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## Russian air carriers awaiting next take-off

### Russian air passenger market 2022 outlook

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— **Passenger air transportation can break the record and reach 131 mln people carried in 2018.** The above would be driven by positive macroeconomic environment, FIFA World Cup, and possible reinstatement of full-scale air service to Egypt. We expect the total passenger traffic in both international and domestic air routes to post a 5.5% increase.

— **Retail lending growth to continue fueling the air passenger market,** although the real disposable income of the population would see no significant gains. Stable domestic currency (with the USD/RUB exchange at 58-63) and retaining current unemployment would support transportation service demand from the population. Owing to the positive macroeconomic environment, the market may record a 2.4% gain.

— **Competition to keep companies from passing increased costs to passengers.** In 2017, the key costs of air carriers (fuel, airport services, payroll) have increased substantially; however, they are unlikely to translate these costs into transportation prices in full. And the reason is high price competition. According to our preliminary estimates, this might result in a 5-7 ppt decline versus the last year figures of the average EBITDA margin, which would run into 5%-8%. Lower margin would have a negative effect on the leverage in the industry as a whole, which would deteriorate the creditworthiness of Russian air carriers.

— **Reinstating air service between Russia and Egypt could be a visible growth driver for passenger air travel,** but only after flights to the major tourist destinations are opened. Recovery of the tourist flow to the country could support the market. Passenger air traffic may increase by another 1.9% in 2018.

— **FIFA World Cup's effect on the industry would be limited; the related hosting benefits would be short-lived.** Additional gains in the air and long-distance railroad traffic would total around 1.3% and 0.5%-0.7%, respectively. We believe that venues built specifically for the tournament as well as the improved transport infrastructure would encourage no substantial passenger traffic growth in the coming years.

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Table 1. Passenger turnover and traffic forecast for air and railroad transportation

| Indicator  | Measure-<br>ment unit       | Actual            |                   |                   | Forecast |       |       |       |       |
|--|-----------------------------|-------------------|-------------------|-------------------|----------|-------|-------|-------|-------|
|  |                             | 2015              | 2016              | 2017              | 2018     | 2019  | 2020  | 2021  | 2022  |
| <b>Air transport</b>                               |                             |                   |                   |                   |          |       |       |       |       |
| <b>Airlines</b>                                    |                             |                   |                   |                   |          |       |       |       |       |
| Passenger traffic                                  | <i>mln pax</i>              | 107.3             | 102.9             | 124.0             | 130.9    | 133.4 | 136.3 | 138.5 | 142.2 |
| <i>International</i> <sup>1</sup>                  | <i>mln pax</i>              | 54.7              | 46.5              | 61.5              | 66.3     | 69.4  | 72.1  | 74.5  | 77.3  |
| <i>incl. international airlines</i>                | <i>mln pax</i>              | 15.2              | 14.3              | 19.0              | 20.1     | 20.2  | 20.9  | 21.6  | 22.4  |
| <i>Domestic</i> <sup>2</sup>                       | <i>mln pax</i>              | 52.6              | 56.4              | 62.6              | 64.6     | 63.9  | 64.3  | 64.0  | 64.9  |
| Revenue passenger kilometers                       | <i>bln pkm</i> <sup>3</sup> | 276.1             | 265.3             | 324.1             | 342.9    | 352.6 | 362.2 | 370.0 | 381.2 |
| <i>International</i>                               | <i>bln pkm</i>              | 176.8             | 161.2             | 209.5             | 225.5    | 236.7 | 246.2 | 255.1 | 265.3 |
| <i>incl. international airlines</i>                | <i>bln pkm</i>              | 49.2 <sup>4</sup> | 49.7 <sup>4</sup> | 64.7 <sup>4</sup> | 68.7     | 69.1  | 71.8  | 74.3  | 77.2  |
| <i>Domestic</i>                                    | <i>bln pkm</i>              | 99.2              | 104.1             | 114.6             | 117.4    | 115.9 | 115.9 | 114.9 | 115.9 |
| <b>Airports</b>                                    |                             |                   |                   |                   |          |       |       |       |       |
| Passenger traffic                                  | <i>mln pax</i>              | 159.3             | 159.6             | 186.8             | 195.7    | 197.5 | 200.8 | 202.7 | 207.3 |
| <i>International</i>                               | <i>mln pax</i>              | 54.1              | 46.4              | 61.3              | 66.2     | 69.3  | 71.9  | 74.3  | 77.1  |
| <i>Domestic</i>                                    | <i>mln pax</i>              | 105.2             | 113.2             | 125.4             | 129.5    | 128.2 | 128.9 | 128.4 | 130.1 |
| <b>Railroad transport (for reference purposes)</b> |                             |                   |                   |                   |          |       |       |       |       |
| Passenger traffic                                  | <i>mln pax</i>              | 1020              | 1037              | 1,118             | 1,134    | 1,133 | 1,137 | 1,146 | 1,154 |
| <i>Long-distance trains</i>                        | <i>mln pax</i>              | 97.9              | 101.4             | 102.3             | 102.4    | 101.3 | 100.4 | 99.8  | 98.7  |
| <i>Commuter trains</i>                             | <i>mln pax</i>              | 923               | 936               | 1,016             | 1,031    | 1,032 | 1,037 | 1,046 | 1,055 |
| Passenger turnover                                 | <i>bln pkm</i>              | 120.4             | 124.5             | 122.7             | 122.9    | 121.8 | 120.9 | 120.3 | 119.4 |
| <i>Long-distance trains</i>                        | <i>bln pkm</i>              | 89.5              | 93.5              | 90.9              | 90.6     | 89.5  | 88.4  | 87.6  | 86.4  |
| <i>Commuter trains</i>                             | <i>bln pkm</i>              | 30.9              | 31.0              | 31.8              | 32.3     | 32.3  | 32.4  | 32.7  | 33.0  |

