

ASSET CAPITAL PARTNERS

**MYTHS AND REALITY OF
DOING BUSINESS IN RUSSIA**

The Performance Theatre
„Inspiring Enduring Performance“, Act 2
5-7 October 2005, Oslo

Vladimir Matias, Managing Partner
Dr. Dr. Jan-Hendrik Röver, Managing Partner



1. **Introduction**
2. Russian Federation
3. Macroeconomic outlook
4. Myths and reality

Introduction

Three misconceptions of Russia

- The negative Russia “hat”: negative preconceptions
 - Dark sides of Russian history (in particular the confrontation during the Cold War)
 - Armada of business finsterlings labelled “oligarchs”
 - Karate-crazy, ex-KGB president
 - Only lightly sprinkled with
 - Wonder pianists
 - Opera divas
 - Tennis princesses
- The positive Russia “hat”
 - Incredible economic rise of Russia since 1998
 - Natural resources which just have to be picked up
 - Tendency to extrapolate developments in a straight line
- The obscurity “hat”
 - Sir Winston Churchill: **“Russia is a riddle wrapped in a mystery inside an engima”**
 - Political Russia still is a closed political system which makes it impossible for everybody except a very small inner circle to report the inside view of the Kremlin
- For the following discussion which will aim at providing insights for achieving „enduring performance“ in a Russian context and we ask you to put your three Russia „hats“ aside in the interest of a psychologically neutral analysis; strong emotions related to Russia make it difficult to find appropriate understanding



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Russian Federation 1 – the framework



Key facts

- Area: 17,075,200 sq km
- Population: 143,420,309 (July 2005 est.)
- Median age: 38.15 years
- Ethnic groups: Russian 79.8%; Tatar 3.8%; Ukrainian 2%; other 14.4%
- Labour force: 71.83 million (2004 est.)
- Government: Federation; President is head of state; bicameral legislature (Duma and Federal Assembly, i.e. Upper House of Parliament)
- Natural resources: oil, natural gas, coal, gold, nickel, platinum, palladium, timber

Source: www.cia.gov

The Russian Federation 2 – dramatic transformation



Russia in 1998

- Weak and unstable central government
- Economic reforms dominated by “oligarchs”
- Weak currency; limited Central Bank intervention
- Disastrous corporate and sovereign credit fundamentals (non-investment grade)
- Critical cash and investment shortages
- Tax collection problems
- Massive capital flight of Russian investors
- Unreformed banking, utilities, transportation and other major sectors
- Major shareholders stripping companies’ cash flows
- Official corruption; hostility toward entrepreneurial investment



Russia today

- Federal government firmly in control; strong national political consensus
- Fundamentally different economic conditions
- Economic reforms driven by government; oligarchs’ influence waning
- Ruble strengthening to all-time highs backed by record Central Bank reserves
- Improving credit fundamentals – Russia now investment grade
- Increasing investment and general market liquidity
- Reform programmes in utilities and transportation; banking reform underway
- Development of equity culture; focus on shareholder value
- Crack-down on official corruption; encouragement of entrepreneurs

Source: The Carlyle Group, own research

The Russian Federation 3 – the wind of change

Good pace of reforms ... but still a lot to be done ...

Main goals

- Double the size of the economy (i.e. GDP) in a decade and reduce the gap between rich and poor
- Reduce dependence on oil by encouraging investment in high-tech industries and services
- Cut red tape, break monopolies and boost small business
- Lower the tax burden, rationalise spending, bring down inflation and interest rates over time
- Create a legal framework for a functioning property market

Freeing up finance

- Phase out capital controls; make the ruble fully convertible
- Reform and privatise state banks
- Boost bank capitalisation and force change to IFRS accounting rules by 2007
- Introduce deposit insurance (completed in 2004)
- Encourage development of debt instruments, including treasury bonds, mortgages and asset-backed securities
- Improve market regulation; insider trading laws; increase & toughen corporate disclosure
- Tax incentives to promote investment fund industry
- Better regulation of insurance sector
- WTO membership

The numbers

- GDP growth targets:
 - 2004 – 7.1% (✓)
 - 2006 - 5-6%
 - 2008 – 7%+
- Inflation estimates for 2006: 5.5% - 7.5% (±)
- Gradual real appreciation of ruble (✓)
- Budget surplus of 0.5% of GDP in 2004 (✓)
- Creation of Stabilisation Fund of US\$ 5-6 billion from surplus (✓)

