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Dividends outpace income and investments

Analysis of dividend payments by Russian non-financial companies

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- **The amount of dividends paid by non-financial companies increased 8% in 2015 to RUB 1,350 bln.** The proportion of net income distributed as dividends climbed from 28% in 2013 to 31% in 2015. This growth was largely driven by a surge in payments to shareholders in the oil & gas sector (+15%), which accounted for 50% of total dividends paid. Other leaders in terms of dividend figures were metals & mining and telecoms.

- **To bring dividends up to 50% of net income, state-owned companies need extra RUB 200 bln.** Increasing dividends may result in further curtailing of investment programs due to insufficient free cash flow, which in turn may undermine creditability of state-owned companies.

- **Metals & mining led the dividend payment growth in 2013-2015.** Having passed the capex peak and supported by ruble devaluation, the metal companies increased dividends. However, to build them up further the sector will need a new growth source.

- **Telecoms will no longer be able to maintain high dividends in the coming years** due to considerable costs of rolling out infrastructure required by the new antiterrorist legislation. Even keeping dividend payments at current levels may negatively impact the credit quality of sector companies.

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Oil & gas, metals & mining and telecoms generate 85% of dividends

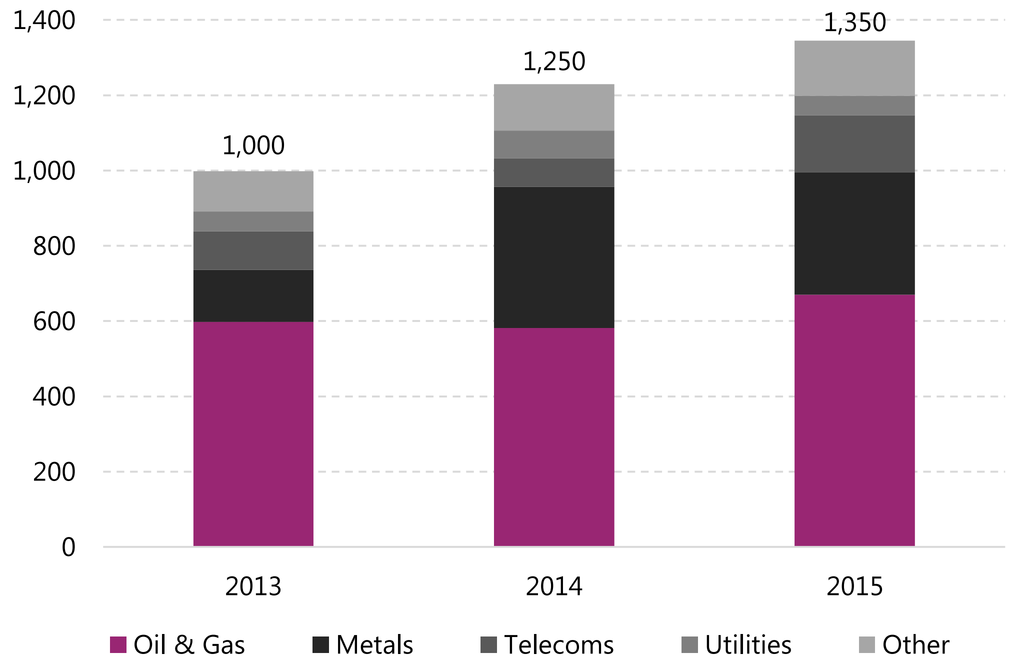
By ACRA's estimates, the total declared 2015 dividends in the Russian non-financial sector ran into some RUB 1,350 bln, which is 8% higher than RUB 1,250 bln paid in 2014, and 35% higher than the 2013 level. In addition to a dividend growth in absolute terms, the proportion of net income allocated for dividend payments also increased, climbing from 28% to 31% between 2013 and 2015.

Traditionally, the main dividend flow is generated by oil & gas companies – in 2015, they accounted for 50% of all dividend payments. The sector dividend total gained 15% in 2015 reaching RUB 670 bln.

In 2013-2015, the most pronounced dividend growth was shown by metals & mining, which increased payments to shareholders over the period by 135% to RUB 330 bln. Excluding Norilsk Nickel, which generates about half of the total dividend flow in the industry, the sector dividend total tripled over the period, while its contribution to total dividend payments by end 2015 amounted to 24%.

Completing the top three is the telecoms sector, which will distribute among its shareholders as 2015 dividends the amount of some RUB 150 bln (11% of all dividends paid by the corporate sector). From 2013 to 2015, telecoms built up their dividend payments by 48%.

Figure 1. Oil & gas remains the key dividend generator, RUB bln



Source: ACRA estimates

The aggregate amount of dividends is based on data from Russia's 184 largest companies that showed RUB 46 trillion of total revenues at end 2015, which corresponds to 35% of total revenues of all Russian companies.

