Russia&CIS
Hotel Investment Conference

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Russia&CIS
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SINCE WE LAST MET — MACRO-ECONOMIC OVERVIEW OF RUSSIA & THE CIS

What has changed in the last 12 months and what is Russia's economic & political outlook for the next two years? Where is the region placed versus the rest of the world?

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Russia & CIS: Macro Outlook

Hotel Investment Conference

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Economy

European crisis and slowing global growth have had only a small impact in Russia – the economy is on course to grow 3.5-4.0% in 2012 and 2013 and inflation is expected to fall after a winter peak.

Politics

The threat of political or social instability has now passed and is unlikely to re-emerge unless the economy slows sharply coming into the next political cycle.

Oil

The current oil price average will lead to a budget surplus this year. Oil price dynamics are not expected to change medium term. Longer term, the risk of lower oil is increased, though a more flexible currency policy by the Central Bank lowers the budget's pain threshold to about $80/bbl Urals.

Reforms

There is greater credibility in plans to improve the business and investment climate outside of strategic state-dominated industries. WTO entry is a good example. But progress will remain very slow.

Risks

The main medium-term risks are external, e.g. a sharp deterioration in global financial stability or a big fall in China/Asia growth. The main medium to long-term domestic risk is that the government does not move far off a "muddle-through" strategy.

Other CIS

Ukraine – no major changes expected, GDP growth of 1.5% for this year, rising to 3% in 2013.
Kazakhstan – strong growth in 1H12 (up 5.6%) has not been sustained – overly exposed to the fuel sector.
Belarus – improving story with growth on track to average 3.5-4.0%.

Russia – Economy: greater resilience

- So far the Eurozone crisis and slowing growth in Europe and China have had little impact on the domestic economy.
- Russia's economy, budget and balance sheet are in better shape than was the case in late 2008.
- Sovereign debt is circa 10% of GDP and the country is running a budget and current account surplus.
- The Central Bank has adopted a much more flexible currency policy. Consumer spending has proven very resilient based on real wage growth and increased lending.
- The outlook for the oil price over the next 12 months looks favorable for Russia.
- Bottom line is that "economic risks" are much more manageable today than was the case in 2008-09.



Russia – Economy: medium-term forecasts

- **Economic growth is relatively healthy –** GDP grew 4.5% in 1H12 and has slowed a little since. There is little risk to the assumed 3.5-4.0% growth over the next 12-18 months.
- **Consumer activity is good but slowing**. Retail sales increased 7.3% y-o-y in 1H12 but has slowed since. Full year growth is expected to be 5.3% y-o-y, falling further to 4.5% in 2013.
- **Spending power is increasing**. Real wage growth increased 10.2% y-o-y and real disposable income gained 2.2% y-o-y in 1H12. Unemployment at mid year was 5.4%.
- **Leverage is growing** – consumer lending rose 40% in 2011-12, but from a very low base.
- More flexible currency management…but oil risk remains.

Macro data

	2009	2010	2011	2012E	2013E
GDP, $ bln	1,219	1,478	1,849	2,000	2,000
Real GDP growth	-7.8%	4.3%	4.3%	4.0%	3.5%
Industrial production growth, real	-9.3%	8.0%	4.7%	3.8%	3.4%
Budget balance/ GDP	-5.9%	-4.0%	0.8%	0.0%	-0.1%
CPI, year end	8.8%	8.8%	6.1%	6.5%	4.5%
CPI, average	11.7%	6.9%	8.4%	5.2%	5.5%
Lending rate, average	15.3	10.8	8.5%	8.9%	8%
Deposit rate, average	8.6%	6.0%	4.5%	5.3%	4.8%
Unemployment	8.4%	7.5%	6.6%	5.8%	5.5%
Average gross wage, R'000/ month	18.8	21.1	23.5	26.0	29.0
Trade balance, $ bln	112	152	198	190	115
Current account, $ bln	49	70	99	90	50
FDI, $ bln	39	38	47	55	65
Monetary reserves (ex gold), $ bln	417	444	454	480	480
Foreign public debt, $ bln	44	47	45	55	60
Foreign public debt, % of GDP	3.6%	3.2%	2.4%	2.8%	3.0%
Foreign private debt, $ bln	425	442	494	545	580
Foreign private debt, % of GDP	35%	30%	27%	27%	29%
R/ $ average	31.8	30.4	29.4	31.6	32.8
R/ $, year end	30.0	30.9	31.4	32.5	33.0
R/ EUR, average	44.2	40.3	40.9	39.7	40.4
R/ EUR, year end	43.8	40.8	41.5	40.6	40.3
Urals average, $/ bbl	61	78	109	110	100

