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Between risks and opportunities

The growth rates of the Russian leasing market may return to the pre-crisis level as early as the second half of this year

- **The slowdown in the global and Russian economies, sustained low demand for energy resources, and air traffic restrictions continue to restrain the country's leasing sector.** The Agency expects to record insignificant and non-uniform growth of the leasing portfolio by 5–10% in monetary terms in 2020. ACRA foresees growth to clock in at 15–25% in 2021 due to the potential recovery of business activity to pre-crisis levels.
- **Structurally high credit risks in the economy reduce healthy growth opportunities of the sector.** The share of problem leases held by the group of rated companies remained approximately in the same estimated range as in 2019: 15–20% of the portfolio. Among individual lessors, an additional 20–30% of the portfolio may have a relatively vulnerable credit quality, in ACRA's opinion.
- **Slow return to sustainable growth of railway leasing.** The probable recovery of the global economy may stimulate coal prices and, accordingly, a recovery in the leasing market in the second half of 2021. In contrast, oil shipments will not support growth earlier than 2022 due to the OPEC+ agreement, which limits production and, consequently, the export of raw materials.
- **Our observations show that leading airlines have put off renewing their fleets until at least the second half of 2021.** The unprecedented decline in passenger traffic amid the coronavirus pandemic and weakened ruble continue to directly constrain the sector.
- **The mass retail segment, including leasing of freight and passenger vehicles, where there is already deferred demand, will be able to stabilize business faster than other transport leasing types.** However, in ACRA's opinion, the credit risks inherent to this segment continue to be the least predictable amid the economic downturn.
- **External support is one of the main factors stabilizing industry risks.** The market leaders have links with the state or are part of financial and industrial groups, which is the basis for competitive advantages and allows them to better cope with the challenges of the operating environment.
- **In summer 2020, the Court of the Eurasian Economic Union granted member states the right to independently regulate leasing activities.** In the Agency's opinion, this ruling may bring Russia closer to carrying out a reform of leasing.
- **Bond issues are becoming an increasingly popular way to raise financing.** Bond funding is continuing to replace bank funding among small and medium-sized retail companies. For state-owned lessors and other companies working with large businesses, bonds are displacing equity in the financing structure, and thereby leading to a tangible increase in leverage indicators.

External conditions are still limiting the development of the sector

Last year's unforeseen economic shocks will continue to test the financial stability of the leasing sector and serve as a serious obstacle to its development over the next 6 to 12 months. In particular, the decline in business activity triggered a significant fall in demand in the economy and caused businesses to doubt the necessity of making capital investments. Continued uncertainty regarding economic growth and the still relevant risks of a new lockdown to counteract the potential spread of coronavirus exacerbate the situation. Together these factors have had a negative impact on the current and potential growth of leasing companies.

The Agency estimates that Russia's real and nominal GDP fell by 4.3% and 6.1% in 2020, respectively. The expected economic recovery this year, in the absence of other unforeseen shocks, including difficult-to-predict geopolitical risks, may be a favorable backdrop for stabilization of the gradual development of the leasing sector (according to the Agency's current forecast, real and nominal GDP growth in 2021 will amount to 3.8% and 8.3%, respectively). At the same time, ACRA does not expect stable business growth any earlier than the third to fourth quarters. Although a number of major one-time deals may stimulate the market, the Agency expects that railway and civil aviation leasing (the sector's largest lines of business in terms of volume) will only be able to return to predictable growth as the global and national economies stabilize along with demand for energy resources, and when restrictions on air travel are eased. The mass retail leasing segment represented by individual companies is already recording business growth and, according to ACRA's expectations, will be able to stabilize faster. However, this area is not material enough to drive the recovery of the entire sector. Consequently, the Agency expects minor (5–10%) growth of the leasing portfolio in 2020, primarily due to one-off factors, and assumes annual growth (15–25%) of the sector in 2021 amid a possible recovery of the economy and realization of deferred demand for leasing.

In addition to falling demand for leasing services caused by a slowdown in business activity, ACRA notes that there are high systemic credit risks which are constraining the healthy growth opportunities in the sector. These risks are already leading to an increase in the level of potential problem exposures under leasing contracts (including growth of problem restructuring) and may exert significant pressure on the sector's capitalization. According to ACRA's observations, many leading companies, both in the large business segment and in the retail leasing segment, are aware of these existing trends and are not seeking to increase their portfolio amid the current conditions. On the other hand, smaller lessors are gravitating towards more aggressive growth in an attempt to occupy a released niche. The Agency views this strategy as potentially risky.