Breaking monopolies

- Spin off and sell generating units of state utility monopoly (UES)
- Privatise electricity transmission and distribution systems
- Gazprom to be more closely regulated, with pipeline transport made more transparent and development of national natural gas market
- Reform and privatisation of state railways monopoly
- Reform and privatisation of state oil pipelines monopoly (Transneft, Transneftproduct)
- However, despite many reform plans government has not made much progress

Source: The Moscow Times



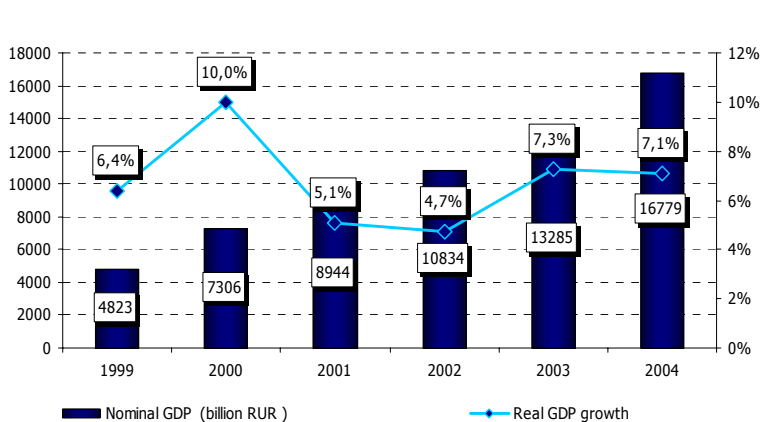
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Macroeconomic outlook 1

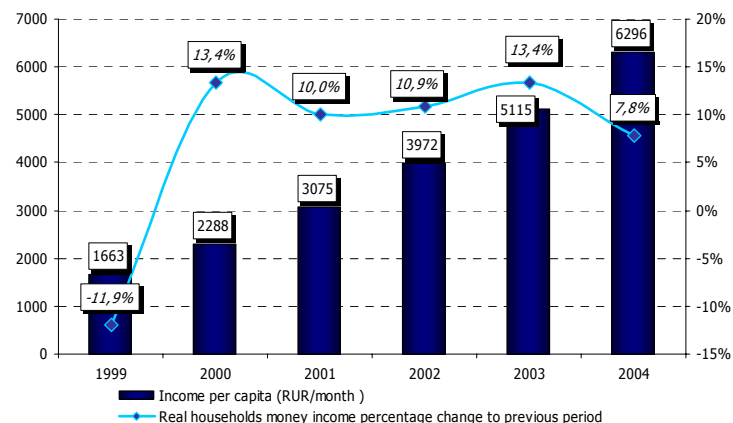
Major trends 2005

- Sixth successive year of impressive GDP growth
 - 7.1 % real GDP growth in 2004 (nom. GDP = US\$ 582 bn compared to German GDP of US\$ 2.7 tr) which is slightly lower than 7.3% growth in 2003 (nom. GDP = US\$ 432.7 bn). The recent slight decrease in GDP growth rates can be explained by the increase of production costs due to a growth of energy prices, ruble strengthening and substantial wage increase
 - Average GDP growth rate in Russia over the last six years approx. 6.8% – a rate that few other European countries have matched
- Household income increased in real terms by 7.8% in 2004 and the poverty level decreased further
- Despite the political factors, such as the YUKOS case, the FDI inflow is at record high reaching \$US 9.4 bn in 2004
- S&P upgraded Russia's sovereign rating to investment grade (BBB-)
- Central Bank reserves (foreign currency and gold) among the largest in the world - \$US 151.6 bn as of July 2005
- Creation of the Stabilisation Fund - as of 1 August 2005 = RUR 721 bn (US\$ 24.44 bn)
- \$US 15 bn advance repayment of Paris Club debt (i.e. state debt) announced for 2005

Nominal and real GDP



Household income



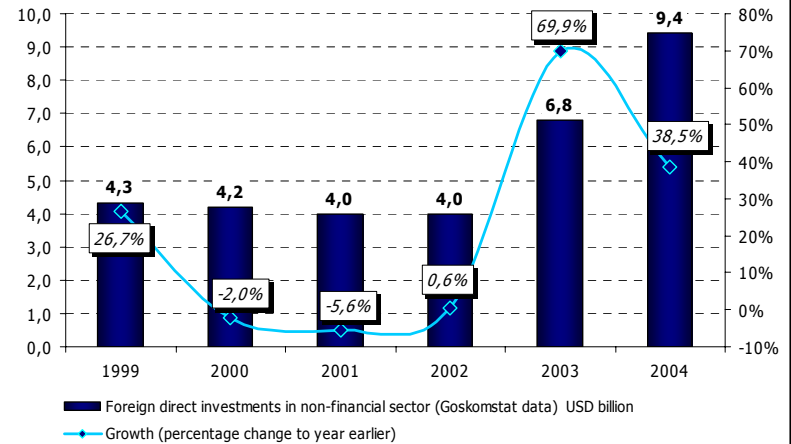
Source: Goskomstat, ICSS, own calculations

