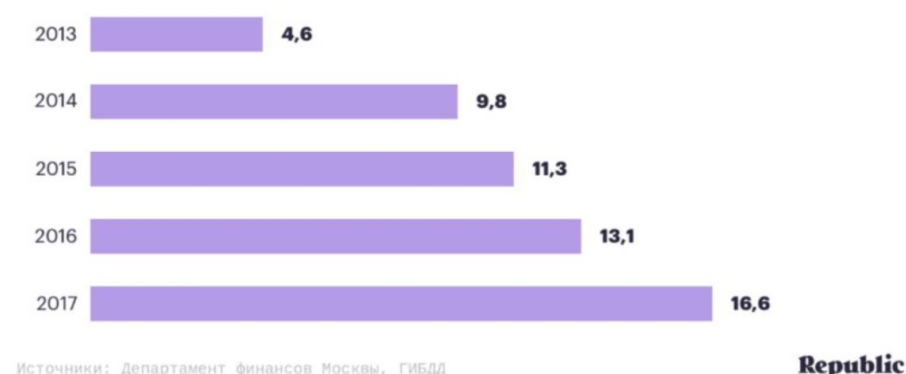
Meanwhile, increasing Mineral Extraction Tax (NDPI) returns drove some 40% of revenue growth in 2017 over 2016, or RUB2.8 trillion (\$50bn).

The key dynamic at play over the last year was rising oil prices, which increased an average 25% y/y, according to Dmitri Kulikov at the domestic rating agency AKRA.

Tax revenue increases were also helped by a temporary limit on loss carryforwards, set to expire in 2020. The trend goes beyond tax revenue, with carry sectors driving industrial output as well, adds Kulikov.

“Officials have talked a big game on structural readjustment away from hydrocarbons. Indeed, hydrocarbon revenue as a percentage of the total has fallen in recent years. But that’s not due to changes in the economy so much as energy prices simply being lower: extractive sectors contributed less to the budget because they made less money,” Bear Market Brief said in a note.

Moscow is bringing in increasing revenue from traffic tickets. Figures indicate billions of rubles - the last one is equivalent to about \$290 million.



6.1.2 Budget dynamics - regions

Putin wants regions to give tax breaks for investment. Putin is unhappy that regions have not used a new option to stimulate investment through tax breaks on corporate income tax.

Putin's [May Decrees](#) force a lot of extra spending on Russia's regions, but they do not provide funding. While the federal government has access to the oil and gas export revenues, most regions have to largely live off income, corporate and VAT tax revenues. They are reluctant to cut into their meagre tax base by offering breaks to companies and that has led to a clash with the federal government that wants to engender regional development as the economy remains too top heavy: Moscow and St Petersburg dominate in the regional make up of the economy.

Regions were given the option to allow investment to count toward corporate income tax two years ago, but most have avoided implementing it, reports BMB. An industrial region in the Urals, for example, restricted the tax break to tourism companies.

Business does not support this particular initiative either. The companies that are doing the most investing are typically new enterprises operating at a loss, so it doesn't make sense to offer them a tax break on profit. Regions prefer to offer investment incentives by cutting real estate taxes or working out individual deals with large companies. Geography and the labour market often play a bigger role in investment decisions than government initiatives, they argue. Putin wants regions to report back to him about implementation of this

tax break by July 15.

Grants from the federal centre to the Russian regions in 2018 for the first time exceeded RUB1 trillion, RBC reported with reference to the data of the Ministry of Finance and the estimates of the agency Expert RA. In 2018, subsidies amounted to RUB1.035 trillion, in 2017 - RUB759bn, and a year earlier - RUB656bn. Last year all regions received grants, including the richest - Moscow and Tyumen Oblast. Moreover, the capital, which received RUB27.6bn, entered the top 7 regions in terms of the amount of subsidies received. About half of the growth of subsidies - RUB136bn from a total of 277bn - was necessary to ensure a balanced budget. At the end of 2018, in 70 regions consolidated budgets were executed with a surplus, and the aggregate surplus amounted to RUB510bn – a record in the last 15 years. A year earlier, there were 45 surplus regions in Russia.

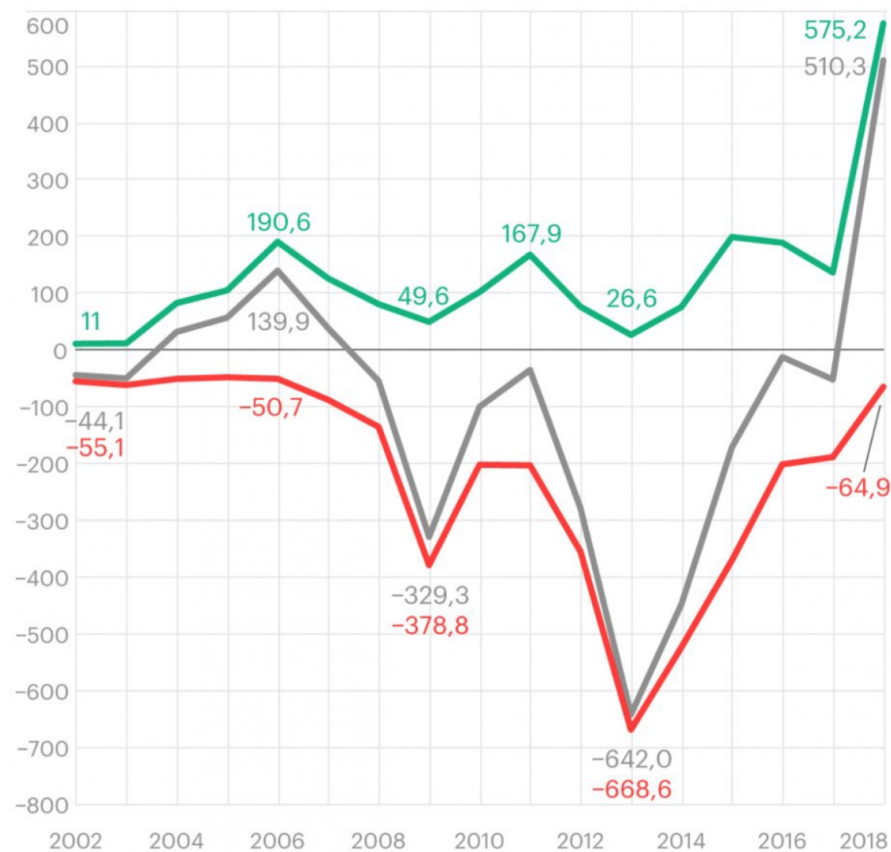
Chart: Budget transfers to regions hit record highs [RUS]

Title: Value of consolidated regional budget deficits and surpluses (billions of rubles)

Green: Total surplus value of consolidated regional budgets running a surplus

Red: Total deficit value of consolidated regional budgets running a deficit

Grey: Aggregate surplus/deficit of consolidated regional budgets



Источники: данные Минфина, расчеты «Эксперт РА»

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Russia's regional debt may grow 1.3-fold in the next three years due to rising social spending. By the beginning of 2022, state debts of regions and municipalities can grow 1.3-fold from the current RUB2.2 trillion (\$33.2bn) to RUB2.9 trillion (\$44bn), Interfax reported on February 18 with reference to the

presentation of the Ministry of Finance, prepared for the meeting of the State Duma Committee on Budget and Taxes.

The state debt will grow in the next three years “against the background of the need for regions to finance social obligations,” notes the Finance Ministry. By early 2020, regional debts will amount to RUB2.57 trillion and by early 2021 RUB2.78 trillion.

“We can conclude from the materials received from the Ministry of Finance the current financial condition of the regions does not allow them to fulfill their social obligations in full,” said the head of the committee Andrei Makarov. “The second conclusion is that we do not provide for the appropriate transfer of funds to the regions so that they can fulfill these obligations without increasing the debt burden.”

The budget committee will review the draft law of the Ministry of Finance, which gives the ministry the right to classify regions into three levels of risk based on their debt burden: low (green), medium (yellow) and high (red). The bill proposes to change the system of assessing the debt sustainability of the regions and to revise the current threshold values.

In the “green” regions, the size of public debt does not exceed 50% of total revenues. Excluding grants, debt servicing should cost no more than 13% of revenues and subsidies, and the cost of debt servicing should not exceed 5% of total spending.

For the regions in the red zone, the corresponding threshold values will be 85%, 18% and 8% respectively.

Regions with high debt sustainability will be exempt from the approval of loan and guarantee programs with the Ministry of Finance. The regions from the yellow zone will have to coordinate loan programs, as well as submit a draft of the main debt policy guidelines to the Ministry of Finance. And regions with low debt sustainability from the red zone will be able to borrow only for the purpose of refinancing debt, they will also have to approve and implement a solvency restoration plan agreed with the Ministry of Finance.

According to the Ministry of Finance, 38 regions are in the green zone, among them Moscow and the Moscow Region, St. Petersburg as well as the Leningrad Region, Sakhalin, Tyumen, Lipetsk, Bryansk, Voronezh and Kursk Regions.

The yellow group includes 43 regions, among them the Krasnoyarsk Territory, the Kaliningrad, Tver, Nizhny Novgorod, and Smolensk regions.

The red group contains the Jewish autonomous region, the Oryol region, the Pskov region, and the Republic of Mordovia.

The number of regions whose national debt exceeds their own revenues decreased from seven to two in 2018, said Larisa Eroshkina, director of the department of intergovernmental relations of the Ministry of Finance , in [an interview with TASS](#).

“There are two subjects whose state debt is higher than revenues as of January 1, 2019, is the Republic of Mordovia and the Kostroma region. At the beginning of last year, there were seven such regions, ”said Eroshkina. And if

the Kostroma region in 2018 reduced the national debt by 7%, and the market - by 10%, then Mordovia, by contrast, increased debt - by 12% and 45%, respectively. These two regions, as well as Khakassia (also reduced debt for 2018) are on treasury escort and are forced to coordinate their expenses with the Ministry of Finance.

In 2017, Mordovia's debt-to-revenue ratio was a whopping 185%. MinFin says regional public debt shrunk by 4.7% in 2018 and that it doesn't expect any region to default on their debt this year. Back in December, a monitoring by RANEPa reported that 15 regions found themselves in deficit in 2018, against 30 the year before.

The debt situation in the regions remains fragile however, and it's likely that at least part of this year's good numbers were due to an influx of money into regional budgets prior to the presidential election. For governors, the dilemma remains the same: the centre demands increased investment to fulfill the May decrees while requiring fiscal responsibility.

6.2 Debt

Russia - External debt	2012	2013	2014	2015	2016	2017	Jan-Jun '18
Budget: external debt (USD bn)	2,363.52	2,844.56	2,729.43	2,169.01	2,073.22	2,096.24	1,005.41
Budget: external debt (% GDP)	29.02	31.73	29.07	37.89	39.83	32.84	/
source: CEIC, CBR							

Russians owed roughly \$450bn to foreign (non-resident) entities at the start of this year. Russia's foreign debt, measured in dollars, fell by 12% in 2018.

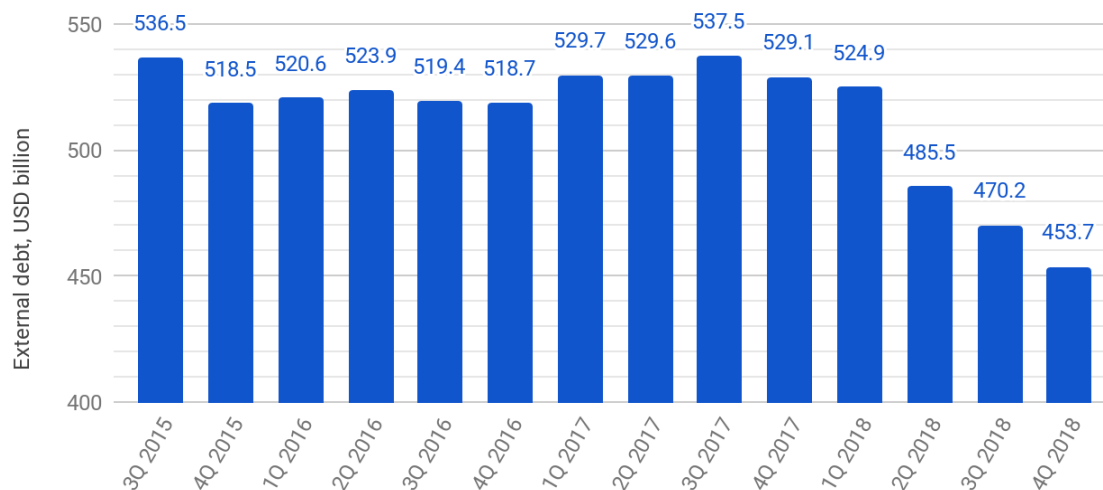
While half of Russia's foreign debt is denominated in dollars and a quarter in rubles, nearly two-thirds of government foreign debt is denominated in rubles. Measured in dollars, the debt has decreased due to debt repayment and depreciation of the ruble. Foreigners have reduced their investment positions, especially in ruble-denominated government debt.

The government accounts for 10% of the country's foreign debt, banks another 19% and non-bank corporates nearly 70%. Especially banks' foreign liabilities are counterbalanced by their assets held abroad and receivables from abroad.

Besides foreign debt, the stock of direct investments that have flowed from abroad into Russian firms (incl. banks) was about 520bn dollars at the beginning of October.

Russia's reserves cover the international sovereign and commercial debt for the first time in history, President Vladimir Putin said on February 20 in his State of the Nation Address to the Federal Assembly. "We have a strong financial safety cushion. I can inform you - and this is a nice and good piece of news - our reserves completely cover the foreign debt of the state, which is very small, and the commercial sector for the first time in our history," Putin noted.

Russia External debt \$bn



source: MinFin

7.0 FX

RUSSIA -FX	2Q16	3Q16	4Q16	1Q17	2Q17	3Q17	4Q17	1Q18	2Q18
Currency (units per EUR) (eop)	71.21	70.88	63.81	60.60	67.50	68.04	69.26	70.36	73.39
Currency (units per USD) (eop)	64.26	63.16	60.66	56.38	59.09	58.02	57.73	57.09	62.73
Currency (units per EUR) (average)	74.38	72.15	68.13	63.27	62.88	69.22	68.78	69.88	73.73
Currency (units per USD) (average)	65.88	64.62	63.07	58.82	57.14	59.00	58.41	56.87	61.783

The Ministry of Finance and analysts are expecting the ruble exchange to remain largely unchanged and to end 2019 at around RUB65 to the dollar depending on external factors such as the price of oil.

The National Bank of Ukraine (NBU) is going to cancel the mandatory requirement to exchange foreign currency proceeds received from abroad by legal entities when "market conditions" allow the move, the regulator's governor of the central bank Yakiv Smolii said on February 22. In February, the NBU announced its intention to reduce the mandatory requirement to exchange foreign currency proceeds received from abroad by legal entities from 50% to 30% from March 1. The statement followed the regulator's decision made in December 2017 [to extend the 50% compulsory sales](#) of export proceeds received from abroad by legal entities due to the fact that this current level remains "an important instrument" for FX stability in the country. In April 2018, the central bank [reduced](#) the limit for compulsory sales of export proceeds to 50% (from 65%), however, the NBU [extended](#) the 50% surrender requirements for FX proceeds received from abroad by legal entities due to "the need to preserve FX market stability".

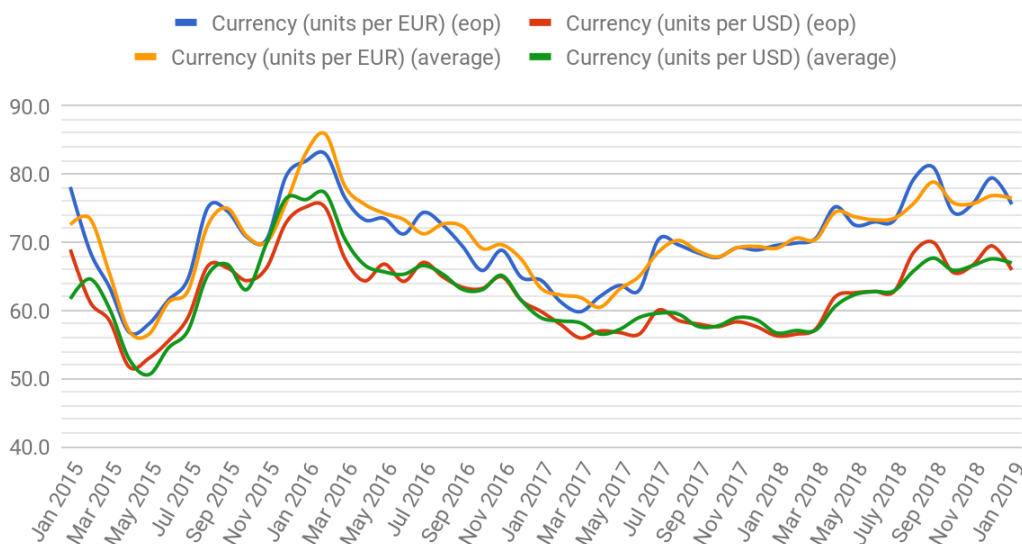
On January 15, the Central Bank restarted its foreign currency buying tied to the government's fiscal rule after a five month hiatus. On January 25, the CBR announced it would on February 1 commence its foreign currency purchases under the fiscal rule that were postponed in last fall.

Since the beginning of 2017, the CBR has purchased under the fiscal rule daily a pre-announced amount of foreign exchange on behalf of the finance ministry. During the period from January 15 to February 6 this year, the finance ministry is using, on average, RUB15.6bn (\$240mn) a day for the forex buys, which in total corresponds to about RUB265bn (\$4bn). The finance ministry has yet to announce the schedule for the next forex buy.

The CBR will make up for its postponed foreign currency purchases under the fiscal rule gradually over the 36 months. These purchases will increase daily forex purchases under the fiscal rule by RUB2.8bn. The CBR may temporarily halt the purchase programme as needed.

Market observers note that the currency-buying in line with the fiscal rule could cause a slight depreciation of the ruble. Large impacts are not expected, however, as the daily forex-buying under the fiscal rule accounts for a small fraction of the forex market's daily turnover. Since the resumption of forex buying, the ruble's exchange rate against the dollar and euro has appreciated just over 1% (as of February 1, \$1= RUB65.5; €1= RUB 75.0).

Russia FX: RUB vs EUR, USD



8.0 Financial & capital markets

Russia -Selected performance indicators of credit institutions (LC bn)	2012	2013	2014	2015	2016	2017	As of Jun 2018
Assets							
Assets (LC bn)	49,510	57,423	77,653	83,000	80,063	85,192	86,586
Loans to non-financial institutions	/	/	29,536	33,301	30,135	30,193	31,398
Loans to resident financial institutions (except credit institutions) (LC bn)	/	/	1,306	1,659	2,777	3,627	4,008
Loans to individuals (LC bn)	/	/	11,330	10,684	10,804	12,174	13,296
Capital and financial performance							
Equity capital (LC bn)	6,113	7,064	7,928	9,009	9,387	9,397	9,512
Provision for losses (LC bn)	/	/	/	/	/	6,916	7,348
Profit for the current year (LC bn)	/	/	589	192	930	790	634
CAR capital adequacy (%)	14	13	12	13	13	12	12
ROA (%)	/	/	1	0	1	1	1
ROE (%)	/	/	8	2	10	8	7
Liabilities							
Individuals' deposits (LC bn)	14,251	16,958	18,553	23,219	24,200	25,987	26,992
Deposits and funds in the accounts of nonfinancial organisations and financial institutions (excluding credit institutions) (LC bn)	/		/	/	/	24,843	25,504
Loans received from Bank of Russia (LC bn)	/	/	9,287	5,363	2,726	2,016	2,710
source: CBR							

8.1 Bank sector overview

The CBR has published its FY18 banking sector statistics. Assets grew 10.4% y/y, supported by a 13.9% expansion of the loan portfolio. Profit increased 70% y/y to RUB 1.3tn, with an implied ROE of 15% vs. 9% in 2017, VTB Capital (VTBC) analyst Svetlana Aslanova said in a note.

The results will be welcomed by the government and sector alike after several years of pain. The banking sector made zero profits during the silent crisis of 2014-2016, whereas what profit was made, was made entirely by state-owned retail giant Sberbank. Since then the banking sector has returned to health, but in 2017 it had a near miss when the Central Bank of Russia (CBR) closed four of the country's largest commercial banks and nearly sparked a systemic meltdown. Profits in September 2017 plunged by over RUB300bn (\$4.5bn),

wiping out almost all the gains to date that year.

Overall, the 2018 stats highlight the uneven recovery of Russian banks, although risk costs are the key driver of ROE recovery. For 2019, we expect competition to pick up, especially as Otkritie tries to regain market share after the completion of its clean up.

The analysts top picks in the banking sector remain the same. Sberbank remains the investor's darling and the "tourist stock" held by everyone with even a passing interest in Russia's equity universe.

The other top pick is Russia's only purely online bank [Tinkoff Bank](#), which remains an outperformer and one of the few Russian shares that has regained its IPO price valuation since 2008 crisis. The bank is abandoning the traditional concept of a stolid bricks and mortar banking establishment and is trying to create a "[lifestyle bank](#)," the bank told *bne IntelliNews* in an exclusive interview last year.

The Central Bank of Russia reports that the household credit stock increased during the past two years.

Retail credit growth accelerated substantially last year, lifting the total household credit stock to RUB14.9 trillion (\$220bn) at the end of 2018 – an increase of 22% y/y. During Russia's last credit boom in 2011–2013, annual growth in credit exceeded 30%, Bank of Finland Institute for Economies in Transition (BOFIT) reports.

While the volume of housing loans grew especially fast last year, growth in unsecured consumer credit was also brisk. Credit stock growth was highest in the Moscow region, St. Petersburg and some regions in the Volga Federal District. In all these places, high growth was generated mainly by housing loans. Due to the housing loan growth in recent years, housing loans now constitute 43% of all household borrowing. Less than 1% of household credit is denominated in foreign currencies.

The increase in credit demand partly reflects a slight drop in interest rates. The average rate on a ruble-denominated household loan for more than one year was 12.5% in December. In December 2017, the similar average rate was 13.5%. The corporate credit stock also grew rapidly, but the rate of growth (11% y/y) was well below the growth in household borrowing.

8.1.1 Earnings

The CBR has published its FY18 banking sector statistics. Assets grew 10.4% y/y, supported by a 13.9% expansion of the loan portfolio. Profit increased 70% y/y to RUB 1.3 trillion (\$19.8bn), with an implied ROE of 15% vs. 9% in 2017, VTB Capital (VTBC) analyst Svetlana Aslanova said in a note.

"Excluding the effect from banks under sanitisation, profit reached RUB1.9 trillion (\$29bn). Sberbank earnings accounted for 60% of sector earnings, down from 83% in 2017," Aslanova said in a note.

Russia's banking sector is back in profit and earned RUB264bn (\$4bn) in January, according to Central Bank of Russia (CBR) data released on

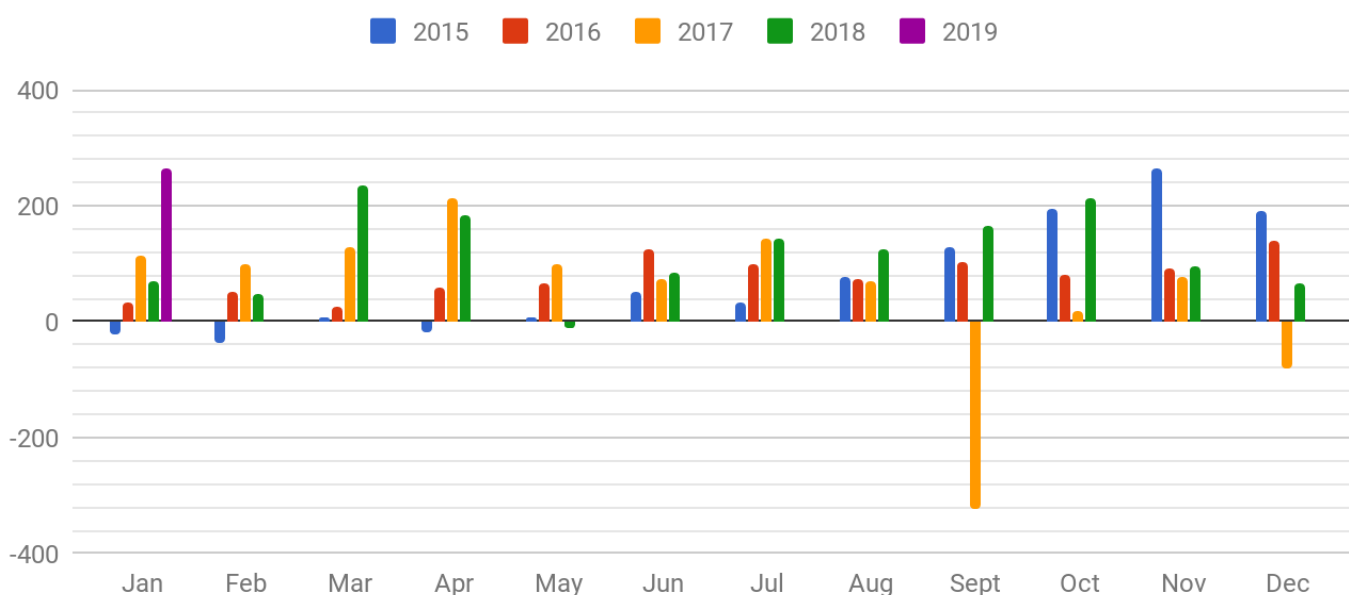
February 28.

