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Russia Sanctions Highlights

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Sanctions on Russia stemming from its annexation of Crimea in March have evolved from initial restrictions on some high profile Russian individuals, to most recently, sanctions targeting key Russian industries as the Ukrainian crisis has continued to escalate. Following the July announcements by the European Union (EU) and the United States (US) of additional sanctions on Russia, we felt it would be useful to review the potential impact of sanctions on Russia, and beyond.

What sectors are most impacted?

- **Energy** – The US imposed sanctions on Russian energy firms including the natural gas company, Gazprom. As the EU is still heavily reliant on Russian natural gas – Russia supplies 30% of Europe's natural gas[1] – the EU's sanctions excluded Russia's natural gas industry.
    - With Russia's oil industry accounting for 40% of the country's total market capitalization[2]; the oil industry is a major component of Russia's economy and a source of foreign currency. While China could presumably provide financing to Russia, both Russia and China lack the requisite technology and skills required to sustainably increase production through unconventional oil drilling, as had been planned, without technical assistance from European and US firms. As such, Russia's oil industry will be hamstrung should sanctions persist for an extended period[3].
- **Financial Services** – The US and the EU banned select firms within Russia's banking and energy sector from raising new equity or new debt funding with maturity greater than 90 days on US and European capital markets. Moreover, the US banned trade and development finance to Russia. Financial sanctions are likely to be highly detrimental should they persist for a prolonged phase.
    - As of June 30, Russia had a current account surplus and its central bank had $472 billion[4] in foreign currency reserves. The central bank has signaled that it is willing to aid Russian banks and corporations with their payments due on external debt. This should mitigate short-term refinancing risk.

- Looking forward to 2015, the Wall Street Journal estimates that "through the end of 2015, $160 billion of foreign currency debt falls due for banks and companies[14]." Net capital outflows during the first half of 2014 totaled $75 billion[4] and the International Monetary Fund (IMF) is estimating net capital outflows for 2014 to exceed $100 billion. The combination of continuing capital flight, a sizeable chunk of external debt repayments due through 2015, and a flailing economy, could lead to significant depletion of foreign currency reserves should sanctions extend into 2015. We note that net capital outflows moderated in the second quarter of 2014, however, historically, Russia has experienced sharp escalations in capital outflows and the moderation observed in the second quarter could swiftly reverse.
- Notably, the fallout from these sanctions will hit a broader universe of firms than the Russian banks and corporations on EU and US sanctions lists. Western banks, which have been fined for violating US sanctions on Cuba, Iran, and Sudan (case in point BNP Paribas which was fined $9 billion in July for violating US sanctions), are wary of being caught in the crosshairs of increasingly punitive sanctions on Russian entities and have cut back on business in Russia. As they reduce operations, a broader basket of Russian organizations will have fewer options for funding and will have higher funding costs.

- **Defense Industry**
  - The EU and the US imposed an embargo on arms sales to Russia and restricted sales of dual use equipment (i.e. equipment that can be used in both civilian and military capacities). EU sanctions apply for future sales only in order to allow France to complete a pending transaction.

Fallout of sanctions beyond Russia

There has been significant coverage of the impact of sanctions on Russian organizations, capital markets, and the broader economy. However, the impact on regions and entities with major trade relations with Russia is worth reviewing.

- **Europe** - As Russia is the EU's third largest trading partner[5] (trade with Russia accounts for 10% of the EU's total trade), sanctions on Russia will cause some pain in Europe, with Eastern and Central Europe potentially bearing the brunt of the fallout from sanctions.
  - **Eastern and Central Europe** - Eastern and Central Europe have strong ties to Russia – for several countries, exports to Russia are in excess of 5% of gross domestic product[6]. Critically, as noted by the IMF[6], "Russian gas accounts for over 50% of total gas consumption in virtually all countries in Eastern Europe." Should sanctions on Russia persist for an extended period and the Russian economy continue to falter, the economies of Eastern and Central European countries will be most impacted.
  - **Western Europe and Germany** - The impact of Russian sanctions on Western European countries will be modest. Having said that, Russia is a key trading partner for Germany. According to the International Energy Agency, Germany is the largest energy consumer in Europe with the country reliant on Russian imports for approximately 40% of its natural gas needs.
  - **United Kingdom** - The United Kingdom (UK) is another country worth noting in the context of Russian sanctions. In addition to the UK's exposure to Russia via London Stock Exchange listed global corporations with significant operations in Russia such as BP and SABMiller, the UK has a mixed reputation from its relations with Russia; it is one of the largest recipients of funds from former and/or current Russian oligarchs. In recent years, the UK has wooed Russian investors with residency permits and has persuaded Russian firms to list on the London Stock Exchange. Russian nationals, who have long been keen buyers in the UK luxury property market, spent £180 million[9] on UK property in 2013. Likewise, the City of London is a major hub for Russian firms to raise capital and Russian firms have generated significant income for the City – The Economist notes[8], "$46 billion of Russian stock has been sold in London IPOs since 1996." As such, the UK's financial sector will suffer most from prolonged sanctions on Russia.

