September 3, 2019

Far Eastern Federal District — long-term debt financing needed

Sources of budgetary investments for the regions of the Far Eastern Federal District

This research has been prepared for the Eastern Economic Forum 2019

- **Budgetary investments are a key source of investment for the underfunded Far Eastern Federal District.** In certain years, budgetary investments account for up to half of total investment in FEFD regions with a low level of industrial development, while per-capita investment is below the national average. Although the Far Eastern macroregion has a significant need for investment, the share of investments financed by regional budgets is lower than the national average, having fallen steadily since 2013.

- **An alternative to the state?** The population of the FEFD is in decline due to the region's harsh climate, underdeveloped infrastructure and other problems. Major investments in socially important projects — currently financed primarily by budgetary funds — are needed to overcome these issues, but infrastructural development must take priority in order to attract private investors.

- **Transfers — big opportunities and specific use.** Infrastructure projects cannot be financed in full by transfers from the federal budget because the volume of funding is insufficient and co-financing on the part of the regions will lead to increased budgetary expenditures. In addition, non-target transfers that are spent on current consumption make up a significant part of transfers.

- **Own revenues are insufficient.** Far Eastern regions expect expenditures, including capital expenditures, to grow by RUB 131 bln in 2019. According to ACRA's assessments, growth of total revenues will not exceed RUB 50 bln. FEFD regions held a little over RUB 50 bln on their accounts at the start of 2019, with three regions providing for the largest part of these funds. This means potential budget deficits will once again be partially covered by borrowings.

- **The FEFD may need to borrow RUB 180 bln over the next three years.** This includes funds for covering regional budget deficits and refinancing the FEFD's debt obligations. ACRA estimates that the macroregion will have to refinance around 65% of its debt as of January 1, 2019.

- **Are bonds a challenge?** At 15%, the share of bonds in the FEFD's total debt obligations is insignificant, even in view of the regional fixed income market's low level of development (the average national share was 25% in 2018). Although bonds are not a popular instrument due to complicated buyback and/or early redemption procedures, in the current

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circumstances they offer the sole possibility of structuring the debt repayment schedule with minimum risk of refinancing.

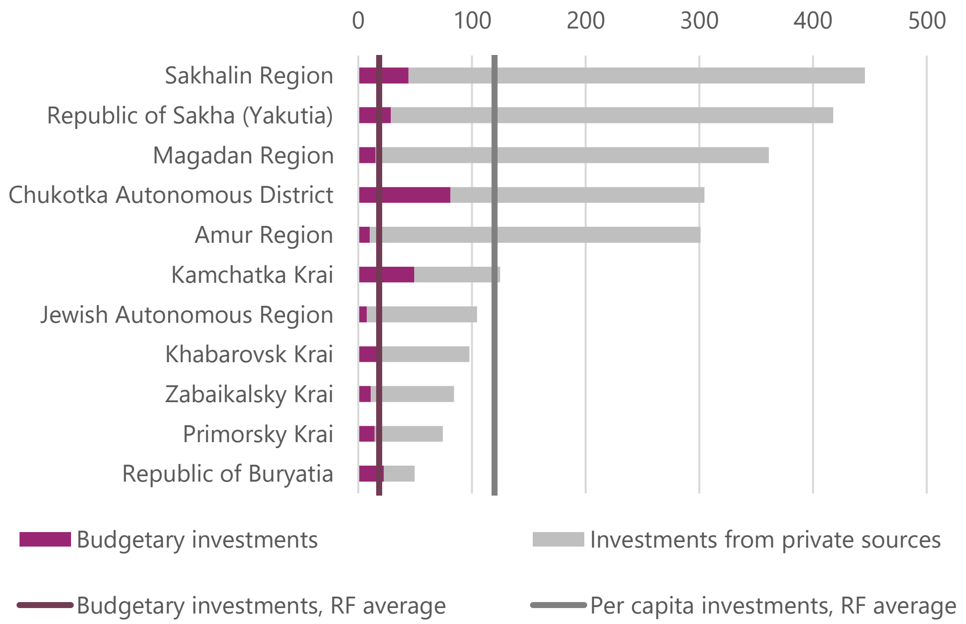
- **Loans are more affordable, however interest in auctions has fallen.** The difference between interest rates on bank loans and OFZ yields shrank in 2018 vs. 2017 as a result of limitations introduced by the regulator. Interest in auctions has waned for the same reason. However, the average spread between bank loan interest rates and OFZ yields over a comparable period is higher than the spread between the yields on regional bonds and OFZs, even despite the cap on maximum lending rates.

- **Favorable conditions are being created for placement of long-term bond loans.** A combination of the Bank of Russia's key rate cuts, the subsequent reduction in yields and high investor demand for government securities is creating favorable conditions for regions to finance infrastructure development and simultaneously improve debt structure.

Budgetary investments are a key source of investment for the underfunded Far Eastern Federal District

Historically, Far Eastern regions have differed in terms of per capita investment in fixed assets. Subjects of the FEFD with the highest share of extractive industry in GRP and low population density, such as the Sakhalin and Magadan Regions, the Republic of Sakha (Yakutia), and the Chukotka Autonomous District, attract the largest volume of per capita private investments. Budgetary investments often form a significant share of overall investment in regions where the industrial sector plays a minor role. These regions include the Republic of Buryatia[1], Kamchatka Krai, and the Chukotka Autonomous District despite its extractive industry. In addition to this, the state was the main investor in the Primorsky Krai during preparations for the APEC summit, and, until recently was the main investor in the Jewish Autonomous Region, where in 2015 the share of budgetary investments equaled 47%.

