KATHREIN CAPITAL MANAGEMENT

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Evolution of the Russian Agricultural sector

Is there more to come?

Das vorliegende Dokument ist als Informationsschreiben zu verstehen. Es handelt sich nicht um eine Research-Unterlage im Sinne von MiFID II.

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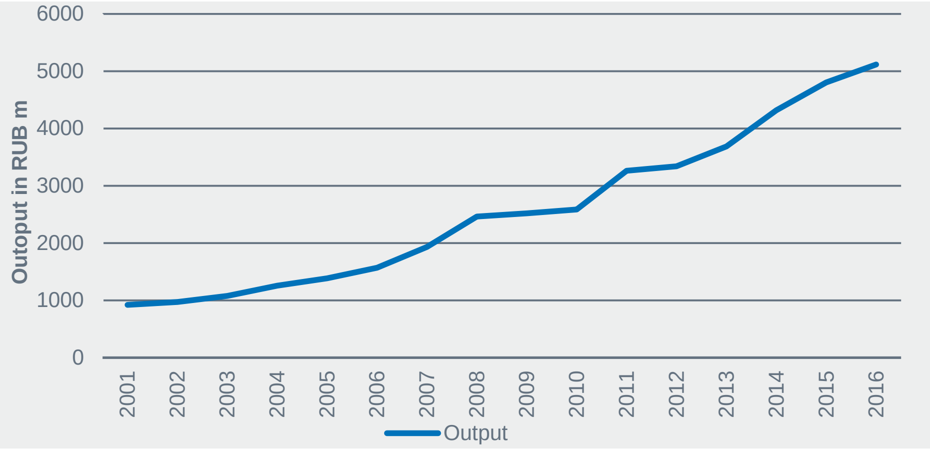
I. RUSSIA & AGRICULTURE

Evolution of the agricultural sector

Since the disintegration of the Soviet Union, agriculture has arguably been Russia's weakest sector. Continuously over the years, through strategic government initiatives, the Russian agricultural industry went on to re-invent itself, going from import dependence in the 90s to almost self-sufficiency today. It gradually started in 2005 when the government made agricultural development one of its "National Priority" projects. This was followed by significant agricultural support policies which culminated in the Program for Development of Agriculture 2008-2012 and later 2013-2020. However, outside factors, such as political tensions with the West and fluctuating commodity prices, were also a contributing factor over the last five years. The value of agricultural output has grown from just under a trillion rubles in 2001 to over 5 trillion in 2016.

Russian agricultural output 2001-2016



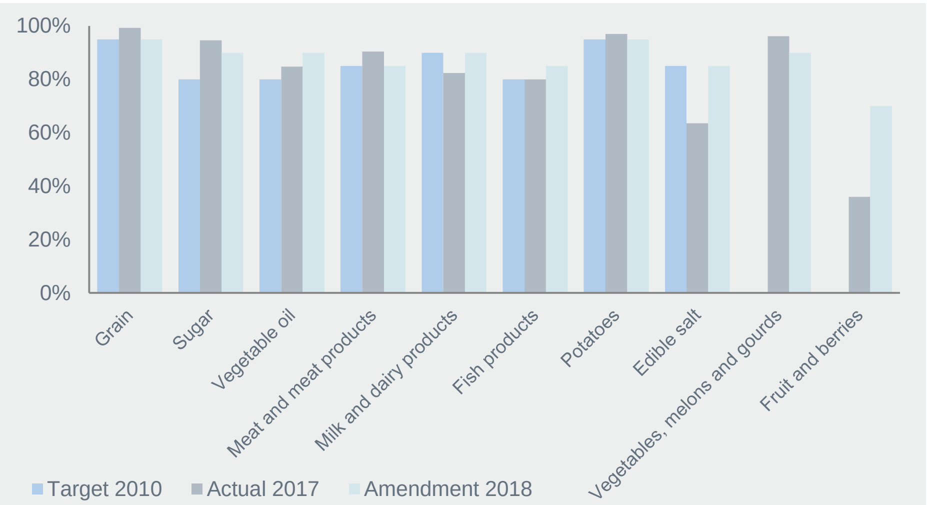
Source: Rosstat

State programs as the main driver

The first significant initiative by the government came with the enactment of the 2008-2012 state program. The program's goals were to increase rural employment and living standards, improving competitiveness of Russian agricultural products, sustainable development and natural resource conservation. The proposed budget to achieve these goals was set at 1.1 trillion rubles (~ 15.5 billion USD), which was distributed through various government funds targeting specific sub-sectors, and an emphasis was put on boosting output for meat. Agricultural production grew by a staggering 72.8% between 2007 and 2012, clearly beating the forecast of 21.7%.