Macroeconomic outlook 2

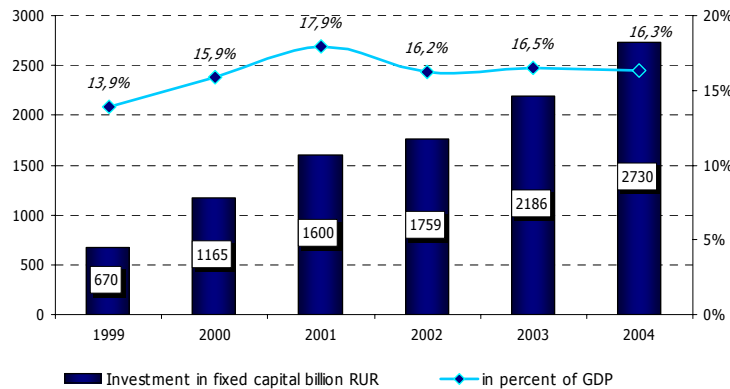
Investments

- Substantial increase in investment demand. With capacity by and large fully utilised, growth cannot be sustained without investments
- In 2004 fixed capital investment amounted to RUR 2,729.8 bn (US\$ 94.7 bn) or 16.3% of GDP. In the first quarter 2005 it amounted to RUR 517.8 bn (\$US 18.63 bn)
- \$US 9.4 FDI in 2004 – 38.9% up from the previous year (\$US 6.8 in 2003). Most of the FDI goes to the fuel and metals sectors of the economy. The foreign investment inflow per capita (ca. \$US 260) is relatively small in comparison to other transition economies

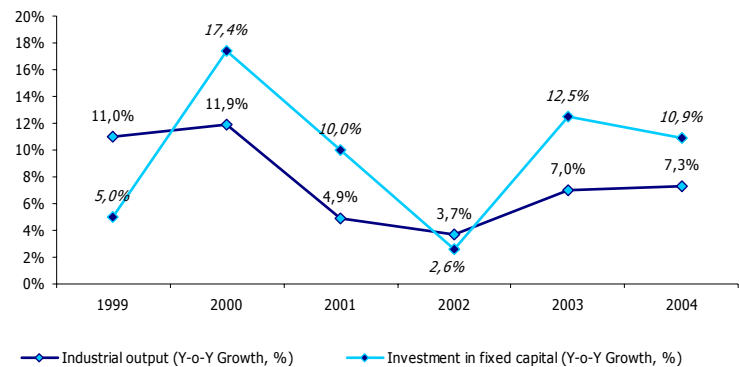
Foreign direct investments in non-financial sector



Fixed capital investment



Industrial output vs. investment in fixed capital



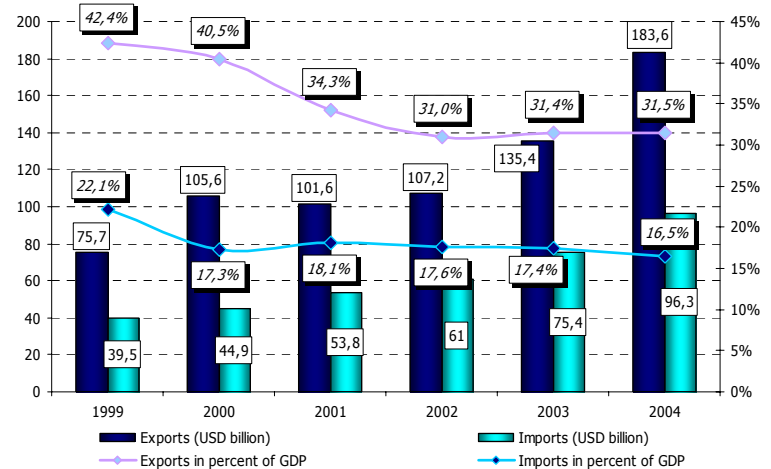
Source: Goskomstat, ICSS, own calculations

