Russia: The land of the bountiful giants

- Russia's state-owned sector has grown to a very sizable 50% or so of the overall economy. The financial links between state-run companies and the budget continue to strengthen.
- The state-owned sector co-finances the Russian government's most ambitious projects. This easy and ready supply of funding reduces the incentive to promote aggressive privatisation.
- The continued growth of the state-owned sector (both in terms of size and its importance to government finances) is making Russian financial flows more opaque and reducing the prospect of aggressive economic modernisation.

A growing state-owned sector

The Russian economic model is well known for the strong role played by government. State control of the most attractive sectors has been beefed up dramatically over the last decade, however. Government-owned companies dominate the country's main economic sectors. In 1998-99, the state ran less than 10% of total oil production; today, it controls 40-45%.

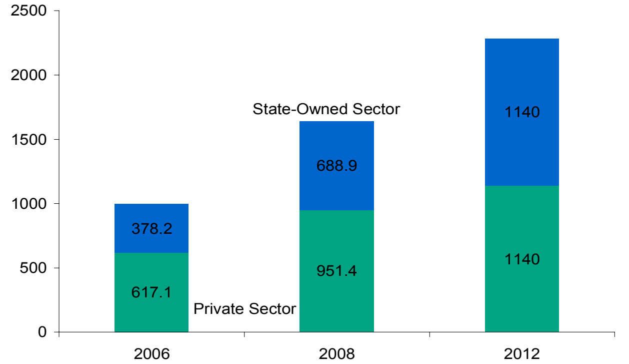
Nobody has managed to put a precise figure on the size of Russia's government-owned sector. In 2006, the Institute of Economy in Transition (the Egor Gaidar foundation) estimated it at 38% of Russian GDP. In 2008, the ministry of the economy estimated it at 40-45%. The ministry then said the share had reached 50% during the crisis of 2009 and it appears to have remained around that level. We do not expect this to change substantially in the coming years, despite the ambitious privatisation plans announced for 2012-15 and beyond. The current support of the state-owned sector for government projects may exceed potential privatisation income, strengthening the incentive to boost the state-owned sector rather than shrink it.

One team, one dream

It is not easy to analyse financial flows between state-owned companies and banks on the one hand and the budget on the other. However, it is pretty clear that fine line between government finances and the state-owned sector budget is becoming more blurred. In addition, the top management of the state-owned giants and the government are members of the same team (and fairly interchangeable), easing coordination between the government and the state-owned sector and ensuring mutual cooperation.

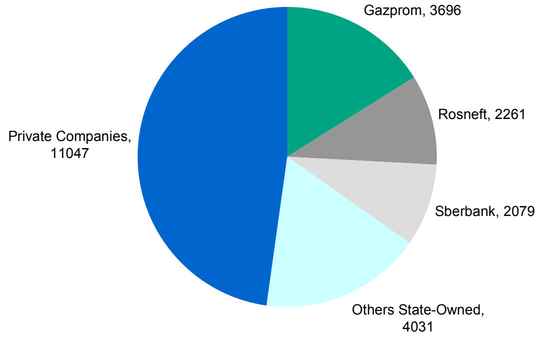
Statistical data show that efficiency in the government segment is lower than in the private sector, probably due to poor management. Labour productivity in the state-owned segment is more than 30% below the national average (Table 1). Government-sponsored management does not concentrate solely on profit maximisation, but usually juggles a number of auxiliary tasks (similar to the old practices of the USSR). The government usually encourages companies and banks to be 'flexible' in this regard, despite promises to increase efficiency. And government requests (often motivated by political or geopolitical factors) can be weighty. For example, to encourage Belarus to enter into the region's customs union and Common Economic Space, Russia gave it a natural gas-price discount that costs Gazprom c.USD 3.5bn a year. Gazprom was happy to buy 50% of Beltrasgaz, but it had to pay a pretty hefty USD 2.5bn for the pleasure. It is not clear how Gazprom

Chart 1: Russian GDP breakdown (USD bn)



Source: Russian Ministry of the Economy, BNP Paribas

Chart 2: Top 50 Russian listed companies by market capitalisation (RUB bn, Oct 2012)



Source: Micex, BNP Paribas

benefited from this move (aside from the geopolitical benefits to Russia in general). A similar example was seen in the banking sphere in 2011, when the Russian government instructed VTB to buy a controlling stake in Bank of Moscow (a top five bank) for RUB 143bn (USD 4.6bn), although the business rationale for the deal for VTB was not obvious.

