

Research:

Country Risks Cloud Future Prospects for Russian Corporates

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Country risks still weigh on the credit quality of Russian corporate entities. Despite improving sovereign credit quality, corporate entities in the region remain subject to the uncertain implementation of legislation and regulations, a centralized and personality-driven political regime, a concentrated economic structure with a lack of diversification, and a weak domestic banking system. These factors are tempered, however, by current incentives for transparency supported by strong international demand for emerging market debt.

Russia's weak institutional structure remains the key constraint on corporate credit quality in the country because it translates into an unpredictable regulatory, legal, and corporate governance environment and leads to the lack of a solid base for improving the country's economic structure. At the moment, it is unclear whether Russia is poised for progress or will regress into an environment where businesses operate under the threat of political intrigues, personal power plays, and ineffective or parasitic bureaucrats.

Risks inherent from operating in The Russian Federation (foreign currency BB+/Stable/B; local currency BBB-/Stable/A-3) have long been factored into the credit ratings on Russian corporates, as Standard & Poor's methodology for assessing corporate credit quality considers country risk a particularly important element of credit risk in emerging markets. This methodology distinguishes between the risk of sovereign default or direct interference--such as currency controls--which are captured by a country's sovereign credit rating, and other indirect risks endemic to a company operating in a particular country (see "Local Currency Rating Criteria Update: The Importance of Country Risk for Corporate and Infrastructure Sectors" published on Nov. 6, 2002, on RatingsDirect, Standard & Poor's web-based credit analysis system at www.ratingsdirect.com). Endemic country risks are important considerations when rating Russia-based corporations, as important reforms and diversification of the economy lag behind the rapid fiscal improvement achieved by the Russian Federation itself.

