

Macroeconomic Environment in 2018

In 2018, the world GDP growth rate slowed down to 3.0% against 3.7% in 2017: advanced economies grew by 2.2% compared to 2.3% in 2017, and emerging markets and developing economies (EMDEs) grew by 4.2% compared to 4.7% in 2017. In 2018, many EMDEs were under pressure, fueled by depreciation of national currencies and higher global interest rates.

Remaining trade tensions among largest countries influenced investors expectations. Despite the growth of Brent oil price, which reached its maximum of US\$ 86 per barrel in October, a dramatic decline followed, so Brent finished the year at the level of US\$ 51 per barrel (-40%), reflecting changes on the supply side (growth of oil production in the United States, OPEC countries and Russia).

Russian GDP growth accelerated to 2.3% in 2018 compared to 1.6% in 2017, supported by growth in the extraction industries, construction, transportation and logistics, and financial and insurance services.

The industrial production index grew by 2.9% in 2018. The raw materials extraction sector grew by 4.1%, while manufacturing showed less positive dynamics (+2.6%). The main growth in manufacturing came from the automotive industry (+13.3%), the pulp and paper industry (+12.6%), wood processing (+10.6%) and pharmaceuticals (+8.2). At the same time, the machinery and equipment production index declined (-0.6%).

The sanctions of the United States and the European Union (including new restrictions on Russian state and private companies, their top managers and shareholders), along with a decline in the global economy, had a certain negative impact on the Russian ruble. By the end of the year, the Russian currency had depreciated by 8% against the US Dollar and by 13% against the Euro (average RUB/USD: from 58.33 to 62.89; average RUB/EUR: from 65.90 to 74.11). Sanctions also led to an increase in the cost of borrowing and to an outflow of foreign capital from the federal loan bond market.

In 2018, consumer inflation in Russia (the Consumer Price Index) increased to 4.3%. Ruble depreciation, a harvest that was lower than the record levels of 2016-2017 and an increased gasoline price pushed up consumer inflation. The upcoming increase in VAT rate in 2019 (from 18% to 20%) also raised inflationary risks. Industrial inflation (Industrial Producers Price Index) reached 11.7%. After the decrease of the key rate from 7.75% to 7.25% in the first quarter of 2018, the Central Bank of Russia raised it by 0.25 p.p. in September and by 0.25 p.p. in December, to the initial level of 7.75%, in order to limit inflation risks.

In May 2018, the 'Executive Order on National Goals and Strategic Objectives of the Russian Federation through to 2024' was signed by the President of Russia. On its basis, the Government of Russia developed 12 National Projects with total budget of Rub 25.7 trillion that will support the economic growth, the development of the infrastructure and of the human capital. Rub 18.2 trillion will come from the Federal Budget, regional budgets and state funds, Rub 7.5 trillion will be attracted from other sources.

Supported by favourable dynamics in oil prices, the surplus of the current account of Russia increased to US\$ 113.8 billion (6.9% of GDP), up from US\$ 33.2 billion (2.1% of GDP) the year before. Exports of oil & gas grew by 32.5%, non-energy export also showed growth by 13.6%. The negative balance of the financial account in 2018 increased to US\$ 77.1 billion compared to US\$ 12.9 billion in 2017. Capital outflow in the private sector reached US\$ 72.1 billion versus US\$ 32.4 billion in 2017; in the public sector, the capital outflow dropped to US\$ 6.9 billion compared to US\$ 13.3 billion the previous year. Banks' foreign debt declined by 18.2% to US\$ 84.6 billion.

The total sum of outstanding loans in the non-financial sector increased by 7.0% (from Rub 37.5 trillion at the end of 2017 to Rub 40.2 trillion at the end of 2018), and the outstanding loans of households increased by 22.0% (from Rub 13.2 trillion to Rub 16.1 trillion). The weighted average interest rate on long-term corporate loans (in rubles) declined slightly from 9.45% in January 2018 to 9.33% in December 2018.

The Russian Budget showed a surplus of Rub 2.7 trillion, equal to 2.6% of the GDP. Budget revenue increased by 29%, while spending grew by only 2%.

In 2018, Russia decreased its external sovereign debt by 1.3% to US\$ 49.2 billion. The total external debt of the Russian Federation (both government and corporate) decreased by 12.4% (from US\$ 518 billion in 2017 to US\$ 454 billion in 2018). At the same time, the ratio of external debt to GDP reached its minimum level of 27.5% since 2000. The international reserves of Russia increased by 8.4% and reached US\$ 468.5 billion. For the first time in Russian history, international reserves exceed external debt.