Earnings for the first month of the year came in at RUB264bn versus RUB71bn in January a year earlier and RUB114bn in the same month in 2017, which marked the start of the recover from the crisis years of 2015-2016.

The January result as also well over double all the profits earned in all the months of last year and four-times more than the RUB65bn that banks earned in December of last year.

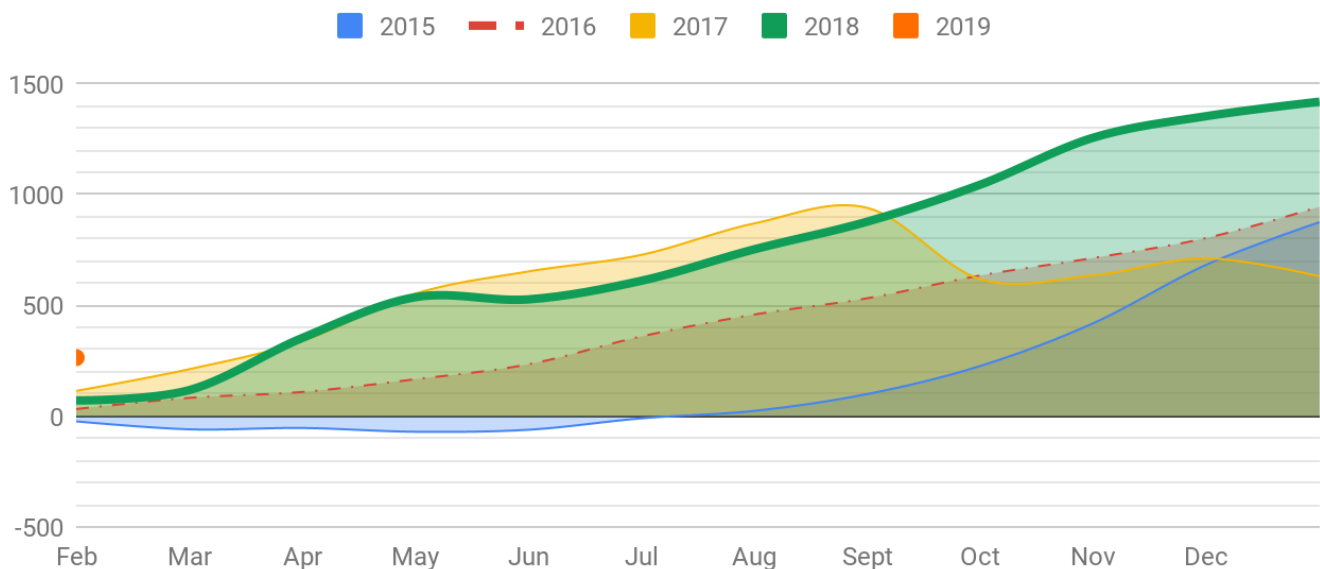
However, some of this impressive performance was due to currency effects: the ruble lost 20% against the dollar in 2018, depressing bank results, but it gained around 5% in January pushing up the results. "In addition, several changes in accounting methodologies came into force that have impacted the sector's financials," bank analyst Andrew Keeley of Sberbank CIB said in a note.

Russia bank profit RUB bn (monthly profits)



source: CBR

Russia bank profit RUB bn (cumulative profits)



source: CBR

8.1.2 Loans

There was good news too on the lending front in 2018. While consumer loans have recovered well in the last two years, corporate borrowing has remained depressed as bankers preferred to go to the bond markets and remain pessimistic about Russia's near term outlook. The presidential elections last March also depressed borrowing activity.

Corporate loans were up 10.5% y/y or 5.1% y/y if adjusted for the 20.6% ruble depreciation against the dollar, VTBC estimates. Retail loan growth momentum remained strong, and the portfolio grew 22.4% y/y, slightly decelerating m/m due to seasonal repayments.

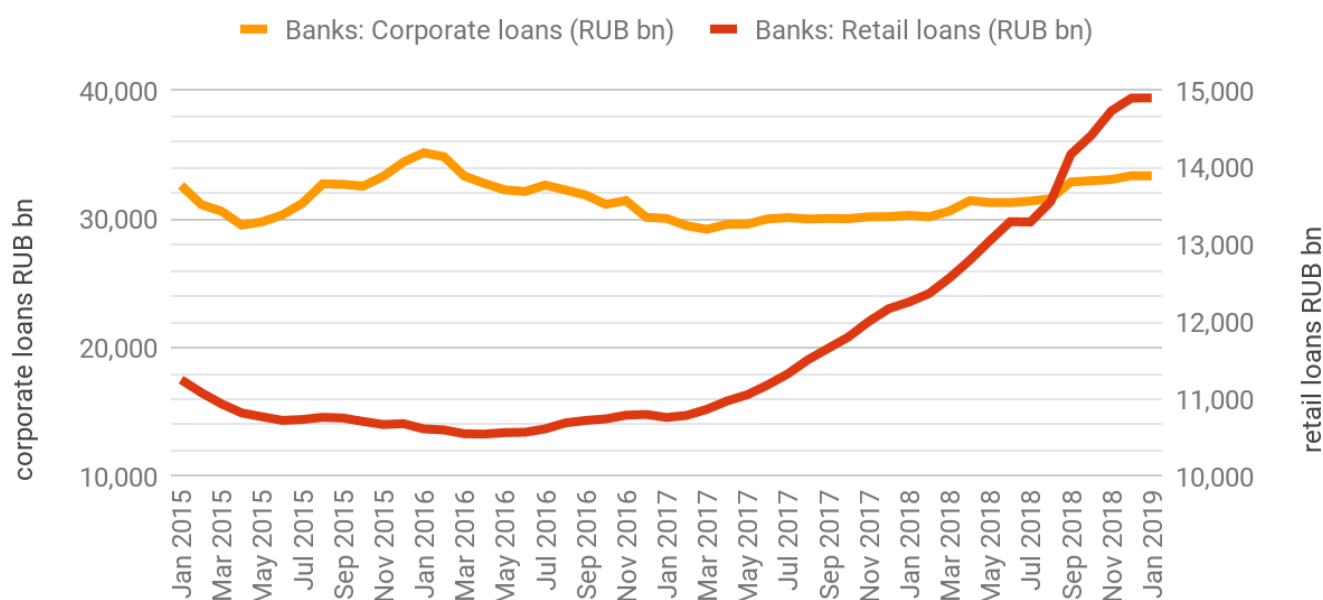
Households contributed to growth in 2018 by taking out more loans. Retail lending rose 22.4% last year after a 12.7% increase in 2017, central bank data showed.

Russia's banking total loan book was flat m/m in January in nominal terms (+13% y/y), while in FX-adjusted terms loan growth was 1.0% m/m (+10.3% y/y and +10.9% y/y excluding banks whose licenses have been revoked).

Retail loan growth was 1.3% m/m in January (up 23.5% y/y excluding banks whose licenses have been revoked). The rate of retail loan growth accelerated in the second half of last year; as incomes stagnate Russian consumers seem to be borrowing more heavily to maintain their standard of living to the point where the CBR is starting to worry.

Corporate lending decreased 0.6% m/m in nominal terms but was up 0.8% m/m in FX-adjusted terms (for FX-adjusted y/y growth of 5.8%).

Russia banks: Corporate vs Retail loans (RUB bn)



source: CBR

8.1.3 Deposits

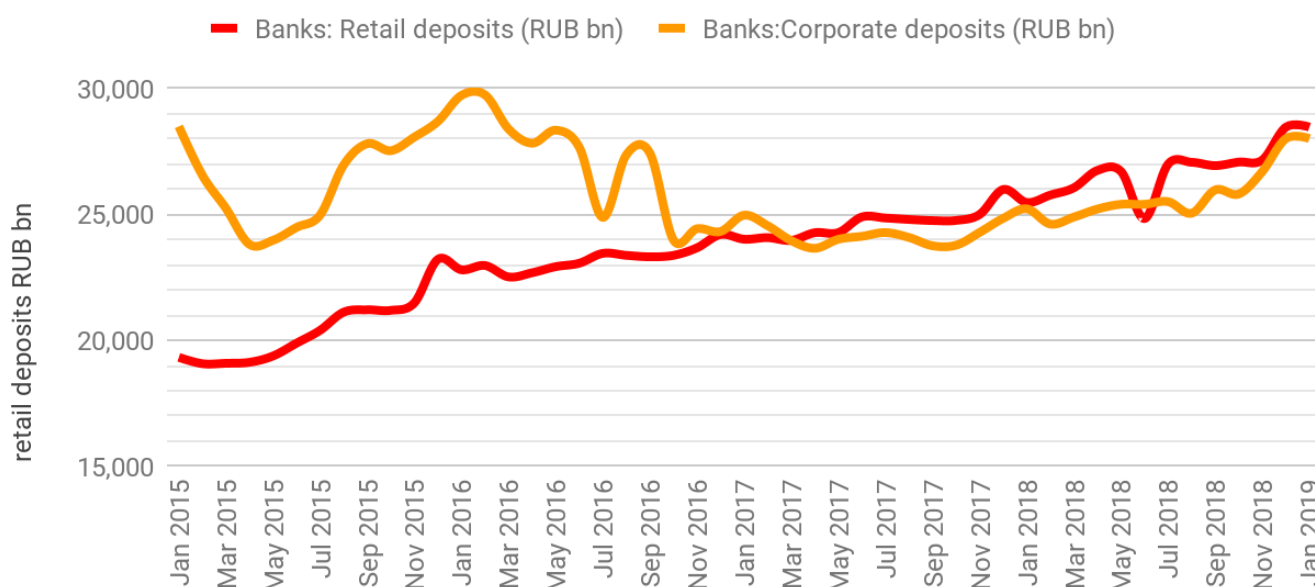
Deposits are also growing again in 2018. Both retail and corporate accounts posted solid growth: 9.5% y/y and 12.7% y/y, respectively at the end of 2018.

Russian banking sector deposits are also growing in aggregate in January, but not at the same pace as borrowing. Retail deposits were down 2.5% m/m in January in nominal terms and down 1.4% m/m in FX-adjusted terms last month, for FX-adjusted y/y growth of 6.5% (excluding banks whose licenses have been revoked).

The fall in retail deposits overall both m/m and y/y when set against the rapid growth in retail credits is clearly a worrying trend.

Corporate deposits were down 1.3% m/m in nominal terms but up 0.6% m/m in FX-adjusted terms (for nominal/FX-adjusted y/y growth of 10% and 4%, respectively).

Russia bank Corporate vs Retail despoits (RUB bn)



source: CBR

8.1.4 NPLs

Non-performing loans (NPLs) situation has also improved in 2018 as banks have profit again to deal with problem loans. The share of overdue loans notably improved both m/m and y/y, VTBC reports, which can be attributed to repayments and write-offs.

As of the end of 2018, the share of overdue amounts in the corporate portfolio was 6.3% and in retail 5.1%. The share of total provisions was also down m/m and y/y, to 8.3%, still helping the coverage ratio to improve to 177% from 171% a year ago.

The share of overdue loans in the corporate portfolio increased to 7.8% in January from 6.3% in December. The CBR attributed this sharp increase to changes in accounting methodologies, particularly in different treatment of overdue receivables. The retail overdue ratio increased to 5.4% in January from 5.1% in December.

8.1.5 NIMs & CARs

Excluding the FX factor, both segments grew 5.5% y/y. CBR funds declined 14.5% m/m, yet were up 29.3% y/y.

8.1.7 Banks specific issues

Putin asked the govt and CBR to consider measures to lower mortgage rates to 8% and below by beg-2020. The CBR hikes last year and some tightening of regulation caused rates to grow – current rate around 10%. Mortgage rates reached a historic low at 9.4% in fall 2018, but have since risen again. In December, banks issued mortgages at an average rate of

9.66%. There are two ways the government can lower mortgage rates. The first is through non-market measures: issuing subsidies or creating a special mortgage bank among those sanitized in the sector's cleanup. However, mortgages have grown well (by 25% in 2018) without these incentives, so experts worry that subsidies will lead to a rise in unqualified lending and thus an increase in banks' credit risk. The second method is much slower: enacting structural reforms that within a couple of years will trickle into the banking sector. The CBR is already taking the necessary steps—reducing inflation and stabilizing the exchange rate—but geopolitical risk continues to interfere with the creation of a low-rate economy.

CBR looks to amend lending requirements. The Bank of Russia is developing a new approach to risk assessment that will free up capital and stimulate lending to the economy. Per new guidelines, banks will be able to reduce risk ratios for sovereign and corporate borrowers. There are two things going on here. First, the CBR is looking to expand the money supply domestically as Russian entities struggle to access Western financing. Banks will be able to borrow and lend at lower rates, and thereby stimulate the economy after the 2014-16 credit crunch. Second, this proposal is part of a broader CBR effort to create a more developed financial system. It is notable that the new guidelines comply with Basel III. While current Russian-Western relations mean that it is not terribly important for the Russian banking system to match European standards right now, this is important institutionally in the longer-term.

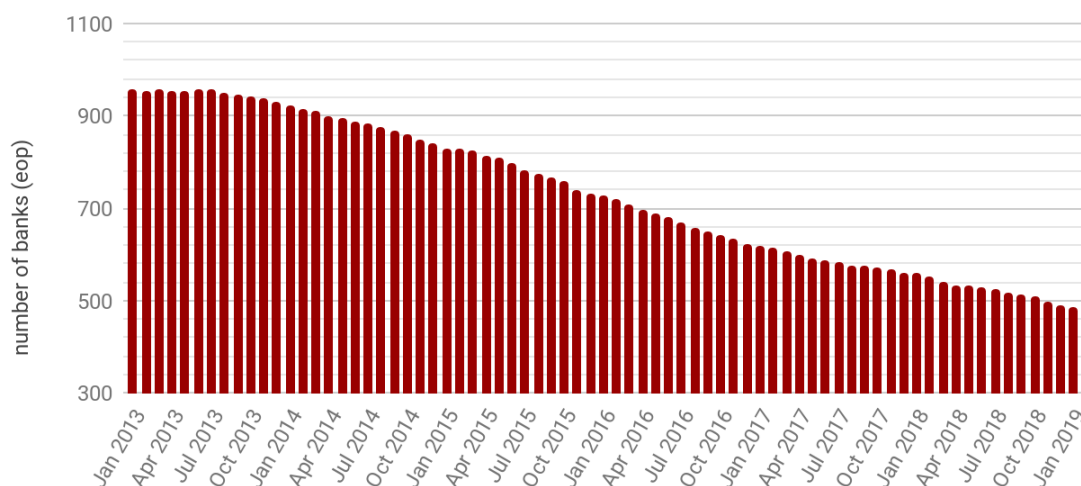
- The reform will comprise two stages. In 1Q19, the CBR will change the risk assessment for sovereign borrowers, and in 4Q19, it will do the same for corporate borrowers.
- Currently, sovereign credit risk is determined by the rating of Russia's domestic credit agency (EXIAR). This rating requires banks use a risk ratio of 100%.
- In 1Q19, banks will transition to using the ratings of international credit agencies. Per Basel III standards, Russia's sovereign rating of BBB- only requires a 50% risk ratio for borrowing.
- Banks will have two options for assessing corporate borrowers risk profile: use ratings from international credit agencies, or develop an independent assessment based on the borrower's solvency, financial position, and other factors dictated by the CBR.
- The CBR developed the alternative approach in coordination with the Basel Committee.
- This method should bring the risk ratio for corporate borrowers down to roughly 65%.

The recent growth of banking rates including rates for mortgage lending following a hike in value added tax (VAT) to 20% from 18% could be expected, but it is short-term, the rates will decrease in the future, Russian President Vladimir Putin said on February 10. "The situation is predictable, the government assumed, and so do I, that the event is one-time and short-term, and the rates will return to previous figures and then decrease," he said. He also said that DOM.RF, previously known as the Agency for Housing Mortgage Lending, used to suspend mortgage payments for people in challenging situations, and may resume the practice.

The number of banks has also continued to fall. The CBR is in the midst of a banking sector clean up that is coming into its end game as the number of banks in Russia [fell below 500](#) in November. This year Russia has started

with only 479 banks left as the CBR continues to close smaller banks at the very steady rate of about three a week.

Russia number of banks (eop)



source: CBR

8.1.8 Sberbank news

Russia's retail banking giant Sberbank earns yet another record profit in 2018, but probably doesn't have the cash to cover a full 50% of profit dividend payout

State-owned Russian retail banking giant [Sberbank](#) earned another record of RUB831.7bn (\$12.6bn) under IFRS, up 11% from the year before, the bank announced on February 28, 2019.

CEO German Gref said last year that the state-owned giant is on course to earn over RUB1 trillion in the next years and the bank remains one of the most profitable in the sector.

Analysts Uralsib expected the bank to earn RUB824.2bn of net profit, VTB Capital RUB830.5bn, Renaissance Capital RUB829bn, Alfa Bank RUB843bn and Aton and BCS Global Markets RUB853bn – the highest projections.

However, despite the good news Sberbank said that it hasn't earned enough to pay out 50% of its profits as dividends, in keeping with the Ministry of Finance orders for all state-owned enterprises (SEOs).

The Central Bank of Russia (CBR) owns 50% + 1 share in the bank and would pay the dividend contributions into the budget. On the 2018 numbers Sberbank should pay out a dividend of RUB415bn but the ministry has already penciled in half as much: a RUB209.5bn contribution to the budget in 2019 from Sberbank as dividend payments.

However, Sberbank is bound to pay less. Part of the issue is that unlike regular companies, a bank has to maintain adequate capital adequacy ratios to ensure its own stability. And in a country as crisis prone as Russia, especially with new "crushing" US sanctions looming making sure the biggest bank in Russia can weather any storm is high on the Kremlin's priority list.

The bank has not said exactly how much it will pay in dividends yet, but analysts are not expecting the full 50% payout. But the dividend payout has been rising in recent years and last year the bank paid record dividends of 36.2% of net profit.

And in other news..

As of the rest of the results Sberbank's net interest income grew by 3.5% to RUB1.39 trillion and commission fees by 18.1% to RUB445.3bn. The cost of creating reserves for the year decreased by 14.6% to RUB225.3bn, Vedomosti reported.

The loan portfolio was up over the year: the corporate loan portfolio was up by 12.9% to RUB12.69 trillion and the retail loan portfolio by 25% to RUB5.39 trillion. Indeed, retail borrowing is growing so fast now that the CBR is starting to get worried and may intervene soon to cool the business by raising prudential thresholds.

Deposits are also growing, but not as fast. The savings of the population in the state bank increased by 9.9% to RUB12.27 trillion, while those of companies were up by 26.6% to RUB5.84 trillion.

The strong results will only underscore the bank's image as an investor darling. After taking a sanctions-related battering last year, the bank's stock has recovered and recently took bank Russia's [king of the castle](#) title from oil company Rosneft to become Russia's most valuable company in January.

Analysts are now speculating that Sberbank will manage the 50% payout next year. "Much depends on capital adequacy: now it is 11.9%, Sberbank's goal is 12.5%, and once it reaches that level it will pay out 50%," Aton's Mikhail Ganelin told Vedomosti.

The growth in capital adequacy was less than hoped as the CBR is pushing through the Basel III rules which means banks have to make larger provisions. In Sberbank's case the new provisions are estimated to have reduced its capital adequacy by 0.8%, which leaves less money as profits.

Another fillip to profits failed to appear: the sale of Turkish bank Denizbank that has been [postponed](#) several times. Investors were hoping that if the Turkish bank were sold then Sberbank would share the windfall with investors. Analysts estimate that the sale of the bank would add the missing 100bp to Sberbank capital adequacy and take it over the 12.5% threshold that would allow the 50% payout.

Sberbank reports 22% increase in ROE for January under RAS, but NIM declines

Russia's leading retail bank [Sberbank](#) has published its January 2019 Russian Accounting Standards (RAS) standalone results that showed the usual strong returns on equity, although the net interest margins (NIMs) slipped somewhat following a rate hike by the Central Bank of Russia (CBR) in December.

The bank's earnings of RUB74bn (\$1.1bn) were up 13% y/y, implying a solid 22.4% ROE, reports VTB Capital (VTBC) said in a note.

“A 12.0% y/y increase in F&C income and low provision charges (due to ruble appreciation) supported the bank’s earnings. However, net interest income (NII) came under pressure from an increased cost of funding, with the 3mo rolling NIM down 8bp m/m to 5.9%, which raises concerns, in our view, with Sberbank targeting the protection of its market share of retail deposits and expecting a delay in the reversal of trends in NIM until 2Q19. The results are moderately negative amid NIM performance, in our view. We reiterate our 12-month Target Prices of RUB 360 for ords (ETR 75%) and RUB 320 for prefs (ETR 82%): Buys reiterated,” Svetlana Aslanova, a bank analyst with VTBC said.

The banking sector returned to profit in 2018, but the [CBR is being extremely cautious](#) in the face of more US sanctions and chose to shore up the ruble with two rate hikes in September and December to 7.75% that is now feeding through to bank profits, as the cost of borrowing has gone up marginally.

The rate hikes have also fed through to the mortgage business where rates have increased again after falling below 10% to post Soviet low towards the end of last year.

“The recent increase in mortgage rates might help NIM in the medium term, although management expects a reversal in the trend only in 2Q19. Net fees and commissions (F&C) income declined 35% m/m, and was up 12.0% y/y amid seasonal pressures of high transactions with cards, but management targets a 15% y/y growth for FY performance,” Aslanova added.

Corporate loans declined 2.0% m/m; however, excluding the FX effect, the portfolio contracted only 0.5% m/m amid demand for ruble denominated loans that balanced deleveraging in FX loans. The retail portfolio showed an unusual 1.0% m/m increase, stoked by a shift of demand as loan rates started to climb, as well as the low base effect after Sberbank sold part of its mortgage loans in December. Retail deposits were down 3.3% m/m (-2.5% w/o FX effect), which is in line with the seasonal trend. This outflow was balanced by a 4.1% (6.3%) increase in corporate accounts.

“The capital position remains strong despite regulatory changes. Both N1.1 and N1.0 remained flat m/m at 11.0% and 14.8%, respectively. These ratios include new regulatory deductions from capital (irrelevant for IFRS), lower RWA amid the FX factor, but do not include 2H18 RAS earnings before they are audited,” Aslanova concluded.

Russia’s retail banking powerhouse [Sberbank](#) increased the authorized capital of its Ukrainian subsidiary bank by UAH3.3bn (\$122mn), or by 15.9%, to UAH24.065bn, the bank said on February 12. As a result of the increase in the authorized capital, the bank has formed additional reserves for loans, as well as increased capital adequacy, the bank said. Sberbank last year returned a loss of UAH7.6bn, after it was sanctioned by the National Bank of Ukraine (NBU). In January, the NBU fined the Ukrainian daughter bank UAH94.737mn for “risky activities.” Sberbank is appealing the penalty in court. Sberbank established a subsidiary bank in Ukraine in 2001. According to the Ukrainian regulator, as of December 1 of last year, the bank held 11th place in the Ukrainian banking system in terms of net assets of UAH31.824bn.

8.1.8 Bank news

Russian multi-industry holding AFK [Sistema](#) and its subsidiary Sistema Telecom Assets have sold 39.5% shares in MTS Bank to mobile operator [Mobile TeleSystems](#) (MTS) for RUB11.4bn, Sistema said in a statement on February 10. As a result of the deal, Sistema's direct ownership of MTS Bank fell to 5%, while MTS' ownership grew to 94.7% from 55.2%. In July 2018, Sistema sold 28.6% in MTS Bank to MTS for 8.3bn

Alfa Bank reports earnings up by two thirds in 2018 IFRS results. ABH Financial, the holding company of Alfa Bank, released strong 2018 IFRS results on February 28 and the bank's management held a conference call. Earnings came in at \$1.32bn for the full year (up 66%) amid notable growth in retail lending, which kept the net interest margin stable despite high competition in the corporate lending segment, the bank's traditional strong suit. In addition, the bank showed good fee income growth and cost control. ROAE rose to 19.6% for 2018 from 13.2% for 2017, VTB Capital said in a note. Operating income before provisions was \$3.13bn, up 34.7%. The net income margin came in at 4.8%, stable y/y due to a growing contribution of higher-margin products in the loan book (the share of retail loans rose from 15.4% to 19.9% over the year). Fee income grew 15.6% and accounted for 31% of pre-provision operating income. Despite the increased retail lending, the bank managed to keep operating costs under control, and the cost-to-income ratio fell to 39.5% from 51.8%. Cost of risk rose from 0.04% to 0.88% over the year, though the figures are incomparable due to IFRS 9 coming into effect at the beginning of the year. "The growth was attributable to corporate loans (whose cost of risk rose from -0.4% to 0.5% in 2018), while the cost of risk on retail loans was flat at 2.9%. Meanwhile, asset quality metrics improved, with 90d NPL/gross loans down from 2.3% to 1.4% y/y (1.3% for corporate loans and 1.8% for retail) and reserve coverage for such NPLs at 208% (183% for corporate, 283% for retail). According to the new standards, the wider category of stage 3 loans represented 3.4% of the overall loan portfolio, and reserve coverage for such loans was 87%," Ekaterina Sidorova of VTBC said. The bank's Tier 1 capital was supported by the higher earnings and January 2018 issue of \$500mn in perpetual Eurobonds. As of January 1, 2019, the local Basel 3 standalone CET1 ratio was 9.5%, while total CAR was 13.5%.