Increased dividends of state-owned companies may lead to further curtailing of their investment programs

By ACRA's estimates, state-owned companies saw their total 2015 dividends up 25% to RUB 465 bln, of which 67% was contributed by Gazprom and Rosneft. The average percentage of all state-owned companies' net income directed to dividend payments amounted to 28%. Profitable state-owned enterprises distributed as dividends 23% of their net income, while excluding Gazprom and Rosneft this figure drops to 17%.

The Finance Ministry is considering an option of obliging all state-owned companies to distribute as dividends not less than 50% of their IFRS net income starting 2017, although already at end 2015 some of these companies announced dividends based on this ratio.

If all state-owned companies paid dividends for 2015 based on these new rules, then their shareholders would get extra RUB 500 billion, by ACRA's estimates, with up to RUB 320 bln landing in the government vaults (via the federal budget and specialized state-owned corporations). In addition, this would broaden the income tax base formed by dividends and would bring around RUB 25 bln of additional revenues to the budget.

FCF (Free Cash Flow) – operating cash flow adjusted for dividends and capex.

Paying additional dividends would significantly increase pressure on companies' cash flows. Some major state-owned companies may have sufficient free cash flow (FCF) to make these payments, but many others see their FCF either close to zero or even in the negative territory. In fact, by end 2015 the average FCF margin shown by state-owned companies amounted to 4%, while excluding Rosneft, whose figures significantly inflate the average, the number stood just at 0.4%. As a result, to pay higher dividends state-owned companies would need additional RUB 200 bln, which may be sourced from investment programs.

The average fixed investments (capex) to revenues of state-owned companies fell between 2013 and 2015 from 21% to 19%. If these companies prove unable to "protect" their investment programs from state appetites, then an additional capex reduction may dampen this ratio by extra 2 pps and overall capex of state-owned companies may squeeze by up to 5%. Sacrificing capex to dividends, coupled with reducing the already meager FCF would adversely affect state-owned companies' creditability.

Metals & mining raised dividends backed by ruble devaluation

In 2013-2015, the metals & mining industry was ahead of other sectors in terms of dividend growth rate, while the share of net income distributed to shareholders was also above average. For 2015, metal producers paid 72% of their net income as dividends (or 52% if Norilsk Nickel, whose dividends exceeded net income by 30%, is not taken into account).

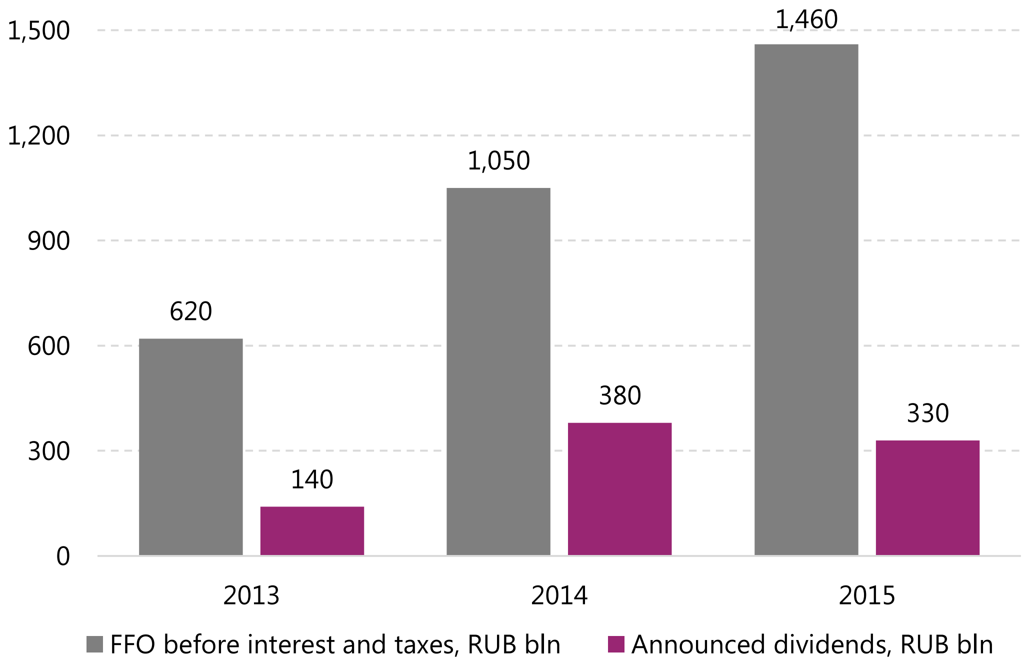
A high dividend payout in the metals & mining sector may be explained by the fact that the period of peaking capital expenditures of 2000-2014 has come to an end. The industry is now enjoying significantly upgraded fixed assets, with open-hearth furnaces phased out at almost all large factories and the proportion of continuous casting increased to about 90%. All further investment programs will focus primarily on maintaining existing facilities and will, therefore, have a much less pronounced impact on cash flows.

