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Continued growth of dividends is driven by metals and mining industry

Analysis of dividend payouts by Russian non-financial companies

- **In 2016, dividends paid out by non-financial companies increased 9% to RUB 1,465 bln.** Companies managed to demonstrate higher dividends owing to metals and mining sector (+37%), while other major dividend generator – oil & gas companies – reduced their payouts by 15%. Dividend payout ratio equaled last year's figure of 31%.

- **Dividends of state-owned companies grow.** Following 2016 results, state-run companies distributed RUB 640 bln in dividends (+25% vs 2015). The average dividend payout ratio climbed from 23% to 26% (excluding Gazprom and Rosneft, it soared from 17% to 32%).

- **Significant growth of dividends paid by metals and mining companies** following 2016 results is largely driven by a higher payout by ALROSA. As compared to last year, sector's dividend payout climbed 37% to RUB 453 bln by virtue of lower leverage and passing the capex peak. However, this growth driver is running its course: any further decline in leverage is unlikely, and dividends announced to FCF before dividends ratio in the sector exceeded 70% limiting any further dividend growth.

- **Dividends paid by telecom companies saw no changes from the previous year** and amounted to some RUB 150 bln. Going forward, dividend dynamics will be driven by the data storage requirements to be set by the government for communications providers: complying with them will require substantial capex.

- **In 2016, FCF margin of large businesses contracted to almost zero.** FCF margin of large state-owned companies fell to -2%. In 2014-2016, major corporations managed to sustain their current leverage and capex levels, but any further growth in dividends may result in quality deterioration of large businesses.

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Continued growth of dividends is driven by metals and mining industry

Following 2016 results, Russian non-financial companies distributed RUB 1,465 bln in dividends. The figure is 9% higher than in 2015; growth rates remained near the previous year's level (2015 dividend payouts increased 8%, while 2014 dividends surged by 25%).

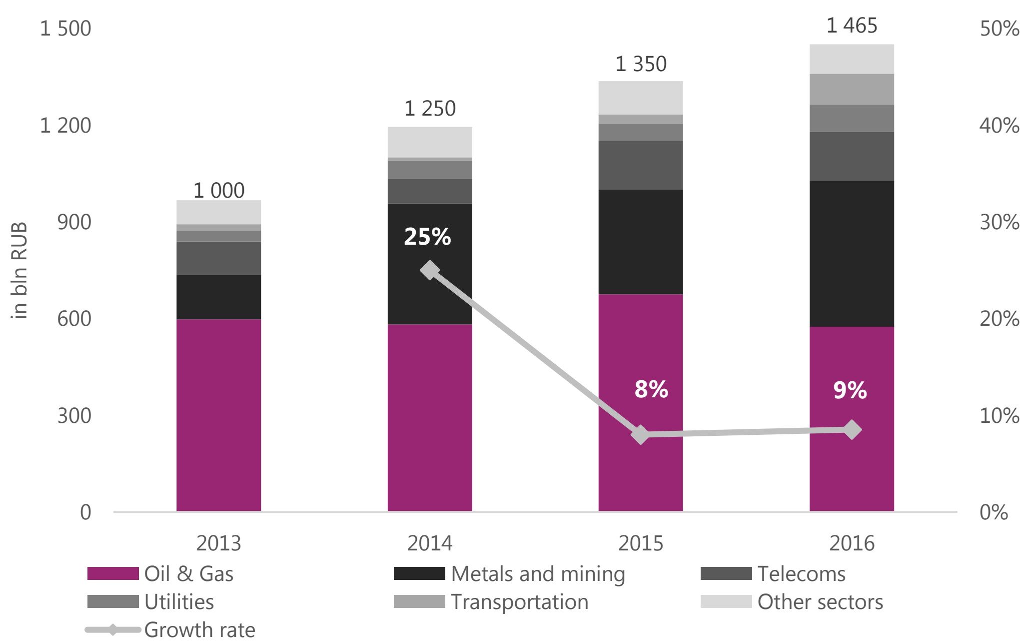
Structure of dividend payouts by industries changes over time. Whereas oil and gas companies accounted for 50% of total dividends for 2015, sector's share in total dividends declined to 40% in 2016. Oil and gas companies reduced their payouts by 15% to RUB 574 bln. On the back of this decline, the share of metals and mining companies in aggregate dividends surged from 24% to 31%, and the dividend amount paid climbed by 39% to RUB 453 bln.

