Strategic Choice Advisory
Strategy and Transactions

Russia Macro Foresight

Covid-19 Pandemic, Year 1 Results: Better Than Feared, Better Than Many, But Where Will Growth Come From?

February 2021

Economy contracts, but less than expected in full-2020; with bright spots in certain sectors (1/2)

Indicator, % y/y	2017	2018	2019	2020
Industrial production	2.1	2.9	3.4	-2.9
Cargo transport turnover:	5.5	2.7	0.7	-4.9
Railway	6.4	4.2	0.2	-2.2
Automobile	2.3	2.3	6.3	-1.4
Agriculture	3.1	-0.2	4.3	1.5**
Retail trade	1.3	2.8	1.9	-4.1
Paid services to population	1.4	1.4	0.5	-17.3
Construction, o/w:	-1.2	6.3	2.1	0.1
Housing	-1.3	-4.5	6.2	-5.9
Fixed capital investment	4.4	5.1	1.3	-4.1*

** - Jan-Sep 2020*   *** - Jan-Nov 2020*

Segment, % y/y	2019	2020	Segment, % y/y	2019	2020
Food products	4.1	3.5	Textiles	1.8	8.9
Bottled water	17.6	-0.2	Apparel	3.5	0.6
Chemicals	3.4	7.2	Footwear	-5.8	-14.5
Fodder feed	2.8	1.6	Furniture	6.8	3.7
Medical equipment	36.7	34.9	Machines & equipment; related:		
Pharmaceuticals	27.4	23.0	Electrical equipment	1.3	-1.0
Computers	-0.2	35.4	Tractors	-8.1	6.3
Washing machines	5.1	8.0	Metal-cutting equipment	-0.1	-1.9
Metal products	7.3	2.0	Cars	-1.9	-17.5
Wood products	6.2	0.2	Trucks	-1.1	-8.7
Building materials	9.0	-2.3	Truck tires	-16.6	3.6

Economy contracts, but less than expected in full-2020; with bright spots in certain sectors (2/2)

- Unsurprisingly, the Russian economy, which hadn't been doing too well amid Western sanctions and low oil prices, took a big hit from the Covid-19 pandemic. **Most sectors were just starting to gain some traction, when this new crisis undid most of the achievements of 2017-2019.** We noted recently that growth in many B2B-driven sectors had begun to slow, after getting spurred by import substitution, while growth in B2C sectors was picking up, but still rather weak. All of this was reset by the pandemic, as output shrank or growth slowed sharply across the board
- At that, **the economy slumped less than feared, as real GDP growth in full-2020 came in at -3.1% y/y** (first estimate). Russian government and IFIs had forecasted 3.9-6.5% contraction, while some analysts expected GDP to shrink by up to 7-7.5%. The outcome was also much better than in many developed and emerging markets worldwide
- While transportation, extraction, manufacturing, retail trade, investment, etc. key indices saw expected contraction or sharp slowdown, **we would like to point out a sector often overlooked by researchers, namely, paid services to the population.** This sector comprises a huge part of service industry SMEs, making people's lives better and employing a large chunk of the workforce. **Contraction of 17.3% after steady growth of 1-2% per year shows just how difficult life has become for many entrepreneurs,** their families, and people they employ
- **Auto transport posted a 1.4% drop, despite the boom in eCommerce and deliveries**, amid overall demand weakness
- **Construction held up better than expected,** its 0.1% growth just below the CAGR of 2017-2019 (2.4%). Despite lower new volumes, the sector was supported by government's low-rate mortgage programs, plus launch of previously started projects amid notably decreased costs. Thus, **the sector's pre-tax profit surged 72% y/y in Jan-Nov 2020. We expect profit to drop this year,** as loan interest rates rise and conditions are toughened, and 2020's woes, i.e. lower volumes, catch up with developers. Investment remains weak, thus industrial construction offers little comfort (apart from some big projects), and further performance depends on mortgage programs (which CBR opposes) and general infrastructure
- **Among the bright spots are agriculture and food** (mass hoarding, higher share of foodstuffs in total consumption, and increased exports), **medical equipment and pharmaceuticals** (although many non-coronavirus-related segments suffer from lack of attention and funding), **textiles** (again, driven mainly by pandemic-related items), **chemicals** (broad-based expansion). Also, **computers and electronics** (even circuit boards!), and **home appliances** are very robust, boosted by the focus on IT and import substitution. **Furniture** stays strong, as people beautify dwellings they are now confined to – a trend that should keep supporting also **DIY and home décor**
- Mirroring the trends above, **aggregate corporate pre-tax profit dropped 31.9% y/y in Jan-Nov** after rising 9.1% in 2019. Agriculture gained 63.3%, IT & communication – 9.1%. Profit in most other sectors declined dramatically