Despite uncertain economic conditions, the MOEX Russia Index increased from 2,110 points at the end of 2017 to 2,369 points at the end of 2018 (+12.3%), with a total capitalisation of Rub 9.8 trillion. At the same time, as a result of depreciation of the ruble to the US dollar, the RTS Index fell from 1,154 points to 1,069 points (-7.4%) during 2018, with a total capitalisation of US\$ 140.5 billion.

A major decision made on the labour market in 2018 was to increase the retirement age by 5 years (to 60 years for women, 65 years for men). The unemployment rate declined to a historical low of 4.8% in 2018 (5.2% in 2017). The total labour force decreased slightly to 76.2 million people (<1%) in 2018.

▲ 0.7 p.p. yoy

2.3%

Russian GDP growth rate in 2018

▲ 12.3%

2,369 points

MOEX Russia Index



Market Trends

Oil and Gas Industry

2018 was marked by the growing importance of the energy sector in the Russian economy. The oil and gas share in the total income of the Federal Budget of Russia, which increased from 36% in 2016 to 40% in 2017, reached 46% in 2018. One of the factors for this tendency was a rise in Urals oil prices from US\$ 53 per barrel in average in 2017 to US\$ 70 per barrel in 2018. Exports of natural gas, crude oil and oil products reached US\$ 262 billion (52% of total Russian exports), compared to US\$ 193 billion (47% of total exports) the year before. Crude oil exports only brought Russian companies US\$ 129 billion (+38%). Total natural gas exports amounted to US\$ 49.1 billion (+27%). In 2018, Russia remained the second largest producer of crude oil (12.4% of the global production) and gas (18.5% of the global production).

Upstream

The Russian Government is currently taking steps to increase investments in depleted and non-conventional oilfields (one of the objectives is to support production in the West Siberia which has declined since 2005). In particular, a number of changes in the tax system were adopted in 2018.

Russia increased its production of oil by ca. 0.5 million barrels per day, accounting for a total of 555.9 million tons produced in 2018 (+1.7%). During the year, the Russian well stock slightly increased from 175.3 thousand units to 177.5 thousand units (+1.3%). The total measured drilling depth remained at the same level.

Investments in extraction of crude petroleum and natural gas reached Rub 1.6 trillion. 54 new oil fields were put into operation, which include several large fields such as Russkoe, Tagulskoe and Kuyumbinskoe (Phase 2).

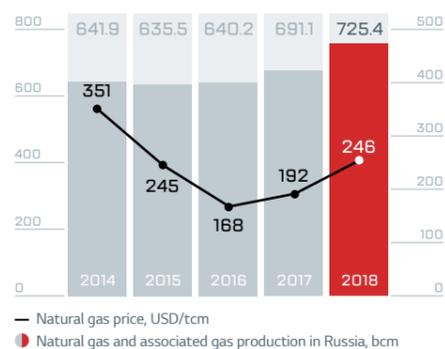
Natural gas production in Russia hit the 18-year record - 725.4 bcm were produced (+4.9%). The volume of gas exports (including LNG) grew from 224.2 bcm in 2017 to 248.1 bcm (+10.7%), and domestic sales increased from 468.0 bcm to 480.5 bcm (+2.7%).

Crude oil production in Russia (including gas condensate) and Urals oil price dynamics



Source: the Ministry of Energy of the Russian Federation, the Ministry of Finance of the Russian Federation

Natural and associated gas production in Russia, and average export price of gas



Source: the Ministry of Energy of the Russian Federation, the Ministry of Finance of the Russian Federation

▲ 38% yoy
US\$129bn

Crude oil exports in 2018

▲ 27% yoy
US\$49bn

Total natural gas exports



Midstream

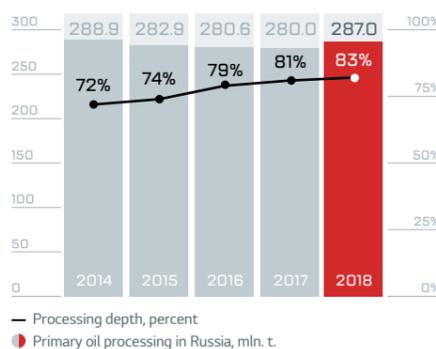
As Russian oil and gas fields are widespread across the country, Russia has the largest oil and gas pipeline networks in the world.