Figure 1. Extractive industry regions attract higher per capita private investment, data for 2018, thousand rubles



Source: Rosstat, ACRA's calculations

Oil and gas projects in the Sakhalin Region receive the lion's share of foreign direct investment in the FEFD.

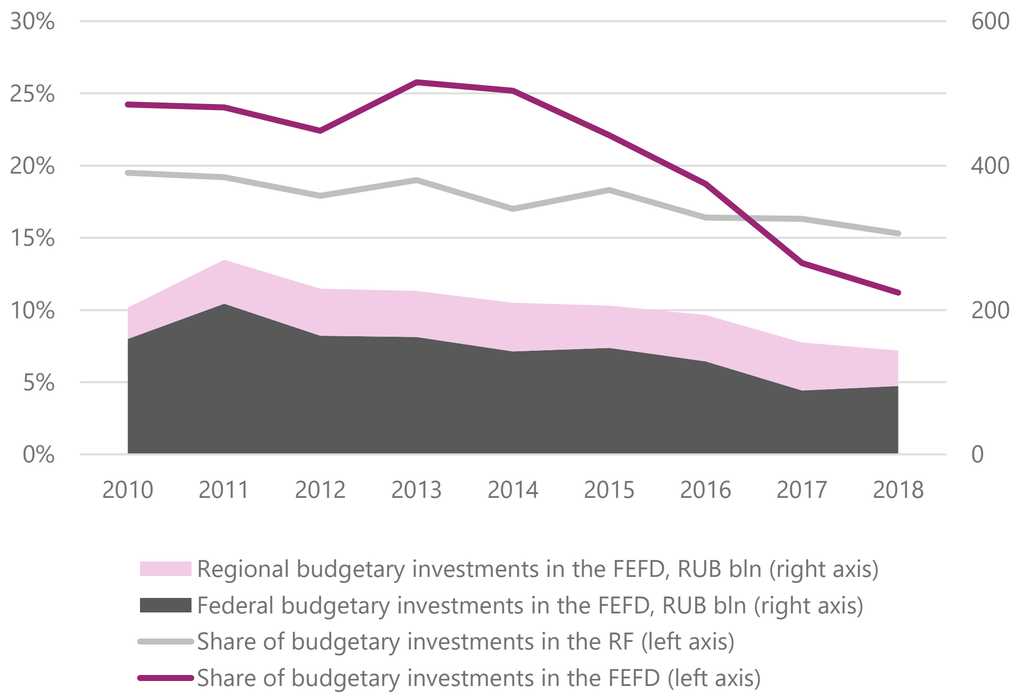
The Sakhalin Region leads the Far Eastern macroregion both in terms of per capita investment and by volume of foreign direct investment (in 2017 it was the recipient of more than 75% of all foreign direct investment in the FEFD).

The average level of budgetary investments (from all budgets, including the federal one) into the FEFD is in line with the average national indicator. However, the macroregion requires a higher level of investment given the unequal distribution of budgetary investments across the regions of the FEFD, higher cost of living, and limited transport accessibility.

[1] The Republic of Buryatia and the Zabaikalsky Krai, which were part of the Siberian Federal District until November 2018, are retrospectively regarded as part of the Far Eastern Federal District for the purpose of this research.

The average volume of investments in the regions of the FEFD financed by regional budgets lags behind the national average, having steadily declined since 2013. In 2018, the share of investments in the FEFD from regional budgets amounted to 3.4% vs. the average national indicator of 6.8%, while from 2010 to 2018 it averaged 5.5% vs. around 7%, respectively.

Figure 2. Share of budgetary investments in the regions of the FEFD is falling



Source: Rosstat, ACRA's calculations

An alternative to the state?

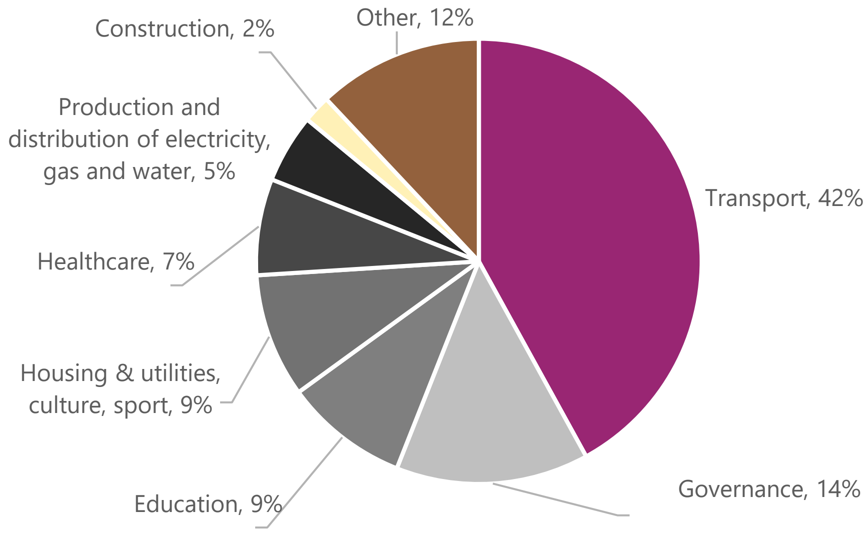
At the start of 2019, the FEFD had a population of 8.2 mln, having declined by 360,000 — the equivalent of the combined population of the Kamchatka Krai and the Chukotka Autonomous Region — since 2005. This is the most significant decline among Russia's Federal Districts in percentage terms. All regions of the Far East, with the exception of Buryatia and Yakutia, suffer from population decline. There are a number of reasons for this, including the harsh climate in the Far Northern part of the macroregion and insufficient development. For example, as of 2017, the road density of the Primorsky Krai, which is the most populous region of the FEFD and has the mildest climate, was only 90 km per 1,000 km^2. In comparison, regions in European Russia on the same latitudes, such as the Krasnodar Krai and the Stavropol Krai, have respective road densities of 463 and 272 km per 1,000 km^2.