Macroeconomic outlook 3

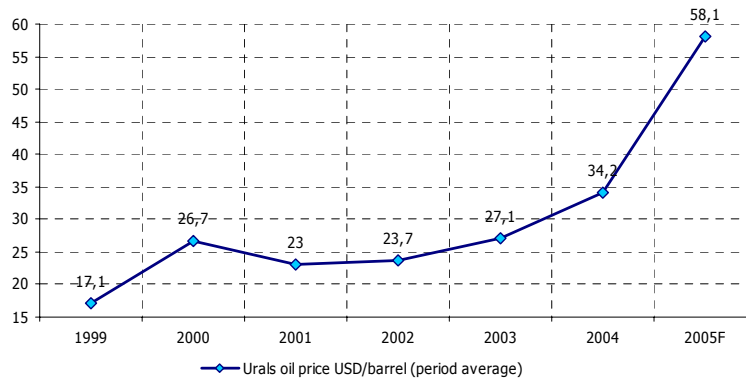
Foreign trade

- Significant increase in import and export volumes. The main reasons for this are ruble strengthening, increase in real incomes and increase in purchasing power of the population
- In 2004 exports of US\$ 183.2 bn (up 34.8% from the previous year) and imports of US\$ 94.8 (up 24.7% from the previous year)
- Positive trade balance increased in 2004 to US\$ 88.4 bn compared to US\$ 59.9 bn in 2003
- Extremely favorable market situation for Russian exporters. High oil and other commodity prices in international markets

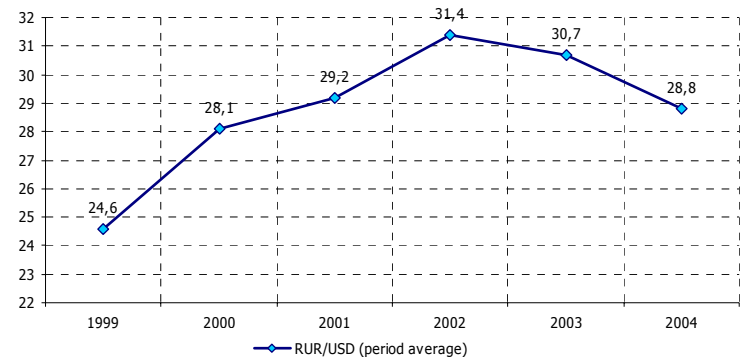
Foreign trade



Oil price



Official exchange rate



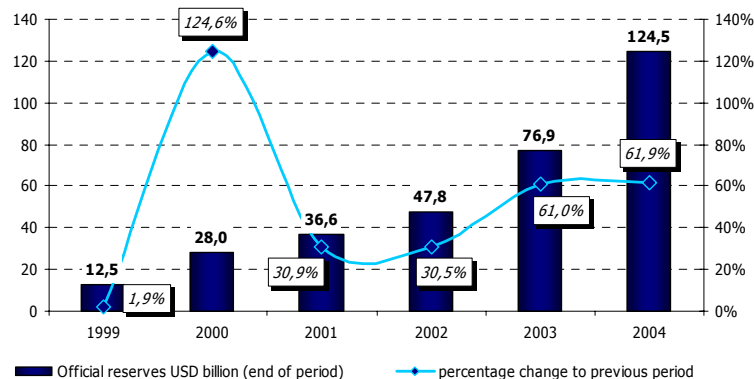
Source: Goskomstat, ICSS, own calculations

Macroeconomic outlook 4

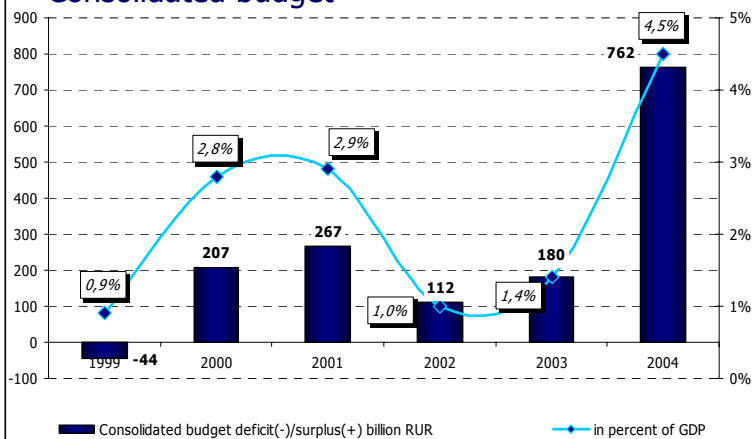
Government finances

- Gold and foreign exchange reserves at historical highs: more than US\$ 151.6 bn in Q2 2005
- Budget surplus in 2004 of RUR 731 bn or 4.4% of GDP
- Stable growth of taxation income
- Stabilisation Fund as of Aug 2005 = RUR 721 bn (only RUR 106 bn in Feb 2004). It was established in February 2004. The Fund is financed from the natural resources extraction tax and crude oil export duties when the price of Urals-grade oil exceeds \$20 per barrel. Above the 500-billion-ruble ceiling, the Government is free to spend revenues for purposes agreed with the Federal Assembly
- Advance repayment of the Paris Club debt in 2005