Telecommunications companies remain the third largest group in the total dividend payouts (with a 10% share); the amount of dividends paid by this group equals the previous year figure at RUB 151 bln. Shares of transportation and utilities sectors saw a significant increase from 2% to 7% and from 4% to 6%, respectively, albeit remaining small.

Dividend payout ratio saw no changes from the previous year totaling 31%. Since 2013, this figure climbed 3 pp.

To calculate the aggregate amount of dividends, we used data from 227 largest Russian companies that generated RUB 47 trillion in total revenues in 2016, a 35% share of the total revenue amount of all Russian companies. This year's sample includes 43 more companies vis-a-vis our analysis of dividend payments by non-financial companies in 2015 (please see research report by ACRA: Dividends outpace income and investments; July 25, 2016)

Figure 1. Dividend growth rates of non-financial companies slow down



Source: ACRA estimates

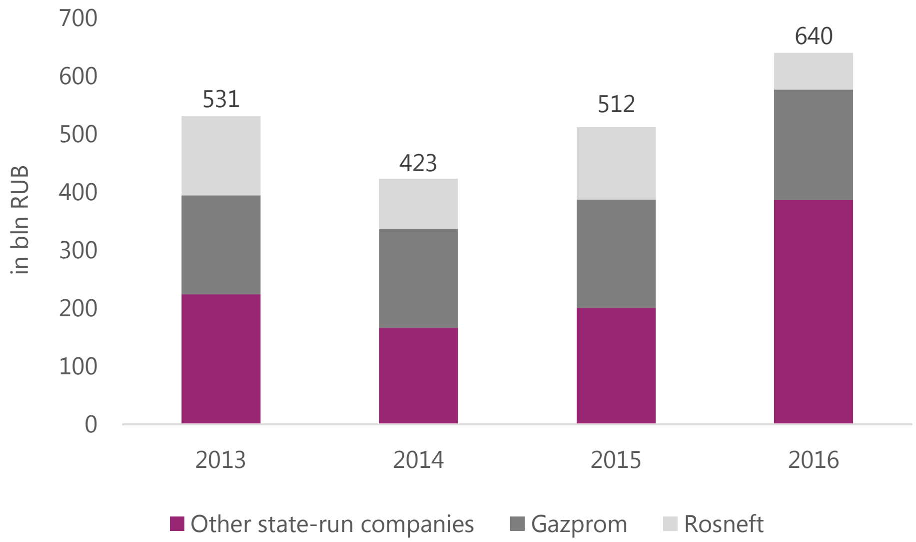
The state manages to collect more dividends

The government manages to increase dividend payouts by state-run companies for two consecutive years already. Whereas 2015 dividends exceeded previous year's figures by 21%, state-owned companies distributed among their shareholder 25% more dividends paying the total of RUB 640 bln. Nevertheless, the government did not manage to reach the budgeted amount of dividend income. According to 2017 budget, Ministry of Finance expected companies directly owned by the state to pay RUB 483 bln in dividends. If payouts by Rosneftegaz (for the purposes of this analysis, we do not consider it as a stand-alone corporation), financial companies, and banks are excluded from the above total, budget's expected dividend income was around RUB 300 bln. In fact, companies in this sample distributed nearly 30% less in dividends: RUB 218 bln. In particular, dividends of Gazprom and Transneft appeared to be substantially less than expected.