8.2 Central Bank policy rate

The Central Bank of Russia (CBR) kept [monetary policy rates on hold](#) at 7.75% at its regular meeting on February 8, saying that inflationary pressures are under control despite a recent rise in prices.

"On 8 February 2019, the Bank of Russia Board of Directors decided to keep [the key rate](#) at 7.75% per annum. In January 2019, annual inflation held at the lower bound of the Bank of Russia expectations," the regulator said in its statement.

Inflation fell to a post Soviet low of 2.2% in the first quarter of last year, well below the CBR's target rate of 4% leading the central bank to cut rates to a record low of 7.25% in February.

However, a fresh round of sanctions in April, the fall of the ruble against the dollar and the expectation by the population of rising prices all contributed to inflation beginning to climb again in the second half of the year, leading the

CBR to hike rates twice in September and December.

Inflation rose to 4.3% in December, slightly ahead of expectations, and jumped again in January to 5% in annualised terms partly driven up by the hike in the VAT rate from 18% to 20% that came into effect in January.

“Inflation expectations of households and businesses increased somewhat. The contribution of the VAT increase to annual consumer price growth in January was moderate. The effect of the VAT increase on inflation can be fully assessed no sooner than this April. There persists uncertainty over future external conditions and certain food price dynamics. The balance of risks remains skewed towards pro-inflationary risks, especially over a short-term horizon. Given the decision taken, the Bank of Russia forecasts annual inflation to range between 5.0 and 5.5% by the end of 2019 and return to 4% in the first half of 2020,” the CBR said.

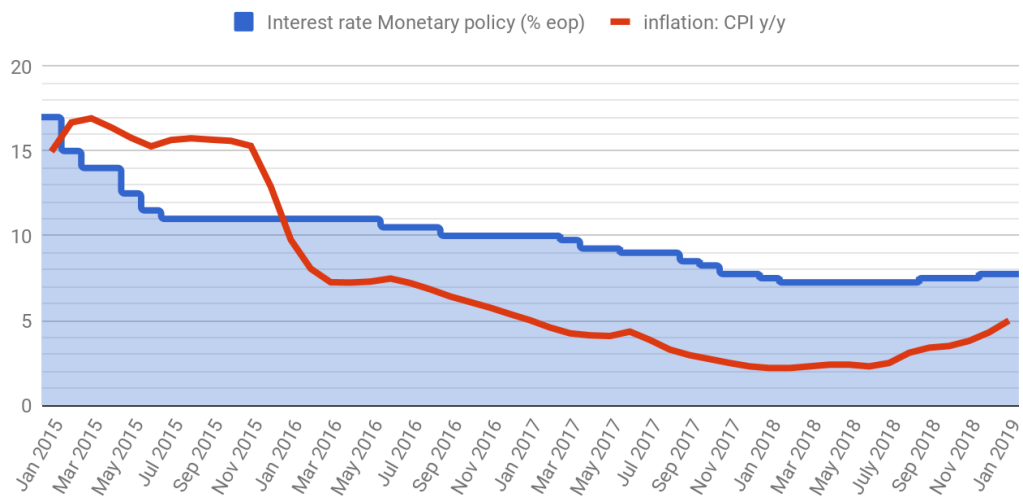
Analysts are divided over where inflation will go in 2019 and hence if the CBR will return to its monetary easing or tighten again. While the CBR has relatively modest assumptions for inflation’s increase this year, many analysts are predicting inflation to rise to 6% by April, before easing again in the second half of the year.

However, Sberbank CIB says that inflation will fall to 4.5% this year due to depressed consumer demand and under investment. VTB Capital (VTBC) also agrees that poor demand will keep prices down this year and the CBR confirmed that the feed through affect of the VAT increase has been a lot more modest than some had feared.

“Why is the [inflationary effect of the VAT hike] modest? Basically there are two non-contradictory hypotheses,” Alexander Isakov, chief economist at VTB Capital said in a note. “VAT front-loading. Given imperfect local competition and the fully expected nature of the VAT base rate adjustment, it makes sense for producers and retailers to adjust prices preemptively... And demand is softening. Household demand strength might have been withering into the year-end, as inflation climbed from the lows of early 2018 and started to bring down real wage growth. We believe both effects were at work.”

VTBC calculates that in order for inflation to peak at around 6% in April-May, average monthly inflation in February-March needs be 0.6%. And while this is not unimaginable, it is at odds with the recent weekly reports that put monthly price growth on the order of 0.1-0.2pp growth.

Russia monetary policy rate vs inflation CPI



8.3 Stock market

8.3.1 Equity market dynamics

International investors remain overweight in Russian stocks, but oil sector loses its appeal

International investors remain overweight in Russian stocks and believe the risks of lower oil and more sanctions are already priced in, but after stellar returns last year, investors are now underweight Russian oil stocks, BCS Global Markets said in a note following a survey of its clients.

The oil sector has been a bit of rollercoaster ride in recent years. Following the collapse of the oil price at the end of 2014 the VTB Capital (VTBC) oil sector index was down over 40% by the end of that year. The following year was one of pain as Russia's economy tried to recover from the shock of the deep associated ruble devaluation and the oil index was flat y/y in 2015.

However, from 2016 the salutary effects devaluation had on costs, which are priced in rubles whereas income is in dollars, saw the oil index soar and return near 50% y/y. 2017 was more difficult for oil stocks as oil prices fell again into the 40s, but as the year came to an end started to rise strongly finishing 2017 with a overall gain for the sector of about 10%.

Last year was another good one for oil stocks has price growth continues, with oil rising from an average price of around \$65 in the first half of the year to around \$75 in the second. However, as the year came to an end oil prices started falling again and in January the average oil price fell to \$56.

That has taken the wind out of the sails for portfolio investors looking at oil. However, there is still some upside left as oil prices recovered in February and were \$66 for a barrel of Brent at the time of writing. Bankers are assuming prices will return to an average of \$65 this year, but much will depend on if the production cuts deal with OPEC will be extended at a meeting in Vienna scheduled for April.

In the meantime BCS reports that while three quarters of its clients were overweight Russian oil stocks in November, now 60% are either flat or underweight. It seems the oil recovery story has run its course. In November half of some international investors' portfolio was made up of oil and gas stocks.

Investors have switched to more domestic stories and currently the utilities sector is the best performing, up 14% YTD according to a BCS, followed by the financial sector up 12% YTD.

"The cautious view on future oil prices is the key reason for the downgrade. Lukoil and Tatneft prefs are the most popular names in Russian O&G. Gazprom is becoming interesting thanks to resilience, low multiples. Domestic players are now the top picks in Russia. Rosneft is the key outcast due to write-offs," Kirill Tachennikov, Director and Senior Analyst at BCS Global Markets said in a note.

Despite the switch out of oil Russia remains portfolio's favourite from the leading emerging markets (EM) partly because of the high dividend yields, partly because of the low valuations and partly because investors believe that the risks from potential new US sanctions have already been priced in.

"Our institutional clients still prefer the Russian market to that of other EM countries. Most of them said they are overweight in Russian stocks v other EM companies' stocks. They consider risks to be priced in. We believe that low valuations combined with high dividend yields will keep the Russian stock market resilient against possible new US sanctions and other problems typical

of emerging markets,” Tachennikov added.

Investors are still holding names like: the privately owned [Lukoil](#) that has seen its share price almost double last year; privately owned [Surgutneftegaz](#) prefs, thanks to its \$40bn cash pile, interest on which account for about three quarters of its dividend payments; along with independently owned gas producer [Novatek](#). The state-owned bluechips have been trading water, as *bne IntelliNews* recently reported in “[Sberbank retakes Russia's equity King of the Castle title](#).”

Sectors connected to the consumer are coming back into focus with the traditional favourites catching the most attention, including: state-owned retail bank [Sberbank](#), internet search engine giant [Yandex](#) and supermarket chain [Magnit](#) among the most popular names, according to BCS.

Eyes on Gazprom

The state-owned gas giant [Gazprom](#) has started to peak investors curiosity and as is the possible candidate for good returns this year. The company's stock has been an underperformer for most of the last two years and had a particularly bad year in 2018, having lost some 30% of its value.

However, things are about to change significantly for the company's business. On February 27 the company announced construction of the Power of Siberia gas pipeline to China is now “99% complete” and it expects to start delivering gas over the border from December this year.

At the same time the company said this month that 700km from 1200km Nord Stream 2 pipeline is now complete and recently moved up the completion date from the start of 2020 to the end of 2019.

Gazprom has been investing a record RUB1.1 trillion in these big construction projects, but as the capex on them falls away at the start of 2020 the company will have significantly more free cash to share with its shareholders – including the cash strapped government that is keen for all state-owned enterprises (SOE) to pay 50% in dividends.

And Gazprom just hinted that it would [pay record dividends](#) its 2018 dividend payments from the 20% dividend yield it has paid in the last two years, blaming the low level on the need for investment into its mega-pipeline projects.

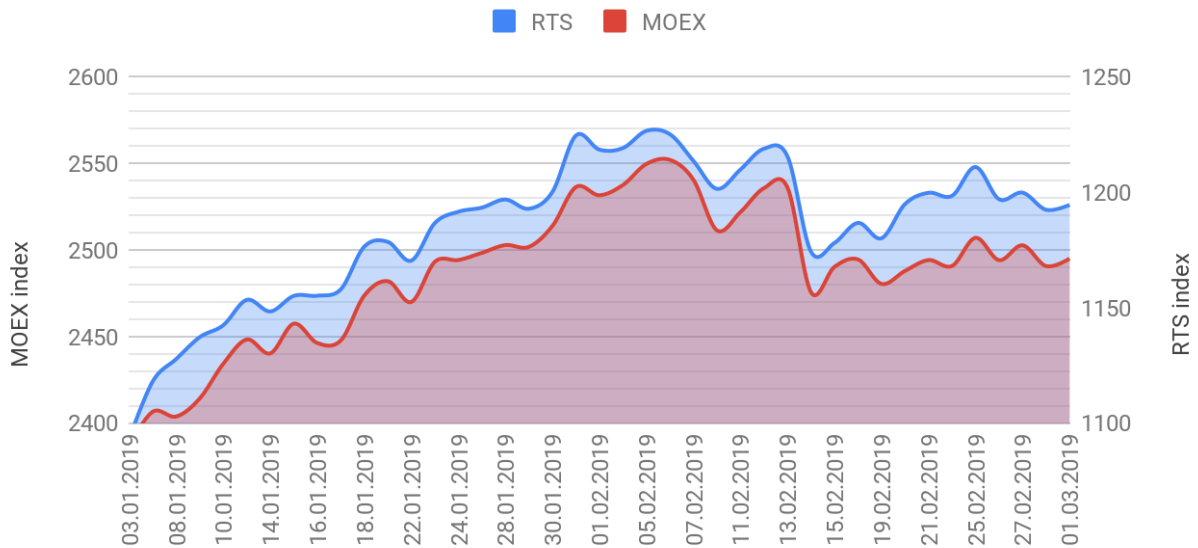
“The high yield in favourites means all eyes are on Gazprom, but investors are still not overweight in the name. Lukoil and Tatneft prefs seem to be everyone's choice now thanks to a decent yield either in the form of dividends or buyback,” says Tachennikov. “Gazprom was frequently the centre of discussion, but although the street agrees that downside is limited, concerns about future capex plans, dividend per share (DPS) and the impact of the new mineral extraction tax (MET) still limit exposure to the stock.”

Rosneft was until recently briefly Russia's most valuable stock on the back of outsized profits in 2017, but the appeal has fall back now and it is out of favour, as investors are concerned about possible write-offs in the Venezuelan crisis, where the company has significant projects.

Gas producer Novatek has also become the focus on investors as its investments into LNG go from strength to strength. The company is again on investors' radar, according to BCS, ahead of the anticipated sale of stake in its Arctic LNG 2 project.

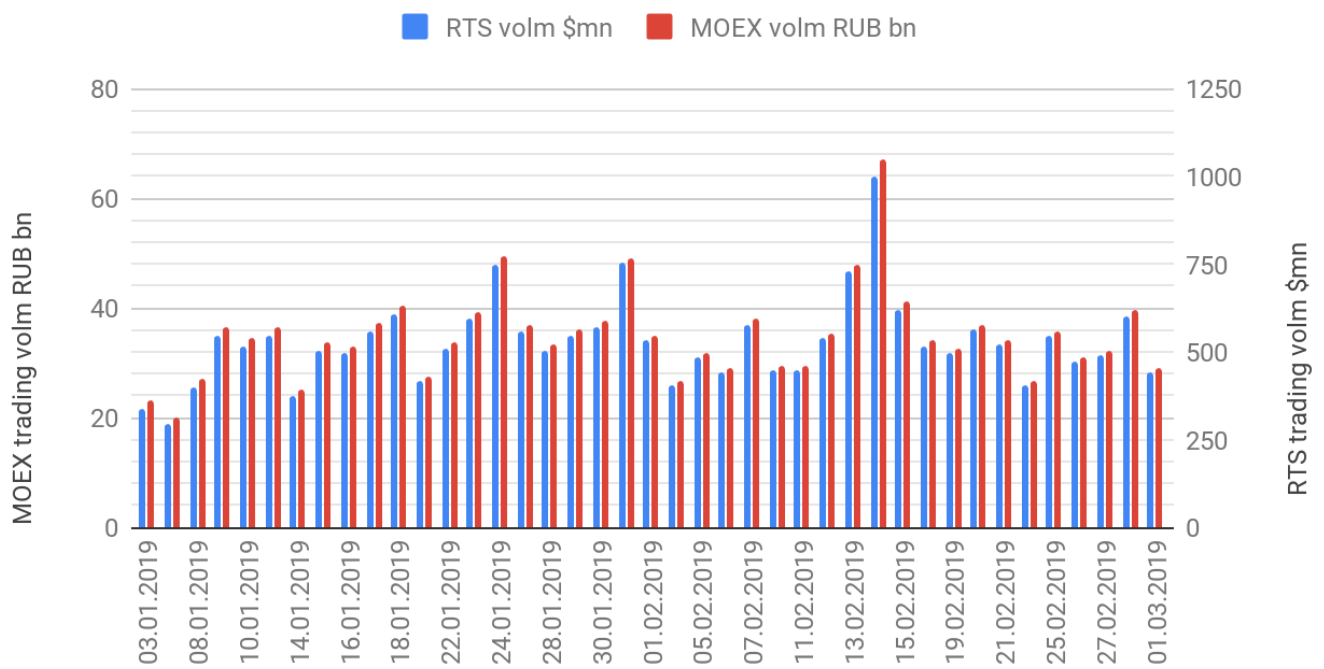
Russia Stocks RTS vs MOEX indices

YTD: RTS 11.4%, MOEX 5.1%, MSCI EM 9.7%



source: MOEX

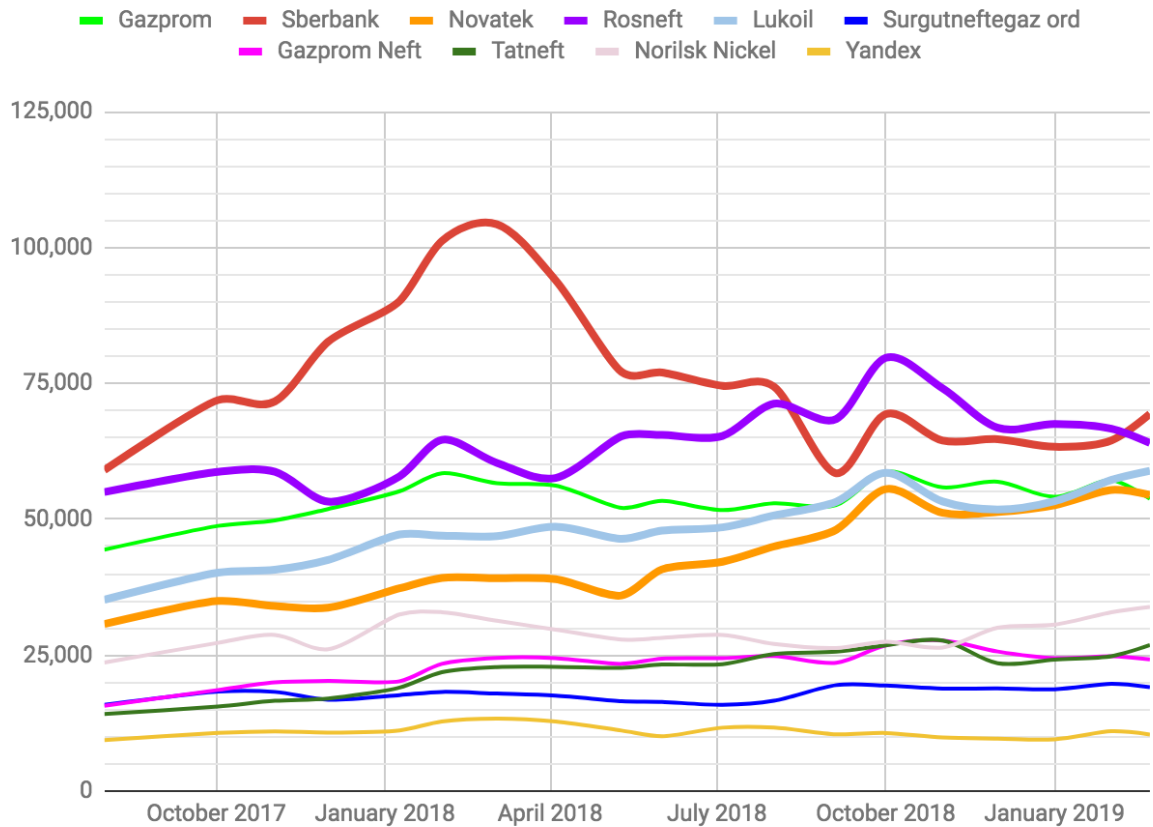
Russia stocks RTS vs MOEX trading volm (\$mn RUB bn)



source: MOEX

Russia's King of the Castle

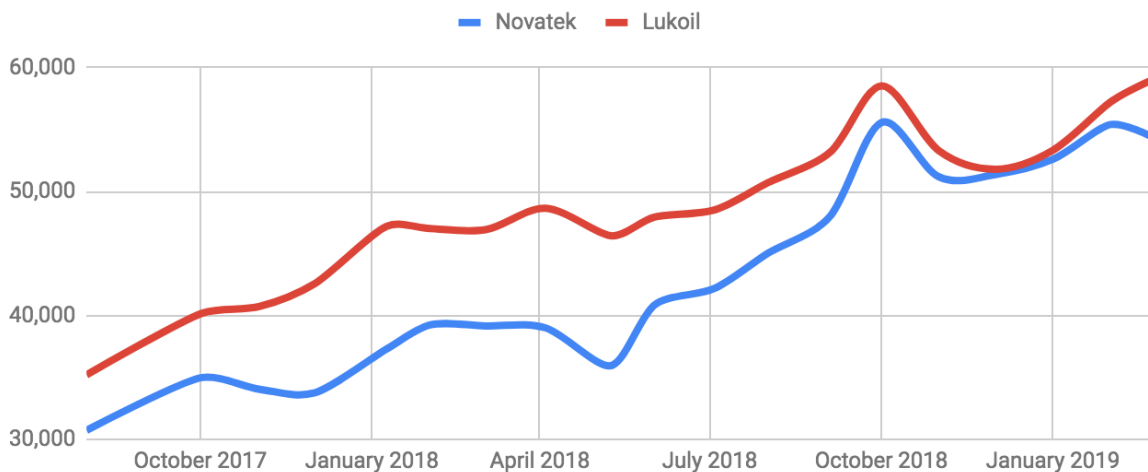
Russian stocks market capitalisation \$mn



source: MOEX, BCS GM, VTBC

Russia fastest growing heavyweight stocks

Russian stocks market capitalisation \$mn



source: MOEX, BCS GM, VTBC



OIL AND THE RTS

About two thirds of the capitalization of Russia's stock market is made up of oil and gas names and in the past the market's performance has been closely tied to the price of oil.

However, as politics have come to play a bigger role the relationship between the cost of a barrel of the black stuff and the height of the leading dollar denominated RTS index has broken down. And the relation was further weakened by the re-introduction of the so-called budget rule at the start of 2018, where all government oil revenues from when oil prices are over \$40 are siphoned off into the state's rainy day fund.

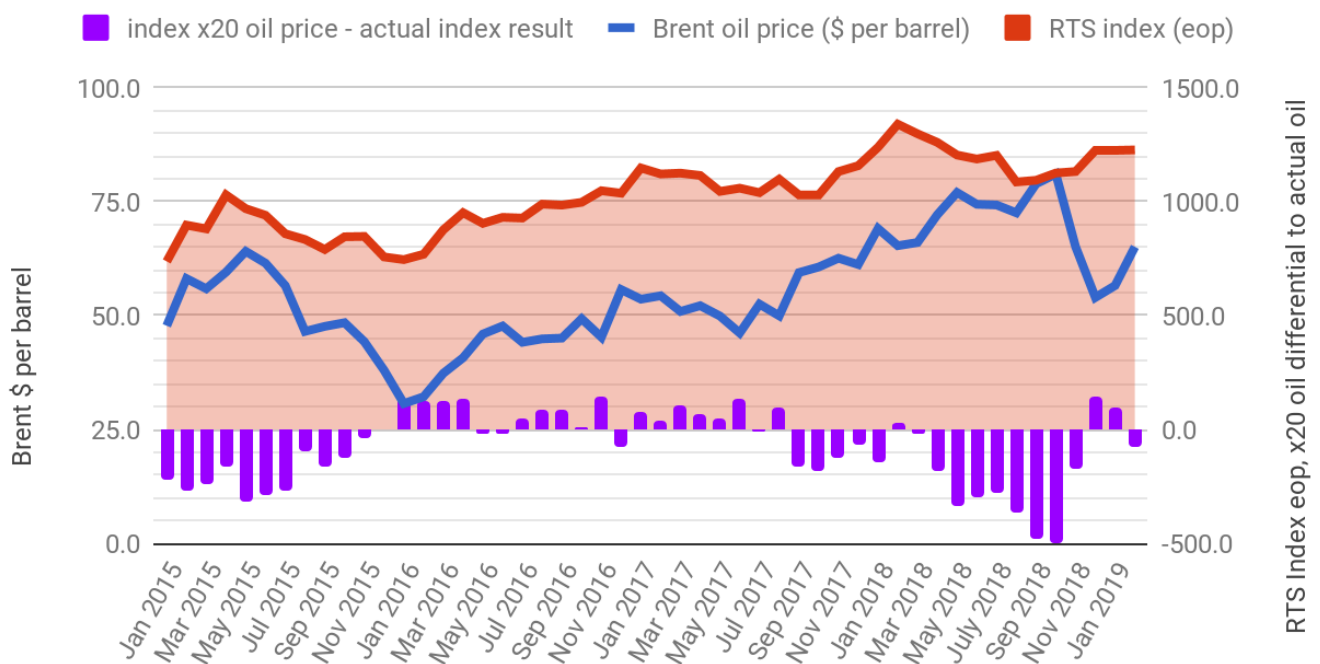
There is a handy rule of thumb for checking if Russian share prices are over or undervalued as the RTS's value is on average x20 the cost of a barrel of oil.

Although this relation doesn't work as well as it used to despite the run up in oil company prices this year, that are easily outperforming the RTS, according to the rule of thumb the RTS is undervalued by over 400 points as of August – the biggest gap it has displayed for at least two years.

At the start of 2019 with oil prices averaging \$56 in January the RTS at 1,200 was overvalued according to the x20 rule by some 100 points.

The average oil price rose to \$65 in February and at this level the x20 rule of thumb suggests the RTS is undervalued by 76 points.