It is not surprising that the idea of social responsibility (aggressively promoted by the government for all businesses) looks particularly overblown in the state-owned sector. The burden of major social projects is growing and affecting the core investment programmes of the state-owned companies. On the other hand, the greater government protection of the state-owned sector in times of economic and financial crisis and the much more favourable competitive conditions in 'normal' periods are pretty attractive reasons for retaining the *status quo*.

Social responsibility on demand

Russia's natural monopolies are the most 'cooperative' part of the state-owned sector, as the government sets the tariffs they can charge and, thus, substantially determines their profitability. It is not surprising that the Russian Railway Company (RZhD) and Gazprom are known to be the main cash cows for financing ambitious government projects. However, it is not easy to follow the trails of their spending on these projects in their balance sheets. The lion's share of their co-investment in government projects or on social spending is not linked to their core activities and tends to sit (and be hidden) in subsidiary balance sheets. Moreover, a detailed breakdown of spending is not available either. The complicated structure of the various affiliated businesses makes estimates very difficult. So, we have looked at only the biggest and most prominent programmes of the natural monopolies, which are the 'poster' projects of the Russian government.

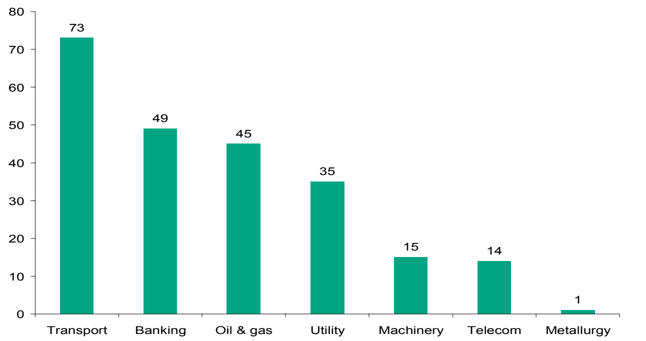
Flagship natural monopolies

Gazprom is the biggest company in Russia, nigh on a state within a state. As Russia's gas producers enjoy a much lower tax burden than the oil producers, Gazprom has been particularly involved in financing government projects, which the government considers a fair trade-off. Gazprom is the second-biggest investor in the 2014 Winter Olympic Games in Sochi after the federal government. The government is planning to finance Olympic projects worth RUB 466bn in 2011-14 (including RUB 314bn under the Sochi-14 Target Federal Programme). Gazprom, alone, spent RUB 44bn on the project in 2011 of a total planned input of RUB100bn (more than 21% of the federal budget outlay). Only RUB 31.5bn will be spent on the Dzhubga-Sochi gas pipeline, which could be considered to be associated with Gazprom's core business. The rest of the funds will go on ski resorts (RUB 36bn) and other infrastructural projects not related to the production or transportation of natural gas. Basically, Gazprom's non-core spending is a direct replacement for federal budget expenditure, to the tune of USD 2.2bn.

Gazprom's participation in another ambitious project, the APEC summit that took place near Vladivostok in September this year, was also impressive. Vice Premier Igor Shuvalov said that the forum cost a total of RUB 660bn, of which RUB 202bn (or USD 6.5bn) came from the federal budget. Gazprom's funding is estimated at a whopping RUB 300bn. Though the company officially invested in a pipeline system and the gasification of the region, current usage of the pipeline remains at slightly below 20% capacity (underlining that the project was motivated more by factors not related to the company's core business).

