Russia: Outlook for 2015 and default risks

February 11, 2015

The brief presents our view of Russia's economic predicament and policy environment in 2015. With this as a foundation, we turn to investors' questions related to default risks for Russian companies.

Context

Economic risks

Oil prices have fallen farther and faster than experts, including the Russians, expected, suggesting that prices will remain volatile and hard to predict for the coming year. This complicates predictions of Russia's creditworthiness.

We believe Russian GDP performance will continue to surprise on the downside in 2015. The IMF and World Bank are forecasting a 3% contraction in GDP. The Central Bank predicted in December that a $60 Brent crude average price would result in GDP falling by as much as 4.5%. Brent presently is trading in the $50-60 range, and Goldman Sachs has revised its 2015 average price forecast down to about $50. We believe this is a reasonable assumption and this market environment will constrain Russia's forex earning potential and sustain downward pressure on the ruble into 2016.

The ruble crisis has begotten an economic crisis. Banks, companies and households with forex-denominated debts are in trouble. Supply chain disruptions are increasing. Inflation, running at about 9% in late 2014, is galloping ahead in early 2015. In late 2014, the government forecast that real wages are expected to fall by almost 3% in 2015, hitting consumption — a mainstay of the economy.

In 2009 Russian GDP contracted 7.9% in the wake of the Global Financial Crisis. **The current situation feels like uncharted territory for the economy,** and our call is that the hit to the Russian economy could be on par with 2009, but more enduring. Policymakers' efforts to spark the economy back to life by burning cash will have limited effect.

Convertibility has been a signal policy achievement of Putinism, and **capital controls, in the near term, remain unlikely,** unless the ruble plunges again — say into the 80-per-dollar range (it is at 66-per-dollar now). Capital controls could be imposed down the road if reserves fall too low. For foreign debt holders, capital controls could cut two ways: They could restrict the ability of firms to repay foreign obligations, or they could be used to constrain flight capital in favor of debt repayment (a more likely scenario).

Political risks

Sanctions will stay in place until at least 2016. Political risk aversion had a modest (circa 10%) impact on the ruble between February and July 2014. The subsequent oil-price hit and policymakers' lack of competency to manage the crisis have taken much bigger tolls on the currency, and, ultimately, the economy and corporate indebtedness. **In this context, if sectoral sanctions are eased, the macroeconomic uplift will be modest, but Russian firms may regain access to capital markets.**

We believe the situation in Ukraine will get worse before it gets better. This includes the possibility of pro-Russia forces making a push across southern Ukraine for Odessa, which would mark a significant escalation in the crisis. In this event, enhanced sanctions could impair Moscow's ability to tap its reserves in foreign accounts.

An intense wave of patriotic fervor also means that government and business decision makers aren't being candid or forthcoming about the situation or what they will do. For example, reports indicate that businesses are being pressed to roll over receivables and non-performing loans, suggesting that the **impacts of the crisis are being repressed and will continue to surprise on the downside.**

Predicting what economic policymakers will do is difficult. They have been promoted for loyalty to the Kremlin, not commercial competence or independent or rational policy thinking. For instance, some officials have suggested that Russia can freely spend forex reserves to revive the economy. A perception of poor management of the currency and economy undermined confidence in the ruble in late 2014.

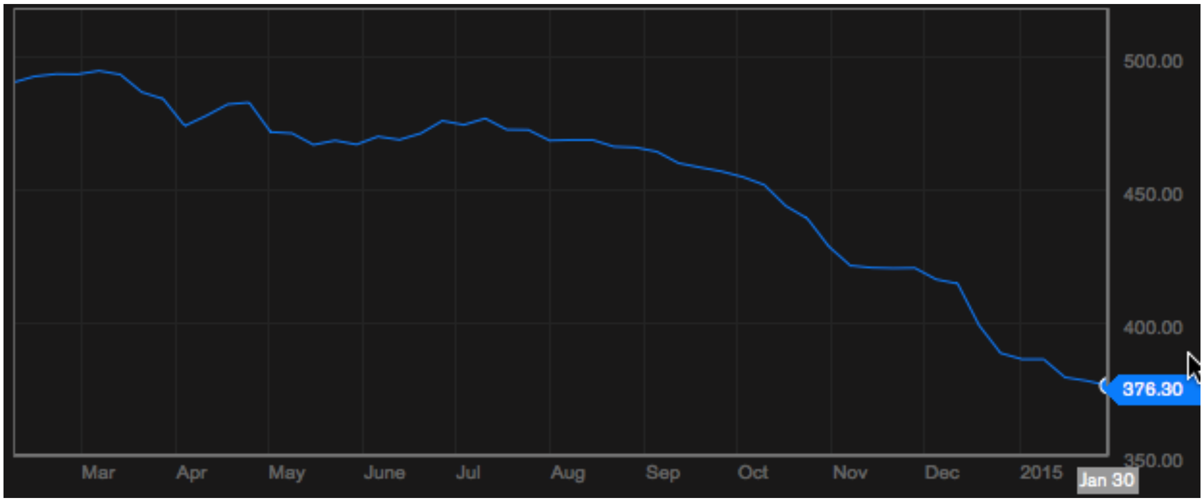
Given the sense that Russia is uncharted territory, economic decision makers appear to be to be in a state of shock, masked by denial and dismissal. In January, former Finance Minister Alexei Kudrin said, "I get the feeling that at all levels of power, including at the very top, there is no objective assessment of the challenges that Russia is facing." **Expect reactive, muddle-through behavior, which could exacerbate the crisis.**