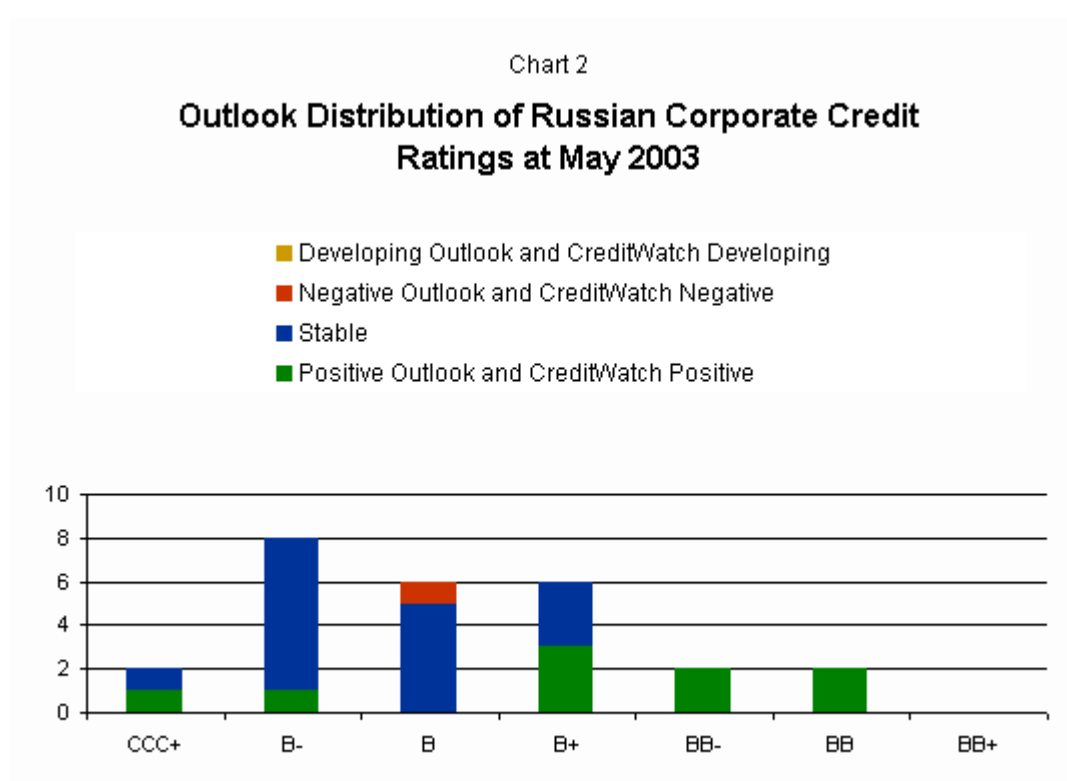
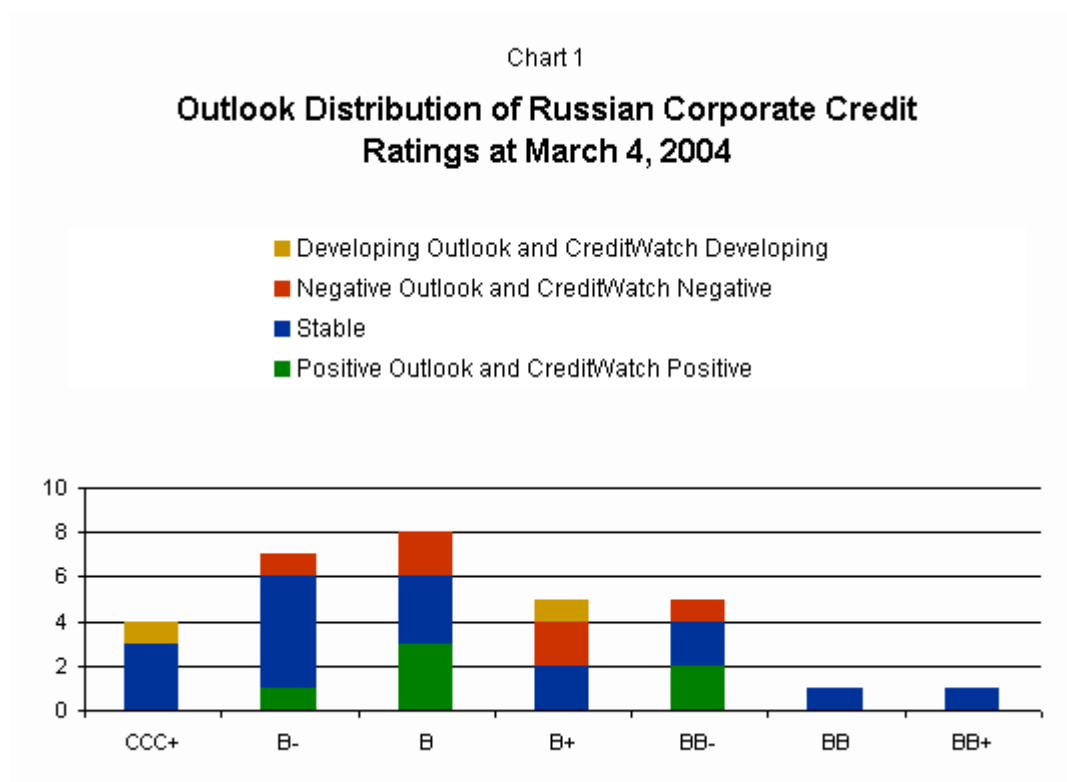
On Jan. 27, 2004, Standard & Poor's Ratings Services raised its long-term foreign currency sovereign credit rating on the Russian Federation to 'BB+' from 'BB', and its local currency sovereign credit ratings to 'BBB-/A-3' from 'BB+/B'. The upgrade was driven by the improved fiscal and liquidity position of the Russian government. This reduces the probability of the government's default and a reoccurrence of the turmoil and stress that such events cause for the corporate sector.

Russia's regulatory, legal, and corporate governance environments remain weak, however, as recently highlighted by the effective reversal of the acquisition of OAO Siberian Oil Co. (Sibneft; B+/Watch Dev/--) by another oil company, OAO NK Yukos (BB-/Watch Neg/--). On balance, the level of such risks remain undiminished in light of the recent evidence that Russian companies and their investors can be subjected to government pressure through selective implementation of regulations and legislation that is either politically motivated or triggered by competing business groups. This, in turn, threatens to negatively affect the investment climate, corporate governance environment, property rights protection, and incentives to transparency.