Source: State Statistics Service, Central Bank, MinFin, Sberbank estimates

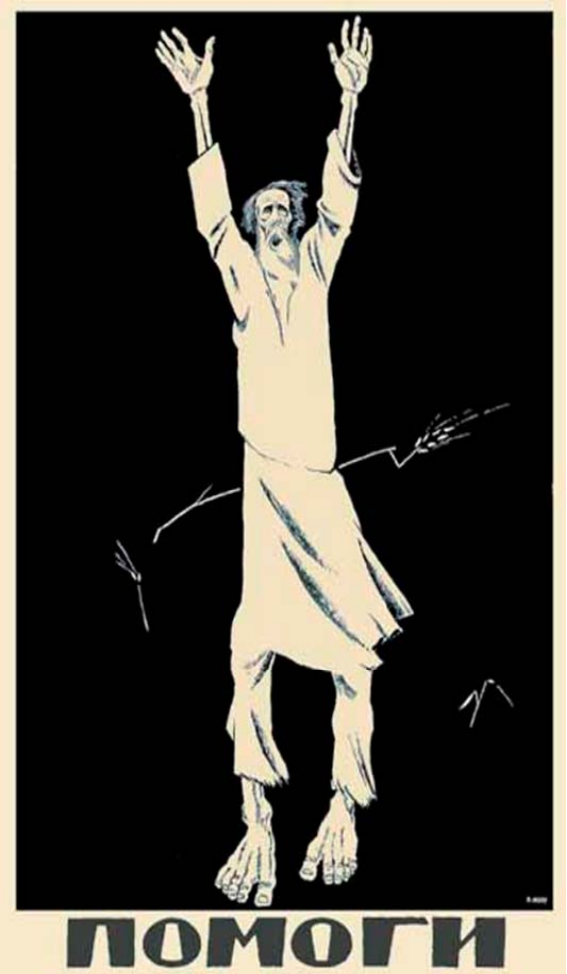
Russia – Economy: inflation is higher than expected

- Higher than expected inflation is the main economic concern this year – a fall to 4.5% y-oy had been hoped for but a year end rate of 6.5% is more likely.

- Opinion polls show that the two issues of greatest concern to the public are rising prices and corruption. Lowering both is therefore a political priority – success in the former is more achievable.

- This year's higher rate came about because of
  - higher international food prices;
  - higher domestic food prices;
  - structural change in spending habits;
  - utility tariff increases at mid year;
  - effects of weaker ruble;
  - 40% increase in consumer lending in 2011-12.

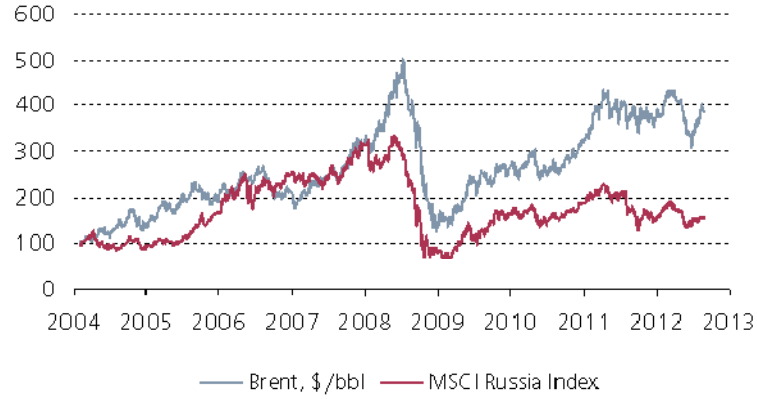
- We see this year's spike as temporary and expect to see CPI at 4.5% by end 2013.



Russia – Oil: investors remain wary of oil risk

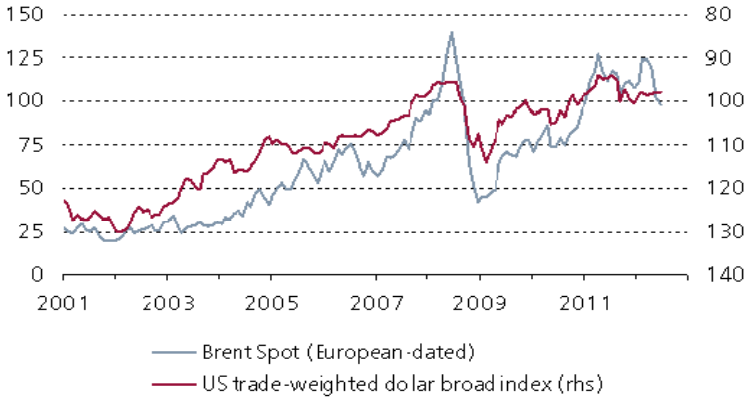
- The Central Bank has partially balanced the oil risk in the economy and budget with much greater ruble flexibility.
- Oil and gas accounts for circa 20% of GDP and total extraction industries equal circa 30%. Oil and gas taxes equal circa 51% of budget revenues (at $100/bbl Urals average).
- Oil and gas revenues = circa 66% of the value of exports while total commodities account for 80% of the total.
- The equity market shows that investors are fearful of a repeat of the 2H08, when the oil price collapse led to recession.
- Outlook for oil (i.e. $90-$100/bbl Urals) looks OK for next 12 months on weak dollar, Middle East risk and modest demand growth.