Russian assets

To assess risk of debt defaults, it is important to evaluate what assets Russian policymakers have to throw at the problem. According to the Central Bank, as of January 31 **international reserves total $376 billion** – a significant decline from nearly $500 billion in early 2014 (see graph below). These reserves include the following:

- Reserve Fund: $85 billion
- National Welfare Fund: $78 billion
- Gold and precious metals: $49 billion
- IMF: $11 billion
- Other hard currency: $153 billion.

Graph: International Reserves of the Russian Federation, 2014-2015



Source: Central Bank of Russia via Bloomberg

The Central Bank reports that **Russian external debt obligations (including those of banks and corporations) coming due in 2015 and 2016 totaled $216 billion**. Those with maturities of one year or less (i.e., 2015) amounted to $138 billion. Debt obligations with maturities of 1-2 years (in 2016) exceeded $78 billion. (The volume to debt with longer maturities is small.) **These headline numbers indicate that the government's ability to bail out domestic industry in the coming two years will be limited.**

A general assumption is that about one-third of Russia's reserves are not readily accessible. Moreover, there are many calls on available resources.

- Moscow is repeating its practice used in 2009 during Global Financial Crisis by drawing down the National Welfare Fund to support troubled domestic entities.
- Hard currency accounts have been actively tapped to manage the ruble. This accounts for much of the decline in reserves in 2014.
- The Reserve Fund is being used to plug holes in the budget, but a portion recently has been made available to defend the currency.
- There is widespread uncertainty about how much of the $78 billion remaining in the National Welfare Fund has already been committed. For example, the government claims it will not tap into these funds to finance the recently-approved $35 billion anti-crisis plan, but this stance may change.
- Major infrastructure projects have been green-lighted by the National Welfare Fund, and current commitments already may exceed 60% of the fund's resources – a statutory ceiling. The most likely outcome is that some projects will be deferred or scaled back to free up capital for uses of higher importance to the overall economy, and those attached to key Kremlin loyalists.
- Gold reserves are generally considered to be less liquid. Moreover, the government has been aggressively buying and moving gold to reduce the possibility that reserves get ensnared by sanctions.
- Tapping into IMF funds would be a sign of desperation.

Default risks

In view of the slide in oil prices and the impact on the Russian economy, what is the thinking among economic decision-makers in Moscow on Russia's debt obligations, both at the state level and among commercial entities?

In line with our points above, **we believe that Russian policymakers have not formulated a forward-looking point-of-view, or strategy regarding debt obligations**. Policymakers are deferring to the prerogatives of President Putin. Short-termism and muddle-through will prevail for the foreseeable future.

- We see the government acting on basic imperatives: minimizing damage to the economy, avoiding social instability, and protecting the economic and ally interests of the Kremlin.
- Infrastructure projects involving energy export, such as pipelines and LNG facilities, would be favorably viewed by the Kremlin.

- Beyond state-owned enterprises (SOEs), each request will be analyzed on a case-by-case basis, leaving companies vulnerable to political decision-making.

What other means do they have for payment of debts once reserves have run out?

There are several resources that could supplement reserves, including the following:

- **Corporate asset sales:** As part of its pivot to Asia, the Kremlin is negotiating deals to sell state assets, especially in the energy sector, to China. Last summer, Severstal sold its North America steel and coal business for $2.3 billion to cut costs and pay down debt.

- **Collateralized debt and futures:** In addition to oil and gas, Russia is a major producer of gold, diamonds, platinum group metals, which could be used as debt collateral and for project finance. Gazprom's deal to build a major pipeline to China, announced last May, entailed an advance payment to cover infrastructure development.

- **The current account:** Russia is producing oil at record volumes, which is contributing to the global glut. We would expect the regime to continue to exporting oil and gas as fast as possible to replenish the forex accounts.

- **Enterprise reserves:** Russian companies could be forced to sell foreign currency holdings. In December, the Kremlin used this strategy with Gazprom and other SOEs to push forex into the banking system.