Source: ACRA, Air Transport Agency, Russian Railroads

<sup>1</sup> International air routes<sup>2</sup> Domestic air routes<sup>3</sup> Passenger kilometer<sup>4</sup> ACRA estimates

## Macroeconomic environment to support air traffic growth

Please see ACRA's forecasts:

- on macroeconomics: [Low inflation in Russia to force the government and businesses to seek new forms of flexibility](#); October 9, 2017

- on the banking industry [Tougher operational environment to hinder banks in generating higher earnings](#); February 26, 2018

The forecast has been prepared in compliance with [General Principles of Socioeconomic Indicators Forecasting](#).

We project passenger air traffic to gain 5.5% in 2018, with half of the gain (+2.4%) likely to come from the favorable macroeconomic conditions. In addition, passenger traffic may get a boost from reinstatement of regular airline service to Egypt as well as from the FIFA World Cup hosted by Russia. The above factors combined may bring additional 3.1 per cent of gains to the market.

The key factors for the air transportation market from the macroeconomic point of view are the evolution of population income and the ruble exchange rate. ACRA estimates an increase in real disposable income of 1.0% to 1.5% annually, and the real wage growth of 1.5% to 3.0% a year. However, as the real disposable income of the population stayed flat in 2017, significant growth of consumer lending by banks had the most profound effect on the market. According to ACRA forecast, the high growth rates in this banking market segment would remain at the annual average of 11%. Mortgage and consumer lending make the major contributions to the above evolution, which may be the driver for higher travel expenses of the population.

Not only the reinstated air service to Turkey supported passenger traffic in 2017. Ruble appreciation started in late 2016: the average annual USD/RUB rate declined from 67 in 2016 to 58 in 2017. The international traffic volume is particularly responsive to the ruble exchange rate as overseas traveling involves foreign currency spending. In addition, the foreign currency component of the operational costs of airlines is higher in this segment due to foreign currency-denominated airport services. A weaker ruble leads to reallocation of passenger traffic from international to domestic destinations, which partially evens the negative effect for airlines from ruble depreciation. We assume a gradual ruble depreciation in 2018-2022 and expect the annual average USD/RUB exchange rate to be in the 58-63 range.