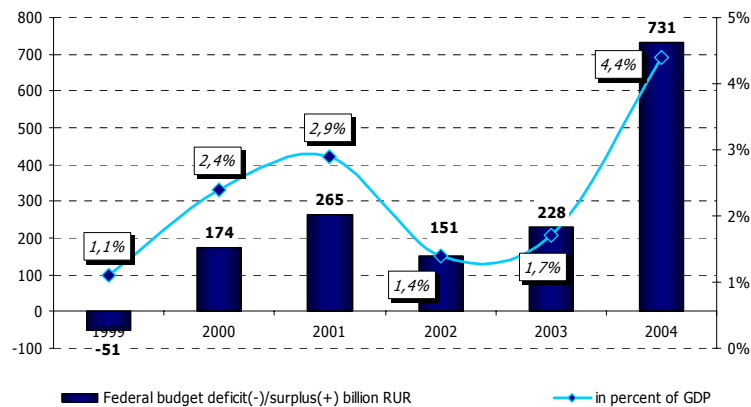
Central Bank hard currency and gold reserves



Consolidated budget



Federal budget

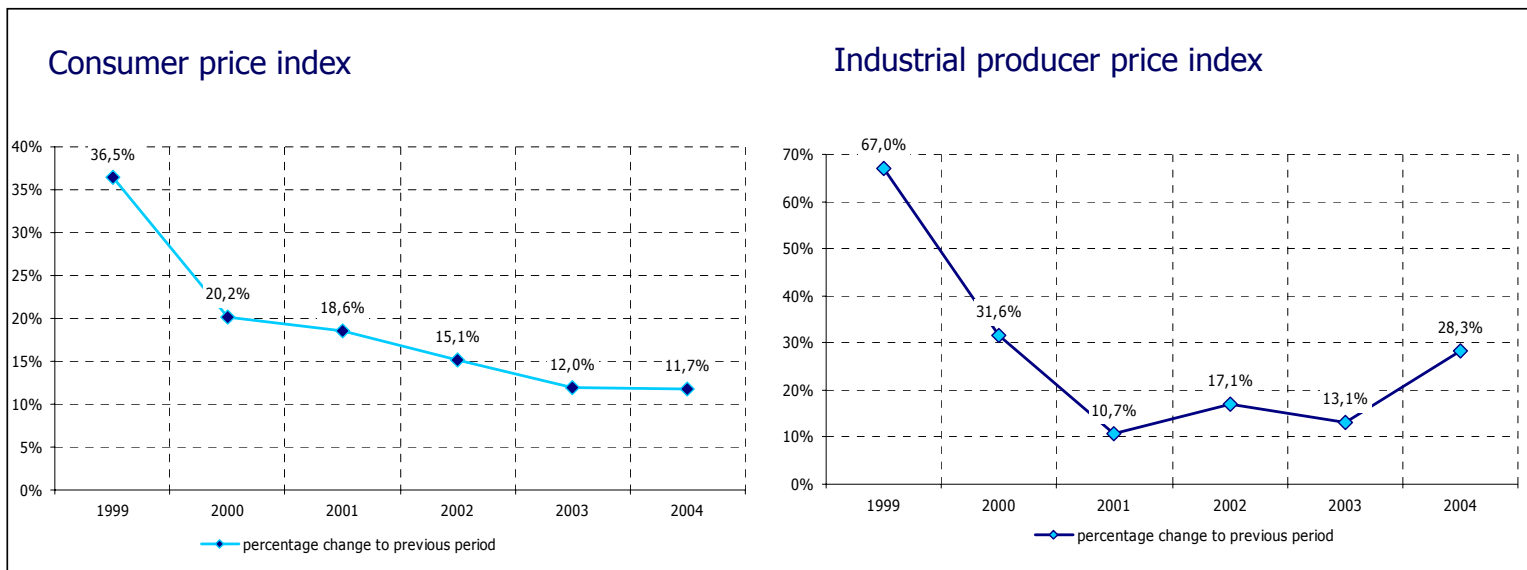


Source: Goskomstat, ICSS, own calculations

Macroeconomic outlook 5

Inflation

- Inflation decreased from above 20% in 2000 to ca. 12% in 2004
- At the end of 2004 inflation was 11.7% which was slightly above the Government target
- The inflation for the first five months of 2005 was 7.1%
- The official inflation forecast for 2005 is set at not more than 10% (which is expected not to be achievable by market observers)