So far, there has been no significant increase in capital outflows from Russia as a result of uncertainty about principles and practices upon which Russian government will be based after the March 2004 presidential election. These political and institutional risks are being counterbalanced in the short term by strong international demand for emerging market debt and Russia's robust macroeconomic and fiscal performance on the back of high oil prices. For individual firms, access to international funding should be an incentive to improve transparency, disclosure, and governance practices toward international standards. Whether Russian companies will continue to enjoy good access to the international financial markets and a healthy operating environment over the longer term, however, depends on the pace and effectiveness of economic, institutional, and legal reforms after the presidential election.

■ Credit Strengthening of Russian Corporates Slows

Standard & Poor's currently rates 31 Russian companies on its global scale. The long-term ratings on these companies range from 'CCC+' to 'BB+'.



Since the 1998 financial crisis, the credit quality of Russian companies has improved steadily and significantly. During 2003 and January-February of 2004, there were 14 upgrades and one downgrade, although the majority of long-term ratings remain in the 'B' category.

The structure of outlooks and CreditWatch placements has become less positive, however, indicating that the remarkably strong positive trend of the past few years is slowing down. One year ago, all the

corporate outlooks, with one single exception, were either stable or positive. Now there are four negative outlooks and four ratings on CreditWatch (two with negative implications and two with developing implications).

Even when accounting for the upgrades of corporate issuers, the gap between Russia's credit quality and that of the rated corporate sector has increased. Following the sovereign upgrade in January 2004, the only change in corporate ratings was an upgrade of the long-term foreign currency rating on OAO AK Transneft--the government-owned monopoly oil pipeline operator--to 'BB+', which reflected the improved transfer and convertibility risks that were accounted for in the raising of the sovereign foreign currency rating.

■ **Bureaucracy Continues to Constrain Credit Quality**

Instead of institutional frameworks serving as the foundation for fair and efficient economic activity, as well as raising the general standard of living for the population, the application of laws and regulation in Russia is driven by personal agendas and rivalries and self-preserving or "rent-seeking" bureaucracies that burden businesses and impede the development of a more vibrant, diverse, and competitive economy. In recent months there have been worrying signs that conditions are getting worse, notwithstanding the passage of a number of pieces of reform legislation. Effective implementation of new laws and regulations and reduction of the bureaucratic burden on business through successful administrative reform is probably the most important challenge for the next administration.

Many of the reforms legislated or documented in 2001-2003 could serve as the basis for progress. From the corporate standpoint, the most significant new pieces of legislation include:

- Tax reform;
- Fiscal reform;
- The new bankruptcy law effective since 2003;
- Electricity sector reform;
- Changes to the corporate law;
- Currency control liberalization;
- Deregulation of small businesses; and
- More transparent tariff-setting framework for the electricity sector.

Questions remain as to the actual implementation and application of many of these and whether the government culture shifts toward serving the public, including private enterprises, as opposed to maximizing the power of the state and often its employees and their beneficiaries. In Russia's still-developing business and regulatory culture, decisions are driven by individuals rather than by institutions with well-established purposes. Personal or political motives, therefore, can prevail over economic rationale and result in biased decisions or decisions that are unpredictable from a purely business standpoint.

Managing high social costs and overcoming resistance to change by entrenched industrial and public sector interests are associated challenges. Russia's administrative burdens delay economic modernization and diversification and increase corruption risks. In the past, administrative burdens afflicted small and midsize enterprises (SMEs) most seriously and were a deterrent to foreign direct investment, but now they seem an increasing threat to large Russian corporate entities as well.

Along with regulators and other bureaucracies, Russian courts remain unpredictable, which does not support fair and efficient economic activity. The weakness of the judicial system results in inconsistent and sometimes selective application of the law. It is not unusual to see different courts coming to contrary decisions on the same issue or overruling each other on unclear grounds. The courts lack independence and often appear to be influenced by federal or regional politicians or by powerful business groups. Corruption in Russian courts, therefore, remains a significant risk. Similarly, regulatory decisions are nontransparent, unpredictable, and often politicized.