The World Cup soccer championship, which will be held in Russia in 2018, is likely to be even

Chart 3: State ownership by sector, 2011 (%)



Source: Interfax, BNP Paribas

Table 1: Relative labour productivity in public and private sectors (% of Industry Average), 2000

	Public sector	Private sector
Electricity	89.4	101.2
Oil & gas	28.7	111.2
Metals	69.5	102.3
Chemicals	55.2	107.6
Machinery	96.3	101
Wood	49.5	105.9
Construction Materials	72.9	101.7
Glass	38.6	102.8
Light industry	79	101.4
Food	71	103
Microbiological	96.6	102.4
Medical	86.3	103.1
Printing	109.6	91.2

Source: BNP Paribas

more expensive than the Sochi Winter Olympics. Gazprom (via its subsidiary GazpromNeft) is involved in building the Zenit Arena stadium in St. Petersburg, at an estimated cost of RUB 44bn. This investment will be probably be partially offset by tax credits and breaks.

These poster projects of the Russian government, alone, are 'costing' Gazprom USD 14.3bn in 2011-14, of which USD 3.7bn is not directly related to the production or transportation of natural gas. In addition, the investment in hotel infrastructure for the football World Cup is estimated at USD 11bn (2012-18) and we cannot rule out that Gazprom will be saddled with part of that burden. Meanwhile, Gazprom's 'sponsorship' of St. Petersburg's Zenit Football Club is another expensive exercise (it bought a majority stake in the club after it got into financial trouble; President Vladimir Putin is, coincidentally, a supporter). In 2012, the Russian Premier League club bought two players at a cost of EUR 80mn (USD 100mn), even though its revenues do not exceed USD 60mn a year and FIFA had asked clubs to rein in transfer fees. It is highly unlikely that such politically sensitive purchases could be made without the informal approval of the government.

On top of this, Gazprom has funded a number of social and charity projects, at an estimated cost of RUB 6.1bn in 2011. And it is not planning to cut this area of spending in 2012 and beyond. Also, over the past five years, Gazprom has spent RUB 17.8bn (USD 600mn) on its biggest social project, the sporting and cultural Gazprom for Children programme.

The Russian Railway Company, RZhD, is 100% state owned and the government subsidises the loss-making parts of its business. In 2011, this subsidy reached RUB 119bn, or USD 3.8bn. Still, RZhD has invested heavily in various Sochi-14 Winter Olympics projects. Although the main part of RZhD's investment has been associated with the modernisation, upgrade and construction of a new rail transportation network, the company was also asked to build a new road (with three tunnels and a 38km-long bridge). It has further built a hotel resort and participated in environmental projects (restocking rivers with 2.5 million new fish and planting 35,000 box trees). Although the details of the total RZhD investment budget for Sochi are unknown, for 2011-14, the company has set aside RUB 70.1bn (RUB 15bn, or USD 0.5bn, of which will go on projects not related to transportation or transport infrastructure). Initially, the government planned to 'reimburse' RZhD for this spending via a fiscal transfer, but for 2013-14, the federal transfer budget has been cut significantly.

Everyone must pay the piper

Although the natural monopolies are the most 'loyal', the other state-owned companies and banks also step up to the plate when it comes to the government's socially important projects. For example, oil giant Rosneft pays three times more taxes than Gazprom, but still funds ambitious social programmes in the regions where it produces oil, including the far north, to the tune of USD 0.7-1bn a year. The most prominent "socially oriented" project of the VTB banking group, for example, is the reconstruction and development of the Dynamo football stadium in Moscow and its environs into the renamed VTB Arena. The project was started in 2011 and is estimated to cost USD 1.3-1.4bn. According to the company's balance sheet, the cost to the bank of such 'associate' investments and non-core JVs is some USD 1bn a year.

Sberbank, meanwhile, controls a sizable share of banking loans to Russia's regions. Its regional lending portfolio totals RUB 268bn (USD 8.7bn) and a chunk of this portfolio is made up of loans motivated by social considerations and/or direct government requests. For example, Sberbank oversees a government programme to support the modernisation and upgrade of the housing and utility sector worth RUB 111.6bn, of which Sberbank's own share is sizable, at RUB 38.3bn (USD 1.2bn). We estimate the bank's non-core investments, aimed at reducing the federal government's direct spending, at about USD 1bn a year – similar to that of VTB Bank.