Equity investors fear a repeat of 2008



Source: Bloomberg

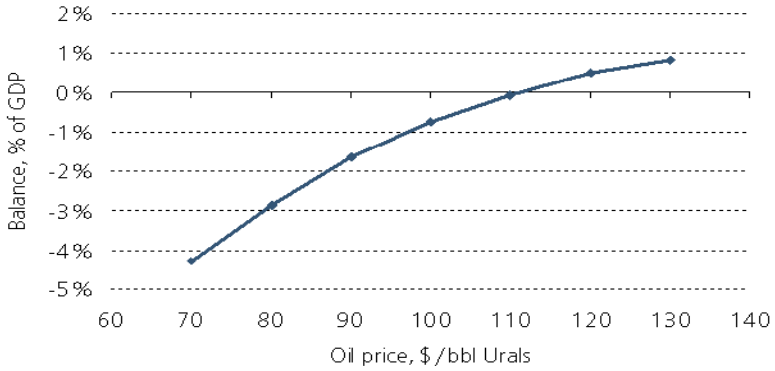
US Fed policy is a key long-term oil price driver



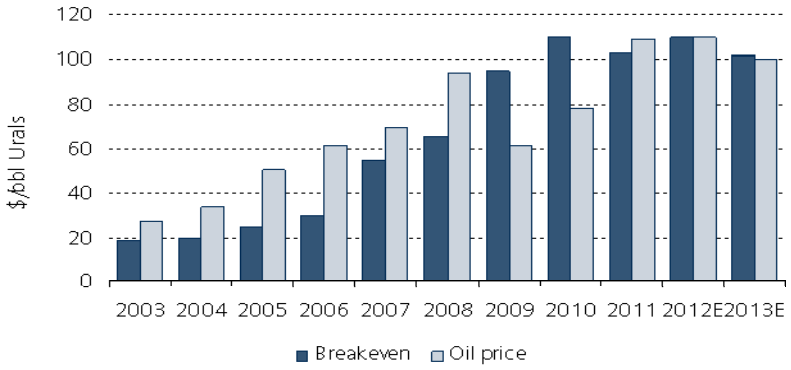
Source: Bloomberg

Russia – Oil: risk is much better managed

Budget deficit is manageable down to $80/bbl



Government spent oil money to survive the crisis



Budget oil requirement falls with weaker ruble

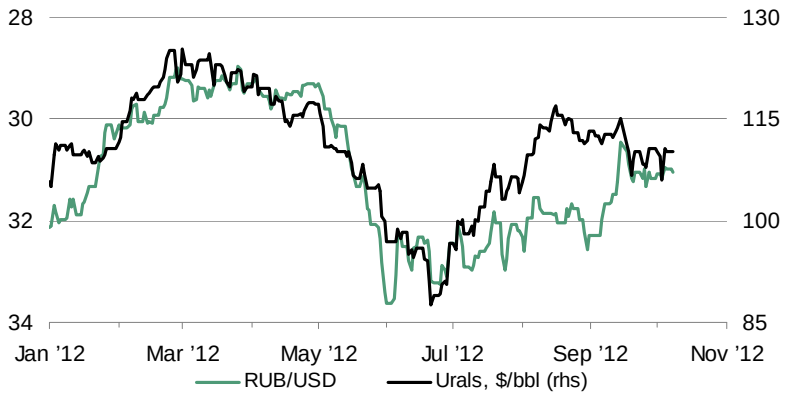
	2012	2013	2014	2015
Official forecast, July 2012				
Oil price, $/bbl	115	97	101	104
RUB/USD	29.2	29.7	30.5	31.5
Breakeven oil price, $/bbl	116	114	109	105
Official forecast, August 2012				
Oil price, $/bbl	115	97	101	104
RUB/USD	29.2	32.4	33.0	33.7