The state needs to focus on developing social and transport infrastructure to halt the depopulation of the Far Eastern macroregion. Budgetary investments are normally used to achieve these goals. For example, budgetary funds make up around 70–80% of total investment in education and healthcare. The transport sector is the recipient of half of budgetary investments, and these funds make up a third of all investment in transport infrastructure. In addition to reversing the outflow of population from the Far East, infrastructure must be developed to make the region more attractive to investors in non-extractive sectors of the economy.

In 2017, the Far Eastern Federal District had 48 private educational institutions (none of which were in the Kamchatka Krai, Magadan Region, Sakhalin Region and Chukotka) vs. 352 in the Central Federal District. The share of students at private educational institutions in the FEFD is two times smaller than in the Central Federal District and 16% lower than the national average.

The FEFD had 201 private healthcare organizations in 2016 out of 3,353 in Russia, which equates to second last place among the Federal Districts by level of private healthcare coverage.

Figure 3. The main share of budgetary investments is channeled into social and transport infrastructure, 2016 data[2]



Source: Rosstat, ACRA's calculations

The volume of expenses on projects in the Far East, sparsely populated regions and their remoteness seriously hinder the growth of private investment in the socially important sphere, which in the long term will prevent it from substituting budgetary funds. Unlike other Russian regions where private investment in infrastructure is slowly growing, it is clear that the state will continue to act as the main investor in the development of social and transport infrastructure in the FEFD.

Transfers: big opportunities and specific use

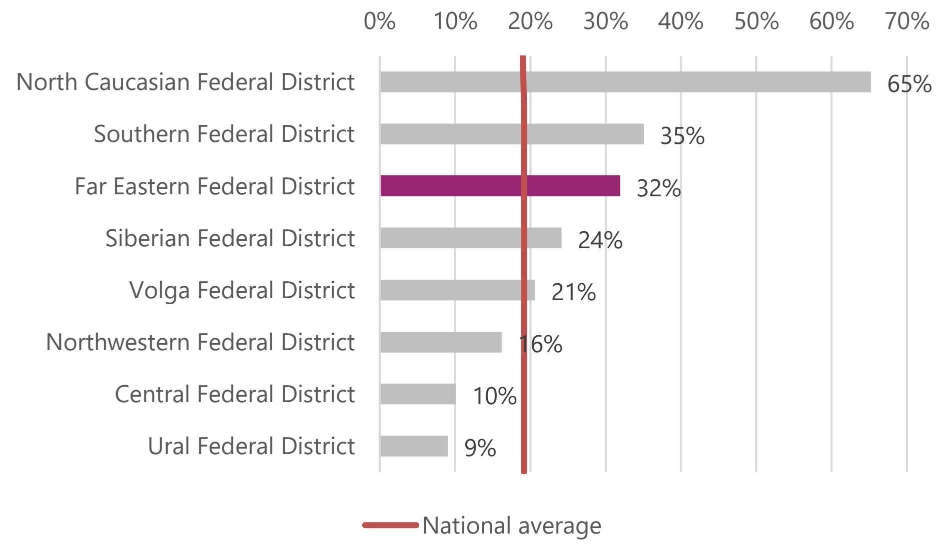
Using inter-budget transfers is possibly the most optimal method for Russian regions to finance investments because these funds are provided free of cost. As a rule, a low level of co-financing is required on the part of the regional

[2] Latest available data.

budget. This may start from 5%[3] depending on the self-sufficiency of the regional budget. Major investment projects, such as the creation and modernization of infrastructure in Vladivostok for the 2012 APEC Summit, were carried out solely with federal budget support.

In 2018, the share of inter-budget transfers in the overall budget revenues of all the regions of the FEFD (except the Sakhalin Region) exceeded the average national indicator (19%). In several regions it exceeded 40% (Kamchatka Krai — 63%, Republic of Buryatia — 54%, Chukotka Autonomous District — 48%, Zabaikalsky Krai — 44%, Jewish Autonomous Region — 41%). The participation of the subjects of the FEFD in achieving the national projects set forth in the latest May Directive[4] provide regional administrations with additional opportunities to receive transfers from the federal budget, including to finance capital expenditures.

Figure 4. Regions of the FEFD on average receive more transfers than other Russian regions, data for 2018, % of total revenues



Source: Federal Treasury, ACRA's calculations

A large share (more than 20%) of the Sakhalin Region's capital expenses is financed by the regional budget. The region's overall capital expenses in 2016–2018 accounted for 40% of the capital expenses of all regions of the FEFD in the same period.