Non-core asset problem deepens

Opaque balance sheets are the natural consequence of the lack of transparency and complicated structure of the state-owned companies. There are several reasons, including historical ones, why non-core assets occupy such a sizable chunk of their business. And although these non-core assets and activities have generally tended to reduce efficiency and limit the resources available for the core businesses, the state-owned companies are in no rush to get rid of them.

Preserving the Soviet business model

Companies set up in the Soviet era (Gazprom, Russian Railway Company) had a hefty social mandate. In the USSR, the regional and federal giants realised that having their own hotels, restaurants, sports facilities and other services encouraged people to stay working for them. In the USSR, employment was close to 100% of the economically active population and wages were set by the government. The more sizable non-wage component of compensation made being employed by the state-run giants more attractive. In addition, Russia's central planning system made a shortage of goods and services pretty much the norm, so the non-monetary element of employee compensation was even more attractive. It was, therefore, not surprising that the non-core assets of the Soviet giants included kindergartens, hotels, restaurants, tailoring shops, beauty salons and so on. What *is* surprising is that this practice appears to continue today, even though it is an increasing burden on companies' core activities (see Table 2). These obsolete business practices have in large part ensured the conservation of the Soviet business model. What's more, the considerable legacy non-core assets often present opportunities for further expansion, a dominant trend. The non-transparency resulting from the complicated company structures, therefore, may seem beneficial to management opposed to change.

More non-core assets acquired during the crisis

The second way in which non-core assets were acquired came about during Russia's crisis period. State-owned banks had to acquire collateral, which added a lot of businesses to their balance sheets (developers, real estate, agriculture and so on). It was not easy to sell those assets during the deepest crisis phase. Now, the banks have little incentive to get rid of non-core businesses, despite the range of activities. Another type of semi-voluntary acquisition stemmed from the government's decision to save socially important banks and companies. For example, the Russian Railway Company was told to buy KIT Finance (the 31st-biggest bank in the country at the time in H1 2008, which was close to bankruptcy).

Plans to cap state-sector M&A have taken a back seat

The government has been unable to ignore the problem of the state-owned companies' non-core assets. In October 2011, President Dmitry Medvedev asked the government to develop a set of measures to limit M&A activity in the state-owned segment and cap the sector as a percentage of GDP. In March 2012, the government prepared a draft obliging state-owned companies and banks to ask for special permission for every M&A deal. However, the law has not yet been approved and the government's attention has shifted. The status of the draft has been downgraded to an addendum, diminishing its importance. The new (old) administration is clearly keen to bolster the state-owned segment and sees it as a power house of economic acceleration. Unfortunately, the effects of its role in said economic acceleration have not been evident as yet. And we see further expansion of the state-owned sector in the coming years.

Table 2: Non-core assets of state-owned companies

Gazprom	
Gazprom-Media	Media holding includes a large number of mass-media companies (TV channels, radio stations, publishing houses, cinemas, film companies, web resources, advertising, etc)
Gazprombank	Top three Russian bank (by assets)
Gazfond	Top five non-state pension fund (by pension savings)
VTB	
Hals Development	Developer portfolio includes 80+ projects
Geotransgaz, Urengoy Gas Co	Companies were bought from Alrosa holding during the 2009 crisis (USD 620mn)
Sberbank	
During the crisis, Sberbank accumulated shares in retail chains, property, oil & gas (Taas-Yuryakh, Sakha Republic and Dulisma, Irkutsk region)	
Sportloto	Biggest lottery company
Russian Railways	
TransCreditBank	Top 12 Russian bank (by assets, H1 2012)
KIT Finance	Investment bank, 62nd-largest Russian bank (by assets in H1 2012)
Blagosostoyanie	Top two non-state pension fund (by pension savings)
Mostotrest	Russia's leading transportation infrastructure construction company
RosTechnology	
RT-Metallurgy	Includes a group of metallurgical companies
IzhMash	Car producer
Novicombank	Top 48 Russian bank (by assets, H1 2012)

Source: Company reports, Wikipedia

Blurred line between the state-owned sector and the federal budget

In 2011-12, Russia's fiscal performance has not raised any concerns. High oil prices have underpinned solid budget revenues and helped to balance the government's books.