RTS vs Brent oil price, difference x20 price of oil indicator



Aton top stock picks for 2H17, drivers

Company	Ticker	TP	Upside potential	Key drivers
Sberbank	SBER RX	RUB210	43%	The bank trades at a 2017 P/E of 5.0x and P/BV of 1.0, which is well below EM peers. It enjoys high and sustainable ROE above 20%. Dividend payout ratio can be increased after 2017. Best liquidity in the market and strong corporate governance.
Alrosa	ALRS RX	RUB125	43%	Trades at 4.7x 2017 EV/EBITDA, offering a discount to global diversified miners (5.3x) and Norilsk Nickel (6.6x). Recent stock underperformance caused by sanction concerns (Alrosa is a state-owned company) is unjustified, in our view. We expect the stock to be supported by strong summer monthly sales as well as its FY16 dividends (10% yield). Alrosa generates strong FCF yielding 15% and has low debt of 0.6x.
Unipro	UPRO RX	RUB3.55	41%	Turnaround story: we expect bright 2017 earnings with further momentum supported by the Berezovskaya unit's relaunch. One of the best high-conviction dividend plays in the sector.
TCS Group	TCS LI	\$15.2/GDR	35%	Management guides for 25-30% EPS growth in 2017, the highest in the sector. Strong 1Q17 IFRS results suggest the bank is on track to reach its FY guidance. Dividend policy assumes a 50% payout ratio from IFRS net income on a quarterly basis. The stock trades at a P/E of 9.0x, high compared to peers, but for this reason the bank operates at the highest ROE in the sector (40%+).
Etalon	ETLN LI	\$4.7/GDR	32%	This year should be a strong for the company in terms of earnings growth: we expect EBITDA and EPS to increase by 53% and 50%, respectively, driven by falling inventories from built flats. The share of more value-added projects in Moscow has increased to 50% of total portfolio, which in turn should lead to better margins. Finally, debt burden is the lowest vs other developers, allowing Etalon to boost its dividends. We believe Etalon's dividend yield may reach 9% for 2017, overtaking LSR Group.

Rosneft	ROSN LI	\$7.3/GDR	24%	The highly likely approval of MET benefits for the Samotlor high watercut field in the coming months could become a strong trigger for the name: we estimate a +5-6% effect on annual EBITDA. The dividend payout increase to 50% is an additional supportive factor.
MMK	MAGN RX	RUB41.5/ GDR	24%	MMK's shares have fallen 20% from the 1Q17 high and it remains one of the cheapest steel names globally at 3.8x EV/EBITDA for 2017. Steel industry is recovering and the steel over bulks premium in China is expanding; MMK, which has the lowest integration into raw materials, is the key beneficiary.
Novatek	NVTK LI	\$133/GD R	17%	The stock has been considerably oversold on the back of the crude oil slump and has not yet recovered. Timely launch of Yamal LNG along with the new strategy presentation in 2H17 are key drivers for a re-rating, in our view.
Globaltrans	GLTR LI	\$8.7/GDR	13%	This year should be successful for the company, because the deficit of gondola cars on the rail network has led to rising tariffs, which have already achieved RUB1,500 per rail car per day. As a result, we see upside risk to our earnings estimates. Additionally, the company may pay interim dividends for 1H17, while the annual dividend yield is close to

8.3.2 Dividends dynamics

Russia's state-owned gas giant [Gazprom](#) held an investor day in Hong Kong on February 25 and announced it may pay record high dividends this year. Gazprom's management sees the possibility of paying 50% of IFRS net income in dividends after the investment cycle is over in 2020, Bloomberg reports, citing the company's CFO Andrey Kruglov at the Investor Day briefing in Singapore.

"The company's budget assumes dividends of RUB10.43/share for 2018, which translates into a dividend yield of 6.7%. Our base case assumes flat dividend per share (DPS) for 2019-20, so we note some upside potential here. We would deem this development as positive for the name," VTB Capital (VTBC) said in a note.

Gazprom paid RUB8.04 per share in 2017, the same as the year before. The announcement follows on from statements last August that the company could increase dividend payout this year.

In the first nine months of this year the company's profits increased 1.8-fold to RUB1 trillion (\$15.2bn), according to its IFRS accounts. Gazprom aims to keep increasing dividends in rubles in 2019-20 due to growing free cash flow (FCF) and declining investments.

The company has taken on several mega-pipeline projects in recent years, including the Power of Siberia link to China and the Nord Stream 2 pipeline to Germany, but as these projects start to wind down the company's capex will fall off, leaving more revenues free to pay out as dividends. Some 700km of the 1,200km are now completed and the deadline for completion has been moved up from the start of 2020 to sometime in the fourth quarter of this year, the company said. After that the company sees gas capex declining in 2019-20 from the 2018 peak.

So far the company has managed to avoid paying out the full 50% demanded from all state-owned enterprises (SOEs) by the Ministry of Finance, but government is keen to increase its revenues via dividend payouts and the pressure to increase the payout has not abated. In 2017 Gazprom paid out a total of RUB190bn as dividends, or 20% of its profits, according to its IFRS accounts. In November the company warned investors that the payout in 2018-

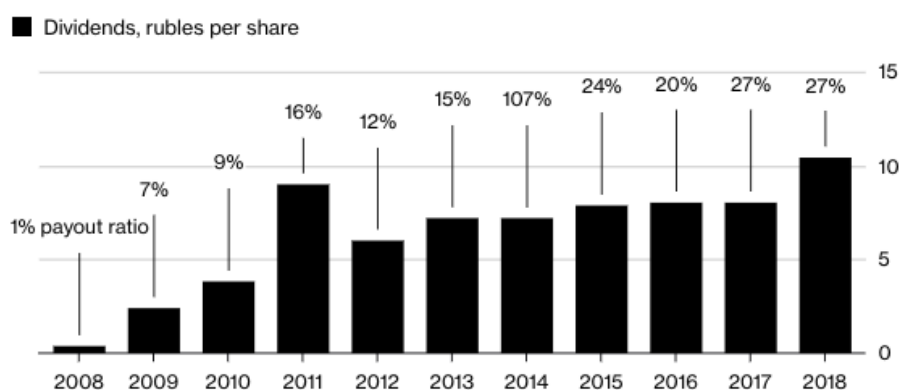
2019 would likely remain at the same RUB190bn level, due to its heavy capex programme, CEO Alexey Miller said at the time.

In 2019, the government expects to receive almost RUB590bn (\$8.9bn) from SOEs as dividends, another RUB626bn in 2020, and by 2021 their amount should increase to RUB675bn. Based on previous budgetary cycles, there is a risk that the state will receive 70% less as dividends, the chairman of the Accounts Chamber Alexey Kudrin warned in October. Gazprom expects natural gas prices in Europe this year to average \$230- 250/kcm. Gazprom estimates that its share of the European gas market grew to 36.7% in 2018, from 34.2% in 2017, amid lower production in the region.

This is still way down on the 80% share in the European gas market Gazprom had in the 90s. Gazprom expects its LNG portfolio to exceed 6mmt by 2020, from 4mmt last year. A buyback is unlikely within the next year, according to the company. The company's natural gas price estimate for 2019 is broadly in line with VTBC's forecast of \$230.8/kcm. However, given the significant drop in European gas prices (which now stand at around \$198/kcm), VTBC analysts see downside risks to the 2019F financial forecasts for the company. To provide an indication, were the current gas price in Europe to remain throughout the year, that would mean 9% lower Ebitda for the company, VTBC estimates.

Record Payout

Gazprom may pay the highest dividends for 2018



Source: Gazprom presentation for investors
Note: Dividends for 2018 as set forth in 2019 budget

Russian utility [RusHydro](#) tried to sooth investors worries over dividend payments at a capital market day. Ahead of the massive write-offs in 2019 after the Russian Far East projects are commissioned, RusHydro's management rolled out its new dividend proposal, which envisages setting a floor for the absolute dividend level at par with the three-year average. "This is a welcome development, in our view, as we expect 2019F net profit to drop at least 35%, thus putting pressure on dividend expectations (which would now be relieved, should management's proposal be adopted)," Vladimir Sklyar of VTBC Capital (VTBC) said in a note. The company guided for capex of RUB123bn (\$1.9bn) in 2019, while VTBC estimate that the companies EBITDA will be RUB112.5bn. That means if the company sticks to its capex plan, the dividends for both FY18 and FY19 will have to be financed out of debt raising some question marks. The management is proposing to set the floor for dividends at the 3-year average, implying smoothed out dividend payments of around RUB15bn (7.0% yield) in the next few years.

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warned in October.

At the end of 2017, 50% of net profit under IFRS was paid by all large state-owned companies, except for Gazprom, which gave up only 26% of profit under IFRS, or about RUB190bn, despite being the largest of the SOEs. The company explained its failure because of its large investment program into pipelines including Power of Siberia, Turkish Stream and Nord Stream 2 pipelines. Having failed to receive additional dividends from Gazprom, the state made up for the lost nby hiking the mineral extraction tax (MET) instead.

It's a new year and Russia's equity markets usually rally through to Easter on the back of seasonal effects. There is an old saw in Russia that if you buy at the start of the year and “sell in May and go away” the market, in non-crisis years, usually returns 20%.

Year to date the dollar denominated Russia Trading System (RTS) is already up 11% on the back of a rally that started at the end of last year, driven partly by improving sentiment after the US Treasury Department (USTD) decided to drop entirely the [April 6 round of sanctions](#) on companies owned by Russian oligarch and Kremlin insider Oleg Deripaska – the first sanctions to be withdrawn since the Russian clash with the west began in 2014 after the annexation of Crimea.

Ruble denominated Moscow Interbank Currency Exchange (MICEX) has done less well but it also up 5% YTD, but its gains have to be off set against the ruble exchange rate and although the index is currently at an all time high the ruble is up 5% against the dollar, lifting the dollar value of the index. That compares with the MSCI EM index, which covers all emerging markets, that has returned 6% YTD, and the MSCI World index that has also returned 6% YTD.

However, both these indices have been more or less range bound for most of the last four years. The market is unlikely to rally unless the show down with the west is resolved. The same is true for most indicators: M&A deals are booming in Central and Eastern Europe (CEE), but down 10% in Russia; investment and economic growth is stagnant; real incomes were down again slightly in 2018 for the fifth year in a row; and so on.

But the same is not true at the corporate level where things are looking decidedly rosier.

Russian companies had their most profitable October in three years (the most recent data available), earning cumulative profits for the year worth \$174bn – about a third more than they earned over the same period a year earlier.

[The Central Bank of Russia \(CBR\) just released the preliminary 2018 results](#) and banks too are also back in the black after two years of losses. The sector earned a healthy RUB1.3 trillion (\$19.6bn) of profits, and if you take out the wounded commercial banks the CBR took over in the autumn of 2017 then the sector earned a whopping RUB1.9 trillion (\$28.6bn). The crisis of the last years has caused a consolidation in Russia's economy and the winners from this process have done very well for themselves – and they are sharing their windfall with investors by paying out large dividends.

Dividend yields

At the start of the year Russian daily Vedomosti calculated [which investments paid out the most in 2018](#) and the winner was the stocks and bonds of Russian conglomerate AFK Sistema that returned 128% and 55% respectively.

That was a special case as its corporate war with state-owned oil major Rosneft came to an end and saw its share and bond prices rally sharply once it became clear the company would not be bankrupted or nationalised.

But across the board leading companies in selected sectors have seen their

share prices rally and return investors double digit gains. Raw materials were the biggest winner in 2018 thanks partly to a 20% devaluation of the ruble against the dollar further improving their profitability, but the leaders in most sectors have been their share price rally.

When stock picking investors start with the companies paying the best dividends as Russians firms currently pay an average 7.7% dividend yield, the highest in the world and more than twice the benchmark MSCI EM average dividend yield.

Below is a list released by VTB Capital (VTBC) of the best paying dividend stocks in the Central and Eastern Europe (CEE). The story is no unique to Russia, as Kirill Chuyko, the head of research at BCS Global Markets pointed out in a recent [interview](#) and [podcast](#) with *bne IntelliNews*. The market has shrunk, but the pieces of pie on offer have become bigger.

All the companies in the list are paying dividend yields in excess of 4% -- on a par with the MSCI EM average dividend yield -- and the majority of them in excess of 5%. Six names on the list pay a huge dividend of more than 10%.

The leader remains Russia's privately owned oil company Surgutneftegaz with a whopping 16% dividend yield, but again this is a special case as three quarters of that is earned not from producing oil, but it interest earned on its giant \$40bn cash pile.

But interestingly the next five names are all Russian utility companies or real estate companies. Both these sectors have seen heavy investment in recent years and are now returning profits to their shareholders.

CIS Top dividend payers															
Name	Ticker	CCT	Dividend Yield				DPS				Next Dividend due		periodicity		
			LTM	NTM	FY17	FY18	LTM	NTM	FY17	FY18	ex date	DY %	DPS		
Surgutneftegas	pref. SNGS P RX	RUB	3.4	16	3.4	16	1.38	6.49	1.38	6.49	18/07/19	16	6.49	A	
Globaltrans	GDR GLTR LI	USD	14.4	14.4	14.4	14.4	1.41	1.41	1.41	1.41	23/04/19	6.7	0.66	semi-A	
NLMK	GDR NLMK LI	USD	13.9	13.2	14	14.1	3.14	2.99	3.15	3.18	24/06/19	7	1.57	Q	
NLMK	ord. NLMK RX	RUB	13.7	13.2	13.1	14.2	20.37	19.71	19.46	21.09	24/06/19	7	10.39	Q	
Moscow Exchange	ord. MOEX RX	RUB	6.1	12.6	6.1	12.6	5.54	11.56	5.54	11.56	10/05/19	9	8.23	semi-A	
Enel Russia	ord. ENRU RX	RUB	13.3	12.6	13.3	12.6	0.14	0.14	0.14	0.14	21/06/19	12.6	0.14	A	
Norilsk Nickel	ADR MNOD LI	USD	10.8	12.4	10.8	12.4	2.17	2.5	2.17	2.5	23/07/19	5.9	1.18	9M+A	

Norilsk Nickel	ord.	GMKN RX	RUB	10.4	12.4	10.4	12.4	1,384.00	1,648.00	1,384.00	1,648.00	23/07/19	5.8	779	9M+ A
LSR Group	GDR	LSRG LI	USD	11.4	11.8	11.4	11.8	0.22	0.23	0.22	0.23	19/06/19	11.8	0.23	A
Severstal	ord.	CHMF RX	RUB	16.4	11.3	16.4	11.3	156	107.62	156	107.62	19/06/19	6.1	58.46	Q
LSR Group	ord.	LSRG RX	RUB	10.5	11.3	10.5	11.3	70	75	70	75	19/06/19	11.3	75	A
Severstal	GDR	SVST LI	USD	16.6	11.3	16.6	11.3	2.4	1.63	2.4	1.63	19/06/19	6.1	0.89	Q
FSK	ord.	FEES RX	RUB	9	11.1	9	11.1	0.01	0.02	0.01	0.02	17/07/19	11.1	0.02	A
MMK	GDR	MMK LI	USD	12.1	10.8	12.1	10.8	1.07	0.96	1.07	0.96	27/06/19	5.2	0.46	Q
MMK	ord.	MAGN RX	RUB	11.8	10.8	11.8	10.8	5.31	4.86	5.31	4.86	27/06/19	5.2	2.36	Q
RusHydro	ADR	HYDR LI	USD	5.9	10.1	5.9	10.1	0.04	0.07	0.04	0.07	06/07/19	10.1	0.07	A
Detsky Mir, ord	ord.	DSKY RX	RUB	8.9	10.1	8.9	10.1	8.27	9.32	8.27	9.32	16/07/19	4.5	4.2	9M+ A
Sberbank	pref.	SBER P RX	RUB	6.6	10	6.6	10	12	18.08	12	18.08	13/06/19	10	18.08	A
Alrosa	ord.	ALRS RX	RUB	11.1	9.6	11.1	9.6	11.17	9.7	11.17	9.7	10/07/19	3.9	3.96	A
VEON	ADS *	VEON US	USD	11.5	9.5	11.5	9.5	0.29	0.24	0.29	0.24	01/03/19	4.7	0.12	9M+ A
NCSP	GDR	NCSP LI	USD	9.1	9.4	6.3	12.1	0.86	0.89	0.6	1.15	01/10/19	9.4	0.89	A
Rushydro	ord.	HYDR RX	RUB	5.2	9.4	5.2	9.4	0.03	0.05	0.03	0.05	06/07/19	9.4	0.05	A
Rostelecom*	pref. *	RTKM P RX	RUB	12.4	8.8	8.3	12.9	7.55	5.39	5.05	7.89	04/07/19	8.8	5.39	A
Phosagro	ord.	PHOR RX	RUB	4.1	8.7	4.1	8.7	105	225	105	225	11/03/19	2.8	72	Q
Sberbank	ord.	SBER RX	RUB	5.7	8.5	5.7	8.5	12	18.08	12	18.08	13/06/19	8.5	18.08	A
Rosneft*	GDR *	ROSN LI	USD	5.2	8.5	5.2	8.5	0.33	0.53	0.33	0.53	28/06/19	4.4	0.27	semi-A
Rosneft*	ord.*	ROSN RX	RUB	5.1	8.4	5.1	8.4	21.23	34.92	21.23	34.92	28/06/19	4.3	17.92	semi-A
Sberbank, DR	DR	SBER LI	USD	5.8	8.4	5.8	8.4	0.76	1.1	0.76	1.1	13/06/19	8.4	1.1	A

Gazprom Neft	ADR	GAZ LI	USD	8.1	8.3	5.6	8.3	2.07	2.13	1.44	2.13	25/06/19	4.1	1.05	semi-A
Phosagro	GDR	PHOR LI	USD	4	8.3	4	8.3	0.55	1.14	0.55	1.14	11/03/19	2.7	0.36	Q
Gazprom Neft	ord.	SIBN RX	RUB	7.9	8.2	5.5	8.2	27.05	28.14	18.84	28.14	25/06/19	4	13.84	semi-A
Unipro	ord.	UPRO RX	RUB	8	8	8	8	0.22	0.22	0.22	0.22	02/07/19	4	0.11	9M+A
Etalon Group	GDR	ETLN LI	USD	8.7	7.6	8.7	7.6	0.18	0.16	0.18	0.16	14/02/19	3	0.06	semi-A
Rostelecom*	ord.*	RTKM RX	RUB	10.1	6.9	6.8	6.7	7.55	5.15	5.05	5	04/07/19	3.4	2.5	A
VTB*	ord.*	VTBR RX	RUB	9.3	6.8	9.3	6.8	0	0	0	0	31/05/19	6.8	0	A
Tatneft	pref.	TATN P RX	RUB	8.7	6.7	13.8	6.7	47.94	37.07	76.41	37.07	05/07/19	3.2	17.67	semi-A
TGK-1	ord.	TGKA RX	RUB	5.2	6.7	5.2	6.7	0	0	0	0	24/06/19	6.7	0	A
Transneft	pref.	TRNF P RX	RUB	4.5	6.7	4.5	6.7	7,578.00	11,215.00	7,578.00	11,215.00	09/07/19	6.7	11,215.00	A
Acron	ord.	AKRN RX	RUB	7.2	6.7	7.2	6.7	337	312	337	312	11/06/19	3.3	153	semi-A
Evrast	ord.	EVR LN	GBp	17.4	6.6	17.4	6.6	82.34	31.34	82.34	31.34	08/03/19	2.9	13.86	semi-A
Gazprom	ADR	OGZD LI	USD	5.3	6.5	5.3	6.5	0.26	0.32	0.26	0.32	18/07/19	6.5	0.32	A
Gazprom	ord.	GAZP RX	RUB	4.9	6.4	4.9	6.4	8.04	10.4	8.04	10.4	18/07/19	6.4	10.4	A
TMK	GDR	TMKS LI	USD	4.5	6.3	4.5	6.3	0.15	0.2	0.15	0.2	01/07/19	6.3	0.2	A
TMK	ord.	TRMK RX	RUB	4.2	6.1	4.2	6.1	2.28	3.36	2.28	3.36	01/07/19	6.1	3.36	A
VTB*	GDR*	VTBR LI	USD	8.7	6.1	8.7	6.1	0.11	0.08	0.11	0.08	31/05/19	6.1	0.08	A
Polyus	ord.	PLZL RX	RUB	5.2	5.9	5.2	5.9	278	317	278	317	07/06/19	2.8	150	semi-A
Polyus	GDR	PLZL LI	USD	5.3	5.8	5.3	5.8	2.19	2.4	2.19	2.4	07/06/19	2.8	1.14	semi-A
Bank St Petersburg	ord.	BSPB RX	RUB	3.4	5.6	3.4	5.6	1.62	2.69	1.62	2.69	30/05/19	5.6	2.69	A
HMS	GDR	HMSG LI	USD	11.9	5.5	14.2	9.7	0.83	0.39	1	0.68	14/06/19	5.5	0.39	9M+A

Mosenergo	ord.	MSNG RX	RUB	7.6	5.5	7.6	5.5	0.17	0.12	0.17	0.12	17/06/1 9	5.5	0.12	A
O'Key	GDR	OKEY LI	USD	5.1	5.1	8.1	5.1	0.08	0.08	0.12	0.08	24/01/2 0	5.1	0.08	A
PIK Group	ord.	PIKK RX	RUB	6.3	4.9	6.3	4.9	22.7 1	17.65	22.7 1	17.65	03/09/1 9	4.9	17.65	A
OGK-2	ord.	OGKB RX	RUB	4.7	4.9	4.7	4.9	0.02	0.02	0.02	0.02	09/07/1 9	4.9	0.02	A
Aeroflot	ord.	AFLT RX	RUB	12.1	4.9	12.1	4.9	12.8 1	5.15	12.8 1	5.15	04/07/1 9	4.9	5.15	A
TCS Group	ord.	TCS LI	USD	5.9	4.8	5.9	4.8	1.07	0.88	1.07	0.88	07/03/1 9	1.1	0.2	Q
CIS & Georgia	ord.	HSBK LI													
Halyk Bank	GDR *	STCM LN	USD	8	10.3	8	10.3	0.83	1.06	0.83	1.06	29/04/1 9	10.3	1.06	A
Steppe Cement	ord.	TBCG LN	GBp	4.9	9.9	4.9	9.9	1.01	2.03	1.01	2.03	05/07/1 9	9.9	2.03	A
TBC Group, Ord	ord.	BGEO LN	GBp	3.4	5.4	3.4	5.4	50.0 1	80	50.0 1	80	16/05/1 9	5.4	80	A
BGEO Group	ord.	AYGA Z TI	GBp	6.3	4.9	6.3	4.9	100. 81	78.34	100. 81	78.34	31/05/1 9	4.9	78.34	A
Turkey		AKCN S TI													
Aygaz	ord.	FROT O TI		12.8	14.7	12.8	14.7	1.57	1.8	1.57	1.8	05/04/1 9	14.7	1.8	A
Akcansa Cimento	ord.	GPH LN	TRY	8.4	10	8.4	10	0.67	0.8	0.67	0.8	29/03/1 9	10	0.8	A
Ford Otomotiv	ord.	TUPR S TI	TRY	5.8	9.5	5.8	9.5	3.43	5.63	3.43	5.63	03/04/1 9	4.8	2.83	semi- A
GPH	ord.	TOAS O TI	GBp	10.6	9.4	10.6	9.4	40.8 9	36.18	40.8 9	36.18	21/03/1 9	5.5	21.1	semi- A
Tupras	ord.	ISCTR TI	TRY	10.1	8.9	10.1	8.9	13.6	12.06	13.6	12.06	29/03/1 9	8.9	12.06	A
Tofas	ord.	TKC US	TRY	8	8.9	8	8.9	1.6	1.77	1.6	1.77	21/03/1 9	8.9	1.77	A
Isbank	ord.	TCELL TI	TRY	5.4	6	5.4	6	0.29	0.33	0.29	0.33	22/04/1 9	6	0.33	A
Turkcell*	GDR *		USD	6	5.4	6	5.4	0.4	0.37	0.4	0.37	17/06/1 9	1.8	0.12	Q
Turkcell*	ord.*		TRY	6	5.3	6	5.3	0.86	0.77	0.86	0.77	17/06/1 9	1.8	0.26	Q

CEE3

Bank Pekao	ord	PEO PW	PLN	7	7.6	7	7.6	7.9	8.61	7.9	8.61	04/07/19	7.6	8.61	A
Komerční Banka	ord	KOMB CK	CZK	5.3	5.8	5.3	5.8	47	51.07	47	51.07	16/04/19	5.8	51.07	A
Magyar Telekom*	ord	MTEL EKOM HB	HUF	5.4	5.4	5.4	5.4	25.13	25	25.13	25	09/05/19	5.4	25	A

8.3.3 ECM news

Over the past fifteen years, VEB.RF “silent” pension funds earned 187.6% return. Inflation over the same period was 245.4%, reports BMB. In real terms, VEB.RF pension funds, the state run mandatory pension scheme, lost almost 58% in value over the last 15 years. There are a few clear explanations for this. First, 2008 and 2014 the fund brought significant shocks to the Russian market just as the global crisis got underway. Second, prior to 2009, [Vnesheconombank](#) (VEB), the state development bank that also manages the pension funds, was very limited in its investment options. True, VEB's ten-year results look much better, with pension returns outpacing inflation by 12.5 percentage points. However, retirement savings are a long-term matter. With VEB.RF being the default manager for any pension funds not otherwise allocated, these results highlight a serious flaw in the pension system. The “Silent,” or molchunyy, pension funds refer to the savings of individuals who did not indicate a specific investment fund to manage their savings that are drawn from social taxes. Nominally Russians can nominate a pension manager for these payments, but if they say nothing then the pension contributions default to VEB. All funds left in the national Pension Fund are automatically transferred to VEB.RF. Until 2009, VEB could only invest in government securities. From 2004-08, its silent pension funds outperformed inflation only once, in 2005. VEB will likely not be able to make up real returns in the coming years. Due to liquidity risk, VEB primarily invests silent funds in short-term bonds (issued by, for example, [Russian Railways \(RZD\)](#), the Federal Grid Company, and [Gazprom](#)). The average coupon at the end of 2018 was about 4.5%. VEB also invests heavily -- 21% of total assets -- in government savings bonds. All issues placed before mid-2008 currently have a rate of 5.5–6%. Subsequent issues have a fixed rate from 7.6-8.15%.

