Association of
Institutional Investors (API)

Attn: Mr. Anton Siluanov,
Minister of Finance
of the Russian Federation

04/10/2017

Concerning the dividend policy
of state-owned public joint-stock companies in 2017-2019

Dear Mr. Siluanov,

The Association of Institutional Investors (API) unites 25 Russian and international institutional and portfolio investors, with a total investment in Russian assets exceeding 1.7 trillion rubles. Medium-term and long-term investments in state-owned companies account for a large part of that amount. At some state-owned companies, API members hold the second largest equity stake after the Government. The long-term investment strategy calls for a balanced approach to combining the current yield and long-term development, which brings together the interests of investors and the Government as the controlling shareholder.

Seeing as decisions on the profit distribution and the declaration of dividends at major state-owned companies depend on instructions from the Government as proposed by relevant ministries, we would like to bring the investment community's position as regards the dividend policies of publicly listed state-owned companies (hereinafter referred to as PJSCs) to your attention. We hope that this position will be taken account of in decision-making on 2016 dividend payments and when formulating the Government's long-term approaches to dividend policies at controlled companies.

In 2016, the Government made a decision to increase the payout ratio for 2015 dividends to 50% of the company's IFRS or Russian GAAP (RAS) net profit; only three major companies were allowed to pay less than 50%.

In 2016 (the actual 2015 dividend payment period), the total debt of the 10 major PJSCs decreased by 7%, the average net debt/EBITDA ratio increased by only 3% to 1.83x, an evidence of stability. VTB Bank increased its equity capital. Investments in fixed and intangible assets held steady for all the companies under review, increasing by 7% on average, while ranging between -20% to +20% against the 2015 level individually for companies (excluding PJSC Gazprom and PJSC Aeroflot). These performance indicators are projected to further improve in 2017.

The minority shareholders of the state-owned companies welcome the full transition to IFRS net profit as the dividend calculation base (even in the periods where it may turn out to be below the Russian GAAP profit); they also believe it reasonable and justified to set the dividend payout ratio equal to at least 50% of the net IFRS profit, with an increase to 75% and higher for some companies.

The analysis of state-owned companies' net debt at the end of 2016 and Bloomberg's average forecast based on investment banks' estimates of free cash flow and EBITDA in 2017 indicates that the increase in the dividend payout to 50% of the IFRS net profit (under the most pessimistic scenario, i.e. when companies will have to fully finance the payment of dividends by borrowed capital) would increase the average net debt/EBITDA ratio from 1.66x to no more than 1.79x.

The analysis of IFRS financial statements for 2016 makes it obvious that the 12-month profit is almost entirely covered by disposable cash flow net of actual capital expenditure. The coverage ratio is 77% of the profit attributable to shareholders for ALROSA, at least 140% for PJSC Aeroflot, 98% for PJSC Rostelecom, an evidence of these companies' ability to earmark 75% of their profit for dividends without a negative impact

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on their financial performance and without prejudicing investments. Even Rosneft Oil Company keeps the cash flow coverage ratio at 85%. If dividends are partially financed by borrowed funds (in case of cash flow shortage), the net debt/EBITDA growth still remains in a comfortable zone. Electric power companies (e.g. FGC UES) are no exception; their cash flow suffices for the payment of at least 50% of the profits in dividends even without including the net profit earned from power connection services (as currently being discussed).

It should separately be noted that investors differ in opinions as regards possible adjustments of profit for non-cash items (currently under consideration) due to insufficient relevance or transparency of their application. Seeing as the decision on this matter is based on the Government's instruction, we propose that the current involvement of the Boards of Directors of major public companies in the instruction preparation process be changed – namely, the Boards of Directors (or their dedicated Committees) should submit related recommendations to relevant federal executive authorities and the Government, including the wording of dissenting opinions given by members of the Board of Directors before the instruction is issued. This would enable Boards of Directors to resume their meaningful participation in decision making on a significant instruction-specific issue which is entirely within the purview of this body by law, but is actually made a subject of negotiations between management teams and government officials.

Apart from the current financial position, the discussion at the Boards of Directors and the Government should focus on the dynamics of investment profitability indicators (ROE, ROIC and IRR for the most significant projects in terms of value), as well as for what purposes and how effectively the Company's retained earnings are used. The assessment of these parameters would also make it clear how earnings should be divided between dividends and investments.

Therefore, the payment of dividends starting from 50% (up to 75% and more for some companies) will not impair the economic and financial condition of PJSCs and will not prevent them from pursuing a well-balanced investment policy. These payments fully meet the 2017-2019 budget policy objectives set by the Government and are a powerful instrument of improving efficiency at state-owned companies.

The approach proposed by the investors would strengthen Russia's position as the leader among emerging markets in terms of dividend yield, which, despite geopolitical and macroeconomic challenges, would contribute to an increase in the investment appeal of Russian companies and improve their equity financing raising opportunities. It should be particularly noted that dividends earned by the largest institutional investors are usually reinvested in shares of Russian companies, further increasing attractiveness and improving stability of the market.

Attached: substantiating calculations (2 pages).