- **Selected global firms**
    - **ExxonMobil**- ExxonMobil has a joint venture with Rosneft and is expected to launch an Arctic oil drilling project, which is in Russian Arctic territory, soon.
    - **BP-** BP still retains a 20% equity stake in Rosneft. According to the New York Times[10], BP signed a joint venture in "May to search for shale oil in the Volga-Urals region [of Russia]".
    - **Boeing** – 35% of Boeing's supply of titanium is from a Russian producer, VSMPO-AVISMA – as such, the firm is likely to face an increase in input costs
    - **Halliburton, Baker Hughes, and Weatherford International PLC** – Bloomberg[11] cites data from RBC Capital Markets which indicates that "Oilfield service companies Halliburton, Baker Hughes, and Weatherford International Plc each generate 4 percent to 5 percent of their global sales from Russia, while Schlumberger gets 5 percent to 6 percent."
    - **Carlsberg** – Russia accounts for approximately 30% of Carlsberg's sales12. In recent years it has grappled with a significant decline in Russian revenue after Russia imposed a hefty excise tax on beer.
    - **SABMiller** – Unlike Carlsberg, SABMiller has broad geographic exposure across emerging markets and as such is not as vulnerable to developments in Russia. SABMiller has a presence in Russia through a joint venture with Anadolu Efes - Russia accounted for 45% of Anadolu Efes' beer sales in SABMiller's most recent financial year[13].

Retaliatory sanctions by Russia

In response to Western sanctions, Russia imposed a one-year ban on the import of agricultural and food imports, specifically: dairy products, meat, fruit, vegetables, poultry, and fish, from the EU, Norway, US, Canada, and Australia, in early August. Reuters' analysis of data cited from the International Trade Center indicates that the newly banned food categories represented approximately 25% of Russia's $39 billion of food imports in 2013. This should result in a supply gap for the balance of 2014 until alternative sources are lined up from Latin America and other regions. Conversely, the banned imports represent a small component of the total exports of impacted countries; EU food exports to Russia in 2013 accounted for 7% of total exports to Russia and a negligible 0.5% of the EU's total exports last year[15]. Likewise, US food exports to Russia in 2013 comprised less than 1% of US global exports.

As such, Russia's ban on food imports will harm Russian consumers more than it will punish targeted countries. With reduced food supplies likely to stoke inflation, the Russian government is exploring potential price controls to staunch further increases in consumer prices. In July the Central Bank of Russia[16] unexpectedly hiked its key interest rate by 51 basis points to 8.0%, citing concern about accelerating inflation. As of June 30, annual inflation was 7.8% compared to a target of 6.0 to 6.5% for 2014; inflation was driven in part by the depreciation of the ruble due to a higher risk premium on the currency.

Having noted that in aggregate, the Russian ban on food imports will have a minimal impact on its trading partners, we discuss below the top country specific industries that are most impacted (in dollar terms) by the ban.

- **Norway** – Although Russia accounted for only 1% of Norway's global exports, Norway's seafood industry will be grossly affected. While fish and fish products represent only 5% of Norway's total exports, Russia is Norway's largest seafood export destination. In 2013, seafood exports to Russia totaled over $1 billion and comprised 20% of Norway's global seafood exports[17]. In the short-term, Norwegian seafood suppliers may be forced to sell seafood that had been destined for Russia at significantly reduced prices while a search for alternative markets is underway.
- **Poland** – The fallout of Russia's ban on imports of fruit and vegetables will be widely felt by Poland's apple farmers. While Poland's agriculture industry contributes a mere 4% of the country's gross domestic product, Poland was the largest global exporter of apples in 2013. Russia was the top destination for Polish apples last year and accounted for 57% of Poland's apple exports[18]. Statistics from Reuters indicate that the estimated value of sanctioned exports is $1.2 billion (based on 2013 trade), with fruit and vegetables comprising a third of that total.
- **US** – Poultry is the largest US agricultural export to Russia. According to the US Department of Agriculture, Russia was the fourth largest export market for US poultry in 2013 and accounted for approximately 6% of US poultry exports, which totaled $310 million. Russia has a history of banning imports of US poultry - for instance, bans were instituted in 2002, 2008, 2010, and earlier this year. As such, the US poultry industry has been gradually weaning itself from Russia and the impact of the ban is modest.

Along with sanctioning food imports, Russia has threatened to ban Western airlines from flying over Siberia. As overflights over Siberia greatly reduce the length and duration of Western airlines' flights to Asia, such a move would increase fuel costs and flight times. While Russia has occasionally implemented policies in conflict with its economic interests and could plausibly do so in this instance, we believe that a ban on overflight rights over Siberia is unlikely for two related reasons. First, Russia's national airline, Aeroflot, receives overflight royalties from Western airlines. With overflight royalties comprising approximately 18% of Aeroflot's annual earnings, a ban would materially reduce Aeroflot's earnings. Second, the Russian economy has slowed significantly since sanctions were first imposed in March, as demonstrated by the IMF's downgrade of Russia's 2014 economic growth projection from 1.3% in April to 0.2% three months later. The combination of an economic downturn in Russia, which should reduce airline travel, and the recent grounding of Aeroflot's discount airline subsidiary, Dobrolet, will further undermine Aeroflot's revenues. We conclude that given the headwind's facing Aeroflot, Russia has strong disincentives to withdraw overflight rights.