In 2010 a new framework was established which outlined Russia's objectives and goals for ensuring food safety, titled "The Food Security Doctrine". One of the key objectives was to increase output to levels which would provide for Russia's food independence. As a result, minimum production targets were set for 8 key agricultural commodities, calculated as the share of domestic production of the total supply of the commodity. Since 2015 the Russian Ministry of Agriculture has been drafting amendments, with the latest one in 2018 proposing additional 4 commodities to be added as well as an increase of some of the previous production targets.

Staple commodities production target

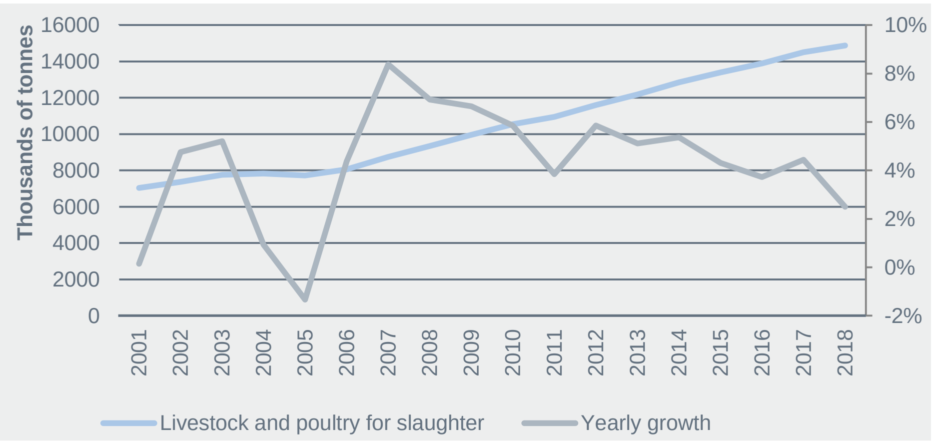


Source: Russian Ministry of Agriculture

After the initial success of the first 5-year plan in 2012, a second for 2013-2020 plan was drawn up and adopted, with further emphasis on import substitutions and enhancement of agricultural exports. The proposed budget was to be doubled to 2.2 trillion rubles (~ 34 billion USD) with improving livestock productivity remaining a top priority. As a result of the plan, agricultural output was forecasted to increase between 8.6% to 10.8% and exports between 32% to 33.3% from 2015 to 2020.

Livestock and poultry production has been on a steady rise since 2001, doubling in two decades, although growth slightly slowed from 2007 onwards, rebounding at the turning of the decade which was in part due to protectionist economic policies. In 2017 Russia almost reached self-sufficiency levels with poultry and pork with 96% and 91% respectively, whilst poultry production was also expected to double by 2030. Forecast of the Agricultural Ministry were that Russia would reach levels of full self-sufficiency within a few years, followed by surpluses and a better positioning to compete in the export market. In terms of harvests, 2016 was a record year during which grain production reached a record level of 120 million tonnes. Russia even became the number one sugar beet producer in the world with 51 million tonnes and the number three potato producer with 32 million tonnes, all being key staple foods.