Shares of Gazprom and Rosneft in the total dividend payouts by state-owned companies declined significantly in 2017. Whereas these two companies accounted for approximately 60% of the total dividend payouts in 2013-2015, their share dropped to 40% following 2016 results. The above can be explained by more power these two companies have in defending their investment programs than other state-run companies. Nonetheless, ACRA expects these figures to return previous values by virtue of Rosneft's transition to a new dividend policy.

The government progressively manages to increase dividend payout ratio of state-run companies. Whereas profitable state-owned companies paid out 23% (17% excluding Gazprom and Rosneft) of their net income in 2015, this ratio was at 26% (32% excluding Gazprom and Rosneft) in 2016.

Figure 2. Shares of Gazprom and Rosneft in dividend payouts by state-owned companies decreased in 2017



Source: ACRA estimates

Further dividend growth sources are almost exhausted for metals and mining companies

FFO (funds from operations) before interest and taxes is operating cash flow before changes in working capital, interest payments, and taxes.

FCF (free cash flow) – operating cash flow adjusted for dividends paid and capex spend.

For more details, please read ACRA's forecast: [Commodity prices recovery to shore up Russia's metals & mining industry](); November 7, 2016

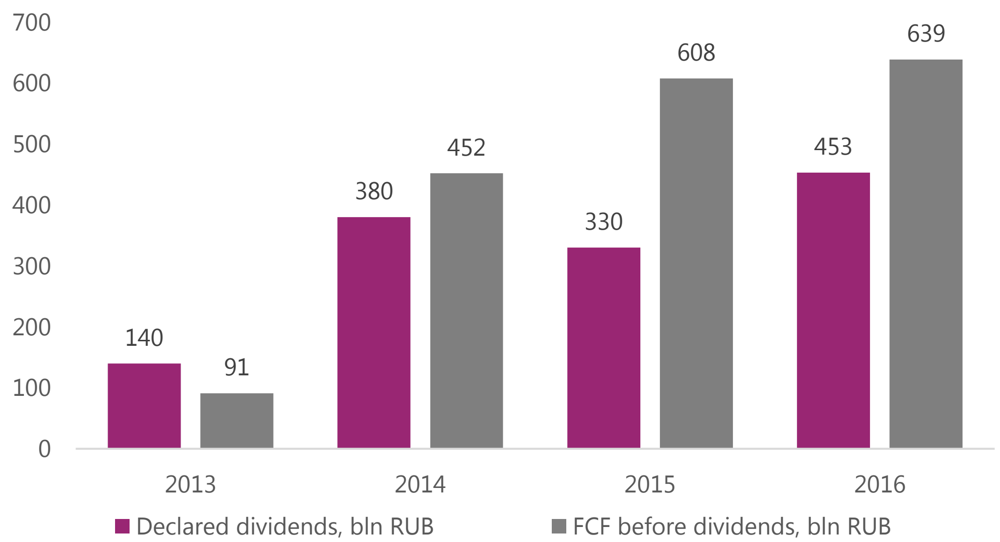
Metals and mining companies continue to be the driving force behind the growth of dividends in the non-financial sector. Dividend payouts soared 3.2x since 2013; following 2016 results, the dividend amount increased 39% to RUB 453 bln.

ALROSA contributed substantially to dividend payout growth distributing over 4 times the amount paid out in 2015 (RUB 65.8 bln). Norilsk Nickel continues generating the highest dividends in the industry: the company paid out RUB 141 bln in dividends for 2016 (+4% vs 2015). This figure represents 32% of the total amount of dividends paid by metals and mining companies.

Metals companies are in a position to increase their dividend payouts owing to passed capex peak as well as declining leverage. In 2016, the average total debt to FFO before interest and taxes stood at 2.4x having declined from 4.0x in 2013. Any further decrease in leverage is unlikely, according to ACRA's estimates.