Corporate governance remains an issue.

Russia's corporate governance system is evolving and not yet firmly rooted. Its very short and dynamic history started with the murky privatizations of the mid-1990s and continued through the bitterly fought struggles to establish large industrial groups in late 1990s. The idea that transparency and predictable corporate behavior will support higher market capitalizations only began to surface

with a few progressive corporate groups after the 1998 financial crisis, generally when the key industrial groups had achieved strong control over their key assets and ownership rights had been more or less settled. The mindset of most decision makers, both in public and the private business environment, was formed in the Soviet era. As a result, private property, entrepreneurship, and value-creation are relatively new concepts, while government involvement in the economy and prevalence of personal relationships over prescribed rules is perceived as traditional. Many decision makers still think in terms of control rather than value creation. This results in poor protection of ownership rights. The weaknesses of the country's legal and regulatory systems can still be exploited by the vested interests in the public and private sectors; for example, to gain control of certain assets or cash flows.

The Yukos affair and similar cases have discouraged transparency to some extent because it is perceived as making companies and shareholders vulnerable to outside threats. This reaction also hurts the legitimate interests of portfolio investors and lenders, however, by making it more difficult for them to assess risk and value and spot conflicts of interest. It will be unfortunate if a fear of regulatory actions or heavier government involvement in corporate affairs--be it politically motivated or at the instigation of rival business groups with political influence--induces more companies to regress back to the sort of aggressive corporate practices that prevailed in the late 1990s.

The legal, regulatory, and corporate governance uncertainties can be illustrated most clearly by the Yukos affair, as well as the recent questioning of the Moscow telecommunications license of Vimpel-Communications (JSC) (Vimpelcom; B+/Stable/--) and other lower-profile cases. Yukos and its subsidiaries and shareholders are the subject of numerous tax and legal investigations, including ones into tax optimization practices that are widely used in Russia. Because of legal and tax charges against the company's beneficial shareholders, the court froze a 44% stake in the company that the major shareholders owned indirectly, via offshore legal entities. Meanwhile, the former core shareholders of Sibneft--in which Yukos had acquired a 92% stake just before Mikhail Khodorkovsky (the former chief executive and major shareholder of Yukos) was arrested--refused to transfer governance and management control to Yukos and started to reverse the transaction. Subsequent canceling by the court of Yukos' share issue used to purchase a 57% block of Sibneft shares, and the resulting conceivable loss of that block (unless the share cancellation is successfully appealed), was a further manifestation of court actions that can impede corporate governance and finance in Russia.

The risk to companies under high-profile investigations can be compounded by lower-level officials, some of whom--in apparent attempts to demonstrate their loyalty and zeal--have initiated narrower investigations of their own into taxes, oil production licenses, or assets. Although there have not yet been any high-profile defaults as a result of official actions, these actions compound the normal financial and business risks that companies face in markets where legal regulatory and governance systems are more developed and predictable.

The practical implementation of regulatory and judicial reforms will be key for Russia's corporate sector environment. In particular this should include:

- Administrative reform--which streamlines the compliance process and reduces the unnecessary interference of government in business--including greater accountability, reengineering of work processes, and staff optimization within the bureaucracy. Real reform, not just a redistribution of the government functions in token compliance with legislation, is essential to boost the efficiency, flexibility, and competitiveness of Russian companies.
- Judicial reform that must increase the fairness, efficiency, and predictability of the environment that businesses and creditors face. Judges also need to be more aware of the needs of the business community. On many occasions individual judges' lack of knowledge and conservatism have posed a greater obstacle to development of business than the legislation.
- Interplay between corporate governance and regulation that encourages a better governance, credit quality, market, and regulatory culture.

■ Centralized and Personality-Driven Political System Adds Risk

For large businesses, particularly in the resource sector, the growing concentration of power in the presidential administration creates new uncertainties. Without effective checks or balances from the legislative or judicial branches, and with a civil service in need of drastic reform, this concentration of power threatens to increase the already personalized relationships between business and government that, coupled with a resurgence of nationalist sentiment and questioning of existing contractual and

property rights, heralds a period of uncertainty for the Russian corporate sector.