Livestock and poultry



Source: Rosstat

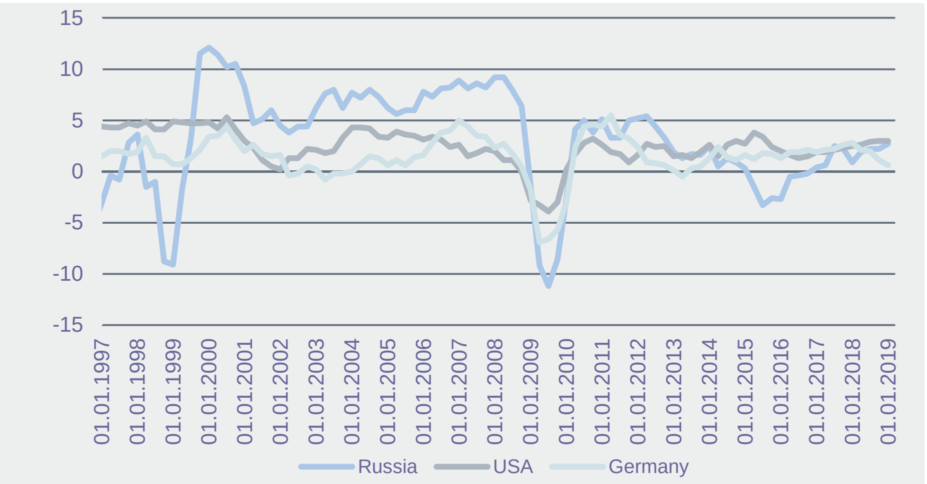
II. ECONOMICS AND SANCTIONS

Political unrest and sanctions

It has been five years since the first wave of bilateral sanctions by the EU and US have been imposed against Russia in light of the Ukraine crisis and the annexation of Crimea. The first wave came in form of restrictive individual measures (asset freeze and travel bans), a list which has been continually expanded over the years and as of December 2018 has grown to include 155 persons and 44 entities. Economic sanctions followed, restricting five majority state-owned financial institutions from accessing primary and secondary capital markets as well as three energy and three defence companies. These sanctions coupled with a dramatic fall in oil prices resulted in a financial crisis and a recession, revealing even deeper structural economic problems.

In retaliation to these sanctions Russia introduced an import ban on a range of EU agricultural products, such as meat, dairy products and fruits & vegetables. The immediate effects were EU exports went down from €11.8b in 2013 to €6b in 2017. With no foreign producers to compete with and a range of available subsidies and grants, domestic agricultural producers were favorably positioned to drastically expand the output and fill the void.

GDP Growth YOY%



Source: Bloomberg

Structural economic problems

During the first decade of the 2000s Russian growth averaged 6.4%, boosted by the oil export boom until the deep recession of 2008-2009 triggered by the global financial crisis. Growth resumed but never reached pre-2008 levels, and gradually declined. This is in part due to an overreliance on natural resources, which account for roughly 70% of Russia's exports, 50% of the national budget and 20% of the GDP, therefore making the economy very susceptible to fluctuation in commodity prices. Estimates show that a $1 decrease in oil prices reduces Russia's budget revenue by $2b.

Such dependence on commodity prices underlines the lack of diversification in terms of exports and national income. As a consequence of the sanctions, the government reversed its course from nationalization to privatization. In 2012, for example, estimate show that as much as 70% of the economy was accounted for by the public sector. On average state-owned enterprises are by more than 30% less efficient than their private counterparts. Governance, on the other hand, has been a problem since the very beginning, even though over the past few years Russia has steadily improved its ranking in the “ease of doing business”, corruption still remains a major barrier.

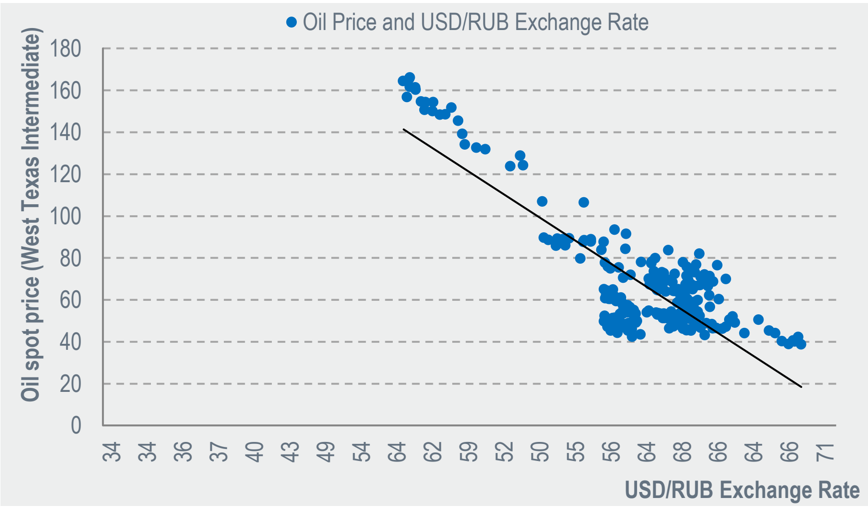
Shrinking and aging population strongly affects human capital. Furthermore the workforce is slowly decreasing and in the worst case scenario could shrink by another 10 million over the next 20 years. This is mainly due to falling birthrates, lower retirement age and recent brain drain, as the number of skilled Russian workforce leaving the country has tripled since 2012.

Investment in fixed assets represents 21% of the GDP which is in line with developed countries but way below any of the emerging economies (China 43%, Korea 30%). Local and foreign businesses are finding themselves more reluctant to invest due to a lack of support from local authorities and high levels corruption.