A consequence of higher risks of leasing portfolios is the observed reduction in credit limits for the leasing industry (especially for small and medium-sized companies that have no ties to the state and are not affiliated with banking groups) provided by its main lenders — banks. ACRA expects the current state of affairs to remain broadly unchanged until at least mid-2021 and continue to somewhat limit the ability of leasing companies to finance the growth of new businesses.

In the Agency's opinion, the relatively low awareness of leasing services and their advantages among small and medium-sized enterprises (SMEs), competition with

For more information, see ACRA's macroeconomic forecast ["Structural and temporary factors of economic growth in Russia"](#) from November 19, 2020.

other financial organizations, as well as the lack of systemic regulation of the industry, which limits the flow of new money into the sector, are additional obstacles standing in the way of sustainable development of leasing in Russia.

The decline in the value of the Russian ruble in 2020 had a contradictory impact on the financial indicators of the sector. On the one hand, the positive revaluation of large foreign currency contracts made it possible to somewhat support the nominal dynamics of portfolio growth last year. On the other hand, the reassessment of lease payments using the new exchange rate puts additional pressure on the credit quality of the respective lessees and may ultimately lead to growth in problem assets.

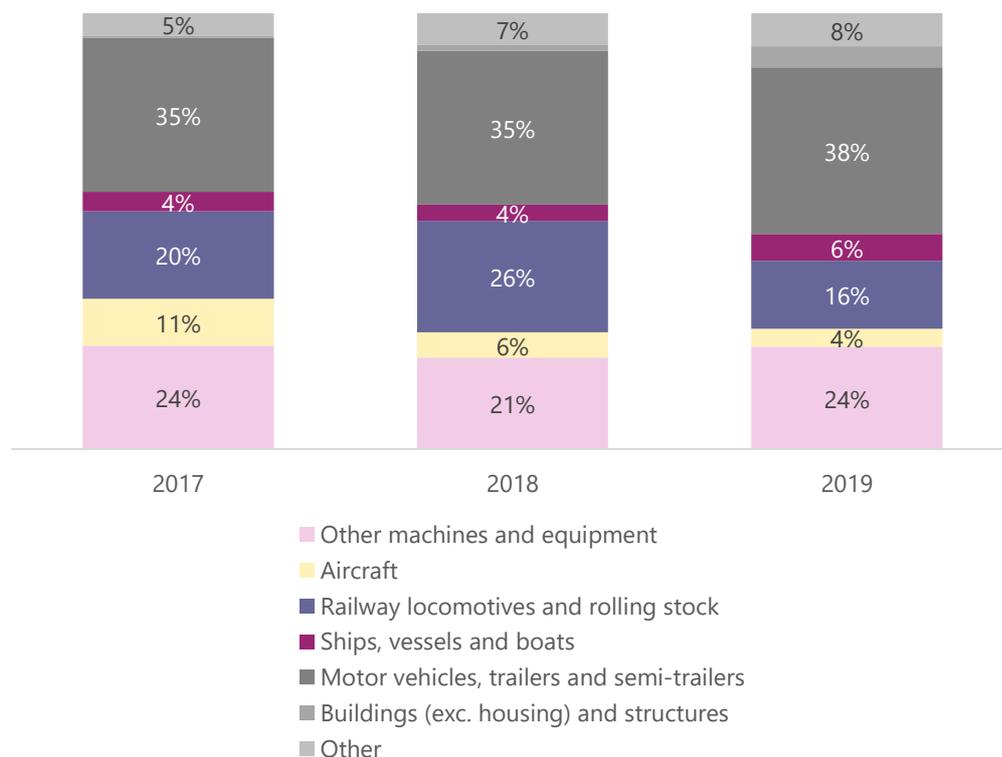
The still currently low level of penetration of leasing services in the economy favors sector's growth potential. However, the positive influence of this factor will have a more pronounced stimulating effect in the long term as the risks of the operating environment stabilize.

In the future, a return to the active implementation of national projects in the area of urban economic development (public transport, ecological projects, modernization and/or replacement of housing and communal services and construction equipment, etc.) will contribute to the development of the leasing industry. However, ACRA believes that most of these projects will most likely be implemented by the largest leasing companies, which will further increase the concentration of the industry and, as a result, worsen the competitive environment.