Source: Goskomstat, ICSS, own calculations



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Myth 1 - 1

Myth

- Russia is an economic giant

Indicators

- Russia is a large and resource rich country and must by definition have a large economy
- Constant news about large companies like Gazprom, YUKOS, Lukoil, Norilsk Nickel, Sibneft, Rosneft
- Russia is party to the G8 talks

Reality

- Germany's GDP (a country with a population of ca. 80 million) is almost 5 times larger than Russia's
- Russia's companies are – except for a few very large companies – relatively small and would be characterised as small and medium sized enterprises in western countries (see comparison between Russian and international companies next slide)



Myth 1 - 2

International companies

Rank	FT Global 500 (2005)	Country	Sector	Market value US\$ m	Turnover, US\$ m
1	General Electric	US	Diversified industrial	382 233,1	151 299,0
2	ExxonMobil	US	Oil & gas	380 567,2	291 252,0
3	Microsoft	US	Software & comp. serv.	262 974,9	36 385,0
4	Citigroup	US	Banks	234 436,7	N/R
5	BP	UK	Oil & gas	221 365,3	285 059,0
6	Wal-Mart	US	General retailers	212 209,0	285 222,0
7	Royal Dutch/Shell	Netherlands/UK	Oil & gas	210 630,4	266 386,0
8	Johnson & Johnson	US	Pharm-s & biotech	199 711,4	47 348,0
58	Gazprom	Russia	Oil & gas	67 942,9	29 242,1
100	eBay	US	General retailers	50 107,4	3 271,3
150	Philips Electronics	Netherlands	Electronic & electric eq-nt	36 257,2	39 307,1
481	Talisman Energy	Canada	Oil & gas	13 139,0	4 355,3
496	ABB	Switzerland	Electronic & electric eq-nt	12 865,0	20 721,0

Russian companies

Rank	Finance Mag 500 (2005)	Sector	Market value ¹ US \$ m	Turnover ² , US\$ m
1	Gazprom	Oil & gas	67 022,5	35 211,8
2	Lukoil	Oil & gas	29 192,1	29 921,3
3	Unified Energy System	Electricity	12 870,5	24 501,0
6	Surgutneftegaz	Oil & gas	17 487,1	11 107,1
7	Sibneft	Oil & gas	14 484,7	8 061,9
8	Sberbank	Banks	12 615,5	7 888,3
9	Norilsk Nickel	Metals	12 561,8	7 304,3
10	Severstal	Metals	4 238,3	6 904,4
20	Mechel	Metals	3 642,4	3 776,2
31	GAZ	Automobiles	216,5	1 681,9
43	Wimm-Bill-Dann	Beverages	753,3	1 235,1
180	VSMPO-Avisma	Metals	1 131,6	381,1
204	Ufa Refinery	Oil products	268,3	352,6

1 - Renaissance Capital (Jun 2005)

2 - US\$ 1 =RUR 27,74

- Foreign direct investment in Russia is still quite low at US\$ 9.4 billion in 2004 versus US\$ 61 billion in China
- Strong dependence on energy and commodity prices
- Russia is on its way to demonstrate impressive „awakening“ not only in the natural resources sector
- Capitalisation of Russian companies is low compared to international peers and, therefore, offers significant growth potential
- The top Russian companies are over-banked and over-approached and it is, therefore, advisable to move to the second and third tier companies; opportunities are with „outsiders“ which can offer higher profit margins and unique growth opportunities but have often not yet been „discovered“ by investors



Myth 2 - 1

Myth

- The Russian investment climate is worse than the investment climate in other countries

Indicators

- Flight of local capital from Russia
- Comparatively low foreign direct investment

Reality

- Russian economy has great potential
 - rich in natural resources, including mineral and power resources
 - highly developed industrial and scientific research background
 - skilled and qualified workforce
 - potentially vast domestic market characterised by unsatisfied demand for consumer goods
- Russia has achieved economic stability and is poised for continued growth
 - GDP growing at 7%+ per year
 - Inflation under 12%, strengthening currency
 - Investment grade from all three major credit rating agencies
 - Growing consumer demand and buoyant private consumption
 - Net creditor (i.e. loans to other states larger than Russian federal debt) since 2004
 - Improved trade conditions