Currency depreciation

The sanctions which were targeted at Russian banks, severely impacted their ability to raise short term capital, and coupled with falling commodity prices and a loss of confidence in the economy all resulted in a financial crisis. By the time the central bank intervened in mid-December 2014 the USD/RUB exchange rate was at 68.49, doubling since the beginning of the year. From a macroeconomic perspective currency depreciation will lead to a decrease in imports due to them being relatively more expensive thus boosting domestic consumption and at the same time boosting exporters as a result of them now being cheaper in foreign countries. This, however, has not entirely been the case, although agricultural output did increase, food prices did so as well, with the CPI reaching 15% for 2015 and food accounting for over half of it. Data shows strong correlation between the USD/RUB exchange rate and the oil spot price since 2014.

Oil spot price and USD/RUB exchange rate



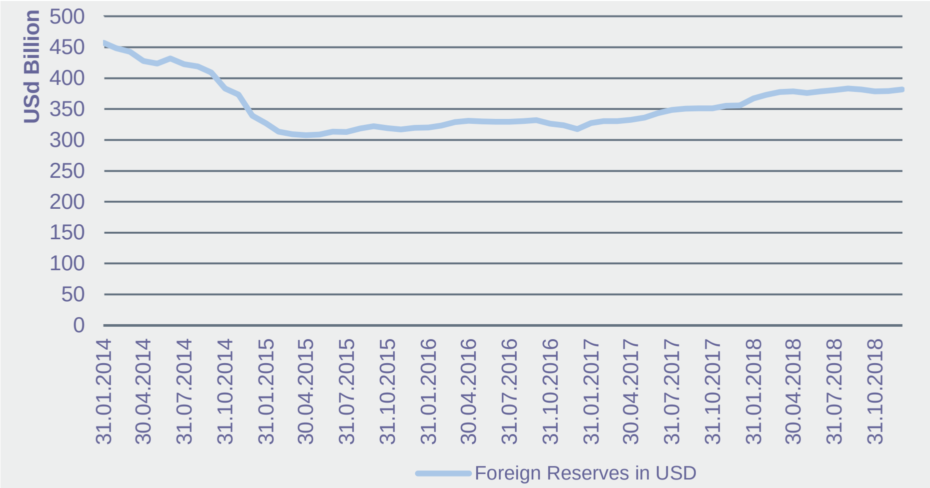
Source: Bloomberg Finance L.P.

Financial crisis and recession

Sanctions and sharp depreciation of the ruble lead to the destabilization of the Russian banking sector which gradually led to a financial crisis. Implemented sanctions restricted state-controlled banks from raising capital from primary and secondary EU and US capital markets. This was devastating for the Russian banking sector since it strongly depends on European capital for external financing. The main trigger for the financial crisis of December 2014 was that the country had to pay a trench of its foreign debt ($35b), during a period where it was cut off from foreign capital whilst ruble had lost more than half its value. Servicing government debt was not so much of a problem, considering Russia's large foreign currency reserves. The private sector on the other hand had debt outstanding in the amount of $658b of which $156 had maturities of less than a year, $209b was the banking sector debt of which $51b was maturing within a year.

Unfavorable exchange rate, import bans, sanctions and a general loss of confidence in the economy resulted in a recession. The recession started in 2015 from which the economy finally reemerged in 2017, GDP growth for 2015 and 2016 was -2.5% and -0.2% respectively. During this period, Russia went from planned privatization to nationalization, where by mid-2015 an estimated 55% of the economy was in state hands. 2017 followed with more nationalizing concentrating, on the banking sector with the bailout of Otkritie Bank and B&N Bank, being two top 10 banks by assets.

Foreign reserves in USD



Source: Bloomberg

III. CONCLUSION

Ever since developing agricultural industry in Russia has become a national priority, growth has been respectable and steady, even during crisis times when the general economy was lagging. Food sanctions implemented against the West created a sterile environment for domestic producers free of competition which were additionally stimulated through subsidy schemes. As a result good outcome had been achieved with the agricultural sector doubling in size in just under 10 years, despite harsh economic environment. The question, however, is how long this growth can be expected to last. Eventually at one point political tensions should ease, if Russia and the West reach an agreement regarding geo-political issues. Once this happens bans and tariffs will need to be abolished, especially considering Russia’s accession to the WTO, which sets limits on how much governments may subsidize exporting sectors. This of course may be a problem since Russian producers are not as efficient producers as their foreign counterparts. Nevertheless the Russian Ministry of Agriculture has pledged to make its agricultural products more competitive and to capture a higher share of exports. However export growth requires higher investment and standard of technology.

Economic reforms are crucial for long-term growth, this would also have a trickledown effect as all sectors would benefit. Technology needs to be updated and this is only possible through investments. If such changes were to take place, then perhaps agriculture could become a significant export sector for the country and not be underestimated on a global scale.

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