The state's position as an active participant in the development of the sector continues to be one of the key elements determining the indicators and dynamics of the leasing market. ACRA's current base case scenario envisages the government maintaining its propensity to support the sector should it become less stable. The Agency also views banking sector regulatory concessions (the possibility to restructure delinquent loans of the leasing sector without placing additional pressure on banks' regulatory capital adequacy) as factors supporting the sector, which potentially create an additional buffer to absorb the negative consequences of the economic downturn and growth in credit risks. The Agency positively assesses such initiatives and at the same time notes that most leasing companies are not yet taking advantage of the concessions.

Besides general factors that constrain and stimulate the entire leasing sector, the sector's performance is largely dependent on the potential development of different areas of transportation, which have historically formed the basis of the leasing business in Russia.

Figure 1. Structure of financial leasing: historically, most of the sector has been occupied by transportation



Source: Rosstat

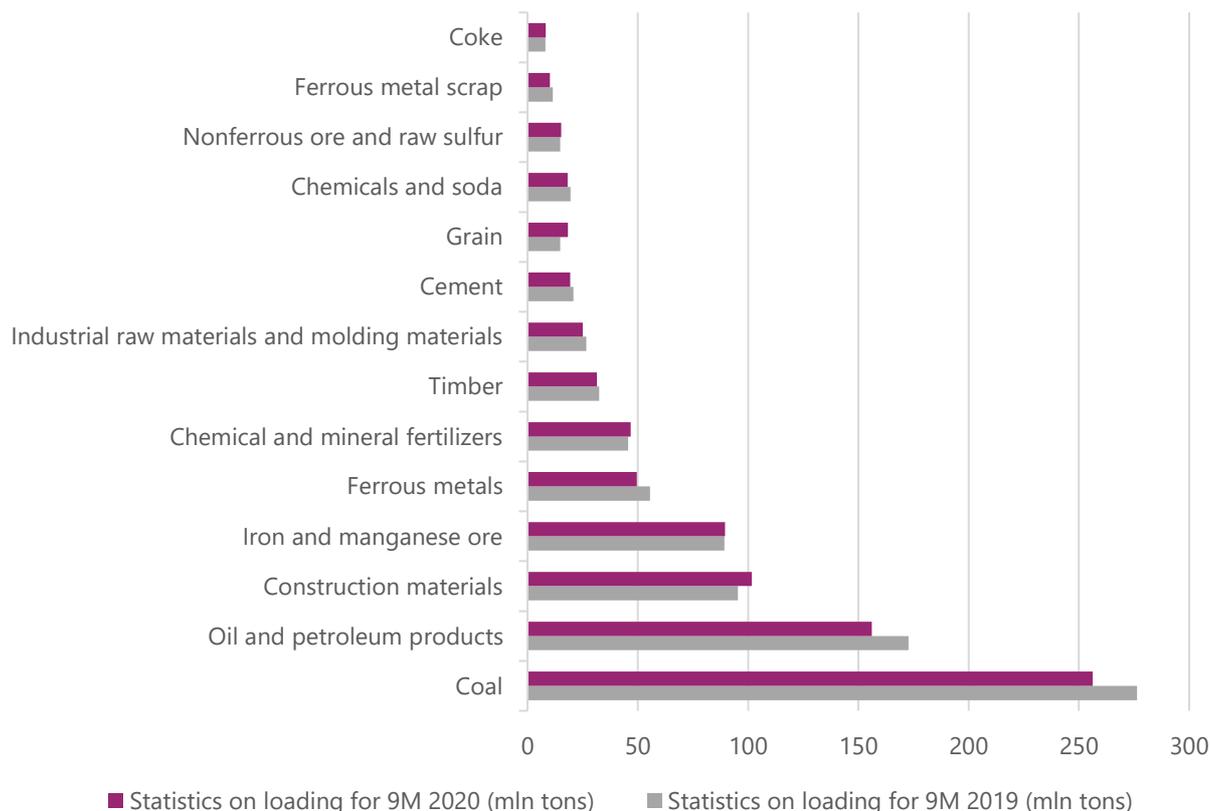
How sensitive is transport leasing to the observed economic challenges?