The labor market dynamics will remain an important factor for domestic passenger traffic in Russia. We expect the current unemployment level to remain and assume it be in the 5.2%-5.5% range. At the same time, the declining economically active population, which we expect to range from -0.5 to -0.7 per cent annually, may have a constraining effect on traffic volume. The effects of the above will be particularly visible in the commuter traffic segment. The favorable macroeconomic environment, however, would help sustain the growth rates.

## Airlines' margins are under pressure

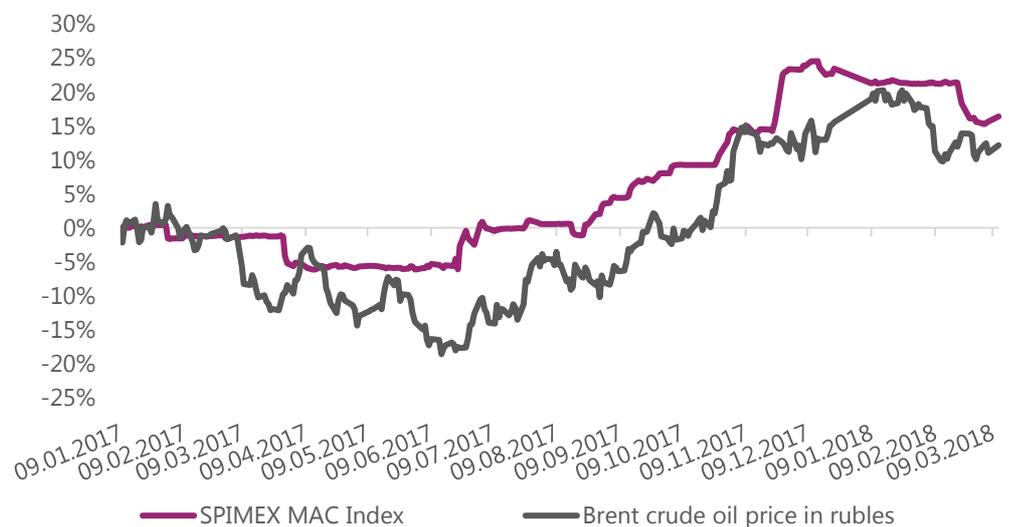
*RASK (revenue per available seat kilometer) represents revenues of airlines from transportation per one seat-kilometer.*

*St.Petersburg International Mercantile Exchange (SPIMEX) calculates the MAC Index reflecting jet fuel price dynamics at airports of the Moscow Air Cluster.*

Carriage cost decline contributed to a substantial growth of the air transportation market in 2017. According to ACRA preliminary estimates, the industry-average RASK declined by 6-9 per cent. The railroad long-distance passenger transportation, on the other hand, saw an increase in carriage costs: for some destinations, the shift of passengers to air travel continued last year. The railway rate dynamics is largely dependent on infrastructure costs indexation priced in in the fare; it was decided, however, that no indexation will occur with respect to both infrastructure costs and rates for passengers in 2018. Going forward, air carriage cost dynamics will continue matching the railroad transportation costs; this is why, we see no background for any substantial further shift of passengers in favor of air traveling. Setting the VAT rate from 10% to zero for domestic air transportation services could add momentum to the shift, but ACRA assesses the probability of this scenario as low.

Carriage cost dynamics will continue determining not only the balance between air and railroad transportation, but also the general development trends of the air travel market. At the same time, the following factors will have a significant effect on the cost. First, a sizable jet fuel price increase that started in 2017. For instance, the MAC index grew by 25% last year (followed by a minor correction in January and February this year). The above fuel price dynamics is explained by the change of crude oil price in rubles. We estimate the correlation between crude oil ruble price and jet fuel price to remain going forward. According to our forecast, the average annual price advance may total 2%-4% in 2018-2020.

**Figure 1. Increase in jet fuel prices was largely driven by the crude oil ruble price dynamics in the second half of 2017.**



Source: ACRA estimates, SPIMEX

Second, changes in airport infrastructure regulation that may result in further growth of operating expenses. Some airport tariffs in the Moscow Air Cluster have already been deregulated, which started affecting airlines' costs. In addition, the initiative of the Russian Ministry of Transportation to harmonize airport service fees for foreign and Russian air carriers is being discussed; if approved, it may increase costs for Russian airlines.