The December 2003 parliamentary elections were a victory for the pro-president centrist party United Russia. They also demonstrated the popularity of a nationalistic economic policy aimed at strengthening the government's role in the resource sector and increasing the sector's tax burden. If centrist parties play to the popularity of a nationalistic agenda, it could negatively affect the tax regime and undermine some recent efforts to liberalize the business environment. A nationalistic tilt might also hamper foreign direct investment, expose selected companies or businessmen to political pressure, and affect corporate governance and transparency incentives and practices.

The Yukos case is unique because of the company shareholders' unusually heavy involvement in politics, but without clear-cut protection under the law and principles of government other companies or institutions have to rightly factor in the risk that they too could attract the particular attention of the authorities. For example, Vimpelcom was subject to a license investigation that was both begun and ended with suddenness and little explanation. In the pre-eminent oil and gas sector, the government recently invalidated the license for Exxon Mobil Corp. (AAA/Stable/A-1+)-led Sakhalin-3 oil exploration project. Although massive nationalization looks very unlikely at this stage--because private property is already deeply entrenched and the key industries have been essentially privatized--the security of title, property rights, and contracts is a risk factor that must be weighed in by both direct and portfolio investors in Russia.

The trend toward political and fiscal centralization should help ease the threat of pressure or action by regional authorities against businesses in the future. In regions where governments have been heavily involved in the economy, however (such as Bashkortostan, Tatarstan, and Yakutia), the centralization process might imply uncertainties in shareholding or corporate governance, sometimes in the form of tax or regulatory pressures. For example, right before the elections in late 2003, in the Republic of Bashkortostan (B+/Stable--) the region's key oil firms, Bashneft and Bashneftekhim, were privatized in a questionable way by the setting up of a cross-shareholding structure that was effectively controlled by the management, which is close to the family of the former head of the region. The companies were subject to tax investigation, while the share issue of the region's key bank, Ural - Siberian Bank (OJSC) (B-/Stable/C), was contested in the court, triggering an outlook change from positive to stable. Both cases appear to have been settled after the president of Bashkortostan achieved a compromise with regional authorities and was reelected to his office.

Standard & Poor's believes that creditors of government-owned companies are unlikely to benefit from the recent rise of nationalistic sentiment and the trend toward centralization. These organizations continue to face regulatory risks, which have been incorporated in the ratings on the entities. It is important to bear in mind that government interests are typically focused on the companies' current operations and long-term strategic projects rather than on avoiding a corporate default, because a default does not necessarily imply bankruptcy or liquidation. Recent fiscal legislation makes it almost impossible for the government to arrange for a timely direct financial support in the event of a liquidity crisis. Russian state-owned companies, therefore, receive little, and normally no, benefit in the ratings as a result of their ownership. Although these companies' business profiles might benefit from a degree of state support or even occasional politically motivated lending by the state-owned Savings Bank of the Russian Federation (Sberbank), their stand-alone credit quality can be affected by nontransparent populist-driven regulations, pressure for politically motivated investments, and generally less sophisticated management and corporate governance risks as well. For example, the rating on OAO Gazprom (BB-/Stable/--), Russia's gas monopoly in which the government holds majority control, is constrained by its low regulated domestic prices. In effect, the company shoulders the social burden for the government. RAO UES of Russia (B/Positive/--), the country's majority government-owned electricity monopoly, has a rating that reflects restructuring, regulatory, and other uncertainties.

Despite many uncertainties about the nature and extent of the influence of the government sector on corporate ratings, political unrest looks very unlikely. President Putin's wide popular support, coupled with Russia's strong presidential system and the Duma's composition after the December 2003 election, ensures wide legislative support if the new presidential administration wants to continue current reforms. Of importance is how committed to, and effective, the new administration will be in achieving desperately important administrative reforms that will both facilitate the broader range of policy implementation and lift the burden of government from business.