Transfers from the federal budget on average amounted to almost a third of budget revenues of the Far Eastern regions in 2018. It is noteworthy that a large part of these transfers was non-target transfers, which can be spent at the recipient's discretion and do not need to be accounted for. Local governments can and do use non-target transfers to cover current expenses instead of investing them in development: in 2016–2018, the FEFD's average capital expenses[5] (excluding the Sakhalin Region) stood at around 8%, while the average national indicator was 13%.

The Russian government pays close attention to the FEFD's infrastructure financing needs. In connection with this, the state program Socio-economic Development of the Far Eastern Federal District was put together, which annually allocates RUB 31 to 48 bln from the federal budget in 2019–2025 for

[3] Subsidiaries are co-financed; the level of co-financing is calculated in accordance with Russian Federation Government Ordinance No. 999, dated September 30, 2014; exceptions are possible.
[4] Executive Order of the President of the Russian Federation dated May 7, 2018 No. 204 "On the Russian Federation's national goals and strategic development tasks until 2024".
[5] Including capital expenses on government property and subsidies for co-financing them, overhaul, and research and development.

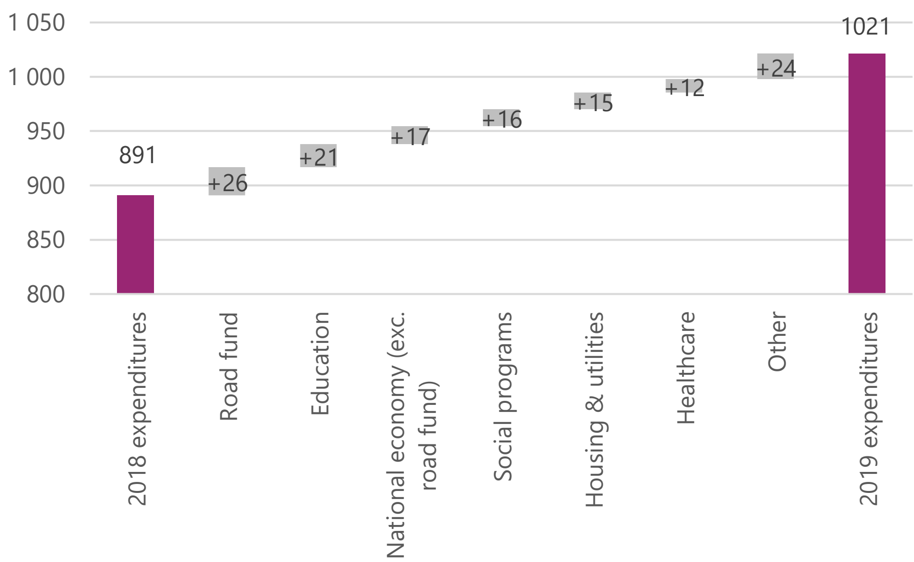
the subjects of the macroregion. These funds will be used to establish and develop priority social and economic development areas, implement investment projects, and so on.

The Russian government has also announced the provision of RUB 95 bln from the federal budget until 2021 to finance the FEFD's social infrastructure. This, however, amounts to less than 4% of the aggregate expenses of the Far Eastern regions planned for 2019–2021, and will hardly be sufficient in view of the needs of the FEFD.

Own revenues are insufficient

Although subsidies require a low co-financing percentage, they still lead to a growth in regional budget expenditures, but the ability to increase expenditures using internal resources is determined by the state of the budgets. The subjects of the FEFD have legislated a significant (around RUB 131 bln, or 15%) increase in expenses for 2019 compared to 2018, which takes into account the allocation of additional funds for infrastructure projects that require investment: road construction (+RUB 26 bln or +43%), education (+RUB 21 bln or +12%), social programs (+RUB 16 bln or +8%), and healthcare (+RUB 12 bln or +17%).

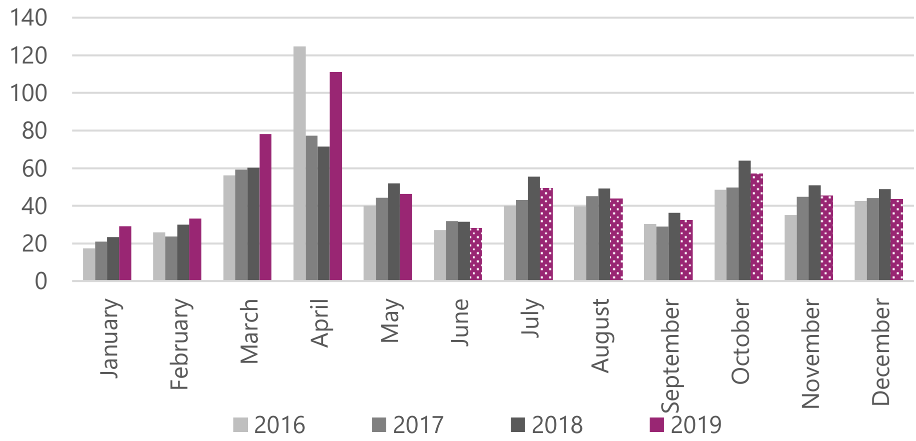
Figure 5. Budgetary expenses in the FEFD are growing, RUB bln



Source: Federal Treasury, ACRA's calculations

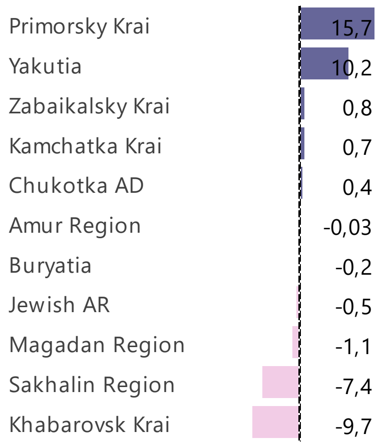
Tax and non-tax revenues (TNTR, own revenues) grew by 36% in January-April 2019 year-on-year, primarily due to the performance of final profit tax settlements for the previous year in March-April 2019. However, ACRA assumes TNTR will decline by 10% year-on-year in the remaining months of 2019. We expect overall growth of TNTR in the Far Eastern regions to equal around 4% year-on-year, while transfers will increase by 7% in accordance with official budget execution parameters. The budget revenues of Far Eastern Regions will increase by RUB 50 bln in 2019.