In 2017, we witnessed migration of flight personnel from Russian airlines to foreign companies, with the difference in compensation being the reason for the above. In an attempt to stop the migration, air carriers increase their payroll costs. According to ACRA estimates, airlines may increase their average payroll costs per one passenger-kilometer by 10% in the forecast period. Overestimated upside potential of the market and the respective carriage capacity additions may represent additional risks for the industry. Capacity oversupply and inefficient air fleet use would have a negative impact on margins.

Price competition between air carriers is stiff; therefore, they will not be able to fully pass their increased costs to end prices for passengers. We expect the margins in the segment to decline as a result. According to our preliminary estimates, the 2017 EBITDA margin of Russian airlines may be 5-7 pps below last year's figures totaling 5-8 per cent. The decline would have a negative effect on the leverage in the industry as a whole lowering the creditworthiness of the Russian air carriers.

According to ACRA estimates, by virtue of the macroeconomic environment and carriage costs dynamics the aggregate passenger traffic would gain 2.4% in 2018 (with a 3% gain for international routes and a 1.5% gain for domestic routes). At the same time, the passenger traffic in long-distance railroad transportation segment would experience no substantial changes.

### Heading for Egypt

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Reinstatement of air service to Turkey had a sizable effect on passenger traffic in 2017. According to the data from the Russian Federal Agency for Tourism, Russians made almost four million trips to Turkey in the nine months of 2017 virtually reaching the 2014 figures. Direct air service from Russia to Egypt was terminated in late 2015. 2.8 and 2.2 million trips were made to Egypt in 2014 and 2015, respectively. In 2018, the authorities started to gradually lift restrictions. As yet, direct flights are available only to Cairo, while Hurghada and Sharm-el-Sheikh are the key destinations for tourists. Reinstatement of direct air service to the above cities could bring the traffic figures for this travel destinations back to the 2014 level within a short time. Nevertheless, it is necessary to consider that there is no deferred demand of the kind as seen in the case with Turkey in 2017 anymore. Many tourists who prefer to spend their vacations in Egypt traveled in 2017 to Turkey, Bulgaria, and other countries traditionally seen as cheap. Under favorable conditions, a portion of the passenger traffic to Egypt would come from other destinations, which would slightly flatten the air travel growth if the air service to the country is reinstated in full.

According to our estimates, if air service (direct flights) to Egypt's major tourist destinations is reinstated midyear, passenger traffic could see a 1.9% gain in 2018. Passenger traffic in these routes would gradually increase in 2019-2020 without, however, any significant impact on the market dynamics.

## The positive effects from FIFA World Cup would be limited

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Russia is hosting FIFA World Cup in 2018. Such a large-scale event would bring great many football fans and spectators to the match-hosting cities. Not only preparation of sports venues but also transport infrastructure development were given special consideration to: capacity of many airports was enhanced; a new airport - Platov - was commissioned in Rostov-on-Don in 2017.

The development of transport infrastructure is well-justified: passenger traffic during the tournament would substantially exceed the previous maximum capacity of many airstrips and terminals. After the tournament, however, we do not expect any significant tourist flow increase in the majority of the hosting cities. Eventually, the enhanced capacity would prove to be excessive, and the maintenance costs may have a negative effect on airport margins.

We estimate that around 400,000 foreign spectators would visit the World Cup matches in Russia. ACRA projects the traffic on international flights to increase by 1.9%.

Spectators traveling between the hosting cities could push domestic carriage volume up. The distance between many cities hosting tournament matches is quite large, which would drive additional demand for domestic flights. According to ACRA estimates, the above factor could add another 1% to domestic air travel growth in 2018. 500-800 km trips of football fans would drive demand for long-distance railroad passenger transportation. We estimate that this segment could add another 0.5%-0.7%.

A feverish demand for flights to the hosting cities can boost financial performance of the airlines. However, the positive effect may be limited as the Federal Anti-Monopoly Service closely monitors air ticket prices and takes measures to prevent them from surging.

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