■ Economic Concentration Adds Further Constraints to Growth

Russia's economy remains very concentrated in terms of its dependence on oil and gas and a few other natural resources as well as the concentration of private firm ownership in a relatively small number of

financial industrial groups (which are controlled by Russia's "oligarchs"). These structural characteristics mean that a downturn in the oil sector is a risk even for firms with little direct or obvious exposure to it. This vulnerability is not likely to be reduced in the near to medium term.

The dependence on oil and gas can be seen in the fact that those sectors accounted for 58% of exports and an estimated 23% of GDP in 2003, while metals accounted for a further 17% of 2003 exports. The dominance of large financial industrial groups in Russia increases the risk that problems at one or more major members of a financial industrial group could ripple through the group affecting members and their main counterparties. The diverse economic cushion of modern SMEs remains underdeveloped and faces impediments to growth from the administrative burden of government bureaucracy and the underdeveloped banking system.

■ Incentives for Transparency Provide Hope

The general level of transparency and disclosure in Russia is improving, albeit from a very low base and with large variances from one company to another. As capital markets become a more important source of financing, this improvement is expected to continue. The government is planning a gradual implementation of IFRS- or U.S. GAAP-based reporting starting with banks and listed companies and continuing somewhat later more broadly. Even if the process takes more time, the positive trend is obvious. For most rated companies, the key issue is the timeliness, rather than the level, of disclosure. Timeliness is hampered by the limited supply of accountants with a good understanding of IFRS or U.S. GAAP accounts and the typically two-stage approach of basing these accounts on Russian statutory accounts with necessary adjustments and clarifications.

Transparency and corporate governance has markedly improved in recent years, but still remains an important issue. Complex corporate structures emerged during privatization, to avoid burdensome regulations or to optimize taxes. This applies to many newcomers to capital markets--such as OAO Caustic (CCC+/Stable/--) and OAO Plastcard (CCC+/Stable/--)--but also to some large corporate players. Typically, such companies have significant related party transactions and it is difficult to determine whether they trade at an "arms-length" basis and to create an appropriate financial and accounting picture to analyze.

Shareholding structures are often obscure. National disclosure standards only require disclosing large names listed in the shareholder register and do not extend to the beneficial shareholding level. In many cases, therefore, the actual interests behind a particular company cannot be known with confidence. Shareholder disclosure is hampered by the fear of corporate raiders, property rights protection, large tax bills, or government pressure. The progress in this area is slow, although there are some examples of improving standards of disclosure such as Mobile TeleSystems OJSC (B+/Stable/--), Wimm-Bill-Dann Foods OJSC (B+/Negative/--), LUKoil OAO (BB/Stable/--), and OAO Severstal (B+/Negative/--) as well as some smaller companies.

Concentrated shareholding structures affect predictability and transparency by making companies overly reliant on several key decision-makers and prone to large unexpected transactions such as dividends and M&A. Even if such transactions are disclosed, the company's destiny is very much in the hands of a particular individual with little accountability to minority shareholders or creditors.

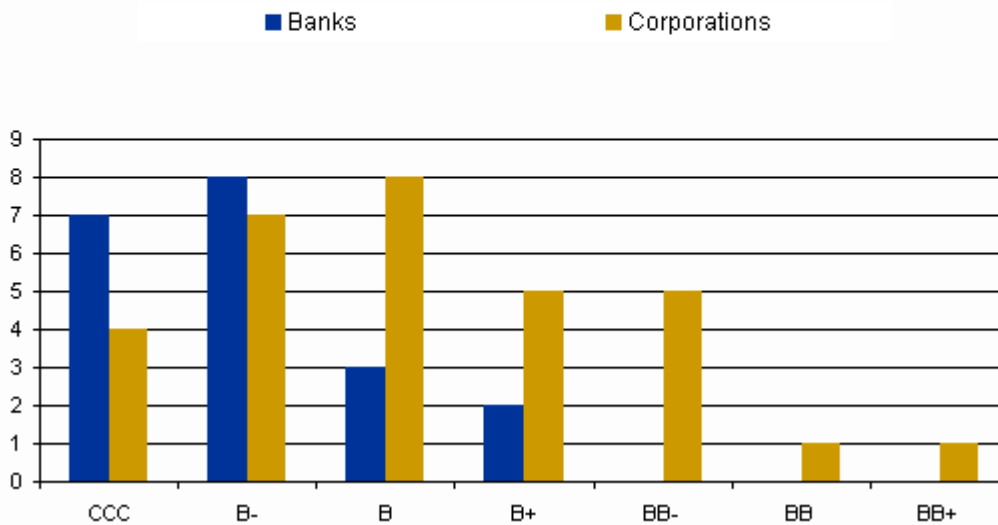
In the future, the incentives to be transparent will largely depend on the balance between the access to capital markets, particularly the ADR market where shareholding disclosure is required, and the risks of pressure from the government or aggressive takeover attempts. After looking at the Yukos affair, some companies might be more cautious in their disclosure but because the story has not affected their access to the capital markets so far, the incentives to be more transparent in order to raise capital should prevail.