Transport leasing, which in the past has accounted for more than half of the leasing sector in Russia, was reasonably included in the list of the most vulnerable segments in the context of the pandemic. The Agency notes the significant decline in demand for the services of transport operators, however, the scale of its negative impact on the main areas of transport leasing was uneven. In addition, ACRA believes that different areas of transport leasing have different growth drivers and potential.

Railway transport leasing

The fall in global demand for coal and oil in 2020 was decisive for the leasing of railway transport. Domestic demand for coal and petroleum products also could not support demand for new wagons, which led to the market contraction. Preliminary data provided by Russian Railways from October 1, 2020 shows that the utilization of its network in January to September last year was 3.6% lower than in the same period in 2019.

Figure 2. Utilization of Russian Railways' network decreased in January–September 2020 compared to the same period in 2019



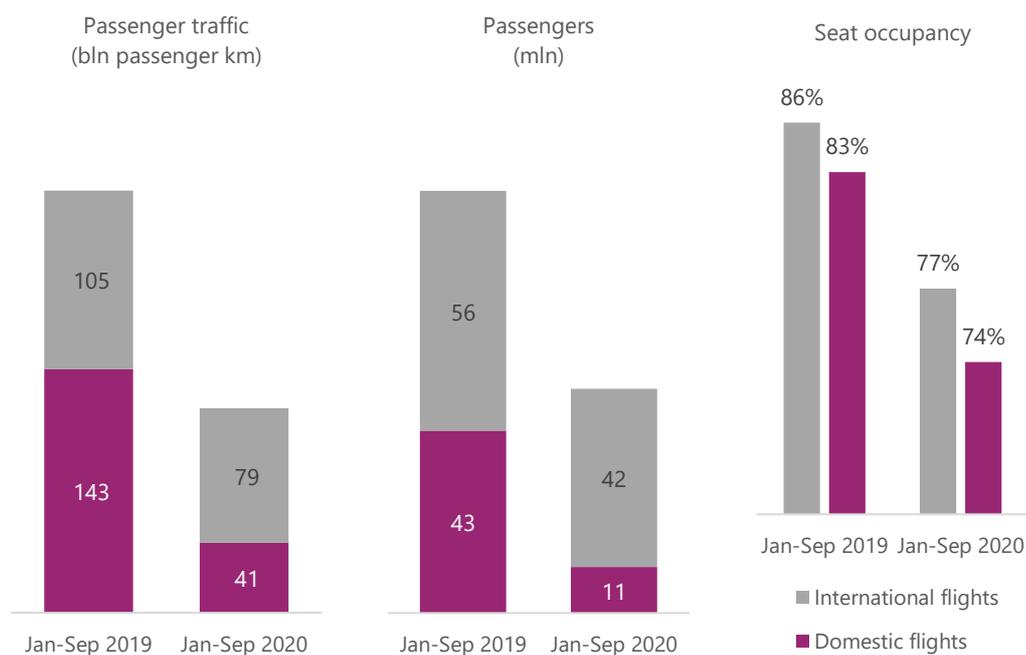
Source: Preliminary data of JSC "Russian Railways"

The recovery of the railway transport leasing market will largely depend on the potential for higher coal prices. In 2020, a significant decline in coal prices limited export markets for Russian coal companies, especially in the west. As a result, the majority of coal was exported eastwards, namely to the Asia-Pacific region, where the prices did not fall so significantly. A certain recovery in the global economy and, accordingly, in demand and prices for coal is possible this year, which may stimulate the industry's recovery in the second half of 2021.

Transportation of oil and petroleum products, on the other hand, will not be able to support the market to a large extent and thus ensure growth in demand for new wagons over the next 12 months. In ACRA's opinion, a substantial increase in the volume of oil exports may not be possible until 2022. The Agency's expectations are based on the prerequisites set out in the agreement signed by oil exporting countries under the OPEC+ deal.

Aircraft leasing

The operating environment's most negative impact can be seen in the aircraft leasing segment. The fall in passenger traffic due to the restrictions imposed to fight against the pandemic and the weakening of the ruble are directly constraining the civil aviation sector. Falling household income are having an additional negative impact on the number of tourists.

Figure 3. The aviation segment faced unprecedented limitations on its business in 2020

Source: Federal Air Transport Agency (Rosaviatsiya)

Another specific feature of Russian aircraft leasing operators, in ACRA's opinion, is tough competition with international financial institutions, which can often offer better leasing conditions to clients thanks to cheaper foreign currency funding. This factor will continue to constrain the development of aircraft leasing.