Russian carmaker [AvtoVAZ](#) applied to the Moscow Stock Exchange to delisting its shares. It notes that the decision was made by the Netherlands company Alliance Rostec Auto BV, which is the sole shareholder of AvtoVAZ. The automaker should also contact the Central Bank with a statement about exempting it from the obligation to disclose information about securities, as well as make changes to its charter, excluding the indication that [AvtoVAZ](#) is a public company, the report said. Trading in AvtoVAZ shares has been suspended since November 30 last year due to a request to repurchase equity securities.

No changes to the top four names in the MSCI Russia 10/40 rebalancing. Russia's retail giant and investor's darling state-owned [Sberbank](#) remained top of the list in the MSCI Russia index rebalancing, although analysts say it is underweight in the index given its popularity. The biggest gainer was carmaker [GAZ](#), which saw the biggest gain in its benchmark index, VTB Capital (VTBC) said in a note on February 19.

The Morgan Stanley Capital International (MSCI) announced the results of its Russia 10/40 rebalancing, with all changes effective after the close of trading on 28 February, together with the Standard review.

The top four names remained unchanged: [Gazprom](#) (GAZP), [Lukoil](#) (LKOH), [Tatneft](#) (TATN), and [Sberbank](#) (SBER RX).

“As we expected, the biggest weight increases came from [Gazprom](#) (GAZP) (+63bp to 9.33%), mobile phone operator [Mobile TeleSystems](#) (MBT) (+39bp

to 4.66%), independent gas producer [Novatek](#) (NVTK) (+37bp to 4.66%), supermarket chain [X5 Retail Group](#) (FIVE) (+33bp to 4.66%) and diamond producer [Alosa](#) (ALRS) (+33bp to 4.66%).

As for weight decreases, gold miners [Polyus Gold](#) (PLZL) (-44bp to 3.21%) and [Polymetal](#) (POLY) (-39bp to 3.01%), as well as steel mill [Novolipetsk Metallurgical Kombinat](#) (NLMK) (-38bp to 4.10%), the [Moscow Exchange](#) (MOEX) (-37bp to 2.71%), utility company [Inter RAO](#) (IRAO) (-36bp to 2.63%), fertiliser producer [Phosagro](#) (PHOR) (-31bp to 2.25%) and supermarket chain [Magnit](#) (MAGN) (-29bp to 2.12%) took the biggest cuts.

“Although SBER (+15bp to 6.91%) is a top two stock in the MSCI Russia index, its weight in the 10/40 index remains far below the 9% level as a result of the MSCI’s sanctions treatment,” Ilya Piterskiy of VTBC said in a note. “As far as we are aware, the index is not followed by any passive money. Instead, it serves as a benchmark for actively-managed European Russia-dedicated funds, with an estimated AuM of \$4.7bn. Following the rebalancing, the funds might find themselves underweight the stocks whose weights were increased and vice-versa.”

Two companies belonging to Russian oligarch and Kremlin insider Oleg Deripaska, the aluminium producer [Rusal](#) and energy holding EN+ are eligible for inclusion in the benchmark MSCI Russia index after the US Treasury Department (USTD) decided to [drop the sanctions on the companies completely](#) in December 2018, BCS Global Markets reported on February 12. Inclusion in the widely followed index usually leads to an increase in the share price of the company as index tracking funds are forced to passively invest in the name to include it in their portfolio. The next adjustment to the MSCI index is due in May. However, the companies need to meet certain criteria before they can be included and while it is likely that Rusal will meet these criteria it is much less likely for EN+, says BCS. “Inclusion of Rusal into the MSCI indexes at May SAIR is very possible, as the stock would need to rise by 9-17%, while liquidity threshold is relatively easy \$1.1mn a day. Inclusion of EN+ is unrealistic, as the stock would need to appreciate by more than 50% by mid-April,” Slava Smolyaninov, chief strategist and deputy head of research at BSC said in a note. The US Department of the Treasury’s OFAC removed EN+ Group, United Company RUSAL, and EuroSibEnergo from its US Specially Designated Nationals And Blocked Persons List ([SDN List](#)). “As we initially noted almost exactly one year ago, the liquidity criteria is an easier one as its liquidity on the Moscow Exchange would need to exceed \$1.1mn on a median basis in February and March, which is more than realistic, in our view. There are two possible treatments of Rusal liquidity by MSCI given the OFAC sanctions removal – either 1M ATVR based solely on March liquidity or the proper 3M and 12M assessment, and in either case trading just north of \$1mn would suffice,” Smolyaninov said. “If Rusal was included today at a minimum necessary FIF-adjusted market cap just below \$1.5bn, it would get a 0.74% weight with \$59mn expected inflows from ETF funds. This translates into 7.4x of days of trading to cover given the \$8mn 3M ADTV of combined liquidity of Moscow and Hong Kong lines. However, liquidity will likely improve further in the coming months given the SDN-delisting,” Smolyaninov added. “EN+ needs to rise by 59-72%, which is unrealistic. While liquidity of the Moscow line of the EN+ receipts would need to increase to c\$1.4bn a day, which is undemanding given the volumes post-sanctions removal, it would need to appreciate by 59-72% in value to meet the minimum requirements on FIF-adjusted market cap by mid-April, an unrealistic scenario, even if it is assigned the minimum 0.2 FIF,” Smolyaninov concluded.

8.4 International ratings

International rating agency Fitch Ratings has affirmed Russia's long-term foreign- and local-currency issuer default ratings (IDRs) at BBB- with a positive outlook, the agency said in a press release on February 16. "The positive outlook reflects continued progress in strengthening the economic policy framework underpinned by a more flexible exchange rate, a strong commitment to inflation- targeting and a prudent fiscal strategy," the agency said, as cited by Prime. This policy has increased the economy's resilience to shocks and helped preserve macroeconomic and financial stability despite the heightened sanctions' risk and reduced investor appetite for emerging market assets in 2018, Fitch said. The agency projects that Russia's inflation will accelerate to 5.3% in 2019 due to an increase in value-added tax (VAT), the ruble's depreciation, and higher inflation expectations and will return to the target of 4% by 2020. Russia's economic growth is expected to slow to 1.5% in 2019 and accelerate to 1.9% in 2020, Fitch said.

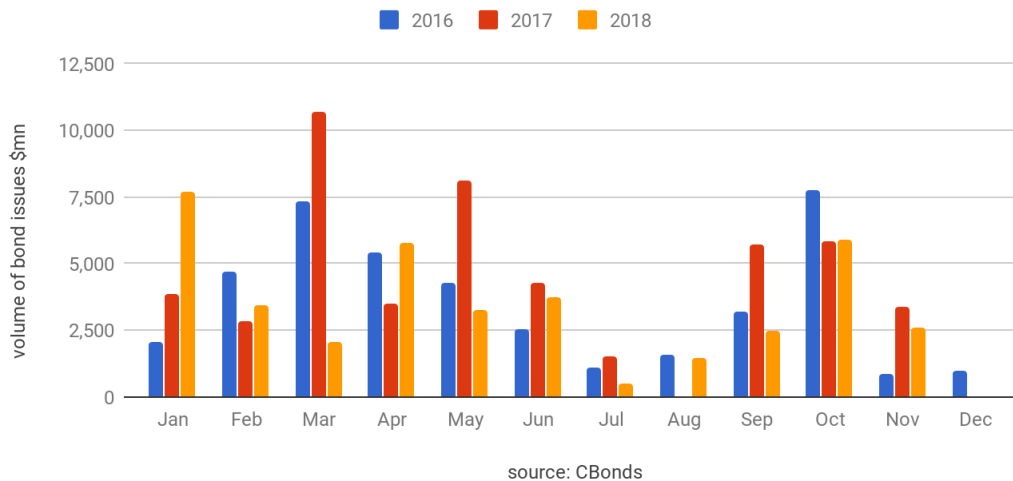
Fitch's decision comes only a week after [Moody's returned Russia to "investment grade" rating](#), completing the hat trick of investment grade ratings from the leading ratings companies.

8.5 Fixed income

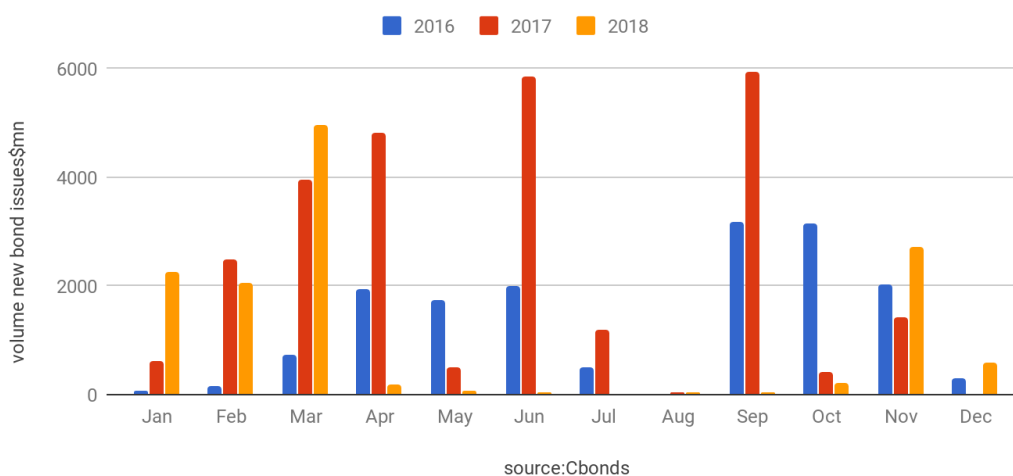
The Ministry of Finance may change its borrowing policy on February 13 by no longer announcing the volume of weekly OFZ (ruble-denominated debt) issuances in advance of auction. This move will allow MinFin more flexibility to react to changes in uncertain market conditions. By scrapping a set limit on bond placements, MinFin can sell bonds based on investor demand and the premium that investors ask for compared with the bonds' yields. Demand has been quite unstable lately, so this change looks logical. Some economists argue that the reduction in transparency will make investors demand higher premiums, but others note that investors rely primarily on general market conditions, the ruble exchange rate, oil quotes, and profitability on the secondary market in determining premiums. Either way, it seems like a good move for MinFin to avoid the uncomfortable optics of incomplete placements.

- MinFin traditionally announces the volume of OFZ issuances on Tuesday, the day before auction.
- The ministry has experienced several volatile issuances lately. In the fourth quarter of 2018, MinFin offered 214bn rubles (\$3.3bn) of OFZs, but successfully placed just 149bn rubles (\$2.3bn).
- On January 16, the ministry successfully placed all 35bn rubles (\$532mn), and demand more than doubled supply. A week later, MinFin only managed to sell 17.5bn (\$266mn) of the announced 30bn (\$456mn).
- Last week, the ministry placed all 25bn rubles (\$380mn), and demand once again exceeded supply by at least three times.

CEE: new bond issues \$mn



Russia: Volume of new issues, \$mn



8.5.1 Fixed income - bond news

The Ministry of Finance held its most successful OFZ treasury bond auctions since 2015 on February 27, placing securities worth RUB57.6bn. At the first auction the ministry placed six-year OFZs in the amount of RUB35.1bn, while the demand for securities reached 46.7bn. The weighted average yield was 8.23% per annum. At the Moscow stock exchange by the close of the same day this issue was trading at a yield of 8.2%. A few hours later, another auction was held for the placement of 11-year securities: the Ministry of Finance sold OFZ for RUB22.5bn with the demand of RUB29bn. The weighted average yield was 8.46% per annum, on the stock exchange this issue was traded yesterday with a yield of 8.42% per annum. The placements come after foreign investors sold off some RUB500bn worth of OFZ last year on sanctions fears and saw the share of foreign investors in the bond fall from a record 34% in April to just under 25% by the end of the year. Demand was so poor that the Ministry of Finance had to cancel several auctions towards the end of the year and yields climbed to touch on 9%. The OFZ is the main work horse for funding the government and the Ministry plans to more than double the amount it issues in 2019 to RUB2.5 trillion.

9.0 Industry & Sectors

9.1 Sector news

9.1.1 Oil & gas sector news

Russia extracted 556mn metric tons of crude oil and associated gas in 2018. Average daily crude production exceeded 11mn barrels a day last year. This is 2% more than in the previous year. Thanks to a reinterpretation of the agreement on voluntary production restrictions among a group of oil-producing countries in June, Russia's daily output increased by 4% during the second half of 2018. However, new restrictions will likely reduce production in coming months. Also natural gas production grew last year. Production reached 725bn cubic metres. This is 5% more than in the previous year.

Most of Russia's oil and gas production still takes place near the Urals mountain range in the Perm, Komi, Nenets and Khanty-Mansi regions. Other fields are found in the Far East, lower Volga and Caucasus regions. About two-thirds of Russian oil production and one-third of gas production goes to exports, mostly to Europe. The combination of increased oil and gas export volumes from higher production and higher oil and gas prices lifted export earnings of the energy sector by a third.

Natural gas has traditionally been transmitted via large pipeline grids, but liquefaction makes cargo shipments possible, too. The recent phased start-up for the liquefied natural gas (LNG) facility on the Yamal peninsula has facilitated gas exports. At the end of last year, about 10% of Russia's natural gas exports were already being shipped in liquid form. In addition to new gas export pipelines to China and Germany under construction, new LNG facilities are planned.

Russia reduced oil production by 97,000 barrels per day on average in January against the level of October 2018, being the reference one in the OPEC+ oil production capping deal, The Ministry of Energy says on Friday citing Minister Alexander Novak. Oil production declined by 145,000 barrels daily against December 2018, when the country reached the production peak. Production of oil as of the end of February 2019 was 118,000 barrels per day lower than last October and 165,000 barrels per day lower than last December, the Ministry said. "Russia fully honours undertaken commitments in accordance with earlier stated plans of phased oil production cut by the end of this March," Novak said.

The US Congress published the text of a draft law that lays out the details of the proposed "crushing" sanctions, the [Defending American Security from Kremlin Aggression Act \(DASKA 2019\)](#), that contained more details of sanctions aimed at Russia's oil and gas sector. The proposed law suggests imposing sanctions against any person who sells, leases or provides to Russia goods, services, technology, financing, or support in excess of \$1mn in value or \$5mn in total over a 12-month period that could directly and significantly contribute to the country's production of crude oil and its ability to develop crude oil resources, VTB Capital (VTBC) said in a note. However, the new sanctions won't apply to the maintenance of already ongoing projects. The US Secretary of State will clarify the list of ongoing projects that are exempt from the sanctions and list specific goods, services,

technology, financing, and support providing, which will be prohibited not later than 90 day after the enactment of the law, Vedomosti reported. The draft law also prohibits investment into Russian LNG projects abroad, of which Russia has none now, nor any plans to develop some. "In the worst case, if the proposed sanctions result in the immediate withdrawal of all the OFS (e.g. multistage hydrofracking, well completion, well logging and all others) provided by international companies (such as Halliburton and Schlumberger), which is difficult for us to imagine, that would have a tangible negative impact on the ability of Russian oils to keep production in the short term. By the medium term, Russian oil companies and OFS providers are likely to adjust, we think," VTBC said in a note. "However, in the longer term, the technological lag would still mean a negative effect on the industry's development. For this, we suggest watching the clarification on the list of the projects and services, which is to be published within 90 days of the law on sanctions coming into force. However, we deem the Russian oil industry to be reasonably self-sufficient in general."

Global demand for liquefied natural gas (LNG) in 2020 could increase sharply by 17% to 384mn tons from the 2018 level, according to a study of Shell LNG Outlook 2019. In 2018, this figure increased by 8% to 319mn tons (approximately 292mn tons in 2017). Shell associates a significant increase in global demand with the growing demand for LNG in China, where work is underway to reduce fuel that pollutes the atmosphere. In 2018, the demand for liquefied gas in the country increased by 40% compared to 2017 and exceeded 16mn tons, the report indicates. In 2017, this figure increased by 41% y/y. Growth in demand for LNG will continue in 2019, Shell analysts predict. Deliveries in the same period will increase by 35mn tons - they are absorbed by the Asian and European markets, the company adds. Moreover, by 2022, China and India can double their regasification capacity, Shell experts say: from 70mn tons to 145mn tons and from 28mn tons to nearly 65mn tons, respectively.

The state-owned Russian gas giant [Gazprom](#) expects the considerable rise in LNG production this year to be matched by an increase in gas consumption, with the new LNG volumes going to the premium Asian markets, Kommersant reported on February 27. The gas monopoly does not expect heavy competition with LNG on the European market, the paper writes. The share of LNG use in Europe has grown, but currently LNG only makes up about 11% of total consumption, according to Gazprom. Gazprom's head Alexey Miller earlier said that the company increased its gas output by 5.4% to 497.6bn cubic meters in 2018, and gas export - by 3.4% to 201bn cubic meters. Gazprom expects gas exports to Europe at 200 bcm in 2019, [the company says](#). Gazprom may increase its output by 80-115bn cubic meters by 2035 thanks to developing projects in new regions, board member Oleg Aksyutin said on February 26. But most of the increase will be going to China as the new Power of Siberia pipeline comes online at the end of this year. Gazprom estimates that its share of the European gas market grew to 36.7% in 2018, from 34.2% in 2017, amid lower production in the region. At the same time Gazprom's average gas price has grown by 24.6% in 2018 and reached \$245.5 for 1,000 cubic meters and expects natural gas prices in Europe this year to average \$230- 250/kcm. "We believe that Gazprom will remain the most price competitive gas supplier, and therefore do not expect a significant drop in gas export volumes due to the increase in LNG production," Ekaterina Rodina of VTB Capital (VTBC) said in a note.

OPEC has maintained its forecast for Russia's liquid hydrocarbon output in 2019 at 11.49mn barrels per day, OPEC said in a report Tuesday. In

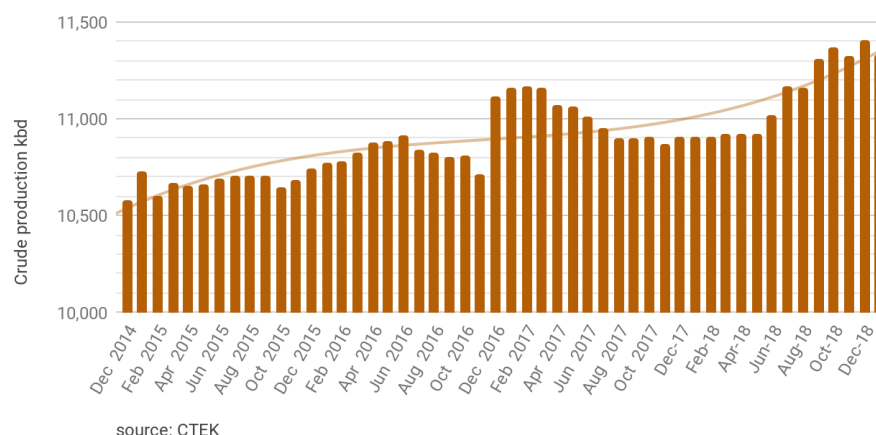
January–June, Russia's output of liquid hydrocarbons will fall by 230,000 barrels per day compared to the level of October 2018, it said. In January, Russia's liquid hydrocarbon production fell by 50,000 barrels per day compared to October 2018 and by 90,000 barrels per compared to December 2018 to 11.56mn barrels per day, OPEC said. OPEC said it fulfilled the OPEC+ oil production cut agreement by 86% in January, having reduced its oil production by 797,000 barrels per day to 30.81mn barrels per day, mainly due to lower output in Saudi Arabia, the United Arab Emirates (UAE), Kuwait, and Angola. The organization lowered its estimate of growth of oil demand in 2018 by 0.03mn barrels per day and reduced its 2019 forecast by 0.05mn barrels per day. According to OPEC, oil demand grew by 1.47mn barrels per day to 98.76mn barrels per day in 2018 and is expected to increase by 1.24mn barrels per day to 100mn barrels per day in 2019.

Russian oil companies mull a pipeline to connect the Vankor oil fields to the newly opened Arctic Northern shipping route. [Rosneft](#) and Neftegazholding might participate in the project to construct a crude oil pipeline from the Russian oil field Vankor cluster to North Bay at Taymyr through the Payakha group of Russian oil companies [Rosneft](#) and Neftegazholding might participate in the project to construct a crude oil pipeline from the Russian oil field Vankor cluster to North Bay at Taymyr through the Payakha group of fields, Kommersant reported on February 27. According to the paper, Neftegazholding and Rosatom have asked Deputy Prime Minister Maxim Akimov to consider such the pipeline infrastructure construction project in order to load the [Northern Sea Arctic shipping route](#) that goes around the top of Russia from Europe to Asia that the Kremlin is developing. Global warming is a boon for Russia and the route is now open an extra month a year due to the receding icecaps. Route would take crude oil shipments from the Vankor and Payakha fields to markets around the world. The pipeline might be as much as 600km long, with nameplate capacity of 25mmt of crude oil per annum and a potential expansion to 50mmt/a. The pipeline might be constructed by 2024, the paper writes.

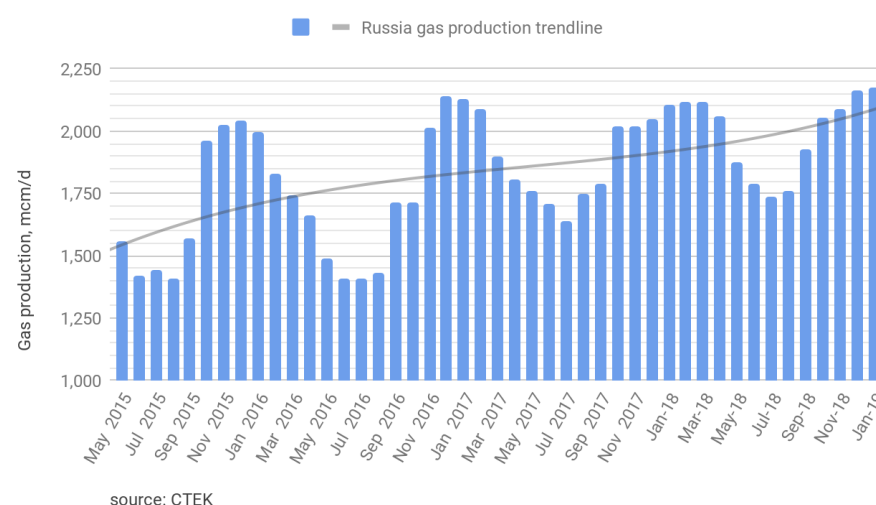
Russian gas giant [Gazprom](#) is mulling building a second Turk Stream pipeline that will further increase the transit capacity that by passes Ukraine, the company said on February 14. The so-called Turk Stream 2 is only an idea now and would be subject to potential demand for gas and getting all approvals. It would also add significantly to the company's future capex at a time when investment into expensive pipelines was supposed to start winding down following the completion of the Turk Stream 1 pipeline from Russia to Turkey, the Power of Siberia pipeline from Russia to China and the Nord Stream 2 pipeline from Russia to Germany – all due for completion starting at the end of this year. [Gazprom approved increasing the investment program for 2018](#) by 17% to record-high RUB1.5 trillion (\$22bn) in September. Gazprom might construct a Turk Stream 2 gas pipeline if there is sufficient demand and the company receives all the necessary approvals, Kommersant reports, citing Gazprom CEO Alexey Miller.

The share of Russian pipeline gas in the E.U. gas imports grew by 3 percentage points on the year to 47% in July–September 2018, the European Commission said in a quarterly gas market report released January 29.