Best regards,
API Executive Director — Alexander Shevchuk

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Table 1. Changes in the net debt to EBITDA ratio and CAPEX in 2013-2016, total net debt in 2015-2016 of major state-owned PJSCs

(million rubles)	Total debt, million rubles		Net debt/EBITDA				Capital investment in fixed and intangible assets, million rubles			
Company	**2016**	**2015**	**2016**	**2015**	**2014**	**2013**	**2016**	**2015**	**2014**	**2013**
PJSC Inter RAO	17,624	76,329	-0.75x	0.16x	0.68x	0.52x	34,746	28,773	35,980	40,982
PJSC Gazprom	2,968,118*	3,442,215	2.06x*	1.19x	0.93x	0.55x	1,157,940*	1,641,024	1,262,140	1,397,195
PJSC RusHydro	199,803	197,393	1.35x	1.6x	1.74x	1.19x	60,957	79,238	78,577	61,641
PJSC ALROSA	142,336	223,159	0.66x	1.74x	1.88x	1.81x	31,752	34,241	36,056	38,165
PJSC Rostelecom	187,105	186,554	1.92x	1.81x	1.72x	1.89x	61,857	62,726	57,666	68,487
PJSC ROSSETI	558,886	584,271	1.4x	2.1x	2.24x	2.36x	196,178	174,052	204,193	266,415
PJSC Transneft	701,552	865,003	1.54x	2.2x	1.87x	1.35x	321,603	323,924	312,020	223,015
Rosneft Oil Company	3,585,000	3,323,000	2.31x	2.37x	3.01x	2.21x	709,000	595,000	533,000	560,000
FGC UES, PJSC	266,614	281,542	1.4x	2.51x	2.15x	3.02	79,770	76,552	77,729	124,930
PJSC Aeroflot	143,103	232,984	1.46x	3.5x	6.27x	2.18x	-334	24,076	17,901	3,781
Total	**8,770,141**	**9,412,450**	**1.83x**	**1.77x**	**1.78x**	**1.26x**	**2,655,485**	**3,041,621**	**2,617,276**	**2,786,624**

*For PJSC Gazprom, the table contains projected data as the Company has not disclosed its 2016 statements yet

	2016	**2015**	**2014**
VTB Bank (PJSC), equity capital according to Basel III, million rubles	1,017,821	1,014,666	771,040

Table 2. Assessment of the impact of dividends on the net debt/EBITDA ratio at major state-owned PJSCs in 2017

Company	**12-month IFRS net profit for 2016, million rubles**	**Dividends for 2016 (50% of the IFRS net profit), million rubles**	**Free cash flow not impacted by any activities (estimate)**	**Net debt / EBITDA ratio in 2017 (forecast)**	**Net debt / EBITDA ratio* in 2017 (subject to payment of 50% of the IFRS net profit in dividends)**
PJSC ALROSA	131,392	65,696	108,135	0.70x	0.43x
PJSC Aeroflot	37,443	18,722	59,598	1.33x	0.84x
PJSC Rostelecom	11,751	5,876	6,371	1.86x	1.86x
PJSC RusHydro	40,205	20,103	-2,761	1.28x	1.50x
FGC UES, PJSC	68,159	34,080	11,794	1.51x	1.66x
Rosneft Oil Company	181,000	90,500	-234,000	1.88x	2.11x
PJSC ROSSETI	98,341	49,171	-14,922	1.40x	1.59x
PJSC Gazprom	854,558	427,279	275,835	1.83x	1.94x
PJSC Transneft	232,856	116,428	20,145	1.56x	1.80x
PJSC Inter RAO	60,761	30,381	55,697	-0.88x	-1.16x
Total	**1,716,466**	**858,233**	**285,892**	**1.66x**	**1.79x**

* Adjusted for borrowing to finance dividends and compensate for cash flow shortage (in case of a negative cash flow) or for the use of FCF surplus net of dividends for debt repayment

Table 3. Ratio between capital expenses and net profit, coverage of capital expenses by available cash funds from operations of some major state-owned PJSCs in 2016

Million rubles	Rosneft Oil Company	PJSC Rostelecom	FGC UES, PJSC	PJSC ALROSA	PJSC Aeroflot [1]
Net profit	**201,000**	**12,249**	**68,382**	**133,471**	**38,826**
Depreciation, stock depletion, impairment of non-current assets	505,000	55,589	78,882	25,553	13,359
Other net profit adjustments [2]	209,000	6,019	-6,484	-24,836	2,171
Total net profit adjustments	714,000	61,608	72,398	717	15,530
Available cash funds from operations (estimate)	**915,000**	**73,857**	**101,680**	**134,188**	**54,356**
Capital investment in fixed assets and equivalent investments	744,000	61,857	79,770	31,752	334
Capital expenses / net profit	**3.70x**	**5.05x**	**1.17x**	**0.24x**	**0.01x**
Capital expenses / available cash funds from operations	**0.81x**	**0.84x**	**0.79x**	**0.24x**	**0.01x**

[1] Adjusted for net advance payments for aircraft

[2] Inclusive of adjustments for non-cash items of incomes and expenses (revaluation, reserves, etc.), exchange rate differences and profits/losses related to investments and changes in fixed assets, not including changes in current assets and current liabilities.

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