Figure 6. TNTR may decline in H2 2019, RUB bln



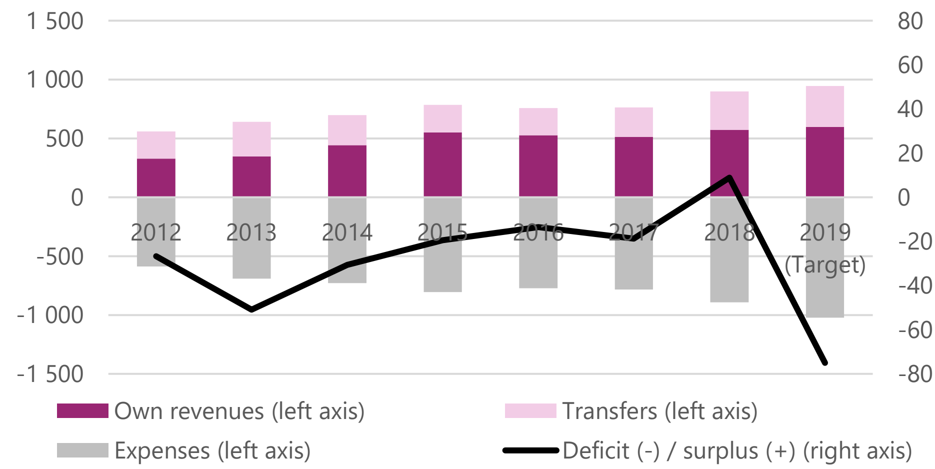
Source: Federal Treasury, ACRA's calculations

Financial result of FEFD regions in 2018, RUB bln:



Nevertheless, these revenues cannot cover planned expenses for 2019 and as a result, regions of the FEFD will again finish the year with budget deficits. Despite the fact that 2018 saw the first overall budget surplus in the macroregion (RUB 8.9 bln) in seven years, six regional budgets recorded deficits. Some Far Eastern regions continue to require financing to cover deficits despite the overall positive financial result.

Figure 7. 2019 may end in another deficit for the FEFD, RUB bln



Source: Ministry of Finance of Russia, FEFD regions, ACRA's calculations

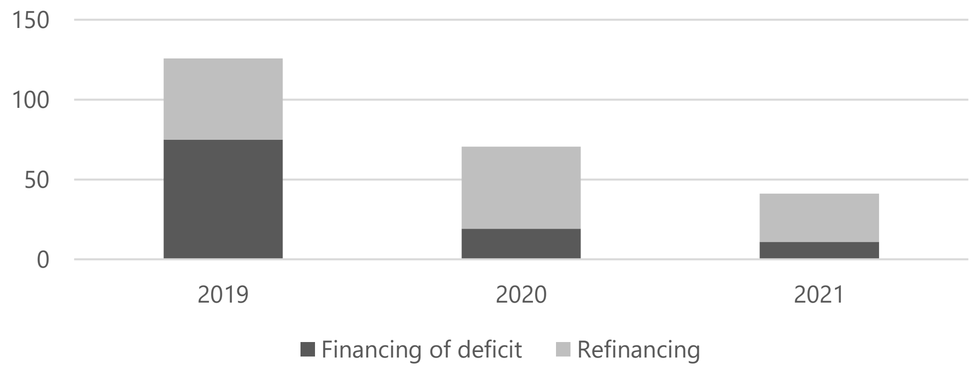
The need to finance current expenses coupled with their low flexibility limits the capacity of local governments to reallocate revenues in favor of co-financing capital expenses. ACRA's experience, however, indicates that even when faced with insufficient own revenues, regions prefer to maintain capital transfers from the federal budget and utilize reserves or attract debt financing.

At the start of 2019, the account balances of the FEFD's regions contained a little over RUB 50 bln, which is only the equivalent of their expenses for a three-week period. This is clearly insufficient to cover a possible deficit in 2019. It is noteworthy that in addition, these reserves are not distributed equally across accounts, with 86% held by three regions — the Primorsky Krai (51% or RUB 25.6 bln), Yakutia (19% or RUB 9.5 bln) and the Sakhalin Region (16% or RUB 8.1 bln). Five regions (Buryatia, the Magadan Region, the Jewish Autonomous Region, the Chukotka Autonomous District and the Zabaikalsky Krai) have minor balances of less than RUB 1 bln each. The remaining regions do not possess any reserves and will have to raise financing via bank loans and bond loans.