■ Increased Appetite for Emerging Market Debt Offsets Weak Banking System

Russia continues to have a weak and undercapitalized banking system, which increases liquidity risk for Russian corporations. Many banks are captive or treasury operations of large industrial groups and a lack of economic diversification affects the banks' ability to grow and diversify their customer base. The level of intermediation is lower than in peer countries: the amount of credit issued by domestic banks to the private sector is low at only 21% of GDP. Most Russian banks are rated well below Russian corporations (see chart 3).

Chart 3

Russian Corporate and Bank Ratings Distribution at March 4, 2004



Although progress is being made, Russia's credit culture remains immature. Bank and bond markets are vulnerable to shocks and surprises due to investment and lending decisions being based on relationships, reputations, or other considerations rather than solid information and analysis. As a result, some companies can opportunistically borrow to fund aggressive investments in M&A, or borrow while keeping large cash balances and thereby expose themselves to weak financial institutions or currency risk.

Russian companies do now, however, have much better access to capital, both domestically and internationally, and this is a significant positive factor for credit quality. Since 2002-2003, large companies have had easy access to the international bond and bank loan markets, supported by strong international demand for emerging market debt and Russia's solid economic growth. As a result, foreign corporate debt has been growing fast in 2003. Notwithstanding the Yukos affair, the international demand for Russian debt has not decreased, as illustrated by several successful eurobond placements in late 2003-early 2004. Even if international investor interest is volatile in the mid term, Russian issuers are not likely to be totally cut off from financing, as they were shortly after the 1998 crisis. Russia's ability to service all its debt in the short term remains relatively strong and the risk of a sovereign default is minimized by the country's very strong external liquidity position and the government's short-term fiscal flexibility.

Meanwhile, domestic bank credit and capital markets have been growing fast, albeit from a low level, so that Russia now has the largest bond markets in Eastern Europe. Oil revenues have created a liquidity cushion on the domestic financial market and provided funding opportunities for midsize companies. These factors improve corporate liquidity in the short term, but Russia's corporate sector would still benefit greatly from a strengthening of the domestic banking system.

Country Risks Still Dominate Outlook

The diverse range of outlooks and a significant number of CreditWatch placements suggests that Russian corporate ratings are likely to be volatile in the year ahead following their strong, steady upward movements in recent years. In the short term, the ratings will be significantly driven by industry and company specific factors rather than by sovereign rating dynamics.

Transparency and predictability of companies' financial policies in areas like M&A, debt, and liquidity will become as important as operating and financial indicators. Although general country risk is already factored in Russian corporate ratings, if a company becomes exposed to an unusual amount of regulatory or legal pressure--such as with Yukos--a CreditWatch placement or downgrade is possible. Overall, these factors are company-level reflections of two country-level issues: corporate governance

and government interference.

The mid- to long-term outlook for Russian corporate ratings will be significantly determined by indirect sovereign factors, particularly by the country's progress--or regress in a worse-case scenario--in terms of establishing robust and independent legal and regulatory institutions, developing healthy corporate governance practices, making the relationships between the government and the corporate sector more predictable, and reducing the bureaucratic burden on business. These indirect factors will be no less important for corporate ratings in Russia than the sovereign's fiscal and macroeconomic performance.

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