Dividends grew faster than FCF before payments to shareholders that has increased by only 5% last year. In 2016, dividends declared to FCF before dividends ratio climbed from 54% to 71%. The remaining portion of FCF after dividends shall be used to repay debts, therefore, sources for dividend growth in the sector are being gradually exhausted. Any increase in FCF (and hence, dividends) is possible only on the back of a considerable price growth for ferrous and nonferrous metal products; ACRA assesses the probability of that scenario as low and expects that dividend payouts by metals and mining companies will stabilize around current levels.

Figure 3. Resource for growth of dividends by metals and mining companies is being exhausted



Source: ACRA estimates

Amount of dividends paid out by telecoms for 2016 saw no changes

Please see research report by ACRA: Dividends outpace income and investments; July 25, 2016

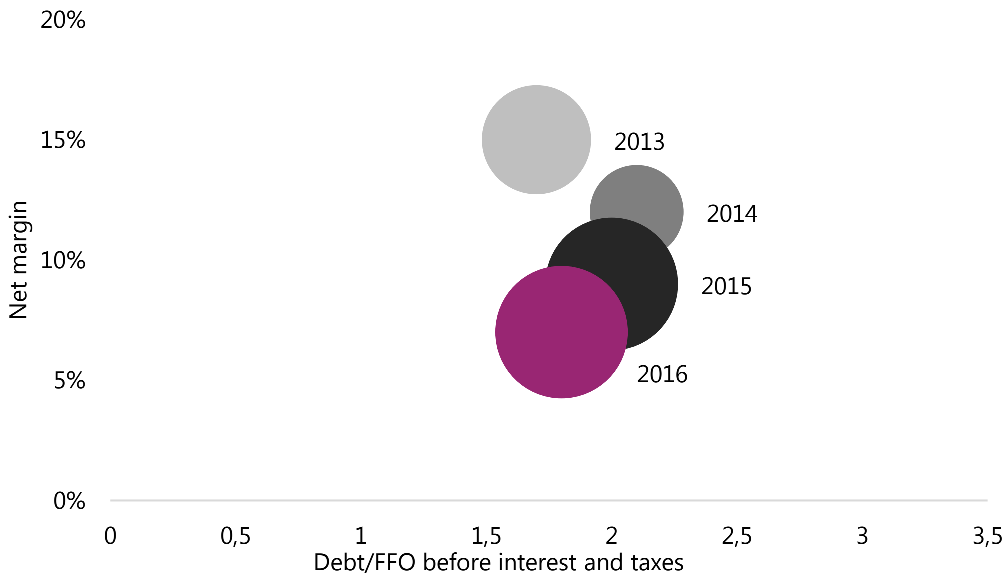
There was virtually no change in the aggregate dividend amount paid by telecom companies for 2016 totaling RUB 150 bln. This dynamics is in line with ACRA's forecast as detailed in the last year's review of dividend payouts by non-financial companies.

The need of telecom companies for continuous capex and their declining net margin limit the amount of dividends they pay.

An additional potential factor for higher capex may be the antiterrorist amendments to the Federal Law "On Counteracting Terrorism" and to the Criminal Code of the Russian Federation that may substantially increase expenditures by telecom companies to expand their data storage infrastructure. No precise parameters and applicable storage period have yet been defined. Nonetheless, even considering that these expenditures will be, to some extent, shared with subscribers and partially subsidized by the government, we expect higher capex in the industry. As a result, leverage of telecom companies may increase.

Possible increase of interest expenses due to higher leverage may result in further decline of the average net margin and FCF across the industry amid growing capex. As a result, sector's dividends will depend on the data storage requirements for carriers to be established by the government. Therefore, we expect that dividends by telecom companies will decline in the coming years.

Figure 4. Declining margin of telecom companies may result in lower dividends



Circle size represents the dividend payouts for the year.