Transneft is the major operator of the Russian oil trunk pipeline system (51,600 km) and oil-product trunk pipeline system (16,700 km). The annual CAPEX in the oil transportation system exceeded Rub 258 billion in 2018.

The company expanded a number of important main pipelines, including the further expansion of the ESPO pipeline.

The total length of the Russian gas transportation system is ~172,100 km, the major operator of gas pipelines is Gazprom. In 2018, Gazprom continued various large gas transportation system projects, including expansion of export pipelines, such as the Nord Stream 2, the Turk Stream, the Power of Siberia.

Primary oil processing volume and processing depth in Russia



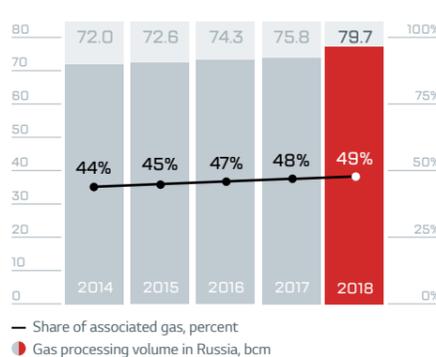
Source: the Ministry of Energy of the Russian Federation, the Federal State Statistics Service of the Russian Federation Source

Downstream

There are 39 large oil refineries in Russia with total crude oil distillation capacity of 0.8 million tons per day. The leading Russian oil company Rosneft is the largest refinery operator, owning nine major refineries. LUKOIL, with four major ones, is the second-largest refinery operator.

A number of further large projects on the modernisations of oil refineries, as well as new construction are planned on the horizon until 2025. Examples of recent and ongoing projects include the construction of new units at the Moscow and Omsk refineries (Gazprom neft), Stavrolen Plant and Kstovo refineries (Lukoil).

Gas processing structure in Russia



Source: the Ministry of Energy of the Russian Federation, HMS Group estimate (for 2017)

Primary oil processing in Russia reached 287 million tons in 2018 (+2.5%).

Capital investments in the production of refined petroleum products and coke slightly fell to Rub 443.6 billion in 2018 (-0.8%). The average processing depth grew to reach 83.4% (a significant increase in comparison with 71.4% in 2013) thanks to a refineries modernization program.

Russian gas processing capacities consist of 31 plants, which processed 79.7 bcm in 2018. The main trend in gas processing is the steadily increasing share of petroleum associated gas processed, which reached ~49% in 2018 (35% in 2007). Another important trend is an increasing volume of LNG production. The volume of LNG produced in Russia reached 26.9 bcm compared to 15.7 bcm in the previous year (+71.6%), also due to the launch of the second and the third lines of Yamal LNG (NOVATEK).

Market Trends

Continue

Power Generation

In 2018, Russia continued to increase its electricity output which reached 1,091.7 billion kWh (+1.7%) and ranked Russia the fourth between the largest producers of electricity across the globe (after China, India and the USA).

Total installed capacity of Russian power system in 2018 increased by 2.8 GW (+1.1%) and reached 250 GW.

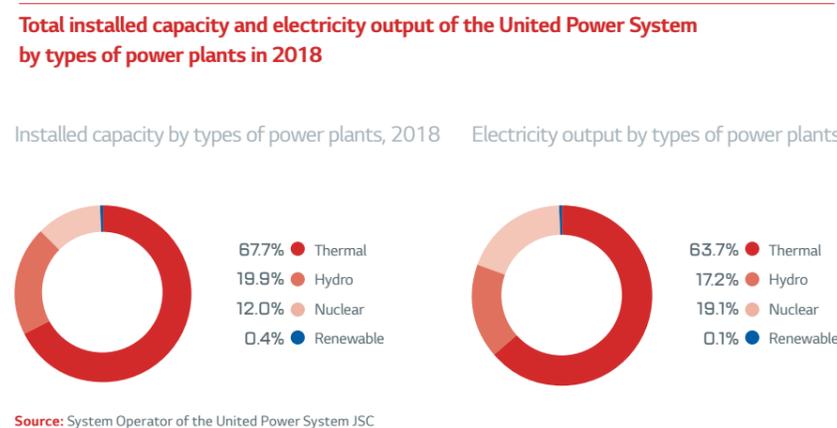
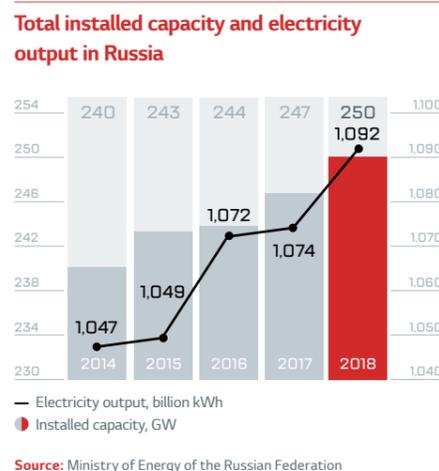
Total number of large power plants in Russia (with installed capacity higher than 5 MW each) amounted to 805. The structure of the installed capacity in the united power system remained practically unchanged since 2017: thermal power plants accounted for 68% of installed capacity, hydro power plants - 20%, nuclear power plants -12%.