The FEFD may need to borrow RUB 180 bln over the next three years

ACRA estimates that the regions of the FEFD will record deficits in 2019–2021 and in connection with this, regional governments will need to raise financing to cover the budget deficit and refinance debt. We have calculated that around 65% of debt held by the regions of the FEFD as of January 1, 2019 must be refinanced in the aforementioned period. Data on the regions' deficits as per the legislation on regional budgets for 2019–2021 was used to assess the need for financing. The planned deficit for 2019 is RUB 75 bln (this coincides with ACRA's estimates); in 2020 and 2021 it will fall to RUB 19 and 11 bln, respectively. In view of the revenues that the regions have accumulated in previous years, they will require around RUB 180 bln in debt financing over the next three years.

Figure 8. FEFD's overall need for debt financing*

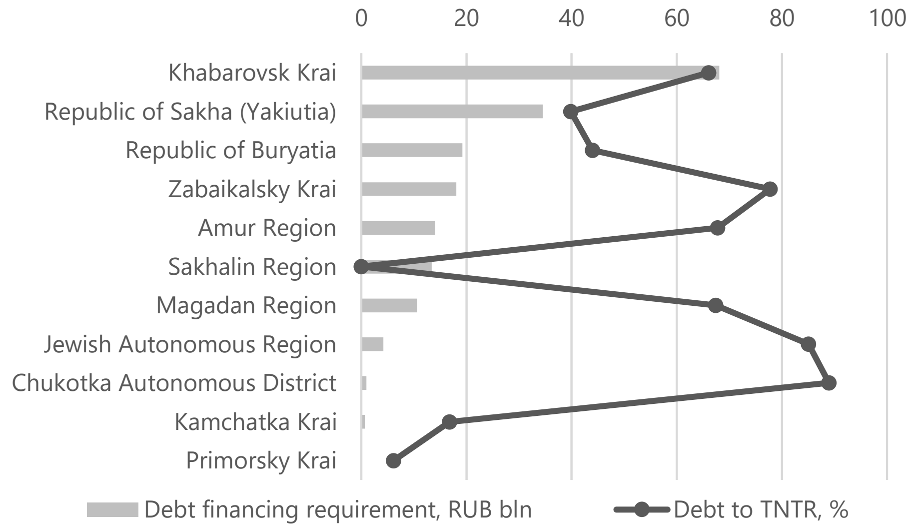


* Size of deficit of regional budgets of the FEFD (excluding regions with budget surpluses and reserves) and volumes of planned debt redemption in 2019–2021

Source: Ministry of Finance of Russia, cbonds.ru, ACRA's calculations

The Khabarovsk Krai is most in need of debt financing in the aforementioned period in absolute terms — around RUB 70 bln, of which more than 60% will be used to refinance debt obligations and around 40% will cover the region's budget deficit. Yakutia and Buryatia, where the debt to TNTR ratio was below 50% at the start of 2019, and the Sakhalin Region, which has operated debt-free since 2014, also require significant volumes of financing to cover budget deficits. Account balances formed at the start of the year may be sufficient to cover the Primorsky Krai's deficit without resorting to borrowing. Other regions of the FEFD require debt financing mainly to refinance existing debt because they plan to finish the year with either balanced budgets or minor deficits.

Figure 9. Potential borrowings of FEFD regions in 2019–2021 and debt load as of January 1, 2019



Source: Ministry of Finance of Russia, cbonds.ru, ACRA's calculations

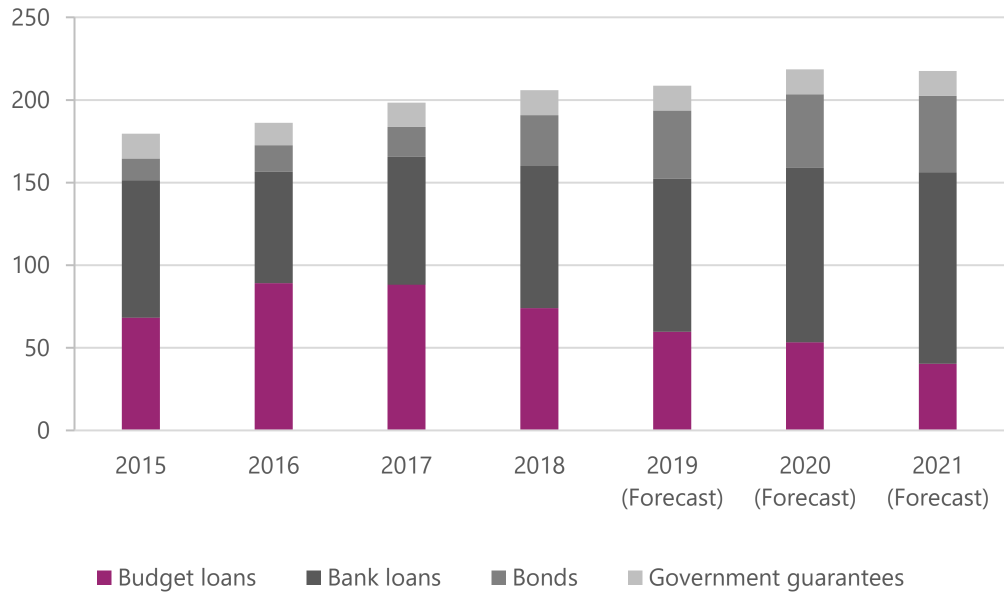
Are bonds a challenge?