Source : Finance Ministry…..all oil prices are for Urals $/bbl

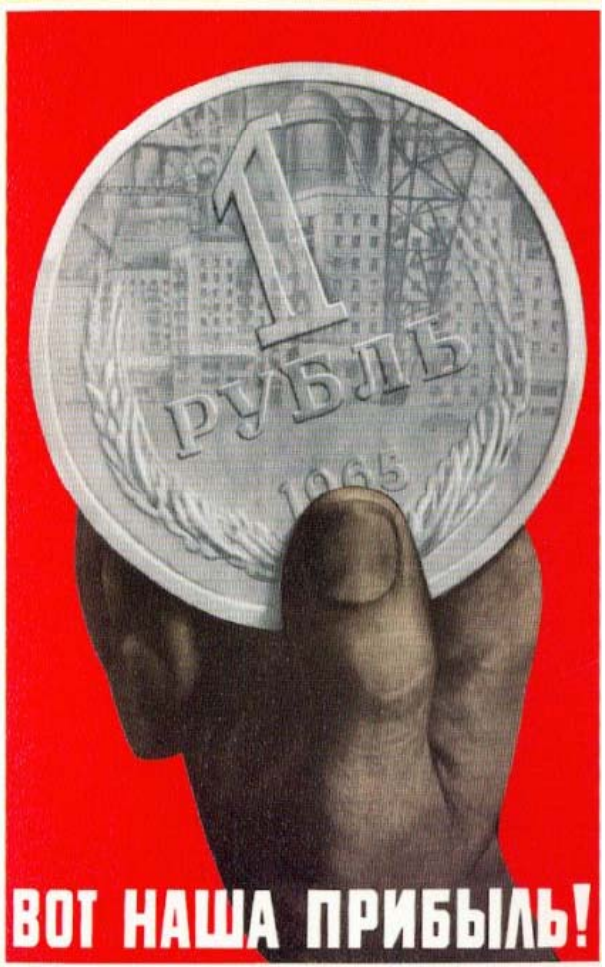
Russia – Ruble: currency is almost free-floating

- Ruble moved almost exactly with oil until end May.
- The steep May fall caused domestic stability-confidence concerns and led to some intervention
- But the currency has recovered with the oil price gain in recent weeks.

Close correlation up to June – since restored



Source: Central Bank, Bloomberg



Russia – Politics: risk of instability has greatly receded

- The threat of political instability only lasted for a brief period.
- There is no credible risk of a return to instability over the medium term.
- Economic stability is a key factor in maintaining social and political stability.
- Public support for both the president and the prime minister has largely recovered to pre-election levels.

Public support for Putin and Medvedev

	May '08	Sept '09	Aug '10	Jan '11	Jan '12	July '12	Aug '12	Sept '12
Vladimir Putin								
Appove	84%	76%	78%	72%	64%	67%	63%	68%
Disapprove	12%	18%	16%	25%	34%	32%	35%	31%
Dmitri Medvedev								
Appove	66%	67%	71%	69%	57%	59%	57%	61%
Disapprove	19%	24%	21%	29%	41%	39%	41%	38%