Russia oil production



Russia gas production



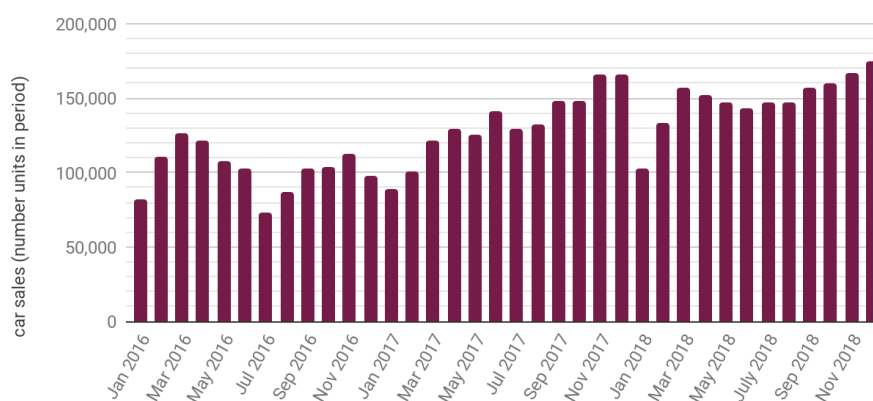
9.1.2 Automotive sector news

Russia's Industry and Trade Ministry will resume car demand programs from March 1, Minister Denis Manturov told President Vladimir Putin, as cited in a protocol by the Kremlin. "Vladimir Vladimirovich, we will continue the launch of a highly effective program: the social programs First Car and Family Car on March 1. We have agreed on the amount of budget subsidies for this year," Manturov said. "We hope that it will give an extra impetus to production and will support the car industry." The First Car and Family Car targeted aid programs active in 2018 stipulated a 10% discount on car purchase. Sales amounted to 85,940 over the first four months of the program, exceeding the plan of 80,600 cars. In July, the program was extended, and the discount was raised to 25% for citizens of the country's Far East.

Consulting firm PricewaterhouseCoopers (PwC) forecasts sales of new cars in Russia to fall 2% to 1.65mn vehicles in 2019 under the baseline scenario, the company said in a research note late on Thursday. Under the optimistic scenario, sales will rise 0.5% to 1.68mn cars. The sales of cars made by national producers may amount to 363,000 this year under the baseline scenario, while the sales of foreign cars assembled in Russia may stand at 1.012mn and of imported cars at 271,000. Implementation of a

baseline or an optimistic scenario will depend on the macroeconomic situation, PwC said. Among the factors that may have a negative impact on the sales, the company lists a rise of VAT to 20% from 18%, possible volatility of the ruble and worsening of the macroeconomic situation if new sanctions are imposed, a higher scrappage fee, and reduction of state support to the sector. But the car industry may start growing if there are no external shocks, no devaluation of the ruble, and no new sanctions. Further improvement of the car industry will depend on conditions of transition from industrial assembly to a new investment regime, and PwC expects the car market in Russia to rise by 7% per year on average until 2023. The company also said that Russia's sales of light commercial vehicles may grow by 1% to 114,000 in 2019, while the sales of trucks might increase by 4% to 86,000 and bus sales may contract by 9% to 11,800.

Russia car sales (number units in period)



source: AEB

9.1.4 Construction & Real estate sector news

Russia's real estate completions were down 5% y/y in 2018 to 75.3mn sqm, but the outlook for the sector is a medium-term recovery, Rosstat reported on January 28. The reported completions primarily reflect the slowdown in residential sales, which was observed in 2015-16, according to Rosstat. Volumes declined with a 9% compound average growth rate (CAGR) during the period, pressured by negative real incomes and the high-interest rate environment as blended mortgage rates rose again to 13%. The result also undermines Rosstat revision up for real estate activity from zero to 5.3% that has raised eyebrows amongst Moscow based analysts. However, some subsections, like elite housing in the capital, are booming. In 2017-18, the number of registered deals on the primary market increased at a CAGR of 4%, which is going to support completions in 2019 and 2020. This year pre-financing construction has been banned and upcoming regulatory changes and the introduction of escrow schemes from July 1, 2019 are the key uncertainty and downside factor, as tighter operational requirements and access to capital is challenging for smaller and regional developers.

Russia's Ministry of Construction proposes exemption criteria from the new ban on pre-selling real estate developments Russia will ban pre-selling apartments by developers to individuals this summer in a move mandated by president Vladimir Putin as part of regulations to improve consumer protections. However, the rules are expected to hurt smaller companies

working in the sector, which will struggle to raise the financing to complete projects. The government has been considering ways to ease the pain. The main thrust of the new law is pre-payments for apartments must be held in escrow accounts until the building is completed. This week Russia's Ministry of Construction has proposed exemption criteria from the implementation of escrow schemes from 1 July 2019. Development projects could be implemented under the existing framework if they have been more than 30% completed and more than 10% of the area is pre-sold. Developers that participate in the Moscow renovation program, and those, which are finishing the estates of bankrupt companies, would also be exempt. One of the upshots of the new scheme is it is expected to drive a consolidation in the sector as the smaller companies, unable to finance developments, will sell out to the bigger companies and/or merge with each other. "The development segment is seeing a significant change in its operating economics. From 1 July, companies are no longer going to be able to collect funds from clients. This is to be replaced by escrow accounts and project financing from banks. This change offers sizable downside risks to the volumes and sustainability of developers, so the government is considering exemptions (the final version is likely by 1 May, we think)," Maria Kolbina of VTBC Capital (VTBC) said in a note. The thresholds offered by the ministry represent a rather liberal scenario, says Kolbina, and imply a transition to escrow schemes over several years. However, the proposal does not consider projects that have attained construction permits and have registered at least one share participation agreement prior to 1 July 2018 and were eligible for exemptions. If a developer builds the necessary infrastructure for the project (schools, medical centres, roads, etc) the threshold is to be reduced further to 15% of the project completion. Another cut is accessible to backbone enterprises (currently leading developers [PIK](#) and [LSR Group](#) (LSR) are included in the list) and implies a further reduction to 6% of the project completion level, if the appropriate developer meets the financial stability criteria in accordance with the data from the latest quarterly reporting, as submitted to the regulatory authority, according to VTBC.

Russian real estate sector sales boom in 2018 ahead of new rules, lead by LSR Group's record sales. Russian real estate developer [LSR Group](#) (LSR) is rapidly becoming the investor's darling in the real estate sector after both the company and the sector reported record high sales in the fourth quarter of 2018.

Russia's listed homebuilders increased sales on average 25% y/y in 2018, outperforming the impressive market demand with primary volumes up 8% y/y to 755,000 deals, according to VTBC Capital (VTBC).

The sales were boosted by punters bringing forward apartment purchases ahead of new rules that come into force this summer that ban pre-sales and record low mortgages rates that are expected to rise this year.

"We see those factors continuing to support the sector in 1H19 but highlight downside risks thereafter as the new residential offer and pricing are dependent on how the escrow schemes are implemented. Large-scale developers are best positioned, in our view, because of their access to capital, large portfolios and wide product offers. They are likely to become the prime beneficiaries of the sector consolidation, we think," Maria Kolbina of VBTC said in a note.

Almost all the leading companies outperformed their original guidance,

establishing a strong outlook for cash flow management in 2018. The strong results came on the back of client concerns over prices and the supply of housing under the new regulatory framework.

Mortgages rates have also been a source of concern but fell to record lows and were 9.4% in October. However following the Central Bank of Russia (CBR) decision to [hike rates by 25bp in December to 7.75%](#) mortgage rates are expected to rise slightly in 2019. [More rate hikes are also expected](#) in the coming months.

“We think the tailwinds for residential demand are going to remain in 1H19 but highlight downside risks thereafter as the implementation roadmap and relationships between homebuilders and credit institutions are still developing. Stocks have dropped a blended 25% in the last twelve months and represent appealing valuations to us,” Kolbina said.

LSR Group currently pays the highest dividend of all the real estate companies in the sector of over 10% and had already attracted investors’ interest as a result.

The company’s strong 4Q18 numbers only increased that interest after residential sales surged 39% y/y to 300,000sqm while the annual figure of 920,000sqm was 8% above management’s target.

The company was hit by an unexpected decline of 20% y/y in the average price in St Petersburg, but analysts say that was due to the sales of flats in Tsvetnoi Gorod project to City Administration that pushed prices down: a more than RUB2bn deal with an average price of RUB68,000 per sqm. The growing share of newly launched mass-market segment projects and inventories sale also depressed prices.

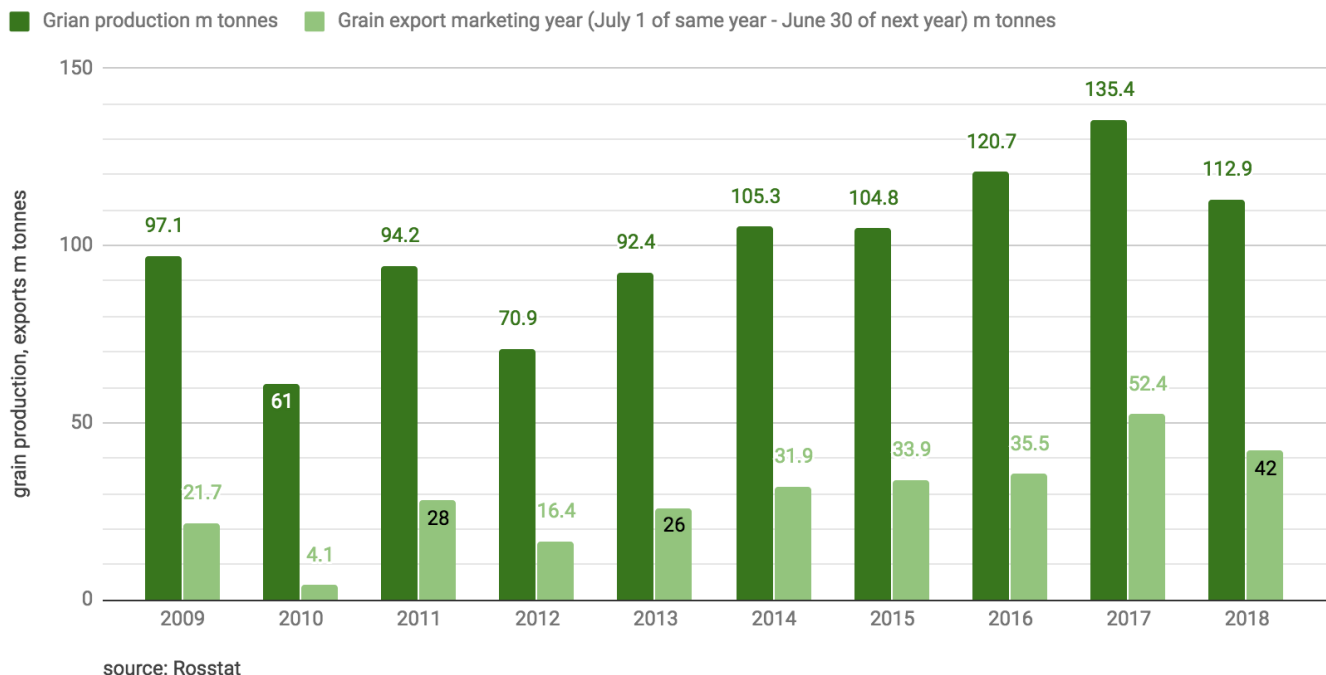
In the development segment, LSR launched 620,000sqm of new projects, which was less than its plan for 880,000sqm, driven by the aim to accelerate sales after the new sectoral rules come into force and by delays to its new proposition at Moscow projects.

9.1.6 Agriculture sector news

Russia’s Ministry of Agriculture has set informal limitations on grain exports from Russia via quotas, Vedomosti reported on February 26. Russia’s grain harvest in the 2019 marketing year (July 2017 to June 2018) was down 17% y/y from the record high base to 113mn tonnes that Russia brought in last year. Grain is becoming the new oil and earned Russia over \$20bn in export revenues last year – overtaking arms exports as the second biggest export commodity after raw materials. “The government said that 42mn tonnes of export was optimal and the figure implied a 22% y/y correction. However, established trading relations and the recovery in global prices brought impressive volumes and by January 2019 traders had covered almost 70% of the target,” Nikolay Kovalev of VTB Capital (VTBC) said in a note. “The decline in supply and the impressive exports, coupled with the global recovery in prices and weaker local currency, meant that Russia’s domestic grain prices surged to a record high. Various grain classes are 65-90% higher y/y in February 2019. Were informal limitations to slow trading from Russia, the price growth would be capped until the new harvesting season in June 2019,”

Kovalev added. Analysts have pointed to the rising price in Russian grain as a problem for Russia and has created an opportunity for US grain producers to win back some of their lost market share.

Russia grain production, export m tonnes



9.1.7 TMT sector news

Internet providers cautious about “sovereign Runet” law. The Duma is considering a bill, known as the “sovereign Runet” law, that aims to protect Russia from cyberattacks by creating redundant internet infrastructure. Internet providers say they support the bill’s goals, but have concerns about the implementation.

This bill would change the way the internet works — if the Russian government can pull it off. It would install defences against cyberattacks, duplicate the infrastructure of the worldwide web in Russia, and allow the Russian government to block sites more easily. Although the political will to accomplish these aims certainly exists, there are still problems with this particular bill. The draft is vague about the technical aspects of the plan (supposedly for security reasons), but it is unclear if the bills’ authors understand how the internet actually works. And, despite bill sponsor Senator Klishas’s claims that it is already included in the government’s budget (which would be a strong signal of support from high up), the government would need to come up with more than 20bn rubles (\$300mn) if it is passed.

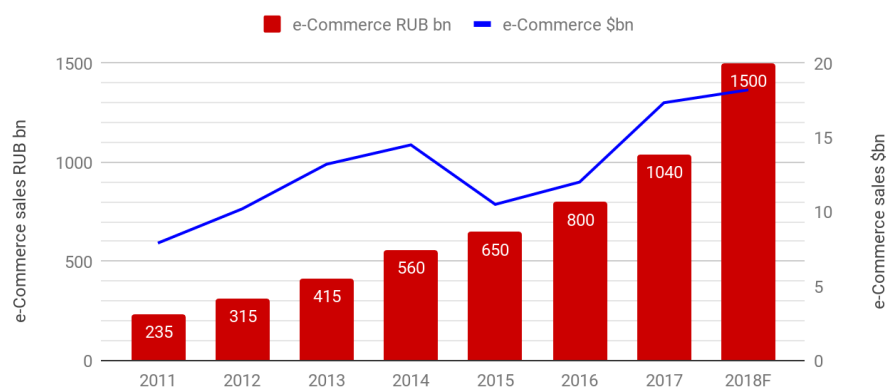
- The bill was proposed by Senators Andrei Klishas and Lyudmila Bokova and Duma deputy Andrei Lugovoy in December 2018.
- Internet providers in the Information Security working group believe that the problem should be studied more carefully. The bill is vague about exactly how it will be implemented, and the working group believes more work needs to be done on the technical details.
- The bill would allow the government to keep a copy of the internet, so that service could continue for Russian citizens even if the country is under

attack from outside. Experts note that keeping a complete map of the internet is almost impossible, because it is constantly changing.

Officials still prefer foreign over Russian software. A new report from the Audit Chamber indicates that government agencies and extra-budgetary funds bought just 8.5bn rubles (\$130mn) of domestically-produced software in 2017-18. This is less than half of their total 17.2bn (\$263mn) software outlay. This week, the Brief covered a couple of stories on the government's import substitution plans for the shipping industry. This story is a fairly good indication of how they will turn out. Despite a strong push to develop Russia's digital economy and impose restrictions on foreign software imports, even the government prefers to use foreign tech. Developing domestic industry takes time, and simply slapping added regulations on a sector cannot circumvent that.

- In 2016, the government created a register of domestic software. Per current regulations, Russian government bodies and SOEs may not purchase imported counterparts of registered software unless they can explain the necessity of doing so.
- The Audit Chamber report found that 3.3bn rubles (\$50mn) worth of software were purchased in violation of this regulation.
- 96% of federal agencies and extrabudgetary funds use programs not included in the register. 82% use foreign mail servers, and almost all (over 99%) use Microsoft, Oracle, or other foreign database management servers.

Russia e-Commerce sales volumes RUB bn vs \$bn



source: Romir, Nielsen, Morgan Stanley

9.1.10 Utilities sector news

A third of Russian coal-fired power plants may be closed. As much as one third of the coal-fired capacities in Russia could be considered ineligible for modernisation and closed, Big Power News reports, quoting the Russia-based Institute of Natural Monopolies Research. Of Russia's total 24.7GW of coal-fired capacities, 65% could in theory take part in modernisation. Of this, the institute contends that as much as a third might be ineligible, mainly due to low load factors, which are below 40%. According to the institute's experts, the current modernisation menu does not reflect the possibility of ash and slag accumulation improvement, which is one of the core problems for coal plant participation in DPM-2. "We note that the conditions of DPM-2

essentially oblige generators to keep DPM2-modernised power units operational for 16 years after relaunch. Moreover, guaranteed returns are only assured if utilisation of the modernised capacity does not dip lower than the auction bid (in most cases, the utilisation of 2017-18). In this regard, we believe taking on an obligation to keep coal-fired capacity working for the next 16 years and expect that its utilisation would not significantly deteriorate – taking into account the ongoing unfolding and expansion of renewable energy, the significant outperformance of coal prices vs. gas prices domestically and an ever-rising railway tariff – would be overly ambitious,” VTB Capital (VTBC) said in a note. As a result most surviving power plants will continue to switch to gas.

Russia’s Electricity Market Council, the electricity generators’ self-governing body, is working on the concept of a green certificates (GC) system in Russia, Kommersant reported on February 13. According to the presentation, the GCs will be allocated for each 1MWh of electricity generated using wind, solar or small hydro capacity. The purchase of GCs would be voluntary, based on whether consumers want to support renewable energy, with the price of the GCs to be defined by the supply-demand situation. Revenues from selling GCs would be subtracted from the DPM revenues that renewable capacities currently receive, generating a guaranteed return on the investment. “We believe the concept of moving towards a GC system (whereby renewables are paid for by those who want, or are required, to support it by international obligations), as opposed to the current DPM scheme (under which all electricity consumers are burdened by providing financial guarantees of return) is fundamentally correct and adds the component of market competition to what is otherwise a highly regulated electric utilities sub-sector. However, unless there are minimum GC purchase requirements for consumers (which is usually within the goals of the share of renewables in the fuel mix as adopted by governments within the Paris Climate Agreement accords), the motion would be fruitless, in our view,” Vladimir Sklyar of VTB Capital (VTBC) said in a note. “Taking into consideration the high energy intensity of the Russian economy and the lack of an environmental agenda (at both the government and the broad consumer levels), we find it impossible to pinpoint where demand for GCs could come from in Russia. Nevertheless, should the government take a stronger stance on renewable energy, the platform might well be utilised on par with the best foreign practices. Enel Russia remains the only listed stock in the Russian utilities universe with meaningful exposure to renewable energy, through the 290MW wind farm which is under construction (due to be commissioned by 2022-23),” Sklyar added.

9.1.11 Metallurgy & mining sector news

Russia’s gold output rose 2.45% to 314.42 tonnes in 2018, the Finance Ministry said Wednesday citing data on gold supplies to refining plants. Mined gold output rose 4.14% to 264.41 tonnes, while by-product gold output decreased 5.85% to 15.44 tonnes, and gold scrap production fell 5.55% to 36.6 tonnes. Russia’s silver output increased 7.24% to 1,119.95 tonnes in 2018. Primary silver production rose 1.17% to 498.66 tonnes, while by-product silver output increased 1.76% to 310.47 tonnes, and production of silver scrap grew 26.2% to 310.82 tonnes.

9.1.12 Transport sector news

The government approved RUB6.3 trillion for transport infrastructure.

Deputy PM Maxim Akimov has approved all nine federal projects comprising the transport portion of the state infrastructure development plan. The projects include developing the China-Europe transport corridor and the Northern Sea Route, as well as building ports, airports, and railways. Total costs will be RUB6.3 trillion (\$96.5bn) by 2024. Infrastructure investors are skeptical that the plan will be completed. One investor interviewed by Vedomosti noted that there's no reason to believe more than 10% will be implemented. Others are more optimistic, projecting 30-40% completion. At the end of the day, Russia simply does not have the building capacity. Builders are already refusing contracts due to excessively tight regulation, siloviki involvement, and low profitability. A lot of well-connected general contractors should make a pretty penny though.

- The government has approved two methods for selecting projects, one advanced by Akimov and the other by MinEkonomiki.
 - The first separates projects into two categories—those that boost economic development and those that support existing infrastructure. The Analytical centre, which effectively works within Akimov's office, will assess potential projects by these categories.
 - MinEkonomiki's method wants to evaluate the direct and indirect effects of potential projects. Direct effects include a reduction in transport costs for companies using the infrastructure, while indirect effects focus on the environment, transport accessibility, and migration.
 - MinEkonomiki will send an annual report on the program's progress to the prime minister and presidential administration.
-
- Trains

Unconditioned freight causing problems. New reports show that a lack of refrigerator or isothermal railcars is having a negative effect on the quality of perishable goods delivered by rail. Over 70% of Russia's annual catch for fish comes from the Far East, much of which is shipped to European Russia by rail. By setting higher tariff rates for more expensive wagons, there are effectively incentives to avoid ensuring product quality as well as parts of fleet modernization for shippers. Better regulations could aid domestic industrial orders, so expect to hear more about this in the coming months. As much as 65% of perishable goods in Russia are delivered in Russia by rail, with average delivery distances hovering at or above 1,000 kilometers on average. German Zverev, president of the All-Russian Association of Fisheries, Fishing Entrepreneurs, and Exporters, estimates that 10-15% of fish deliveries are lost due to spoilt deliveries. Refrigerator cars are estimated to be 50-60% more expensive on average than normal rail wagons. Isothermal cars (which trap and record temperatures) are 20-30% more expensive.

Russian Railways is asking Russia's government to temporarily lift a ban on the import of locomotives engines and generators from Ukraine, reports Belprada, a Belarussian news site. The railroad asked Russia's Industry and Trade Ministry exemption from Moscow's Dec. 29 ban on the Ukrainian-made parts until Russian manufacturers learn how to make their own. Separately, Russian rail car manufacturers, barred from buying Ukrainian wheels, are turning to two Chinese companies to supply 400,000 wheels through 2022, reports Kyiv's centre for Transportation Strategies.

- Ships

Russia's Ministry of Transport asks from the budget RUB98bn for the construction of non-nuclear icebreakers and special vessels. The Ministry of Transport has prepared amendments to the state program "Development of the transport system", which the government adopted in December 2018. To ensure year-round operation of the ports of the Far Eastern and North-Western basins ice thickness up to 2 m RUB7.3bn each. For the same purposes, the ministry is asking for the construction of two auxiliary icebreakers with a capacity of 12–14 MW (RUB6.5bn each) and a port icebreaker with a capacity of 6–8 MW for RUB5.5bn. The disbursement period is 2019–2024.

The Ministry of Transport has launched a campaign to increase the share of exports shipped on Russian vessels from 2% to 50%. It plans to do so by mandating that exporters who receive state support—either SOEs or companies receiving investment financing from the budget—conclude long-term contracts with domestic shipping companies who fly the Russian flag. MinTrans says its goal is to increase the competitiveness of the Russian fleet and ensure economic security by reducing dependence on foreign shipowners. Don't expect this lofty goal to pan out anytime soon. Even the head of a lead Russian shipper has called the 50% quota "figurative." Russia simply does not have enough ships in its fleet. In five years, with a concerted effort, 20-25% may be possible. Conversely, state-owned Sovkomflot could transfer its vessels currently flying Liberian and Cypriot flags, over 130 ships, to the Russian fleet. But that's not really the point, now is it?

Tanker orders for Novatek's Arctic LNG project for the Zvezda shipyard may be subsidized from 2020 through 2036 so as to match prices offered by South Korean competitors, per reports from Minpromtorg. The subsidies speak to how inefficient production in Russia is for its most important strategic sectors, as well as how Rosneft - largest shareholder in the Zvezda shipyard - is forcing Novatek to pay it for tankers. The timeline on the table for subsidization is also quite long, and a precedent that other industries will undoubtedly look to when lobbying for greater spending thanks to the new \$49/barrel of oil breakeven point for the budget. Expect the policy to be little more than a payoff for Rosneft, and to do very little for import substitution writ large.

- Subsidies are meant to match the price differential between production at Zvezda and production in South Korea, traditionally a dominant supplier of ships for Russian firms. However, no figures for subsidies have been offered yet by the relevant ministries.
- Experts estimate that costs at Zvezda are up to 50% greater, and calculate that subsidies will cost at least 10bn rubles (\$153mn) a year.
- Zvezda is currently contracted to build 37 tankers, 26 of which have been ordered by Rosneft alone.
- Rosneft leads the consortium that owns and operates the Zvezda complex

9.1.13 Other sector news

Russian generics supplant foreign drugs. In 2018, the volume of imported pharmaceuticals by monetary value increased by just 1.1% year-over-year.