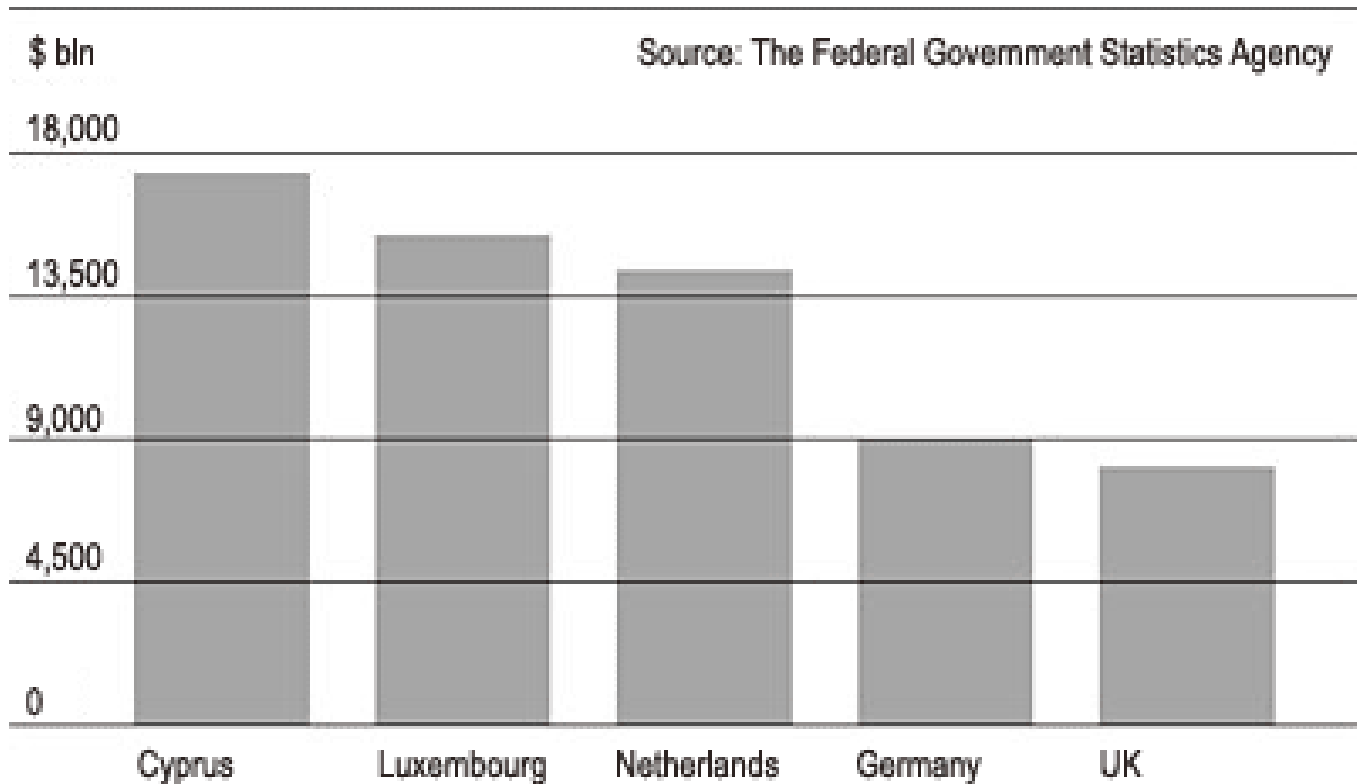


Myth 2 - 2

- Improving investment environment
 - Significant growth in foreign direct investments (from US\$ 4.2 bn in 2000 to US\$ 9.4 bn in 2004); for nationality of investments see next slide)
 - Intensification of strategic investor interest
- The new reform agenda (for Putin's second term which began in 2004)
 - Strong economic fundamentals underpinned by aggressive political reform
 - Strong central government will drive reform and economic growth
- One of the lowest tax rates in Europe (income tax of 13%, corporate tax of 24%)
- Contrary to popular impression that "money is everywhere", domestic financing market unable to cope with demand for capital
 - Domestic banks provided estimated 5% of investment capital in 2004
 - Private equity funds able to invest in Russia have commitments of US\$ 2-3 bn (ACAP estimates) only
- There is no reason not to do business in Russia because the „investment climate is bad“
- Russian investment environment has improved dramatically and to an extent which was unthinkable 7 years ago; Russia is one of the most impressive turn around stories of recent years and it should be noted that the changes are not only due to increased natural resources prices but also to successful political management
- Russia offers investment opportunities to foreign capital providers due to the shortage of capital