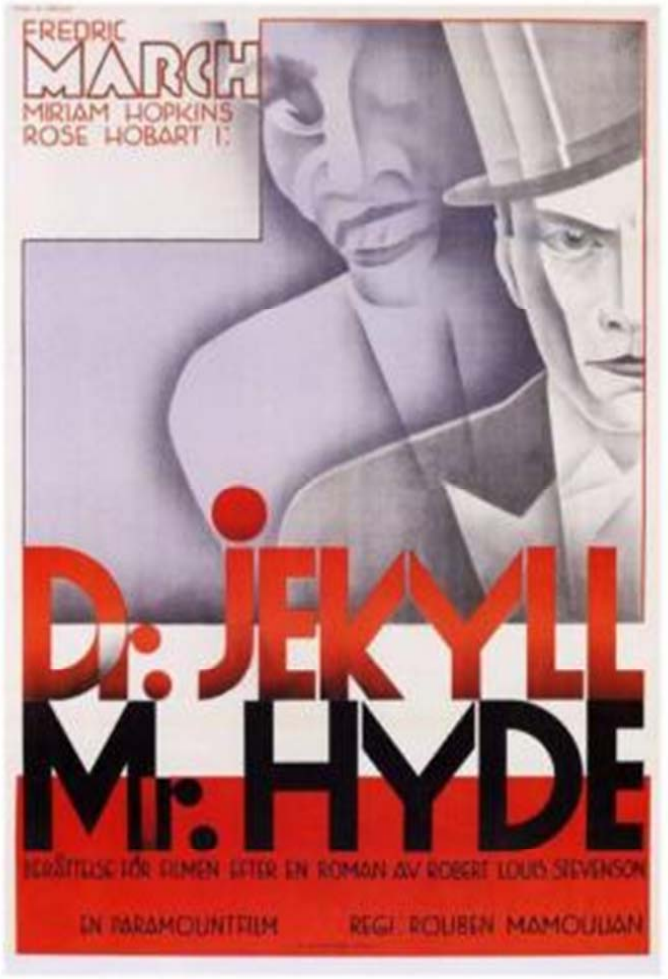
Source: Levada Center

Russia – Politics: headlines exaggerate the risks

- Foreign media headlines greatly exaggerate the risk of further instability – there is no evidence to support many of the headlines.
- Polls show that while a majority of people are now more aware of the protests and the aims, only a small minority are willing to take an active role.
- This weekend's elections (Oct 14) have passed without any surprises or threats.
- The government has toughened laws that can be used to control opposition:
  - Libel laws;
  - Rules defining and preventing illegal gatherings;
  - Registration of foreign-funded NGOs;
  - Greater power to restrict internet and close web sites.
- But also some positive changes:
  - Easier registration for political parties – 66 new parties this year;
  - Return to direct governor elections starting at the October '14 elections.
- If there is to be a return to political instability it may only come as a consequence of a failing economy. The next major elections are in Dec '16 (parliament) and March '18 (president).

Russia – Reforms: economic tandem

- There is a clear divergence in government strategy toward the energy/strategic sectors and for the rest of the economy.
- The state will retain a dominating presence in the energy/strategic sectors via direct ownership and regulation. The “revised” privatization agenda shows this clearly.
- The approach to the other economic sectors is different – there will be greater efforts to boost investment, efficiency and the involvement of foreign competitors-JV partners. But here also do not expect any fast-track progress.
- WTO membership is a pragmatic example of the improving “domestic” agenda.
- Success in attracting very high profile global events to Russia, e.g. World Cup 2018, is also consistent with the “tandem” approach.



Russia: the next phase in the evolution

Putin was not very interested in attracting FDI or economic reforms last time – he always talked about a 20-25 year plan based on slow managed steps. His presidency was all about domestic restructuring.

The Medvedev presidency was one of crisis management and even more policy caution. But it also led to greater pragmatism that has helped refine strategy.

Several crisis events have made a difference:

The debt crisis and state bailout of big industries in 4Q08;
Steep recession in the industrial heartland in mid-2009.
Hydro-electric dam explosion in August 2009 and the agriculture failure in summer of 2010;

The more demanding middle-class.

It is clear that the oil-driven model no longer works. There now needs to be much greater expansion in other parts of the economy…

…but for that to happen the country needs to bring in more foreign companies…

…and that needs an improved business climate.



Russia – Challenges: need for political and economic pragmatism

- **Improving the business climate** – *lots of commitment but still waiting for specifics…progress is likely to be a series of very slow steps.*
- **Reducing corruption** – *planned and implemented legislation appears weak and incomplete.*
- **Poor international image and excessive risk perception** – *no evidence of any changes here.*
- **Weak and insufficient domestic capital sources** – *there is a plan to change this over three to five years.*
- **Pensions system needs to be radically changed** – *the deficit is becoming a bigger strain on he budget and the solutions are highly political.*
- **Workforce demographics are poor** – *country faces a big increase in retirements over the next eight years.*
- **Institutions are weak** – *no evidence of any major plans to improve their effectiveness.*