In 2013, the government is likely to enjoy additional budget revenues if oil prices (Urals) exceed the USD 92/bbl set down in the 2013 budget (please see our report entitled *Russia: A budget with a social conscience*, 2 October 2012, for more detail). Still, the fiscal environment is changing. In 2000-08, the government not only enjoyed a sizable fiscal surplus, it managed to increase expenditure by 30% y/y on average. Now, further sizable increases in spending are not really possible (the current breakeven oil-price threshold is USD 110/bbl), while the ambitions of the Russian government mean more and more investment projects need to be financed. And this is where the state-owned companies have tended to step in. By our rough calculations, in 2011-14, such financing is likely to amount to USD 24bn, or c.USD 6bn, a year on average. Moreover, if the government needs more support for its ambitious targets in future, the state-owned sector may see its coffers tapped for up to double that amount, particularly Gazprom. The state-owned companies know how to demonstrate their loyalty, though. And often have it tested. Just recently, the government instructed state-owned Rosneft to dramatically increase its dividends and channel RUB 50bn to the 2013 budget (despite the company's ambitious investment programmes in new fields in eastern Siberia).

State cash cows kill the incentive for privatisation

Speeding up the privatisation of Russia's state-owned companies has been presented as the obvious way of boosting the government's finances. In 2009, a sizable privatisation programme was launched with a target of USD 10bn a year for the government purse in 2010-13. The programme has not materialised, however, as the demand for budget-deficit financing has dropped substantially. Indeed, in 2010, oil prices increased 26.3% y/y, propping up Russian budget revenues. In 2012, the government has returned to the privatisation issue and approved a privatisation plan for 2012-16. The new variant is even more aggressive than the previous one. It assumes the government should will its share in a large number of companies and banks to zero by 2016. However, the government is not desperate for revenues in 2012-13. So, we think substantial revisions of the "new" privatisation plans are likely down the line. Earlier this year, President Putin said the privatisation of the oil and gas sector should only go ahead under favourable market conditions and that prices (at that time) were not sufficiently high. This raised concerns about the pace of privatisation in the coming years.

We think such concerns are well founded. The 'cooperation' between state-owned companies and the government significantly reduces the incentive for privatisation. Even now, the money being stumped up by the state-owned sector to finance government projects is almost equivalent to the potential amount of privatisation revenues.

State sector may grow rather than shrink

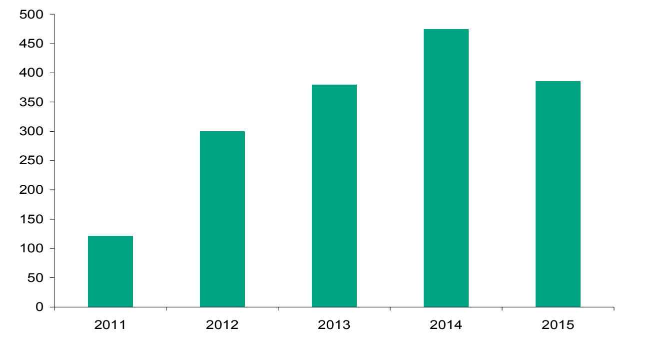
This means that the state-owned sector may continue to grow in size. We see this tendency as unhealthy for competitiveness and modernisation. In addition, growing the state-owned sector does little to improve the transparency of government finances, reducing the need for control over spending and increasing the fiscal risks.

Table 3: List of companies to be privatised by 2016

Company	Current state shareholding (%)	Share to be kept by 2016 (%)
VTB	75.5	0
Agricultural Bank	100	0
RosAgroLeasing	99.9	0
SovKomFlot	100	0
Sheremetyevo	83	0
Aeroflot	51	0
United Grain Company	100	0
ALROSA	83	0
RusGidro	60	0
Rosneft	75	0
Zarubezhneft	100	0
Inter RAO UES	20	0
Russian Railways	100	75
FSK UES	77.7	75
Transneft	100	75
United Shipbuilding Corp	100	50
United Aviation Building Co	93	50
UralVagonMash	100	50

Source: Russian Government, BNP Paribas

Chart 4: Privatisation revenue plan 2012-15 (RUB bn)



Source: MinFin, BNP Paribas

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