Real income contracts sharply, while inflation picks up, showing purchasing power to stay weak

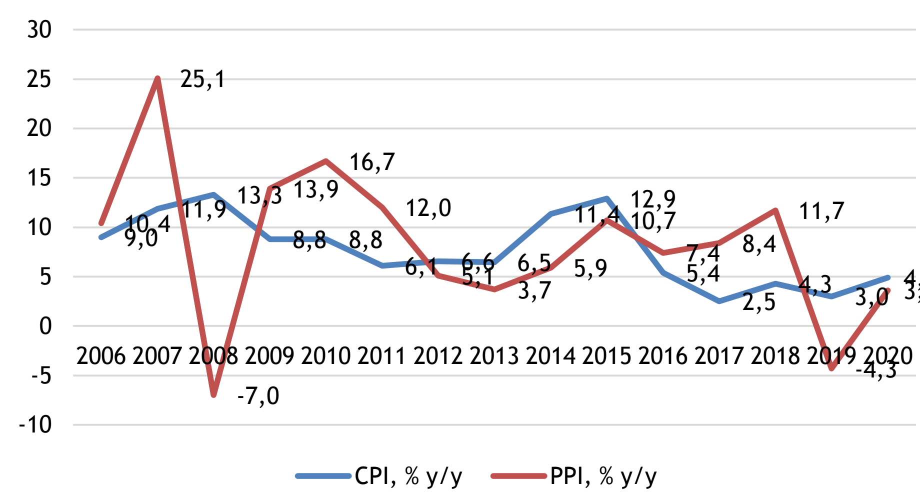
- **Real disposable income** (RDI) dipped 3.5% y/y in 2020 after growth fluctuating around zero for a few years. RDI is now 10.6% lower than in 2013, the last pre-sanction year. No wonder turnout at the latest mass protests has been so high…
- Nominal and real wage growth slowed less significantly, but **in 2020 there were various government support programs and handouts. So far this year, there is little sign of any such luck for the population**
- **Official unemployment shot up 3.2-fold in 2020, while ILO-definition unemployment surged 27.6% to a multi-year high 5.9%.** Only the stick of strict prosecution by authorities, and the carrot of lower-rate loans and other benefits for employers prevented an all-out labor crisis
- Working actively in healthcare, we believe **the latest drop in Covid-19 cases is mainly artificial.** True, cold weather and less mingling in most of Russia, divers restrictions, plus the recently started vaccination campaign do help contain virus spread. But we also know the number of tests is being reduced (via various policies), while laboratories, deemed to have too many positive tests, are being pressured via sanitary inspections., etc. **This poses serious risks of further Covid-19 outbreaks, and we expect consumer demand to stay weak**

Indicator, % y/y	2017	2018	2019	2020
Real disposable income*	-0.5	0.1	1.0	-3.5
Real wages	2.9	7.4	2.5	2.2
Nominal wages	6.7	10.3	7.2	5.5