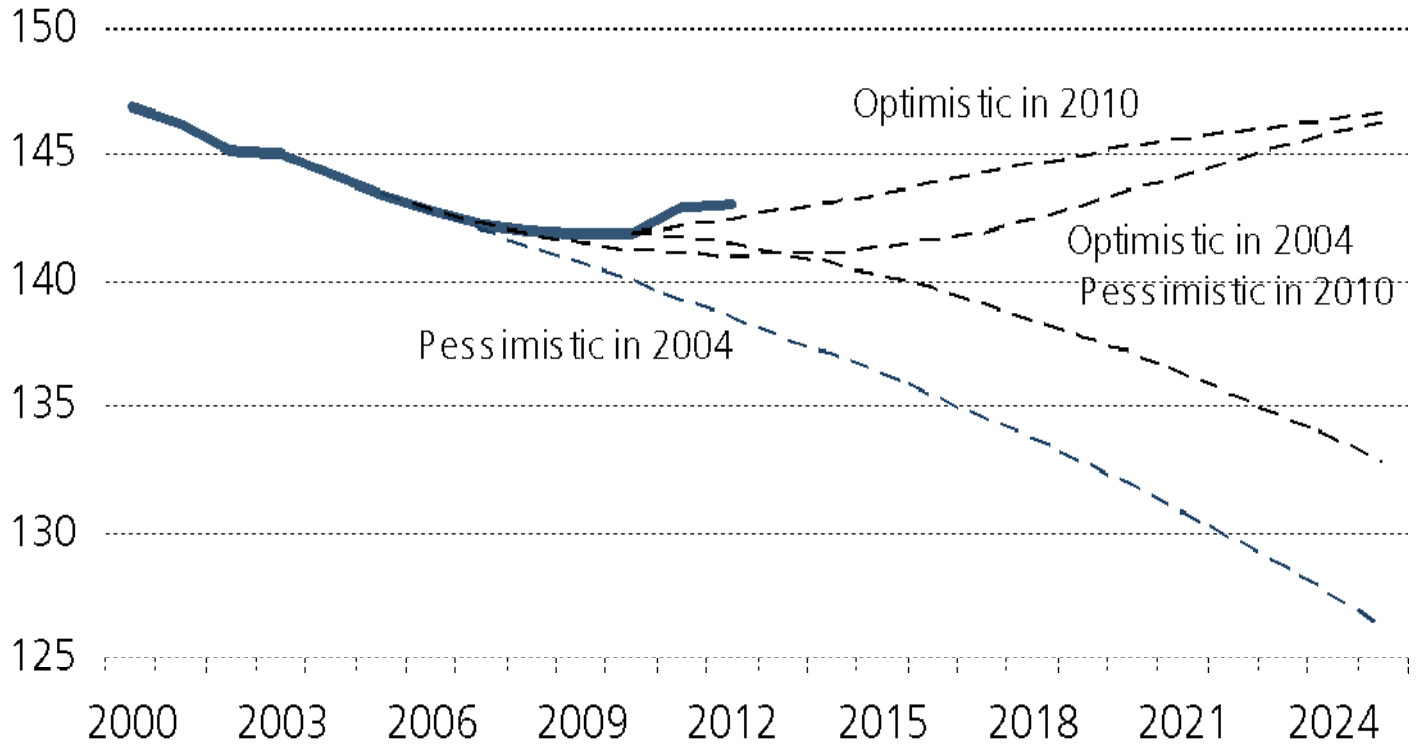
Russia – Domestic Economy: no longer a leap of faith

- Russia is today the second largest consumer market in Europe….very likely to be the largest by end 2013 and the fourth largest in the world.
- Since 2000, retail spending has grown at a 20% CAGR…from $80 bln annually to $660 bln (est.) this year. 54% of that is non-food.
- Average monthly wage has grown from $50 in 2000 to $850 currently…but disposable income is catching up with the European average because of low taxation (13% personal taxation is not likely to change for “years”) and very low household and personal indebtedness.
- Russia’s middle-class is growing.
- Demographic trends have greatly improved.
- Encouraging progress in improving visa regimes and access for tourists.



Demographics: exceeding previous optimistic scenarios

Trend in actual and projected demographics



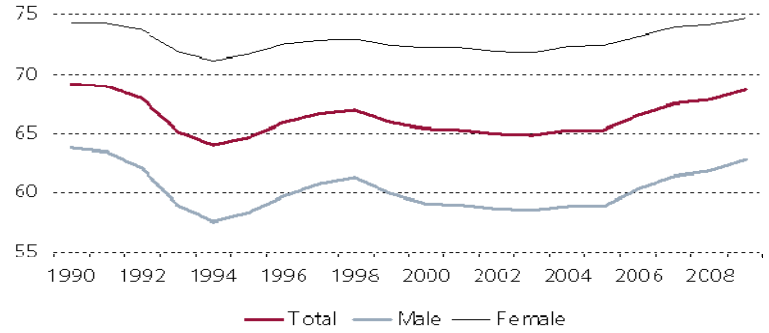
Source: State Statistics Service

Demographics: better lifestyles and higher net immigration

- Better healthcare.
- Government campaign against smoking, excessive alcohol consumption and bad driving.
- Better lifestyles as disposable incomes grow and consumer choices increase.
- *But…still facing a near 10% drop in the workforce over the next eight years that will need to be addressed.*