The regions of the FEFD have a minor presence on the fixed income market, having issued a mere 5% of current bonds in the regional market. Yakutia, the Khabarovsk Krai, the Magadan Region and the Kamchatka Krai are the only regions that issue bonds. The Republic of Sakha (Yakutia) is the sole region in the Far East that has had a continued presence on the fixed income market over the past few decades. The other regions have either made one-off issues or not issued at all.[6]

The regions of the Far East have overwhelmingly opted for bank loans to finance their debt in the past five years — as of January 1, 2019, loans accounted for 42% of overall debt while bonds only made up 15%. The remaining portion of debt is made up of budget loans (36%), which are to be gradually substituted by commercial debt and guarantees (7%). ACRA estimates that by the end of 2020, the FEFD's ratio of commercial to non-commercial debt will have shifted to 70:30, with bank loans continuing to account for the largest part of commercial borrowings.

[6] The regions of the FEFD were among the Russian regions that issued so-called agribonds in 1997 to refinance debts to the federal budget.

Figure 10. FEFD prefers loans, RUB bln



Source: Ministry of Finance of Russia, FEFD regions, ACRA's calculations

Share of bonds in debt obligations as of January 1, 2019:

SiFD – 44%,

UFD – 34%,

NFD – 27%,

CFD – 25%,

VFD – 23%,

FEFD – 15%,

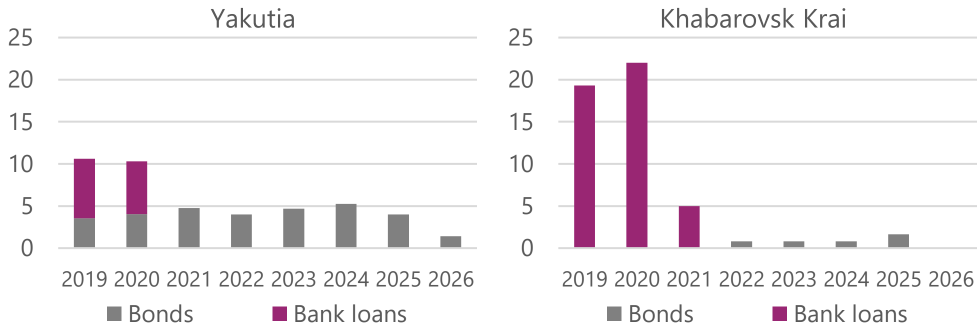
SoFD – 13%,

NCFD – 10%.

At 15%, the share of bonds in the FEFD's total debt obligations is insignificant, even in view of the regional fixed income market's low level of development (for comparison, the average national share in 2018 was 25%). ACRA is of the opinion that regional administrations take little interest in bonds for two reasons: complex procedures for placing bonds and complex buyback and/or early redemption procedures. As for the latter, it can be noted that a trend of sub-sovereign debt amortization has taken shape on the Russian market. Although this partially compensates for the inability to buy back or redeem bonds in the event of an interest rate decline, it also inconveniences investors as they are forced to refinance funds received upon partial redemption of the nominal value. Loans, on the other hand, are a shorter-term instrument that can be repaid ahead of schedule, which is why they appear to be simpler and more convenient in a market characterized by declining interest rates. The apparent inconvenience of bond loans, however, allows the borrower to structure the repayment schedule to minimize refinancing risk. For example, the weighted average maturity of bonds placed by Russian regions in 2018 amounted to 6.8 years (excluding amortization of debt), while the weighted average loan period for the same regions was 2.4 years. It is also worth mentioning that the use of loans may result in the accumulation of a stack or large volume of short-term debt.[7] Bonds do not possess this disadvantage.

[7] Legislation also highlights the risk of refinancing: the new version of the Budgetary Code requires the share of short-term debt to be assessed when establishing the debt sustainability of subjects of the Russian Federation.

Figure 11. Bonds reduce the refinancing risk, RUB bln*



* The graphs illustrate the repayment of potential commercial debt of the Republic of Sakha (Yakutia) and the Khabarovsk Krai on the assumption that all credit lines available as of January 1, 2019 were drawn by the regions.

Source: cbonds.ru, ACRA's calculations

Loans are more affordable, however interest in auctions has fallen

Over the past two years, on the one hand the regional bank loan market has seen a reduction in interest rate spreads to the yield of federal loan bonds compared to 2017 levels, while on the other hand, interest in auctions has fallen as indicated by the increasing number of failed bond offerings. The share of unsuccessful offerings was 5% in 2017, 19%[8] in 2018 and 47%[8] in January–July 2019. We associate these changes with the restriction imposed by the Ministry of Finance of Russia's restructuring of budget loans (ACRA estimates that at least 70 Russian regions and no less than half of the regions of the FEFD took part in the restructuring). This limitation prevents regions from borrowing from banks at interest rates higher than the key rate +1%. ACRA expects a second phase of restructuring to take place, which will push debt repayments back another five years (until 2029), so it is possible the limitation will be in place for some time. The low rates offered by bonds coupled with the lack of this restriction may entice a number of regions to enter the fixed income market.

However, the average spread between bank loan interest rates and OFZ yields over a comparable period is higher than the spread between the yields on regional bonds and OFZs, even despite the cap on maximum lending rates. According to ACRA's calculations, the spread of coupon rates on bonds placed in 2018, weighted by volume of issue, to the yield of five-year OFZs was 44 bps, while the average weighted spread of interest rates on loans attracted in 2018 by the same regions to two-year OFZs was 99 bps. Only three bond placements (Yakutia, the Belgorod Region and the Yaroslavl Region) have taken place so far in 2019[9]. Their weighted average life (excluding amortization of debt) was 6.4 years and the spread of coupon rates to the yield of five-year OFZs was 90 bps. In 2019, loans have been attracted for an average of 1.3 years; the spread to one-year OFZs equaled 143 bps.