Do they see default as an acceptable path to follow, given the current poor state of relations between Russia and the West?

Default is not considered an acceptable path for SOEs, even vis- -vis the West.

- Russia's 1998 sovereign debt default is viewed as a humiliating low point in Russian economic and political history. A hallmark of Putinism was restoring Russia's credit worthiness, and with it, its superpower status. In short, Russia, as a proud and great power (and its national champions), don't default.

- While Russia's pivot to Asia is all the rage in Moscow, the country remains economically tied to the West in many fundamental ways.

- In the event of the risk of widespread defaults, the Kremlin would likely impose currency controls to make forex available for debt repayments, but it is not clear at this point how approvals for such transactions would be meted out.

For non-state owned enterprises, the political calculus may be different.

- The government could use a default (or risk thereof) to achieve a domestic political purpose. For example, after seizing Sistema's lucrative Bashneft oil-producing subsidiary in 2014, the government may still go after the parent company and impose financial penalties for alleged improprieties, threatening Sistema's ability to repay forex debt.

- Similarly, the government could allow a private enterprise to become insolvent and then swoop in and assume control and pay off debts. This would be in line with the trend of the government asserting greater control over the economy.

Are they likely to favor some countries in terms of repayments, and if so which?

We see no indication policymakers would play favorites.

- Russian debt is held by private Western investors, not governments, so the geopolitical benefit of selective defaults against certain countries would be limited.

- If any creditor country is less politically exposed, we would point to Italy and, to a lesser extent, Spain. They have been less supportive of sanctions.

How do those decision-makers assess the financial stability of Russian SOEs, and which are seen as particularly at risk?

The Ministry of Finance and Central Bank are monitoring the situation, especially in the financial system. As we noted above, we do not believe there is an elaborate assessment or decision process in place for SOEs.

Is the Russian state determined to back SOEs, or might it be prepared to let some fail?

Again, we believe default is not an option, especially for SOEs. This would go against a central pillar of Putinism. But, given the dwindling reserves noted above, all SOEs ultimately are not created equal. We note a few examples below:

- Given its outsized importance to the Russian economy, **SOE Rosneft likely will be a major beneficiary of state largesse** as international sanctions prevent the company from accessing capital markets. Rosneft has approximately $40 billion in debt, and the next $7 billion tranche is due February 15. (Rosneft is reportedly raising short-term capital with the aid of Western trading companies to meet this obligation.)

- **Gazprom has significant debts coming due in 2015, but it likely is safe as well.** Gazprom has not officially asked for funds, and as noted above, it is being tapped for forex to support other entities. Despite the crisis in Ukraine, the Russian government has maintained gas exports to Europe and it would not want to threaten Gazprom's standing. If conditions in Ukraine deteriorate significantly, resulting in curtailed energy exports to Europe, this would be a signpost of elevated default risks for Gazprom.

- **Another strong candidate for government support is Russian Railways** (RZhD) which is seeking $60 billion in support, and is headed by close Putin associate Vladimir Yakunin. RZhD is the country's largest employer and is critical to social and political stability. We believe RZhD will receive some state support, but far less than requested.

To what extent is there a dialogue between the SOEs and the government on these issues, and what is the SOEs' level of influence?

Leaders of indebted firms are either trying to demonstrate their loyalty and importance to the Kremlin, or are keeping their heads down and carrying on.

- The Kremlin has made it known that executives should not complain or come hat-in-hand.

- Last year, Rosneft requested $40 billion from the National Welfare Fund, although it has lowered this amount since to roughly $20 billion. Last week, President Putin rebuked Rosneft CEO Igor Sechin for seeking government aid, but this was likely intended for public consumption (Sechin is a close friend and long-time ally). The Kremlin has little alternative but to support allocating reserves for Rosneft, given the company's importance to the federal budget.

- Last week Putin publicly rebuked Deputy Prime Minister Arkady Dvorkovich because regional rail passenger service had been cut in several regions due to financial issues. Again, this probably was for show: RZhD CEO Yakunin is another close friend and long-time ally of Putin, so he has pull.
- The oligarchs in particular are expected to show loyalty to Russia and fealty to the Kremlin. Last year's arrest of Sistema Chairman Vladimir Yevtushenkov, historically one of the most canny oligarchs, was a clear message to others to not cause trouble.

Recommended next steps

Given these questions, we would suggest power mapping and scenario exercises to explore the ability of such companies to marshal Kremlin support as the economic crisis and debt pressures unfold in the coming 1–2 years.

The situation is evolving very quickly and surprises on the downside are likely. Regular monthly or bi-monthly updates on the economic and business environment and these questions would be advisable to stay abreast of developments.