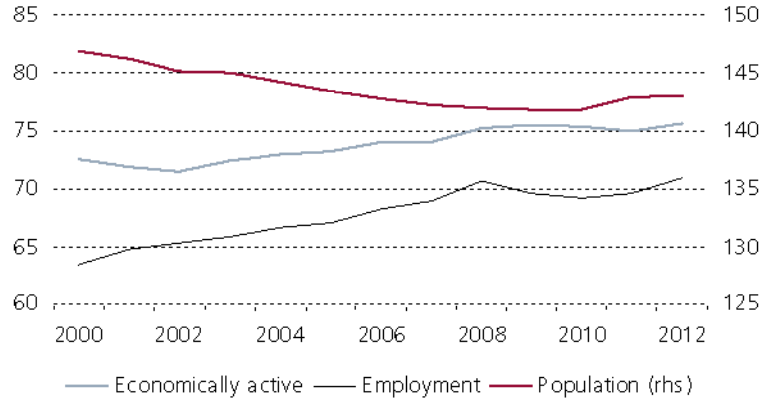


Life expectancy is improving



Source: State Statistics Service

Numbers in employment may soon fall



Source: State Statistics Service

Russia – backdrop for hotel and leisure sectors

- **Growing consumer market with capacity to retain growth above the European average.**
- **Efforts to attract more foreign investment and investor participation will generate more business traffic.**
- **Under-developed tourist market but with greater progress in areas such as visa access.**
- **Events that cause negative headlines and sustain a high level of Russia-phobia should be fewer. Several major international events will drive local/regional infrastructure spending.**
- **Regional economic development is now a greater priority for government – also to minimize future instability threats from the regions.**
- **Relatively safe(r) economic backdrop with improving fiscal predictability. No tax rate changes expected (outside of oil and gas) for several years.**



Ukraine: facing a looser fiscal regime

- Economic activity has fallen sharply this year because of the weakness in agriculture, slow external demand and a tight monetary policy.
- Budget execution is poor, with support for Naftogaz Ukrainy still running at 1.5% of GDP.
- The government has maintained a strong commitment to a stable exchange rate – a policy clearly associated with the upcoming elections.
- We should see a much more flexible exchange rate after the elections and a weaker hryvnia in 2013.
- The elections are not expected to deliver any major changes, although polls show that two-thirds of people have low confidence in the future.
- Retail turnover was at 12.9% y-o-y in July but is expected to slow to single digits by year end.

Macro data

	2009	2010	2011	2012E	2013E
GDP, $ bln	117	138	165	180	190
Real GDP growth	-14.8%	4.2%	5.2%	1.5%	3.0%
Industrial production growth, real	-21.9%	11.2%	7.6%	1.0%	3.5%
Budget balance/ GDP	-8.7%	-7.4%	-4.2%	-5.0%	-2.5%
CPI, year end	12.3%	9.1%	4.6%	3.5%	6.5%
CPI, average	15.8%	9.4%	8.0%	1.5%	6.0%
Lending rate, average	20.9	15.7	13.5%	12.0%	10%
Deposit rate, average	14.0%	10.3%	8.0%	11.0%	6.0%
Unemployment	8.8%	8.1%	7.9%	7.8%	7.5%
Average gross wage, UAH/ month	1,906	2,239	2,600	3,000	3,200
Trade balance, $ bln	-4.7	-8.7	-13.8	-17.4	-18.0
Current account, $ bln	-1.8	-2.9	-9.0	-11.0	-10.0
FDI, $ bln	4.7	5.7	6.9	6.0	6.5
Monetary reserves (ex gold), $ bln	26.5	34.6	31.7	25.0	28.0
Foreign public debt, $ bln	24	33	33	35	38
Foreign private debt, $ bln	79	85	93	98	100
Total foreign debt, % of GDP	88%	85%	77%	74%	73%
UAH/ $ average	7.8	7.9	8.0	8.1	8.5
UAH/ $, year end	8.0	8.0	8.0	8.5	9.0
UAH/ EUR, average	10.9	10.5	11.1	10.3	10.6
UAH/ EUR, year end	11.4	10.6	10.3	10.8	11.3

Source: State Statistics Service, National Bank, Sberbank estimates

Kazakhstan: economic model is unsustainable

- Economy expanded 5.6% in 1H12 but has been slowing since.
- The industrial and agriculture sectors have seen the biggest slowdown while retail sales (up 12.8% y-o-y) and service sector are growing strongly.
- Budget remains in relatively good shape.
- Kazakhstan's economy is not diversifying – it remains too dependent on the fuel sector.
- Kashagan Phase 1 is expected to start production in 1Q13 and will add about 250k bbl to existing daily production of 1.6 mln bbl. Eventually adding up to 1.5 mln bbl.
- The problem for Kazakhstan is that the budget stimulates consumption and imports, while monetary tightening hurts manufacturing.