Total shipments, which amounted to 1.87bn packages, decreased by 7.7%. There are two factors driving this trend. First, and most importantly, declining real incomes have led to a decrease in public demand for expensive pharmaceuticals. And second, a large number of generics have appeared on the Russian market, thereby replacing imported brands. Due to the rise in Russian generics, some large pharma, such as Novartis, Johnson and Johnson, and Teva, have declined to localize production in Russia.

- Swiss pharma Novartis imported the most drugs last year at 41.6bn rubles (\$634mn).
- French Sanofi saw the biggest increase in shipments, boosting supply to Russia by 10% in 2018.
- Israeli Teva saw one the biggest drops, reducing supply by 10% in monetary terms. This was due to a nearly 50% reduction in the import of two of its leading cardiovascular and antiviral drugs.

Foreigners start to use Russian medical services. AFK Sistema subsidiary Medsee has launched a separate department for foreign patients after seeing a 40% increase in foreign consumers of medical services last year. The ruble devaluation has taken time to have an impact, but it looks like inflows of tourists from CIS states are rising and, most importantly, Chinese tourists are beginning to consume Russian medical services. If the sector becomes more competitive and domestic replacements for imported medications and medical equipment take root, Russian healthcare would benefit considerably. The weaker ruble is a competitive advantage. Don't hold your breath yet, though. Flows will likely keep rising, but we're far off from seeing a full-fledged medical tourism industry take root.

- Only 5% of all Medsee clients are foreigners, but the company has noticed the trend and is looking to profit off of further growth in medical tourism inflows.
- The current national plan to develop the healthcare sector through 2024 calls for annual medical exports exceeding \$1bn so as to help finance the sector's growth.
- The global market for medical services will exceed \$3 trillion by 2025, and is likely to keep growing given longer lifespans.
- By comparison, Israel earns roughly \$100mn annually on medical tourism, but the profits are centred in 6 multipurpose medical centres. Moscow alone has a much larger existing network of facilities that could tap into the market.

9.2 Major corporate news

9.2.1 Oil & gas corporate news

- **Gazprom**

Russia's Gazprom guides for at least 200bcm of gas exports to Europe in the short term The management of Russia's state-owned gas giant [Gazprom](#) said that the company will continue to deliver a record circa 200bn cubic meters (bcm) of gas to Europe in the near term, the head of Gazprom Export Elena Burmistrova told Kommersant on January 30. Russia's share of gas supplied to Europe was in over 80% in the 1990s, but fell to a low of 34% in recent years as other sources came from Norway and LNG became available. However, with European demand for gas rising again the Russian share rose again and was 47% in 2018, according to Gazprom's estimates. With demand continuing to rise and the new Nord Stream 2 pipeline due to come online at the end of this year, Russia's share is likely to remain the same or rise next year. In the longer term, the company anticipates exports growing on the back of declining natural gas production in Europe and stable gas demand. These two trends might increase the total imports of natural gas to Europe by 81bcm by 2030, according to Burmistrova. "Gazprom's strong operating data for 2018 (the company increased supplies to Europe 3.8% y/y to 201.7bcm) was mainly driven by the cold weather in Europe, as well as external problems at other gas suppliers, such as issues at the Groningen field. The company's guidance is in line with our short-term forecast for the company's supplies to Europe to remain flat at 200bcm/a in 2019F," VTB Capital (VTBC) said in a note.

Gazprom's investment programme remains a problem as it reached a record RUB1.5 trillion in 2018. Even after the completion of the current major construction projects the company still plans to invest not less than RUB1 trillion a year, according to Deputy Chairman of the Board of Gazprom Andrei Kruglov. The upcoming programme includes RUB1.326 trillion in 2019, before falling to RUB1.065 trillion and 1.251 trillion, respectively in 2020 and 2021. The Russian Railways' investment program for 2018 was RUB550bn, utilities holding Rosseti invested RUB240bn, and Transneft is spent RUB342bn.

Russia's pipeline operating company Nord Stream 2 AG is hoping to attract project financing worth €6bn, Chief Financial Officer Paul Corcoran told reporters on January 29. "We are still in discussions with export credit agencies. We are looking at somewhere around \$6bn euro," he said as cited by Tass. The Nord Stream 2 pipeline is expected to come into service at the end of 2019. The pipeline runs from Russian gas field to Germany under the Baltic Sea. It will go through the exclusive economic zones and territorial waters of five countries - Russia, Finland, Sweden, Denmark, and Germany, thus bypassing transit countries of Ukraine, Belarus, Poland and other Eastern European and Baltic states. Each of the pipeline's two stretches will have a capacity of 27.5bn cubic meters. The total cost of the project has been estimated at €9.5bn. Russia's state-owned gas producer [Gazprom](#) is the only shareholder in the operating company. Gazprom's European partners in the project are Germany's Wintershall and Uniper, Austria's OMV, France's Engie and Royal Dutch Shell.

The Deputy Chairmen of Gazprom's Management Committee, Alexander Medvedev and Valery Golubev, who were overseeing the export and domestic gas markets, respectively, are to leave the company, Vedomosti

reports, citing a company press release. Both men have been at the company for years. In addition, Vsevolod Cherepanov is leaving his post as Head of Department 307 (responsible for the production of gas, gas condensate and oil), but is to continue working in a different position in Gazprom.

- **Novatek**

Novatek plans to launch the first train of its third LNG (LNG-3) project at the end of 2024, increasing its total LNG shipment flow to 46.5mmt/a, Kommersant reported on January 29. According to the paper, the third LNG project might include up to three trains with capacity of 1.5-1.6mmt of LNG each, constructed based on Novatek's Arctic cascade liquefaction technology. The resource base for the project might be either the Verkhnetiuteyskoye and West-Seyakhinskoye fields at Yamal or the Shtormovoye and Utrenneye fields at Gydan, the paper reports. "The company's plans to increase LNG shipments to 46.5mmt/a by the end of 2024 are part of Novatek's long-term strategy, which implies increasing production to 57mmt/a of LNG by 2030. We also note that the project is currently at an early stage, with the final investment decision (FID) expected in 2020-21. Therefore, for now we deem the news as neutral for the name," VTB Capital (VTBC) said in a note.

Russia's leading independent gas producer [Novatek](#) sent a proposed deal on Total's purchase of 10% in Novatek's Arctic LNG-2 project for approval to the Government Commission on Foreign Investments that is under the Federal Antimonopoly Services (FAS), Kommersant reported on February 25. Arctic LNG2 is the second of a three stage plan to develop gas deposits in Russia's frozen north that the company is planning and could make Russia a major player on the international LNG market. Previously Novatek said the deal should be closed in 1Q19, in line with the initial plans and in full compliance with federal law, according to the paper. "Novatek and Total signed a binding agreement on the sale of a 10% stake in the Arctic LNG project in May," Dmitry Loukashov of VTB Capital (VTBC) said in a note. "Given that the government has previously supported the deal and that the company has confirmed its initial plans to close it by the end of 1Q19, we expect it to be finalised in the near term. We think, though, that the news might be negative for sentiment on the name."

9.2.2 Automotive corporate news

The Russian-French-Japanese joint venture Avtovaz will delist from the Moscow Stock Exchange.

9.2.3 Aviation corporate news

[Aeroflot](#) reported mixed January traffic data on February 20. Aeroflot increased the total volume of passengers carried by 14.5% to 4.2mn in January, with the airline showing 13.4% growth. Passenger volumes for international and domestic flights were up 15% and 14.2%, respectively. RPK was solid at +14.3% for the group, 13.6% for international and 15.4% for domestic flights. The passenger load factor continued to slide to 75.9% by 1.2pp and 1.4pp v December 2018 and January 2019, respectively, reports BCS Global Markets. "Solid passenger volumes and RPK data, however passenger load factor continued to slide to 75.9%, which means a mixed result for the airline," Anastasia Egazaryan of BCS said in a note. "Traffic numbers,

flight hours and average flight time per aircraft are strong as well. Meanwhile PLF is disappointing sitting at its lowest levels since January 2016. January traffic data provides a mixed read across for January profitability, in our view.”

9.2.4 Construction & Real estate corporate news

Following [speculation](#) in the market that leading real estate developer [Etalon Group](#) would sell a stake to AFK [Sistema](#), it did. The largest shareholder in Russian leading real estate developer [Etalon](#), the Zarenkov family, sold the majority of its 30.7% stake to Sistema on February 19. The Zarenkov stake was worth RUB11.5bn (\$175mn) at last week's market prices. Etalon announced last week a binding agreement to [acquire a 51% stake in Leader-Invest](#) (aka Lider-Invest), a Moscow-based developer, from Sistema for RUB15.2bn. The target has a portfolio of 1.3mn sqm, which was valued at RUB66.6bn by Colliers as of October 2018 (assuming a 55% discount). Etalon has announced that Sistema has bought a 25% stake in the developer's share capital from the family of its founding shareholder. The acquisition price for the deal was \$3.07/GDR, implying a total deal value of \$227mn and 55% premium to Etalon's closing price yesterday. Etalon has highlighted that it has no intention of changing its strategy and has called for the continuation of its current dividend policy (40-70% payout ratio of IFRS net income). The BoD is to see the arrival of two Sistema representatives (one as chairman) as well as two new independent directors. The total number of Board of Directors members is to increase from nine to 11. “We believe that the market environment will remain challenging and the integration process could take time. Further, Sistema still has to prove itself as a key shareholder in the business. Due to uncertainties arising prior the finalisation of the deal and the presentation of a proper strategy for the new company, we are putting the stock Under Review,” Maria Kolbina of VTBC Capital (VTBC) said in a note. The new company would control a portfolio of 3.6mn sqm, strengthening its position in the top-10, and becoming the second-largest developer in Moscow. Etalon plans to take a RUB15.2bn loan at an interest rate of 10.1% in rubles; combined net debt/EBITDA would be around 1x. “Etalon has lost one third of its market capitalisation in the last twelve months as sentiment to domestic stories in general and developers in particular has materially worsened, and investors feared the exit of the key shareholder. The arrival of Sistema to Etalon's share capital brings uncertainty in terms of the sustainability of management, as well as its strategy and capital allocation for the new company. At the same time, we acknowledge that Sistema is a more aggressive shareholder that could bring much needed change and speed to the combined company if it chooses strategy wisely,” Kolbina said.

9.2.5 Retail corporate news

The management of Russia's struggling second tier supermarket chain [O'Key](#) met with investors to explain the new strategy, but left analysts unimpressed. “O'Key has held a strategy update, chaired by [recently appointed CEO Armin Burger](#). Although all the issues were addressed, we do not think there has been any improvement in the outlook on the operational turnaround and an acceleration in revenue growth,” Maria Kolbina of VTBC Capital (VTBC) said in a note. [O'Key has unloaded dozens of its supermarkets](#) and is focusing more on the hypermarket format as the explosive growth of Russia's supermarket chains has come to an end and [organised retail starts to run up against structural constraints](#). The leading chains have switched from

expansion to grab more market share to improving profitability and have even begun to close some of their more unprofitable stores. However, its hypermarket format remains promising, says Kolbina, with the prime focus being on a more extended offer beyond that of convenience stores, refurbishment, 2-3 store openings annually, and optimising selling space to 6,000-7,000sqm, 10% less than at present. The bigger format means discounters aim for more efficient operations with suppliers via a larger store base, and O'Key says it should have up to 30 new stores and breakeven by the end of this year. "Management guided for flat leverage at YE18 (3.1x net debt/EBITDA last year), with capex in 2019 comparable y/y (RUB 7bn), and also commented on tighter resources for dividend distribution. O'Key is down 40% in the last 12 months and now demands EV/EBITDA of 5.0x. Our 12-month Target Price of \$2.10, which envisages the successful delivery of the aforementioned strategy, implies an ETR of 41%: Buy reiterated. We summarise management's outlook below," VTBC said in a note.

X5 Retail Group announced plans on February 19 to develop a parcel lockers network via a joint venture with Pickpoint, Russia's largest operator of parcel lockers and pick-up points. The ownership of the JV is to be 50/50, and its aim would be to install 1,500 parcel lockers throughout the year. X5 Retail Group already has over 1,700 lockers and pick-up points in its chains, most operated by Pickpoint throughout a unified sales network. Pickpoint operates 5,500 parcel lockers and pick-up points in over 540 cities in Russia. "The growing focus on e-commerce and the digital transformation of its business is upbeat for X5's investment case. As of December 2018, X5 operated 14,431 stores and 42 DCs covering more than 1.1mn sqm of logistics space, being the second largest logistics operator in Russia, creating additional benefits for the development of a parcel lockers network," Alexander Gnusarev of VTB Capital (VTBC) said in a note. "We see online trade increasing at a CAGR of 18% in 2018- 22F, to reach RUB3.3tn and 8% of retail turnover. Traditional retailers are focusing on soon-to-become obsolete measures and have overlooked the chance to form alliances with IT companies, credit institutions and online retailers that pose competitive threats to them, in our view. X5 Retail Group has a valuable asset base to fit into the ecommerce era and appears to be making the most tangible progress towards that among traditional food retailers," Gnusarev added.

Lenta has released weak 2H18 IFRS numbers, underperforming the analysts' consensus estimates by 7% on EBITDA and 20% on net income, VTB Capital (VTBC) said in a note. Lenta is in the second tier amongst Russia's organised food retail chains and struggling to keep up with market leaders [X5 Retail Group](#) and [Magnit](#). It has been closing its smaller stores and focusing on its hypermarkets. The explosive growth of Russia's supermarket chains has come to an end as [organised retail starts to run up against structural constraints](#). The leading chains have switched from expansion to grab more market share to improving profitability and have even begun to close some of their more unprofitable stores. Since cutting the organic pipeline, however, Lenta's financials have taken a back seat to corporate updates on capital allocation and returns to shareholders, reports VTBC. "Lenta's 2H18 IFRS results were hit by decelerating revenue growth (fell twice half on half to 9% y/y), losses associated with almost discontinued wholesale operations, 70bp higher shrinkages to 2.4%, and a less favourable allocation of selling, general and administrative expenses (SG&As) (up 90bp to 12.2% of the top-line). Thus, amid a 13% y/y higher FY18 top-line, EBITDA was flattish, while net income dropped 11% y/y," VTBC's Maria Kolbina said in a note. For this year the management guidance points to modest organic growth of about

3% y/y according to VTBC, and aggressive capex of RUB15bn (4230mn), which is seeing pressure from supply chain and IT. VTBC cut its 2019-23 net income forecast by 20% and 12-month TP 25% to \$3.70/GDR, revising the stock down from Buy to Hold as a result. "The prospects for the distribution of expanding cash flows to shareholders are vague, the buyback pace is slow, and we are waiting for updates on tender offers or dividends," Kolbina added. Forecasts for the profitability of the company are also downbeat. The gross margin remained flat at 21.1%, as the improvement in supplier terms were offset by the increasing penetration of promos (4pp y/y) and 70bp surge in the shrinkages, highlighting to us lesser operational control. SG&As increased across the board and added 90bp y/y in total revenues, to 12.2%. Thus, EBITDA margin lost 120bp y/y to 8.7%, while semi-annual EBITDA and net income underperformed the consensus a blended 7% and 20%, respectively.

9.2.6 Agriculture corporate news

Leading Russian agricultural holding [RusAgro](#) released strong 4Q18 operating results that show a 25% y/y gain in total revenues year-on-year, the company said on January 30. The most recent results were driven by the strong pricing environment, as sugar grew 35% y/y and key farming crops surged 50-90% y/y, seeing better supply and demand balances, global pricing recovery and a weaker local currency, VTB Capital (VTBC) said in a note.

The recovery in domestic prices for soft commodities is positive for agriculture producers in Russia and leading agro-company [RusAgro](#). VTBC forecasts 2019F EBITDA up 33% y/y to RUB23bn, reflecting a recovery in the sugar and farming divisions. The stock is up 20% since the launch of the new marketing year and we consider the improving financials as fairly priced (2019F EV/EBITDA at 5.5x). Further upside comes from more strategic initiatives, such as the launch of the Russian Far East project in 2020, successful M&As in the vegetable oil division and an acceleration of exports to Asia.

Russia's second largest bank VTB has acquired a 50% minus one share stake in United Grain Company, as seen by PRIME on Wednesday in the materials of the bank. Other details of the deal were not disclosed. United Grain Company was established in 2009 to support Russian farmers and to improve the infrastructure of the grain market.

9.2.7 TMT corporate news

Apple Inc. detailed the user data it is storing in Russia, [reports East-West Digital News](#) (EWDN). Apple users in the region have data including their name, delivery address, email address and phone number stored on servers in Russia. The company said it collects that information for customer service and to send users information on new products, according to a recent filing with the Russian government. The filing does not mention more personal data such as messages, documents, photos, and contacts that are often saved on Apple's iCloud service. The move to store some data locally is not the first time Apple has agreed to the requests of the Russian government. Last year, Apple stopped publishing updates of the Telegram messaging service for about two months after the government asked Apple to pull the app from its App Store, according to the Telegram's founder. Apple did not remove the app, though. Adopted in 2014 and applicable since September 2015, the Russian data-

localization law requires companies operating in the country to store Russian users' or clients' personal data on servers physically located in the country. Numerous foreign and domestic players were concerned, including global players who tended to store their users' data in borderless clouds (see white paper by EWDN and EY). While many businesses — including Alibaba, AliExpress, Apple, and Google — have managed to transfer user data from foreign data centres to Russia, others refused or failed to comply so far, as exemplified by LinkedIn. In response, Roskomnadzor, the Russian telecom and Internet regulator, blocked access to this platform in November 2016, following a series of exchanges with the company and two court decisions.

Roskomnadzor, the Russian telecom and Internet regulator, initiated a lawsuit against Twitter for failing to provide information about its compliance with the Russian data-localization law on February 21. The US microblogging platform is now facing an administrative fine of RUB5,000 rubles (\$764 at the current exchange rate). Ultimately Twitter, should it violate the law, could be blocked in Russia – as was the case with LinkedIn in 2016 following two court decisions. Adopted in 2014 and applicable since September 2015, this law requires companies operating in Russia to store Russian users' or clients' personal data on servers physically located in the country. Numerous foreign and domestic players were concerned, including global players who tended to store their users' data in borderless clouds (see white paper by EWDN and EY). While many businesses — including Alibaba, AliExpress, Apple, and Google — have managed to transfer user data from foreign data centres to Russia, others refused or failed to comply.

MTS and Ericsson sign 5G roadmap agreement and to launch first test stations this year. Russia's leading telecommunications operator and digital service provider in Russia [Mobile TeleSystems](#) (MTS) and Sweden's Ericsson, a global leader in communications technology, have announced an agreement to launch the first 5G network segments in Russia, the Russian company said in a press release on February 26. At the Mobile World Congress 2019, the two companies signed the agreement on 5G Russia roadmap for 2019-2022. The roadmap outlines the steps to develop and deploy the first segments of 5G networks within pilot zones and commercial clusters in the first year. The roadmap further describes the planned process of the current LTE networks evolution to high-speed LTE Advanced Pro Gigabit LTE networks, as well as strategies for further development and launching of innovative commercial solutions and products based on 5G technologies, MTS says. Alexey Kornya, MTS President and CEO, commented: "Back in December 2015, we signed a cooperation agreement with Ericsson on 5G technology. We hit all the targets envisaged under that agreement. Together, we have successfully tested advanced 5G-technologies and solutions on the MTS network with excellent results. Today, we are entering a new phase of our collaboration as we move towards the next generation standard. We are ready to launch the first 5G pilot zones on the MTS commercial network, combining our achievements and insights with exciting new technologies. We hope that our continued cooperation with leading vendors in conjunction with the earliest possible availability of the required frequencies to Russian telecom operators will accelerate the deployment of 5G networks across the whole country, and prove to be an impetus for further innovation." Arun Bansal, President and Head of Europe & Latin America, Ericsson, added: "MTS and Ericsson continue to demonstrate industry leadership through ongoing innovation and collaboration. We continue to work closely with MTS to expand our strategic partnership and support MTS in successfully deploying 5G. This year we will deploy commercial Gigabit LTE networks based on LTE Advanced Pro

standard, Massive MIMO and LAA with peak data rates close to 1 Gb/sec. Our joint efforts will make MTS subscribers among the first in Russia to benefit from 5G services.” The companies outlined their plans. The first 5G stations will be rolled out in 2019 and a pre-commercial pilot phase with a 1Gb/s data transfer rate. At the same time the companies will introduce Internet of Things (IoT) capacity for use in industry, agriculture, city infrastructure and utilities. The following year the companies will roll out 5G networks in Russia’s regions. In 2021-2022 the networks will be extended to private networks for smart manufacturing and support for virtual reality applications for commercial use. At the same time the first test zones for “driverless” vehicles will be introduced.

Russia’s leading mobile phone company [Mobile TeleSystems](#) (MTS) says it will sell its 18.7% stake in Russian online retailer [Ozon Holdings](#) to [AFK Sistema](#) for RUB7.9bn (\$120mn). MTS paid a total of RUB5.9bn for the stake: RUB2.7bn in 2014 and RUB3.2bn in 2018. As a result of the deal, MTS will have no ownership in Ozon, while Sistema will control 35.6%, of which 16.3% will be through Sistema VC, in which Sistema has an 80% stake. The deal is targeted to close in early March. The payment will be made in 3 installments, with the third paid in July 2021 (a market interest rate will apply). The sale will be at the minimum Ozon valuation, with a delayed payment scheme (plus interest) – suggests c30% premium to MTS investments, reports BCS. “The deal suggests a Rb42bn valuation for 100% Ozon. The price is at the lower end of valuations for the recent deals, in which Sistema and Baring Vostok increased their stakes in Ozon – Kommersant. The price suggests a c30% premium to MTS investments, and a c10% annualized return. Strategy-wise, we were not big believers in the synergies between the carrier and e-tailer,” Maria Sukhanova of BCS Global Markets said in a note.

Swedish investor VNV injected \$8.5mn in Russia’s Busfor ticketing service in 2018 In December last year Vostok New Ventures (VNV), a major Swedish investment firm operating internationally, invested \$4.5mn in online bus ticketing platform Busfor, in addition to the \$4mn it had injected in the company in mid-2018, reports East-West Digital News (EWDN), citing VNV’s latest financial report and exchanges with Busfor’s founder Ilya Yekushevsky. Busfor (previously known as Gillbus) aims to change what has been mostly a grey and offline market so far. Launched in Ukraine in 2010, the company is now headquartered in Poland. It operates in Belarus, Georgia, Poland, Russia, Ukraine, Thailand, Tanzania, Rwanda, Iceland and several countries of the EU, according to its website. The company claims to partner with more 700 bus transport companies, and hopes to sell more than 10mn tickets in 2019. According to Yekushevsky, the number of sold tickets already tripled in 2018. The average ticket price amounts to \$22, with Busfor getting a 15% fee on each sale, reported Kommersant last year, citing company data. The bus transportation market in Eastern Europe and the former Soviet Union amounts to some \$9bn, with online ticket sales accounting for just 2%-5% in 2018. Busfor believes online sales will grow to some 30% by 2022, and aims to control a third of this volume. Since its inception in Ukraine in 2010, Busfor has received financial support from Intel Capital, InVenture Partners and FinSight in 2014, from Ukraine’s Chernovetskyi Investment Group (CIG) in 2015, then from Baring Vostok and Elbrus Capital in 2016.

Russia’s HeadHunter has acquired a 25% stake as a result of a capital injection into [Skillaz](#), a developer of advanced recruitment solutions, [reports East-West Digital News](#) (EWDN). The news was [reported](#) earlier this week by business daily Vedomosti, which cited exchanges with an official company HeadHunter representative. The funding will be used for recruitment and

company development purposes. Neither the amount nor other details of the transaction were disclosed, but an “unnamed source close to the deal” told Vedomosti that Skillaz was valued at 1 billion rubles in total (\$15 million at the current exchange rate). HeadHunter has received an option to complete the acquisition in the future, according to this source. Founded in 2015, Skillaz has developed tools to help companies automate personnel selection. These tools include robotic processing of job boards, social networks, and evaluation of candidates using AI. Skillaz’s solutions are used by such companies as Gazprom Neft, KPMG, MegaFon, Sberbank, Uber and others. In 2017, the startup was [distinguished as “one of Russia’s 12 best startups”](#) at an international event. Among the company’s shareholders are top managers from MegaFon, notes Vedomosti. HeadHunter is the leader in the online recruitment segment in Russia as well as in several neighboring Russian-speaking countries. It was founded in 2000 under the name ‘National Job Club’. Starting from 2007, Yuri Milner’s Digital Sky Technologies (which later became Mail.Ru Group) bought stakes in HeadHunter, but Mail.Ru Group [sold the company](#) in 2016. HeadHunter’s new owners are “investors close to Alisher Usmanov,” a key shareholder of Digital Sky Technologies and Mail.Ru Group, [notes industry observer Yuri Amnosov](#).