Total investments in power generation and transmission in 2018 were Rub 714.6 billion (+0.6%).

A number of new power units started operation in 2018, including nuclear, thermal and solar power units.

Russian energy companies continued construction of new power plants, such as Kursk-2 NPP, Leningrad-2 NPP, Novovoronezh-2 NPP, the world's first floating nuclear co-generation plant named Akademik Lomonosov, Primorskaya TPP, Voronezh TPP (new 115 MW unit) and other facilities.

The State Atomic Energy Corporation ROSATOM also runs a number of projects on NPP construction abroad, such as: Akkuyu NPP in Turkey, Kudankulam NPP in India, Bushehr NPP in Iran, Belorussian NPP in Belarus, Tianwan -2 NPP in China and has a number of projects under negotiation.



Metals & Mining

Metals

The steel industry is becoming an important contributor to the Russian economy, its share in the Russian GDP increased from 1.8% in 2017 to 2.1%, the share of metals in total exports reached 8%.

Steel production in Russia increased by 0.3% and reached 71.7 million tons, while the production of cast iron decreased by 0.6% to the level of 51.8 million tons.

Russia was one of the leading exporters of steel and metal products in the world in 2018: the country exported 33.3 million tons of steel (+7%), and 5.8 million tons of cast iron (+20%) which kept Russia in the position of the world-leading exporter.

Mining

Russia has the world's largest reserves of most ores and minerals. For example, the country has the largest iron ore and zinc reserves, the third largest copper and lead ore reserves, and the sixth bauxite reserves.

The mining industry of Russia is very concentrated and consists of few large companies, which typically own the whole production chain, from ore mining to the manufacture of metal products with high added value.



As a result of sanctions against RUSAL, aluminum exports from Russia showed a decrease by 1.3% and amounted to 3.1 million tons.

Total investments in metals production showed a slight decrease (by 0.1%) to Rub 277.6 billion.



In 2018, the volume of coal production reached Rub 1,511 billion (+25.1%), the volume of metal ores production rose to Rub 1,153 billion (+15.5%).

Russian metalworking and mining companies continue to implement large-scale investments programs. EVRAZ, Severstal, Rusal, Nor Nickel and others carry out long-term programs aimed at developing new mines and establishing new production units (like coke batteries or new furnaces) that will ensure further investments in the industry for the next years.

Water Utilities

Municipal water utilities constitute one of the consistently developing segments of the Russian economy, supported by the steady growth of tariffs (for example, tariffs on cold water supply increased by 5.1% in 2018, hot water supply by 4.9%, and sewerage by 6.1%) and an increasing inflow of private investments.

Total investments in water utilities and waste utilization in Russia reached Rub 130.5 billion (+2.2%).

The most important projects in water utilities construction and modernization in Russia include the reconstruction of Kuryanovsk wastewater treatment facilities in Moscow, the re-equipment of water and wastewater facilities in Saint-Petersburg, and the reconstruction of water utilities in Tyumen (including the new water intake development).

In 2018 the Russian Government launched a number of National Projects including the 'Housing and urban environment' project with total budget of Rub 1,066 billion. The project will increase the volume of housing from 79.2 million square meters to 120 million square meters by 2024 (+52%), thus supporting the water utilities development in all regions of the country. A number of other projects were launched in 2018 to ensure the development of water utilities, including the 'Volga recovery' project with total investments to the tune of Rub 122.9 billion for 2019-2024.