Source: ACRA estimates

Future growth in dividends is possible either by cutting investment programs or by increasing debt

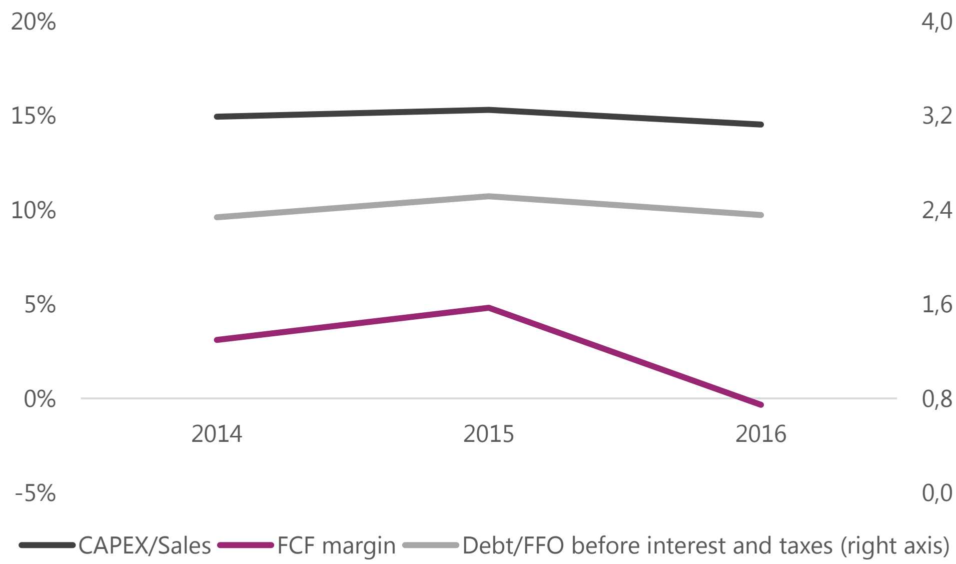
It is increasingly harder for large businesses – key dividend generators – to increase dividend payouts without affecting their creditworthiness. The major limitation is lower FCF registered by not only metals and mining companies but by all major corporations in 2016. Specifically, FCF margin for large businesses dropped on average from 5% to zero over the last year. For large state-owned companies, the indicator contracted from 7% to -2%.

Regardless of lower FCF margin, large corporations manage to keep their key financial metrics stable. Average total debt to FFO before interest and taxes ratio is in the range of 2.3x-2.5x. At the same time, this ratio for state-owned companies has increased from 2.4x in 2014 to 2.8x in 2016.

Both large businesses and state-run companies manage to keep their investment program spend at a stable level. Capex to sales ratio for large businesses was stable at 15% over the last three years. This ratio for state-owned companies was in the range of 18%-19% over the same period.

With FCF close to zero and lack of any additional growth drivers, any increase in dividend payouts is possible only by cutting investment programs or by increasing debt, which may result in corporate credit profile deterioration.

Figure 5. Large businesses manage to maintain leverage and capex programs stable, but FCF margin declines



Source: ACRA estimates

Calculation methods

The dividend amount paid by non-financial companies for each year was determined as the sum of intermediate and announced annual dividends, although the actual payment was reflected in the financial statements only the following year. The aggregate dividend amount was calculated based on data collected from 227 largest Russian non-financial companies from various sectors, with the total revenue amount of RUB 47 trillion generated in 2016 representing 35% of the total revenues of all Russian companies. By ACRA's estimates, the selected companies account for 95% of the aggregate dividends paid out by all Russian non-financial companies, as only large businesses can afford to pay high dividends.

To avoid any "double counting" of dividends distributed by parent companies and their subsidiaries, we incorporated dividends paid by parent companies in full in our calculations and adjusted dividends by subsidiaries to the amounts payable to minority shareholders. To correctly calculate aggregated financials when the results of one company from the selection were consolidated into the financial statements of another company, only consolidated numbers of parent companies were taken into account.