** - Methodology still under review by RosStat; further adjustments may be possible*

- **CPI inflation sped up notably**, as we predicted in our last report, **to 4.9% y/y in Dec 2020 vs. 3% a year earlier. PPI inflation rebounded from -4.3% y/y in Dec 2019 and -10.5% in May 2020 to 3.6% in Dec 2020.** While still quite low, it will soon shoot past CPI inflation again, as has been the case historically
- Built-up input price pressure (in part owed to RUB real weakening by 7.5% vs. the FX basket), desire to recover recent losses, and first signs of demand strengthening when restrictions are eased, will prompt price hikes. **This should further hurt profit margins**
- The key CPI inflation driver is food prices (6.7% y/y). Biggest rises are seen in cereals & beans, sunflower oil, fruits & vegetables, and pasta. **Government is yet to find a solution to balance solid export growth and domestic prices**
- Non-food prices rose 4.8%, strongest in pandemic-driven products (drugs, detergents, electronics, DIY goods, etc.). **Service prices rose just 2.9%, further highlighting the sector's vulnerability**

CPI & PPI Inflation



Current account surplus, FDI crash through the floor, but exports continue diversifying. Liquidity situation and banking sector indices stay strong, but the latter distorted by regulation easing

EXTERNAL SECTOR

- **The current account surplus shrank further to USD 32.5bn in 2020 vs. USD 64.8bn in 2019, USD 115.7bn in 2018.** The trade surplus also dropped 2-fold to USD 89.4bn, as imports declined less than exports (the latter hit by lower demand for oi&gas). At the same time, service and investment income deficits also declined considerably to USD 18.3bn and USD 30.5bn, respectively
- **FDI crashed through the floor to a mere USD 1.4bn vs. USD 25-35bn per year, on average,** reflecting poor investor sentiment. Positively, **total foreign debt inched down 4.3% to USD 470.1bn,** sliding across most borrower segments
- **The goods export breakdown reveals highly positive trends.** Although oil&gas accounted for 57% (had been 10-15pps higher at times), 18% is oil products and LNG (higher value-added goods). Foods leapt 2.9pps to 8.7% (volumes up 18.2%; FCS Jan-Nov data); chemicals +0.8pps to 7.2%; machines & equipment +1.1pps to 7.2%; metal products +1.1pps. Plastics export volumes soared 60%; drugs, soap & detergents - 20% each! EU lost another 2.9pps to 38.8%, as APR added another 2pps to 34%. Thus, **goods and destinations export structure keeps diversifying**

PUBLIC SECTOR

- **The federal budget deficit widened notably to 3.8% of GDP (RUB 4.1tn) vs.1.8% in 2019**, as tax and customs revenues slumped. Showing maintained fiscal prudence, expenses were RUB 1tn (4.2%) below target, while the Welfare Fund surged 74% to RUB 13.55tn. Still, sizable financial and monetary stimuli provided early in the pandemic has dried up, and **more is needed to repair the damage to the economy**

MONETARY AGGREGATES

- Beating initial expectations, **broad-definition monetary base grew 9.8% in 2020 vs. 4.7% in 2019, national-definition money supply - 13.5% vs. 9.7%.** Cash & equivalents soared almost 30%, as people withdrew extra money amid lockdowns. Still, cashless transactions also surged, as their share reached 54.1% (Sberbank's estimate), driven by corporates continuing switching to digital payments

BANKING SECTOR

- **Assets rose 12.5% vs. 5.9% in 2020,** mostly on support measures for loans to corporates (up 9.9% vs. 5.8%) and individuals (13.5% vs. 18.6%, but still comely). Cash & equivalents rose 9.2%, investment in securities – 34.3% (mainly in various bonds)
- 2020 data should be taken with a grain of salt, as CBR eased rules on reporting asset quality, capital adequacy, etc. What worries us is **overdue debt may be underreported, thus loan loss reserves are not increased enough** (up just 15.3%), with all the let-ups
- Growth of corporates' funds revved up, while individuals' funds rose 4.2%, but deposits slid 7.3%, as people favored current accounts
- **Sector profit dipped after soaring in 2018-2019, but stayed solid** (RUB 1.6tn). Banks are mainly in risk aversion mode, and rightfully so