Siberian startup secures \$1mn to develop “vertical farms” across Russia and Europe [iFarm](#), a Novosibirsk, Siberia-based startup, has just secured \$1mn in a round led by Gagarin Capital – the California-based VC firm founded by Nick Davidov and Mikhail Taver – with participation from individual Russian investors. The details of the deal have not been disclosed, reports [East-West Digital News](#). “We created iFarm to grow natural vegetables, berries and greens in the city at any time of the year, using innovative technologies,” the company says on its website. Russia has enormous agricultural potential, but the weather makes growing fruit and vegetables difficult on most of the country’s territory. This agritech startup builds vertical farms, which “use a footprint of land more productively than traditional greenhouses.” It has also designed automated all-year-round greenhouses from 100 to 1000 sq.m. as well as growing trays “for growing greens and strawberry right in your restaurant or grocery.” iFarm’s first experimental projects were completed in 2017. The next year, iFarm developed vertical farms to grow such short-term crops as strawberries, lettuce and herbs. Two such vertical farms of 500 sq. m. were developed with grocery stores. This year, iFarm plans to launch a new 3,000 sq. m. project in Novosibirsk, a smaller one in Moscow (100-500 sq.m.), and to experiment its technology on the European market. It will also use the money raised in the recent round to develop further its technology and enlarge its team. The company has offices or representatives in Novosibirsk, Moscow and Luxembourg.

Rosnano, the Russian state-controlled nanotechnology corporation, has exited Quantenna Communications with a five-fold return on investment. Rosnano invested around \$20mn into the US-based provider of high-performance Wi-Fi solutions [six years ago](#) . Revealed by [SEC documents](#) and confirmed by Rosnano, the exit transaction took place December 2018. The Russian firm received some \$43mn in exchange for its stake of approximately 7% in the Quantenna. This provided Rosnano with a “more than fourfold ROI or 28.9% IRR in ruble equivalent,” according to Rosnano’s press service, or around twofold in US dollars, taken into account the ruble’s sharp depreciation since the year of the investment. Quantenna has a Russian R&D team of around 60 researchers and engineers, whose microschemas are praised by industry experts.

Gazprom-Media, Russia's largest Russian media holding and a subsidiary of Gazprom, has led a \$2mn funding round for Catery. This Moscow-based catering startup, launched in 2016, organizes deliveries to corporate clients. It operates in Moscow, St. Petersburg, Kazan, Rostov-upon-Don and Nizhny Novgorod, based on partnerships with more than 500 restaurants. According to a Catery representative, cited by business daily Kommersant, the deal also involved "a pool of foreign investors, including Bill Franke." Franke is the managing partner of Indigo Partners, a major US fund, which has invested in a range of airline companies across the world, including Avianova in Russia. Franke could not be reached to confirm the information, but Kommersant saw his name in official Russian and Cypriot company registries. According to this official information, Gazprom Media owns a 14.6% stake in the company, while Bill Franke has 3%. According to Catery, cited by Kommersant, the Russian catering market amounts to some \$1.2bn per year. In 2017, reports Kommersant, Gazprom Media invested 20mn rubles (around \$300,000) in food delivery startup Instamart in a media-for-equity deal.

Moscow-based grocery delivery service Golama has attracted RUB150mn (\$2.3mn) in equity funding from an unnamed individual investor, according to media reports, [reports East-West Digital News](#) (EWDN). The funding will be spent on expanding Golama's network of partners, which include retail chains and stores, and its goods and services offer. Golama told Russian online tech resource Rusbase that the round was completed in January, with the first funding received in November last year. Rusbase also heard from an unnamed "source close to the deal" that Golama's valuation amounted to 750mn rubles (around \$11.5mn). One hundredmn rubles (around \$1.5mn) had been invested in the startup at the launch phase, in March 2018, Golama told Rusbase. The startup claims that more than 250,000 users have downloaded the app so far, and that the number of orders grows "by 20%-30%" every month. Golama partners with such chains as METRO, Lenta and Vkusvill. It operates in Moscow and surrounding cities Balashikha, Dolgoprudny, Mytishchi, Reutov and Khimki.

Major Russian mobile operator [Mobile TeleSystems](#) (MTS) has launched a platform dealing with second-hand IT and telecom equipment, [torg.mts.ru](#), which works like an auction, business daily Vedomosti reported on Tuesday, quoting MTS spokesman Alexei Merkutov. Floor tests started a year ago and the system was free, now MTS starts charging a commission from sellers, Merkutov said without disclosing its size. Clients can subscribe to the floor paying 7,000 rubles per month and sell up to 200 items. A seller can hire a personal manager for 50,000 rubles, Merkutov said. MTS specialists can help set the initial price of goods, which can fall or rise during trading, he said. Vice President Vyacheslav Nikolayev said a year ago that new services brought MTS up to 20% of revenue.

Russian software engineering company [Luxoft](#) reported weak 3Q19 results on February 12, but broadly in line with the lower end of management's guidance. Founded in Russia by [IBS IT Services](#), Luxoft was a spin off from the main company and concentrates mainly on the international markets. "The main trends among verticals remained unchanged and were in line with expectations. We believe that the main pressure on the Luxoft top line and margin was due to the weak performance of the Financial Services Vertical. We note that Luxoft's results are largely irrelevant, as the company is being acquired by DXC Technology for \$59 per share, with the deal likely to be closed by June 2019. We have a Hold recommendation on

the name (TP \$59, +1% ETR),” VTB Capital (VTBC) said in a note. Luxoft 3Q19 revenue declined 3% y/y to \$230mn and came in 2% below the consensus, but at the lower end of its guidance (\$230-235mn). The main trends across verticals were in line with management’s earlier comments. Financial Services accounted for 50.5% of revenue in the quarter, which implies a 16% y/y revenue drop of this vertical vs. a 3% y/y decrease in the previous quarter. Automotive revenue growth accelerated to 56% y/y in the reported quarter vs. 26% in the previous quarter, while Digital Enterprise showed a negative y/y trend but continued to grow Q/q (+8% Q/q), based on our calculations. The share of the largest two accounts decreased 24.9% in 3Q19 vs. 30.2% in 2Q19 and 34.4% in 3Q18. This implies that their revenue fell 30% y/y in the reported quarter vs. a 15% y/y drop in the previous quarter. “Excluding the largest two accounts, Luxoft revenue growth improved to 11% y/y vs. 8% y/y in the previous quarter, we think primarily due to strong dynamic from the Automotive Vertical,” VTBC added. Financial Service revenue excluding the largest two accounts was up only 4% y/y in 3Q19 vs. +16% the previous quarter. Luxoft’s adjusted EBITDA margin was down to 14.1% in 3Q19 and came in at the lower end of the management guidance (14-15%). Thus, adjusted EBITDA decreased 19% y/y, and was 5% below consensus. The company reported non-GAAP diluted EPS of \$0.61 (vs. \$0.62-0.69 guided) and GAAP diluted EPS of \$0.32 (vs. \$0.29-0.37 guided).

Google cuts a deal with Roskomnadzor. Google has reportedly agreed to share search results for websites banned in Russia with Roskomnadzor, signaling a willingness to share data to aid Russian legal authorities. Google’s decision is likely to set a precedent for future negotiations with major western tech firms in Russia. Roskomnadzor itself admits it cares more about receiving a list of sites that fall under its ban regulations every day from Google than Google’s actual formal registration within its database. The desire to maintain market access and share in Russia and Eurasia likely necessitated Google’s compliance, but shareholders and employees wouldn’t back anything handing Moscow all it wants. Expect more tug-of-war as attempts to regulate Runet continue to evolve.

- Google’s willingness to work with restrictive states isn’t totally, given its plans last year to build out a censored search engine in China. But after reportedly ending that project, Google has learned its lesson with the public and can’t sign on fully to something similar in Russia.
- Apple has recently admitted to storing Russian users’ data on local servers, thus making it accessible to security authorities in the country.
- Google is not formally part of Roskomnadzor’s automatic registry—Yandex, for example, is—but reportedly decides on a daily basis which sites conform to the law as it understands, and then sends the links along to Roskomnadzor.

Belarusian software engineer EPAM was downgrade to Sell by VTB Capital (VTBC), despite its strong performance and outlook, the bank said in a note on February 18. “EPAM’s financial performance and outlook remain strong, as confirmed by the company’s 4Q18 results and 2019 guidance. However, the recent appreciation of the stock has brought the share price to levels that we view as unwarranted even by these strong fundamentals,” said Vladimir Bespalov of VTBC. “In particular, we see the 2019F P/S multiple of 3.9x and P/E of 30.5x (on a non-GAAP basis) implied by the guidance, as demanding. Even though our 2019 forecasts are slightly higher than the

guidance, we still see the stock as overpriced. Having fine-tuned our model, we are raising our 12-mo TP 4% to \$145, which nevertheless points to a negative ETR (-6%). We downgrade EPAM from Hold to Sell and advise investors to take profits,” Bepalov added. Originally from Belarus, the company has a corporate headquarters in New York and does most of its business international. It has been a good example of a successful tech company coming out of the Commonwealth of Independent States (CIS) and deals with a raft of blue chip names. However, the lion's share of its engineers are still based in Minsk. The company continues to put in a strong performance. EPAM's 4Q18 revenues of \$505mn (+26% y/y) and non-GAAP EPS of \$1.27 (+26% y/y) came in 1% and 4% above the consensus and its own guidance, respectively. EPAM's strong revenue generation, high utilisation (over 80%), as well as the decrease of SG&A (excluding stock-based compensations) as a share of revenue to 17.7% vs. 19.9% in 4Q17 and 18.2% in 3Q18, supported margins. In particular, the non-GAAP operating margin stood at 18.4% in 4Q18 vs. management guidance of 17-18%, VTBC reported. “We believe that EPAM's ability to deliver consistently strong growth and stable margins has been behind the strong share price performance over the past couple of years. EPAM's guidance for 2019 also implies continued strong top line growth, at 22% y/y (21% organic). Meanwhile, management believes that the high profitability of 4Q18 will not be sustained throughout the year, as utilisation will normalise at 77-79%, while SG&A will return to 18-19% of revenues,” Bepalov said.

9.2.8 Telecoms corporate news

Russia's leading mobile phone company [Mobile TeleSystems \(MTS\)](#) reported earnings up by a third (34%) y/y in the fourth quarter of 2018 and management guided for more growth in 2019, the company said on February 28. “The results came in line with consensus on revenue and EBITDA (if adj. for UMA consolidation), and the company delivered on its FY 2018 guidance. Expectations for 2019 look good, with our forecasts (and Bloomberg consensus) falling in the middle of the guided range for revenues and EBITDA (excl IFRS 16 impact),” BCS Global Markets said in a note. MTS's top line was RUB23.4bn (\$355mn), which was up 34% over a year previously and EBITDA up 42% to RUB8.7bn with a 37% margin. The key growth drivers included: ad revenue which was up 38% and games revenue, up 37%, with the top performing title “Hustle Castle.” Also contributing to the profits was MTS's subsidiary social media site Vkontakte (VK) which saw revenues grow by 27% and an EBITDA margin of 18%.

9.2.10 Utilities corporate news

Russian utility company [Unipro](#) has released strong 4Q18 and FY18 operating data, with an 11% y/y increase in production in 4Q18 alone, offsetting the 8.3% y/y drop in 9mo18. Thus, full year production was down just 3.3% y/y to 46.6bn kWh. All power plants, except for Yavinskaya GRES, saw a y/y production rise in 4Q18: 22% at Smolenskaya GRES, 13% at Berezovskaya GRES, 12% at Surgutskaya GRES and 9% Shaturuskaya GRES. This was driven by the increased load owing to the weather conditions and the repairs schedule. Total heat sendout improved 4.3% y/y to 2,218 thGCal.

Russian utility InterRAO has released its FY18 operating data and Russian Accounting Standards (RAS) results. The group's total electricity

production printed at 132.5bn kWh, implying a 1.7% y/y reduction with the load factor decreasing to 45.3%. At the same time, the total heat production printed at 41.7mn GCal, translating into 4.4% y/y growth driven by the weather conditions in the areas where it operates. Total supply volumes increased 4.3% y/y to 190.5bn kWh, giving the company a 17.7% share of the Russian market. Despite export levels falling 17.8% y/y, import operations saw growth of 17.2% y/y. On the RAS financials level, InterRAO holding company (which consolidates trading operations and dividends from subsidiaries) reported a 21% y/y upturn in the bottom line to RUB 18.8bn, while InterRAO's electricity generation subsidiaries recorded 4% y/y growth in the bottom line to RUB 38.8bn. The largest supply company, Mosenergosbyt, recorded a 23% y/y slide in net income due to taxes and other costs lines. "The production data implies slight upside to our profitability estimates, positioning the company well to deliver on its RUB 110-115bn EBITDA guidance for FY18. We note that InterRAO's RAS net income reflects exclusively the import-export operations and dividends lifted from subsidiaries (gencos, supply, international operations) levels, while being fully consolidated on the IFRS financials," VTBC Capital (VTBC) said in a note. "Thus, the key takeaway from the results is the absolute value of net income: RUB 18.9bn (under Russian corporate law, InterRAO's dividends cannot exceed 100% of its RAS net income). And, according to our estimates, the reported bottom line is similar to what we expect to be a 25% of IFRS net income dividend payment. The bottom line is that InterRAO's payout is to stay at 25%, despite potential expectations, and the dividend yield is unlikely to exceed 4.5%, in our view," VTBC added

Russian utility OGK2 has released its FY18 operating results. Production was down 7% y/y to 58.9bn kWh, with certain plants seeing drops of 42% to 81% vs. 27+% growth at other selected power plants. The total heat sendout printed at 7,007th GCal, implying a 4% y/y increase, which can be explained by the weather conditions. "We believe that the operating results are relatively muted, though not unexpected (following the 9mo18 dynamics), with a sharp reduction in production at certain power plants and an overall deterioration in production. We do not anticipate any significant market reaction to the results and, in fact, on our numbers, the combination of factors along with the strong free market prices in 4Q18 suggest that the company's FY18 IFRS results could slightly exceed our current expectations," VTBC Capital (VTBC) said in a note. "However, along with deleveraging and a 25% dividend payout, we expect the dividend yield not to exceed 4-5% for FY18, out of a strong 35% FCF yield."

9.2.11 Metallurgy & mining corporate news

A number of Russian companies, including Uralkran, Energoavangard, Veza, Promtreidimpeks, South Ural Plant and Permglavsnab, signed contracts to supply equipment for the Tashkent Metallurgical Plant (TMZ), which is currently under construction, the press service of TMZ said in a statement. The plant, set to launch in December 2019, is set to cost €286mn. Russia's MetProm has been selected as the general contractor for the construction of the TMZ. After reaching full capacity, the company will annually produce 500,000 tonnes of cold-rolled metal. Approximately 20% of the output will be exported to Iran, Turkey, Afghanistan, Azerbaijan, Armenia, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, Ukraine, Latvia, Lithuania, Estonia, according to local media reports. SFI

Management Group is managing project, the reports said.

- **Gold**

Russian junior gold mine [GV Gold](#) announced a record production of 304.4koz in 2018 and also beating out management forecasts. A relatively young miner, the company has more than doubled its production in the last two years, the company said in a statement released on January 28. “GV Gold’s performance in 2018 has positioned the Company as one of the most dynamic players in the sector. We are confidently moving toward our goal of becoming one of Russia’s top five gold producers. We have successfully completed a large-scale investment cycle, a key result of, which was the launch of two strategic projects. By ramping up production capacities, the Company has reached an entirely new level, practically doubling gold production from 164 koz in 2016 to 304 koz in 2018,” GV Gold CEO German Pikhoya said. GV Gold has launched two new projects in the last two years at a time when the Central Bank of Russia (CBR) is snapping up nearly all the gold produced in Russia. [Russia has been actively building up gold as a share of its gross international reserves \(GIR\) since 2007.](#)

Russian leading gold producer [Polyus Gold](#) reported 4Q18 IFRS results, which came mostly in line with expectations on key numbers. Revenue declined by 7% q/q to \$774mn, which was fully in line with consensus forecasts. The company’s EBITDA declined by 10% q/q to \$484mn, which was 4% higher than BCS Global Markets estimates and again fully in line with consensus. Net income fell to a negative \$28mn materially missing consensus numbers due to non-operating losses, which 2018 capex came in lower than expected at \$736mn vs the forecast \$850mn. However, the 2019 target for capex is increased from \$650mn to \$725mn. The second half dividends expected to be \$296mn, which implies a dividend yield of 2.7%. The record date for dividends is expected to be in May 2019.

[Polymetal International](#) has completed the sale of its Kapan mine in Armenia, according to a company press release on January 31. The deal is in line with the guidance on the sale announced earlier. The sale of Kapan, one of the highest cost mines in company’s portfolio, is part of the company’s moves to re-profiling and concentrate on lower cost and more profitable assets by selling non-core, high-cost assets. The Kapan mine had total cash costs (TCC) of \$960/tonne in the first half of last year, which is high, and so the company decided to sell it. The Russian gold miner [Polymetal International](#) [was downgraded to Hold](#) by VTB Capital (VTBC) this week after a string of big gains have been realised, the bank said in a note on January 29. In June 2018 Polymetal commissioned a [major Kyzyl mine in Kazakhstan ahead of schedule](#) that has performed even better than expected. The company has managed to deliver on [ambitious growth plans](#), and in general Russian precious metals miners could push the country to become the second-largest gold miner behind Australia by 2030, estimates by Aton Equity and the Institute of Geotechnology showed. The company trades at 2019F EV/EBITDA of 7.2x and P/NAV of 1.7x, roughly in line with global quality gold miners.

Leading Russian gold miner [Polymetal](#) to build the largest gold concentrate processing plant in Russia. The project is worth \$431mn and will eliminate the need to use a similar plant in China, the company said on February 11. The board of directors of Polymetal has already approved the construction project of the second Amur hydrometallurgical plant (AMMK-2, Khabarovsk Territory), the company said. Capital costs in the period from 2019

to 2023 are estimated at \$431mn and will be financed from cash flow from operating activities. The capacity of the line will be 250,000–300,000 tonnes of concentrate and 48,000 tons of sulfur per year. The plant will be the largest in Russia. The internal rate of return in the baseline scenario is estimated at 14%, and the net present value at \$112mn. The economic benefit of the project is to process the concentrate of refractory ores on its own capacities, rather than farm the work out to other facilities overseas. The implementation of the investment project will allow Polymetal to increase production by 30,000–35,000 ounces of gold per year, while cash costs for production will decrease by an average of \$100–150 per ounce, the company expects. Refractory ores account for more than half of Polymetal's reserves. Creating its own processing facilities is of strategic importance for the company against the backdrop of tightening environmental requirements and capacity reduction in China, which is the main market for refractory concentrates, Polymetal CEO Vitaly Nesis said at a presentation of the project in London. In the future, Polymetal plans to process not only its own ores, but also third-party ores at the new facilities. The project's feasibility study has already been developed jointly with the Canadian company Hatch Inc. Construction should begin in the second quarter of 2019. The company's planned output is scheduled for the fourth quarter of 2023. Polymetal expects to process 13.6mn ounces of gold at the plant in 23 years of the plant's lifetime.

- **Steel**

Leading Russian steel mill Novolipetsk Metallurgical Kombinat (NLMK) reported expectedly weak 4Q18 IFRS numbers, with a 17% q/q decline in EBITDA mostly due to negative steel price dynamics as well as a deterioration in the product mix, Dmitry Glushakov of VTBC Capital (VTBC) said in a note on February 11. "Free cash flow (FCF) was also lower q/q at \$502mn, though that beat our forecasts by \$100mn solely on the working capital release. Management is to recommend a 100% of FCF payout as dividends, which implies a 3.4% yield, on our numbers. The company schedules major upstream steelmaking maintenance in 2019, which is set to lower steel output by 1mnt y/y and we estimate it to have 3% negative effect on EBITDA. Our unchanged 12-month Target Price of \$23.5/GDR implies a 6% ETR; Hold reiterated," Glushakov said. EBITDA was 17% lower q/q. Despite sales volumes of steel products being higher q/q, revenues declined 4% q/q to \$3.0bn (in line with consensus and 2% below VTBC) on the back of lower steel prices as well as the worse product mix. EBITDA, as a result, lost 17% q/q and in 1Q19 it might be even weaker than 4Q18, given the further deterioration in prices and seasonal decline in volumes. The lower earnings will reduce the dividend payments. Dividends are set to be 100% of free cash flow (FCF), which implies a modest (by Russian standards) 3.4% dividend yield. Management says that it will recommend a 100% of FCF dividends payout, of \$502mn for 4Q18.

Iconic Russian steel mill [Magnitogorsk Iron and Steel Works \(MMK\)](#) reported weak 4Q18 results, due to lower steel prices in Russia, VTBC Capital (VTBC) said in a note on February 8. "EBITDA contracted 20% q/q on deteriorating steel margins. FCF slightly disappointed, arriving at \$239mn vs. the \$300mn we had forecast for the quarter, due to a lower working capital release than we had expected. The company's board of directors has not yet recommended dividends, though we stick to our estimate of a 100% FCF payout. The dividend payment would thus be \$239mn for the quarter (3.1% yield). Therefore, we view the results as neutral. While we still estimate MMK to have more attractive valuations on normalised price levels than its local

peers, we note that the recent rapid increase in seaborne iron ore prices negatively affects the company's profitability in the short and medium term, as it has the lowest level of vertical integration among Russian steelmakers. We leave unchanged our 12-month Target Price of \$12/GDR, which implies a 49% ETR. Buy reiterated," Dmitry Glushakov of VTBC said in a note. The company's EBITDA was down 20% q/q on falling prices. The company reported a 6% decline in revenue as the average realised price per ton of its Russian Steels segment fell 5% q/q. As a result, despite total cash costs remaining relatively flat, MMK saw a 20% q/q decline in EBITDA, as expected. In 1Q19, this might fall further, as in January, Russian domestic flat steel prices were 2% below their 4Q18 average, while raw materials were flat or slightly higher. However, the company still pays 100% free cash flow (FCF) as dividends, or a 3.1% dividend yield. "The company has not yet announced its 4Q18 dividends, though we expect the recommendation from the board of directors by the end of the week. We maintain to our estimate of a 100% FCF payout, which yields dividend payments of \$239mn for the quarter – USc 29/GDR, a 3.1% yield," Glushakov added.

Leading Russian steel mill [Severstal](#) is contemplating the sale of its Balakovo EAF mill, reports Bloomberg. The company has not confirmed the news, but said that no final decision has been taken. "Such a move might be sensible, we believe. The mill has no captive scrap capacity, and the rebar-scrap margin, at \$120/t, is 30% below the 2012-2018 average. Additionally, the mill is not being fully utilised, with the 2018 level at 88% (of 1mnt capacity). However, given thin margins, we believe the company is unlikely to be able to sell it for the entire \$700mn it invested in mill construction. In fact, our view would be that any sale consideration would be as little as a half or a third of that amount. We see the weak performance of Severstal's long division has having already been largely priced in by the market, and thus do not expected any negative price reaction to the news of the potential sale," Dmitry Glushakov of VTBC Capital (VTBC) said in a note.

- **Other**

Russia's diamond mining monopolist and investor's darling [Alrosa](#) reports rough diamond sales were down 44% y/y in January to \$278mn, the company said on February 12. Although the decline was steep, a large part of the fall was due to a high base effect from a year earlier. Rival De Beers' also saw sales down by 24% y/y in the same period, also due to the base effect. In terms of historical sales, Alrosa's January result was exactly in with the historical average between 2015-2017. The management comments on market the market conditions at both firms were similar, saying that demand in January was lower than usual, especially given that December sales by both companies were stronger than usual. The outlook for Alrosa February sales y/y growth is currently downbeat as well, according to analysts at VTBC Capital (VTBC). "We think focus remains on March sales, which historically (2015-2017) showed 1.5x seasonal pick-up compared with average level for January-February, and hence absence or presence of this pick-up might be an indicator of rough diamond market conditions," Dmitry Glushakov with VTBC said in a note.

9.2.13 Other sector corporate news

[AFK Sistema](#) is considering the possibility of selling up to 20% of private medical services company Medsi shares, said Artem Sirazutdinov,

Chairman of the Board of Directors of Medsi Group of Companies, managing partner of AFK Sistema. Investors from Japan, China and the Arab countries have already shown interest in the company, he says, this topic is being discussed with the Russian Direct Investment Fund (RDIF). A partner of the corporation and a person close to one of the funds that invested in Russian medical assets also heard about this. While this is a preliminary consultation, there were no substantive negotiations, one of the Vedomosti interlocutors notes. RFPI Director General Kirill Dmitriev admitted the possibility of acquiring a minority stake in Medsi. The representative of the RDIF declined to comment.