A number of major air companies have postponed plans to renew their fleets, and the Agency expects this to stimulate growth of aircraft leasing no earlier than the second half of 2021. The market is currently only being supported by domestic flights. The plans of leading civil aviation operators to significantly boost the volumes of passenger traffic up until 2025 is still a long-term growth factor.

Freight and passenger vehicle leasing

Leasing of freight vehicles did not show significant negative dynamics amid the economic downturn. Demand was supported by food retailers, government procurement of public transport and transport for the army, as well as the relatively short suspension of construction when the quarantine was in effect in Russia. In general, according to the Agency, the fleet of trucks needs to be updated, and the expected economic recovery this year may serve as a favorable environment for growth in the segment. In the long-term, national projects to develop urban economies will also support growth in leasing of public transport.

The operating environment put serious pressure on leasing of passenger vehicles, mainly due to the self-isolation regime during which Russians used taxis and car sharing services a lot less often. Nevertheless, the aforementioned services are still in demand among the population, and therefore, in the absence of strict quarantine measures, the Agency expects the segment to recover in the next 6 to 12 months.

It should be noted separately that against the backdrop of the economic downturn, significant credit risks are the least predictable in the leasing of trucks and cars, since most of the lessees in this segment are representatives of SMEs. The latter's financial

stability is the most sensitive to the current deterioration of the external environment, which may become an obstacle to healthy growth of the industry.

Industry leaders continue to dominate the market thanks to external support

Competitive advantages, like business scale, external support potential, business digitalization, and partner network, are the main factors driving the most comfortable overcoming of the operating environment's challenges.

According to the Agency, the current crisis further strengthens the market positions of the dominant players and leaves less room for competition. Market leaders generally have access to sustainable sources of funding and/or liquidity and, if necessary, they can rely on emergency support, including equity injections, since they are members of large banking and financial/industrial groups or act as specialized state financial institutions. The total assets of such companies exceed half of the total assets of the leasing sector. The aforementioned advantages become even more valuable on the backdrop of systemic decline in lending limits in the leasing industry.

The potential for extraordinary external support (from a group or the government) as an important competitive advantage is reflected in ACRA's ratings, pushing up the credit profiles of leasing companies. The Agency's base case scenario assumes that the operating environment risks will be somewhat balanced by the capabilities and willingness of the state or the majority of financial and industrial groups to continue supporting the industry. In addition to financial assistance, ACRA expects other forms of support to be used, including access to wider client bases and additional distribution channels through affiliated offices and other points of sale, sharing advanced risk management procedures, technologies and IT processes, corporate training programs, qualified personnel pools, and employing experienced managers from allied industries, primarily the banking sector.

Digitalization in the leasing industry still lags behind other segments of the financial services sector and will remain a significant source of opportunities and competitive advantages for the most successful market players. In general, we would say that the sector has managed to adapt to the challenges of home working during the period of strict self-isolation and quarantine measures and has accelerated the digital transformation of the business.

Maintaining a high quality and wide range of services by expanding partner networks for smooth service of leased items will remain an important line of development for leasing companies.

Leasing market reform has been greenlighted

In ACRA's opinion, last year's judgement of the Court of the Eurasian Economic Union on the powers of Russian regulatory bodies to exercise special supervision over the leasing industry has brought the leasing market reform in the country much closer. In particular, the court recognized the right of each EAEU member state to introduce their own regulations of the leasing sector in its territory, including financial standards and reporting requirements, as well as the right of a member state to establish their own special taxation rules for leasing transactions. Thus, the court

upheld the position of the Russian Federation, which gives the government a green light for its current roadmap of reforms.

In ACRA's opinion, the leasing market reform, which assumes a fundamentally different level of transparency in the sector and regulation close to banking standards, will be one of the key long-term drivers for the industry. The reform includes new requirements for mandatory disclosures, prudential supervision, and accounting standards. In addition, it is planned to create self-regulatory associations, which, most likely, will report to the Bank of Russia, and to establish a register of leasing companies (similar to bank licensing).