Indicator, % y/y	2017	2018	2019	2020
Banking sector profit	**-15.1**	**70.3**	**71.9***	-6.2*
Total assets	**7.9**	**6.2**	**5.9**	12.5
Loans to individuals	1.1	22.7	18.6	13.5
Loans to corporates	1.1	7.3	5.8	9.9
Total overdue debt, o/w:	3.5	1.9	20.1	16.3
Individuals	-1.0	-10.4	0.5	22.0
Corporates	2.7	7.8	25.9	13.6
Individuals' funds	10.4	6.3	9.7	4.2
Corporates' funds	4.9	5.4	4.7	14.4

Balanced scorecard of pandemic's influence on selected range of sectors (1/2)

Period	2019	2020	2021	2022-2023	2020-2023
Weight in Balanced scorecard	--	0.4	0.3	0.3	1.0
Industry/Segment (scale: 1-5) | Horizon	**Pre-Coronavirus**	**Pandemic, Year 1**	**Short-term**	**Mid-term**	**Total**
Extraction, oil & gas	**2**	**2**	**2**	**3**	**2.3**
Extraction, non- oil & gas	**3**	**2**	**3**	**3**	**2.6**
Manufacturing	**3**	**2**	**2**	**3**	**2.3**
Food & beverages	4	4	4	3	**3.7**
Textile & apparel	3	3	3	3	**3.0**
Wood products	4	2	2	3	**2.3**
Pulp, paper & printing	3	3	3	2	**2.7**
Oil products	3	2	2	3	**2.3**
Chemicals	4	4	4	4	**4.0**
Pharmaceuticals	5	5	5	4	**4.7**
Resins & plastics	3	3	3	4	**3.3**
Building materials	4	2	3	3	**2.6**
Metal products	3	3	3	3	**3.0**
Computers & electronics	4	3	3	3	**3.0**
Machinery & equipment	4	2	2	3	**2.3**
Transportation equipment	4	2	2	3	**2.3**
Furniture	3	3	3	3	**3.0**
Medical equipment	5	5	5	4	**4.7**

Color legend	1.0-1.4	1.5-1.9	2.0-2.4	2.5-2.9	3.0-3.4	3.5-3.9	4.0-4.4	4.5-5.0

Balanced scorecard of pandemic's influence on selected range of sectors (2/2)

Period	2019	2020	2021	2022-2023	2020-2023
Weight in Balanced scorecard	--	0.4	0.3	0.3	1.0
Industry/Segment (scale: 1-5) | Horizon	**Pre-Coronavirus**	**Pandemic, Year 1**	**Short-term**	**Mid-term**	**Total**
Agriculture	4	4	4	3	**3.7**
Retail trade	3	2	2	3	**2.3**
Cargo transportation	3	2	2	3	**2.3**
Construction	3	2	2	3	**2.3**
IT & Communication	4	4	4	4	**4.0**
Personal services	3	1	2	3	**2.3**
Delivery services	4	4	4	3	**3.7**
Entertainment	4	1	2	3	**1.9**
Tourism & Hospitality	4	1	1	2	**1.3**
Restaurants & Catering	3	1	2	2	**1.6**
R&D, Innovation	4	3	3	4	**3.3**
Healthcare services	5	4	4	5	**4.3**
Banking & Insurance	3	2	2	3	**2.3**
Education	3	3	3	3	**3.0**
Repair services	3	2	3	3	**2.6**
Utilities	3	3	3	3	**3.0**
Passenger transportation	3	1	2	3	**1.9**