Macro data

	2009	2010	2011	2012E	2013E
GDP, $ bln	115	148	186	200	200
Real GDP growth	1.2%	7.3%	7.5%	3.0%	0.5%
Industrial production growth, real	2.7%	9.6%	3.8%	0.0%	2.0%
Budget balance/ GDP	-2.9%	-2.4%	-2.1%	-2.3%	-1.8%
CPI, year end	6.2%	7.8%	7.4%	5.0%	4.0%
CPI, average	7.3%	7.4%	7.6%	6.2%	4.5%
Lending rate, average	15	13.8	11.9%	11.0%	8%
Deposit rate, average	6.4%	7.2%	6.3%	6.0%	5.0%
Unemployment	6.6%	5.8%	5.4%	5.3%	5.0%
Average gross wage, KZT'000/ month	67.3	77.6	89.9	105.0	115.0
Trade balance, $ bln	15.0	28.9	47.3	45.0	42.0
Current account, $ bln	-4.1	3.0	14.1	9.0	6.0
FDI, $ bln	10.1	2.9	8.4	11.0	12.0
Monetary reserves (ex gold), $ bln	45.0	56.0	68.9	90.0	105.0
Foreign public debt, $ bln	4	5	6	6	7
Foreign private debt, $ bln	109	113	118	130	140
Total foreign debt, % of GDP	96%	78%	65%	65%	71%
KZT/ $ average	147.5	147.4	146.6	149.0	150.0
KZT/ $, year end	148.7	147.4	147.9	150.0	150.0
KZT/ EUR, average	205.7	195.7	204.1	195.2	195.0
KZT/ EUR, year end	217.7	194.6	195.4	195.0	195.0
Urals average, $/ bbl	61	78	109	110	100

Source: State Statistics Service, National Bank, Sberbank estimates

Belarus: good short-term performance, becoming riskier later

- GDP gained 2.9% in 1H12 and should pick up in 4Q12 (low base effect).
- Manufacturing and consumer activity are driving growth – retail sales up 10.6% y-o-y in 8m12.
- Real wage growth is still too high, rising 10.5% over 7m12. Government is targeting average monthly wages at $500, versus $378 now.
- Country looks likely to return to a trade and current account surplus by year end.
- Benefits of devaluation are now nearly exhausted and signs of a more rigid macroeconomic policy are emerging.
- But the currency should now be a lot more stable and inflation contained around the 20% level.

Macro data

	2009	2010	2011	2012	2013
GDP, $ bln	49	55	59	70	90
Real GDP growth	0.2%	7.7%	5.3%	3.6%	4.0%
Industrial production growth, real	-2.0%	11.7%	9.1%	8.0%	7.0%
Budget balance/ GDP	-0.7%	-1.8%	3.0%	0.5%	0.3%
CPI, year end	10.1%	9.9%	108.7%	22.0%	24.0%
CPI, average	13.0%	7.7%	53.3%	65.4%	23.0%
Lending rate, average	19.5	14.4	31.3%	47.0%	25%
Deposit rate, average	20.0%	17.3%	28.2%	40.0%	20.0%
Unemployment	0.9%	0.7%	0.7%	1.0%	1.0%
Average gross wage, BYR'000/ month	982	1,217	1,925	3,100	3,750
Trade balance, $ bln	-7.1	-9.3	-3.9	6.0	11.9
Current account, $ bln	-6.1	-8.3	-5.7	0.0	5.0
FDI, $ bln	2.5	1.6	4.2	2.0	4.0
Monetary reserves (ex gold), $ bln	5.7	5.0	7.3	7.4	7.4
Foreign public debt, $ bln	9	12	14	14	16
Foreign private debt, $ bln	13	17	20	15	17
Total foreign debt, % of GDP	38%	46%	53%	45%	35%
BYR/ $ average	2,793	2,978	4,624	8,200	8,300
BYR/ $, year end	2,839	3,011	8,450	8,300	8,300
BYR/ EUR, average	3,885	3,950	6,432	10,800	10,400
BYR/ EUR, year end	4,156	3,978	11,200	10,400	10,400

Source: State Statistics Service, National Bank, Sberbank estimates

The Last Word

- Russia is a normal developing economy that sometimes appears abnormal because of politics and energy…
- …it has one of the fastest growing consumer economies in the world and with considerable potential for much larger tourist traffic…
- …the country is now moving into a new development phase that will place greater emphasis on attracting foreign investors into domestic-facing economic sectors and the regions…
- …WTO entry is a real long-term game-changer…
- …the energy and strategic industries will remain largely under state control with little change…
- …reforms will pick up elsewhere but only very slowly and when forced…
- …patience remains a profit generating virtue for foreign investors in Russia.



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