[8] Excluding failed offerings of the Republic of Mordovia.
[9] January 1, 2019 to August 12, 2019.

Favorable conditions are being created for placement of long-term bond loans

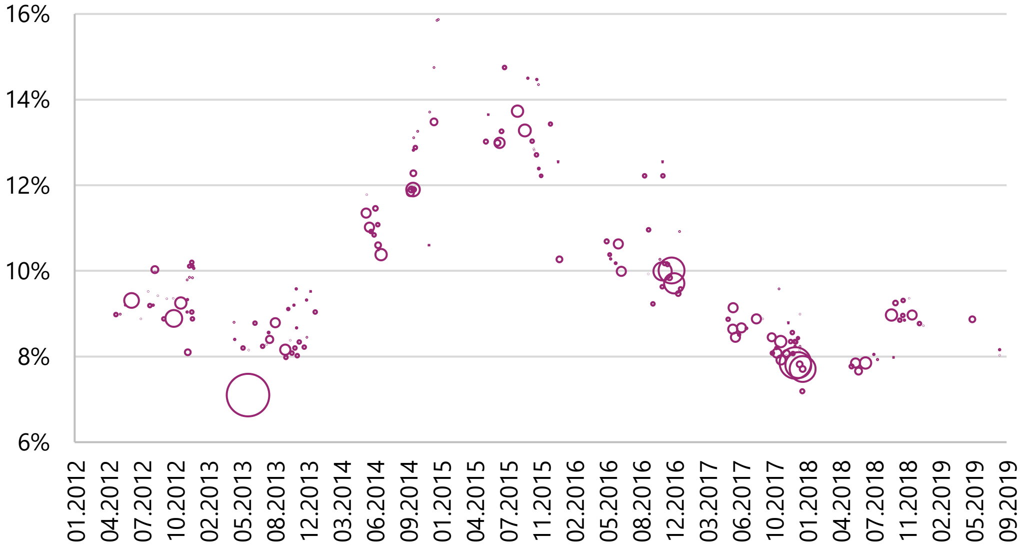
The volume of bonds placed by Russian subjects and municipalities hit a seven-year low of RUB 94.4 bln in 2018, whereas the year before placements totaled RUB 263.9 bln. The decline in the volume of bonds offered by regions and municipalities stems from three factors.

Firstly, regions' need for debt financing has declined on the back of higher budget revenues. In 2018, profit tax revenues grew by RUB 576 bln, which allowed regions to achieve a budget surplus of RUB 492 bln.

Secondly, the federal government took action to support regions and lessen their debt load — the restructuring of budget loans in late 2017[10] reduced regions' need for new refinancing and additionally, they committed to lowering the debt burden.

Thirdly, regions and municipalities were less willing to offer bonds due to higher yields in late 2018 compared to the same period in 2017, and instead opted to wait for rates to fall in the future.

Figure 12. Yields and volumes of bond placements* of regional and municipal governments



* The size of circles is proportional to placement volume.

Source: cbonds.ru

The Bank of Russia cut its key rate from 7.75% to 7.25% per annum in June-July 2019. According to base scenario of ACRA's 2019–2023 macroeconomic forecast, the key rate will remain unchanged until late 2020 and may be reduced to 6.75% in 2021. The key rate may stand at 9.25–10% if the Russian economy develops in line with the pessimistic scenario, while the optimistic scenario places the rate a little lower (0.25–0.5%) than the base scenario. In view of these forecasts, the potential savings produced by servicing debt refinanced at lower rates will not compensate for high refinancing risks if the economy develops in line with the unfavorable scenario.

[10] The repayment periods of these loans were extended.

Further detail is available in ACRA's macroeconomic forecast World trade tensions may escalate to economic downturn by late 2019 from July 23, 2019.

The number and volume of placements are currently behind the indicators for 2018, despite the Bank of Russia's key rate cut and the fall in bond yields that followed. There have only been three placements to a total of RUB 12 bln so far in 2019, yet over the same period in 2018, five placements took place amounting to RUB 38.5 bln. Regions have cut back on borrowing this year in connection with increased revenues since the start of 2019, with regional budget revenues growing by 15% in 5M 2019 compared to the same period in 2018 mainly due to profit tax.

It should be noted that the regions' borrowings in H1 2019 may not be representative in an annual context due to the seasonality of the sub-federal bond market, where the majority of offerings are made toward the end of the year. The three placements so far in 2019 show that investors are interested in these securities. In particular, Yakutia's bonds were oversubscribed by eight times and the Belgorod Region's placement had a threefold oversubscription (issues were placed in full).[11]

In view of the above, it is possible to talk about favorable market conditions for Russian regions to issue long-term bond loans as there is high demand for these securities coupled with record-low interest rates. The regions of the FEFD, whose total debt financing requirements exceed RUB 100 bln this year (and at least RUB 180 bln on a three-year horizon), can be expected to bolster the volume of bond offerings if these conditions stay in place until the end of 2019. Long-term bonds will allow the regions of the FEFD to refinance budget loans and commercial debt while minimizing the future risk of refinancing and also serve as a source of long money to co-finance the national projects, including capital expenditure on infrastructure development.

[11] ACRA does not possess information about demand for the Yaroslavl Region's bonds.