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

In 2013-2015, dividend payments were mainly capped by a relatively high debt burden of the sector on the back of negative price environment on global markets of ferrous and nonferrous metals. However, ruble devaluation tangibly increased cash flows in the sector. From 2013 to 2015, industry's total FFO before interest and taxes climbed 135% to RUB 1,460 bln, while the sector average debt to FFO before interest and taxes went down from 4.0x at end 2013 to 3.1x in 2015, which allowed to increase dividend payments with no big damage to creditability.

By ACRA's estimates, dividends of metal companies will stick to the current level of RUB 300-360 bln, as their growth sources have been largely exhausted. Unless a significant increase in world prices for ferrous and nonferrous metal products occurs or some other factors emerge, a substantial dividend increase in the sector is unlikely in the coming years.

Figure 2. With capex peak out and ruble devaluation in, the metals & mining sector increased dividends substantially



Source: ACRA estimates

A drop in metals & mining dividends in 2015 was due to lower payout by Norilsk Nickel to its shareholders. Apart from Norilsk Nickel, dividend disbursements in the sector climbed 27%.

Increased infrastructure spending will significantly reduce telecoms dividends

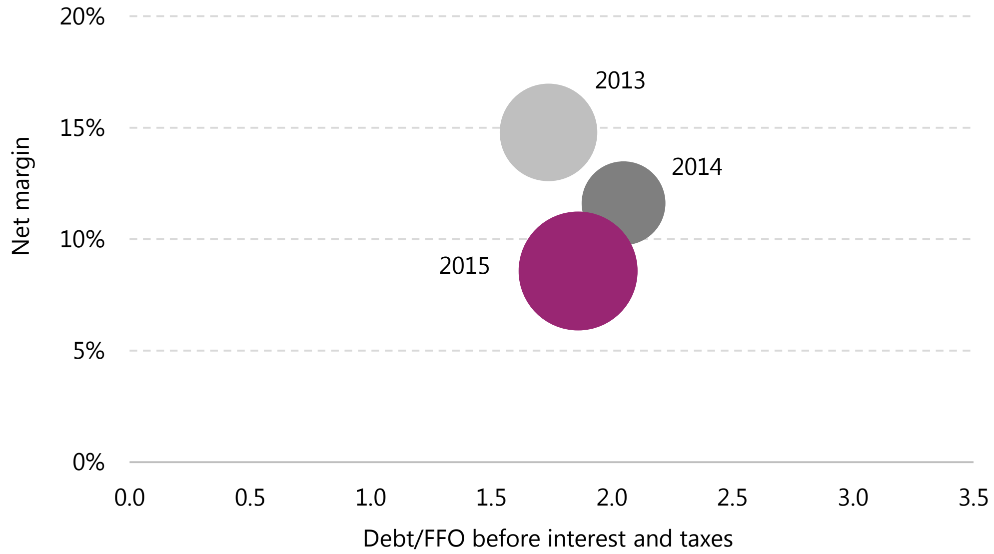
Sector specifics requires telecom companies to constantly upgrade equipment, which is why this industry was one of the few in the Russian economy not to post a reduction in the capex to revenues ratio over the last three years. Moreover, this ratio even rose from 19% in 2013 to 21% in 2015.

In the coming years, capital expenditures in the sector will increase significantly, as operators will have to put up a new infrastructure required by antiterrorist legislative changes, according to which starting July 1, 2018, telecom companies will have to make and keep recordings of voice calls, messages, etc.

Market participants estimate that their costs may run into some RUB 2 trillion, which corresponds to three annual FFOs before interest and taxes of the entire segment. If the current price parameters remain and no subsidies are provided by the state, the sector may see its debt burden increasing to 4-5x FFO before interest and taxes. In addition, telecom operators expect their activities to become unprofitable in the next five years.

Expansion of investment programs will have a material effect on telecoms debt load and profitability. Maintaining dividends while incurring losses may be possible at the expense of retained earnings, however this option would eat into companies' capital, which may adversely affect creditability. By ACRA's estimates, telecom dividends for 2016 will still be comparable to those paid for the previous year, however payouts to shareholders for 2017 may be much lower.

Figure 3. Declining profitability may force telecom companies to dramatically cut dividends



Each circle's square corresponds to the amount of dividends paid for the year.

Source: ACRA estimates

Calculation method

The dividend amount paid by non-financial companies for each year was determined as the sum of intermediate and announced annual dividend, 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 184 Russia's largest non-financial companies in different sectors, with the total revenues amount at end 2015 amounting to RUB 46 trillion, or 35% of total revenues earned by Russian companies. By ACRA's estimates, the selected companies pay 95% of the dividend amount distributed by all Russian non-financial companies, as only big business can afford paying generous dividends.

To avoid a possibility of "double counting" of dividends distributed by parent companies and their subsidiaries, a complete accounting of parent dividends was made, while payments by subsidiaries were adjusted to the amounts owed 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.

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