ACRA is positive about the leasing industry regulation initiative and notes that this approach is in line with the best international practices. In the Agency's opinion, such regulation will contribute to the consolidation and recovery of the sector, as it will push weak and unscrupulous players out of the market. ACRA also expects that greater transparency and clear regulatory standards that protect lenders and investors, both corporate and retail, will facilitate an inflow of funding, which could ultimately improve diversification of the current, rather concentrated, funding base of many leasing companies. Regulatory standards similar to banking and stricter risk management approaches are likely to increase competition both in the leasing industry and between leasing companies and banks. Nevertheless, changes in the competitive environment will have minimal effect on market leaders that have more mature business models, well-recognized brands, well-established customer bases, and significant market positions in certain niches.

The pandemic's impact on asset quality depends on the specifics of leasing companies' portfolios

In order to analyze the quality of assets and funding of the leasing sector, the Agency used data from leasing companies rated by ACRA. In terms of leasing portfolio volume, these companies occupy almost half of the market.

The Agency is of the opinion that the level of credit risks in the sector has increased significantly in 2020. The share of problem leases on the balance sheet of leasing companies has slightly increased, but, for the entire group of analyzed companies, it is approximately in the same estimated range of 15–20% of the portfolio. In addition, ACRA assesses that up to 20–30% of leasing portfolios of some companies may have, in the Agency's opinion, questionable credit quality. Materialization of corresponding credit losses and their impact on the sustainability of certain companies and the sector as a whole will depend on the depth and duration of the economic downturn and the timeliness of government support.

ACRA also notes that amid tough conditions of the past and current years, the difference in the dynamics of asset quality metrics between large companies that are part of financial groups and/or benefit from government support and market companies operating with retail clients has increased.

A major increase in overdue payments, restructured loans, and potentially bad debts is currently shown by companies in the first group. It is caused by the following key factors: (1) portfolio profile, namely the presence of industries most affected by the pandemic, with large amounts of lease contracts (aviation, railroad transportation), (2) high concentration on large lessees, and (3) willingness and ability to accept

greater risk, relying on potential external support from a parent group or the state. The fact of potential support has also led to a smaller increase in credit risk provisions in comparison with small and medium-sized retail lessors. According to ACRA's estimates, the share of potentially problem exposures in the portfolios of a number of companies in this group may be as high as 50%.

On the contrary, retail segment companies that have a credit rating from ACRA are currently demonstrating slower growth in terms of both the share of overdue payments and the share of potentially nonperforming assets. The latter, according to ACRA's estimates, ranges from 1.5% to 11% of leasing portfolios, depending on the company. At the same time, such companies generally apply a more conservative approach to reserves. Their leasing portfolios mostly consist of cars and trucks, buses, construction and road-building machinery; a small share of portfolios falls on various specialized vehicles. To maximize the quality of their portfolios, retail companies significantly reduced their risk appetite in 2020 by suspending sales in the market segments most affected by the pandemic (passenger transportation, tourism, commercial construction). In addition, they shrank leases to enterprises whose operations require unique and, accordingly, low-liquid equipment and increased the size of advance payments.