Color legend	1.0-1.4	1.5-1.9	2.0-2.4	2.5-2.9	3.0-3.4	3.5-3.9	4.0-4.4	4.5-5.0

Comments on Balanced scorecard methodology

- The scores are assigned on a scale of 1 to 5, and the higher the score, the better the outlook
- The colors are assigned in line with the traffic light color pattern: thus, the closer to the red end of the color spectrum, the worse; the closer to the bright green end, the better. Yellow means generally safe/stable (not a warning sign!)
- Although the scores are difficult to quantify in terms of exact measurements, as each sector contains numerous, very diverse segments, here are the general principles:
  - ✓ 5 – output growth at the level of tens of percentage points (pps) y/y, or generally very robust
  - ✓ 4 – growth somewhere from 3-4% y/y (above average for the Russian economy) to 10-12% y/y, or generally robust/ above average
  - ✓ 3 – growth in the lower single-digits, or marginal declines (just below zero), after robust growth in previous years (thus, it may have plateaued and/or is affected by the high base)
  - ✓ 2 – declines from lower single-digits to around 10% y/y (the latter, if rather strong readings had been observed earlier, per comments on the previous category)
  - ✓ 1 – output contraction at the level of tens of pps y/y
- Scores for 2020 are assigned, based on latest available data, usually full-year, or for 9 or 11 months
- Our base scenario, considering our focus on working in the healthcare sector, and experience in dealing with the latest and other known coronaviruses, is that there will be several waves of the epidemic (three major ones, most likely). The overall duration of the acute phase of the pandemic is expected to make up around three years from the start of the outbreak, i.e. from late 2019
- We are also mindful of the fact that such viruses sometimes disappear suddenly or become less aggressive (only to come back stronger and more effective in several years or even decades). This is not our base case assumption now, but still, it is important to think in scenarios, and make plans for the business accordingly

Russian economy should normalize as the pandemic eases eventually, but where will long-term breakthroughs come from? Opportunities still few and far between, so place your bets wisely!

- After two Covid-19 waves in 2020, third and subsequent waves remain highly likely in 2021-2022, **dampening recovery prospects for a lot of sectors.** Performance can thus be very uneven, for some time to come, due to government restrictions and market inhibitions
- **Sectors driven by import substitution are expected to recover faster/ stay robust longer,** pending a demand rebound. E.g. computers & electronics, machinery & equipment, R&D and innovation, chemicals, etc.
- **Sectors boosted now by crisis demand are expected to return to normalized performance** in the long run. E.g. food & beverages; agriculture; delivery services; textiles; pulp, paper & printing, etc.
- **Some sectors that are holding up** fairly well so far, coming off of strong performance in previous years, **may turn sour** due to demand weakness. **But they should recover to generally positive readings** from 2022 onwards, depending on the pandemic situation. E.g. textile & apparel, building materials, cargo transportation, etc.
- **Certain sectors will be supported by additional infrastructure investments**, including in the framework of emergency response and situation planning. **But growth therein should normalize, slowing in the long run.** E.g. construction, building materials, metal products, certain chemicals and pharmaceuticals, etc.
- **Outperforming industries may be a bit tricky,** as pent-up demand in some segments may be offset by lack of attention and investment in others. E.g. in healthcare, medical equipment and drugs, chemicals, IT, etc.
- Word of caution: **sectors enjoying increased attention now may also see severe competition and lower margins** in the long run. E.g. healthcare, IT, online services, etc. Thus, thorough business planning is needed to succeed!

- **Opportunities still abound in manufacturing.** Especially as government support for import substitution and production localization keeps strengthening, and **export opportunities diversify amid RUB weakness.** As usual, such decisions need to be supported by thorough market analysis and forecasting
- By the same token, we expect R&D and innovation to become all the more important for the local economy. Thus, **partnering with R&D institutes and innovators may turn out to be a good bet**, also utilizing government stimuli
- **Digitization is here to stay,** as both hardware and software solutions may be highly lucrative (minding competition)
- Now may be the time to optimize sales & distribution channels, **focusing on local partners who are the most motivated to sell your products.** And of course, **excellent service quality can become a key differentiator**!

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