Market and portfolio exposure to Russia

As noted previously, US and/or EU sanctions on select Russian firms, including Sberbank Russia, VTB Bank, Novatek, and Rosneft, preclude these firms from raising new longer-term bonds (any debt with maturity greater than 90 days) and new equity on US and EU capital markets as of July 16, 2014. However, equity and debt issued prior to July 16 remains a component of secondary capital markets. As of July 31, 2014, Russia comprised approximately 1% of the Russell Global ex-US Index and approximately 5% of the Russell Emerging Market Index, as shown in the table below.

Table 1. Top 10 Country Weights: Russell Emerging Markets Index as of July 31, 2014

Country	Weight
1. China	21%
2. South Korea	14%
3. Taiwan	12%
4. Brazil	10%
5. India	7%
6. South Africa	7%
7. Russia	5%
8. Malaysia	5%
9. Mexico	5%
10. Thailand	3%

Source: Russell Investments, Bivium Capital Partners

Given that sanctions do not apply to debt and equity that pre-dated the July sanctions, and with Russia being a small but meaningful constituent in major indices, we expect international investors to remain participants in Russia's capital markets to the extent that the securities were issued before sanctions were imposed.

Among the managers in Bivium Capital Partners' portfolios as of July 31, 2014, our emerging debt manager had a 6% allocation to Russia versus a 10% Russia weight for the Bank of America Merrill Lynch Emerging Markets Corporate Bond Index. For equity managers with international exposure, Russia holdings ranged from approximately 8% (versus approximately 5% for the Russell Emerging Market Index) for an emerging market equity manager, while a non-US manager had a 50 basis point position in Russia (versus approximately 1% for the Russell Global ex-US Index).

Conclusion

The scope of the potential fallout from Russia's annexation of Crimea has been expanding, with the financial and human toll having increased beyond what most observers would have initially anticipated. As the crisis continues to escalate without an evident catalyst for resolution, we felt it would be useful to review the potential impact, should the situation be prolonged. As we discuss investment outlook and positioning with managers, an assessment of the potential impact of sanctions on Russia and beyond brings context to our engagement with managers.

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Footnotes

[1] Source: Fitch Ratings.
[2] Source: Russell Russia Index as of July 31, 2014.
[3]Source: Gallucci, Maria. (July 29, 2014). "New Russia Sanctions: Latest EU Moves On Russian Oil Sector Would Hinder Drilling In Arctic Ocean And Shale Fields." Retrieved August 5 2014 from http://www.ibtimes.com/new-russia-sanctions-latest-eu-moves-russian-oil-sector-would-hinder-drilling-arctic-ocean-1642528
[4] Source: Reuters
[5]Source: European Commission
[6]Source: Husain, Aasim M. and Ilyina, Anna and Zeng, Li . (August 1, 2014). "Europe's Russian Connections" Retrieved August 5 2014 from the International Monetary Fund Blog http://blog-imfdirect.imf.org/2014/08/01/europes-russian-connections/
[8]Source: The Economist. (March 22, 2014)."Russian money in Britain: Honey trapped."
[9]Source: Savills PLC - Savills PLC is a global real estate services provider listed on the London Stock Exchange.
[10]Source: Baker, Peter, Cowell, Alan, and Kanter, James. (JULY 29, 2014). "Coordinated Sanctions Aim at Russia's Ability to Tap Its Oil Reserves" Retrieved August 5 2014 from http://www.nytimes.com/2014/07/30/world/europe/european-sanctions-russia.html?_r=2
[11]Source: Wethe, David and Carroll, Joe. (Jul 29, 2014). "Russia Sanctions Spread Pain From Putin to Halliburton." retrieved August 5 from http://www.bloomberg.com/news/2014-07-29/energy-companies-gear-up-for-more-pain-in-russia-with-sanctions.html
[12] Source: Carlsberg
[13]Source: SABMiller
[14]Source: Barley, Richard. (July 30, 2014). "Playing the Long Game in Russia: What Matters About the Sanctions Is How Long They Last." Retrieved August 5 2014 from http://online.wsj.com/articles/heard-on-the-street-playing-the-long-game-in-russia-1406728726
[15] The European Commission
[16]Source: The Central Bank of the Russian Federation. (July 15, 2014). "On Bank of Russia Key Rate."
[17]Sources: Statistics Norway (Norwegian Central Bureau of Statistics) and the Norwegian Ministry of Trade, Industry and Fisheries.
[18] The Economist
[19]Source: Bloomberg

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