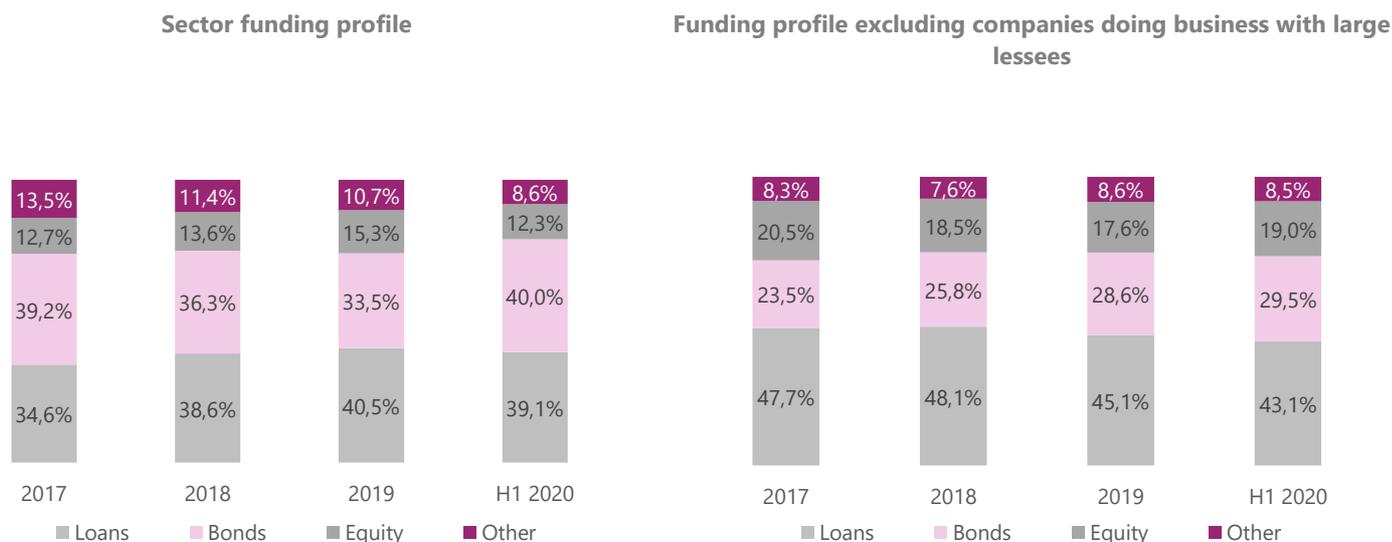
A number of retail companies noted a deterioration in customers' payment discipline in April–May 2020 (including due to the specifics of the SME segment), which led to an increase in lease payments overdue for over 90 days by the end of Q2 2020. However, by the end of the third quarter, the level of such exposures, according to companies' estimates, returned to the value seen in 2019.

It is important to note that despite relatively stronger current asset quality metrics, credit risks in the retail leasing segment remain the least predictable compared to similar risks for companies doing business with large corporate lessees. The uncertainty about the pandemic's impact on SMEs is still high. Therefore, medium and small leasing companies remain prone to increased credit risk.

The trend toward funding diversification remains

For several years now, leasing companies have been actively entering the bond market, which contributes to greater diversification of funding sources for leasing operations and smoother distribution of the funding base by maturity of obligations. As a source of funding, the bond market is currently popular not only among large players, as it was before, but among medium and small leasing companies as well.

Figure 4. The share of outstanding bonds is growing and forcing out other funding sources



Sources: ACRA, corporate financial statements

ACRA expects a further increase in the share of bond funding, as this instrument is of interest to leasing companies, since it allows them to manage their debt more flexibly against the backdrop of a downward trend in bond rates. Taking into account low rates on bank deposits, the Agency also notes the interest in bond financing among investors, legal entities and individuals.

As seen in *Fig. 4* (specifically, the funding profile for retail companies), bond funding have been replacing bank loans. In 2017, bank loans accounted for 48% of liabilities while bonds for 23%; but at the end of H1 2020, the shares were 43% and 29%, respectively. The Agency also notes that the share of equity has been quite stable at about 20% of the balance sheet of retail companies, while the large players have been relying on debt securities to replace their equity as the source of funding, which share in the liabilities decreased from 27% in 2017 to 12% in H1 2020.

Taking the above into account, capital adequacy ratios (CARs) demonstrated by companies operating in the air and rail transportation segments as well as member companies of financial groups are more volatile than those of companies operating in the retail segment. The CAR of retail companies calculated as of H1 2020 is in the range of 18–22%, while the CAR of large players shows a negative trend and is equal to 10–15%. The decrease in the ratio relative to 2019 shows that the capitalization of large companies and the stability of their business are still dependent on external support.

ACRA continues to note still high single-name funding concentration of companies focused on large customers, as financing of large players by related entities and banks within the groups remains the key driver. The share of the top five lenders in this segment reaches 80% of liabilities. In the retail segment, there is a gradual increase in diversification and a decrease in the share of the largest lenders (segment averages: the largest lender accounts for 20%, the five largest lenders — 35%).

In a survey conducted by ACRA, representatives of the retail companies rated by the Agency noted that in the quarantine period, a number of banks were cautious

in issuing new loans to leasing companies, and some even stopped lending altogether. Nevertheless, high diversification among lending banks, lower risk appetite under new leasing agreements, and a slowdown in the growth rate of new business allowed most of the leasing companies in the sample to get through the quarantine period without a critical funding and liquidity shortfall. Weekly monitoring of cash flows of leasing companies carried out by ACRA from March to July 2020 showed that receivables collection techniques and a balanced approach to the terms and conditions of new contracts provided the companies with the sufficient cash flow required to service their debts.

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