Myth 2 - 3

Who Invested in Russia Most (the volume of accumulated investment by July 2005)



Myth 3

Myth

- The Russian industry is controlled by the “oligarchs”, a group of super-wealthy Russians and foreign individuals who dominate Russia both economically and politically

Indicators

- A World Bank study published in 2004 (for reference see www.worldbank.org.ru) confirmed that 23 individuals or groups control more than a third of the country’s industry as measured by sales, 16% of employment and hold 17% of all banking assets

Reality

- Despite the fact that the so-called group of “oligarchs” is particularly important in the Russian industry, a sector of small to mid-sized companies has emerged; however, small enterprises play a subordinate role (only 10-15% of Russian GDP)
- Government has firmly consolidated influence and control

Performance
impact

- As already discussed large investment opportunities are rare
- However, there are a great number of quickly growing Russian small and mid-sized companies; they could be a good entry point to the Russian market
- It is probably a better strategy to associate with a Russian company with a proven track record of growth than to shoot for white elephants which may never appear
- Small and mid-sized investments have proven to be of interest to foreign small to mid-sized companies in the past

Myth 4 - 1

Myth

- The Russian legal system is inadequate

Indicators

- There are plenty of stories which describe the pitfalls of the Russian legal system. Many describe the difficult 1990s where investors made many a bad experience with their investments in the Russian Federation
- There are still a lot of gaps and loopholes in the Russian legal system
- YUKOS case

Reality

- Russia has undergone an almost unprecedented overhaul of its legal system; new Russian legal system was developed on the basis of the legal system of the FSU and in recent years absorbed many best international practices; a new civil code has now been tested in practice already for several years; ongoing legal reforms (currency liberalisation, new subsoil law, Kyoto protocol)
- The Russian Federation sooner or later intends to join WTO, hence it is in a process of adapting its legislation to the requirements of a free trade
- One of the most efficient parliaments and governments in Russia's history
- The court system has been improved; however, there are still some enforcement problems
- There are still pitfalls in the Russian legal system which have mainly to do with the fact that many pieces of legislation have no long history. However, the pricing of Russian assets seems to compensate for these uncertainties (which are no longer of fundamental nature) more than probably asked for



Myth 4 - 2

- In many cases it is possible to agree on neutral law (such as English law)
- Courts are increasingly providing real protection to creditors; recent decision with respect to YUKOS confirmed this: the Moscow Arbitration Court recognised US\$ 475 million bank debt owed to YUKOS lending banks (a similar decision taken by the High Court in London in June this year)
- International players are used to work in far less developed legal environments!



Myth 5 - 1

Myth

- It is almost impossible to do business in Russia in a timely manner and with predictable results

Indicators

- Russian partners often do not meet their commitments, transaction steps are byzantine
- There is almost no institutional business in Russia
- Estimated US\$ 36 bn of bribes annually (according to study by think tank Indem in May 2005) which would make Russia the „world leading“ in the bribery business

Reality

- The investment universe for potential western investors is large and very diverse. It is, hence, dangerous to make any generalisations
 - There are many Russian independent oil companies which welcome foreign investment if it comes with access to western technological know how
 - They are also often interested in sharing capital expenditures with foreign partners, in particular if they pursue a clear growth strategy
 - There are also infrastructure investments which small to mid-sized players owning larger assets cannot finance themselves



Myth 5 - 2

- All the situations mentioned under „reality“ offer interesting investment opportunities to foreign investors
- Success is based on knowledge of local specifics and readiness to adjust to the situation
- You may be dealing with the wrong people, i.e. not the decision makers (which will typically be the shareholders; see next slide)
- You may not understand the other party's position and/or you may not address their interests adequately
- Transaction acquisition takes typically more time in Russia than in western countries; relationships are of particular importance and therefore time and effort investment shall be spent on people and relationships first



Myth 6

Myth

- Russian business is characterised by poor management; there are no local professionals who are able to solve difficult business tasks

Indicators

- Inefficient Soviet style management in some of the Russian companies, often where there is a large government stake
- No or little delegation of decision making power from shareholders to management

Reality

- The Russian oil industry can serve as an example for good Russian management in recent times
 - It has undergone significant changes in the 1990s which is indicated by (i) the remarkable reserve replacement performance as well as its astounding increase in total production (from 303 million tonnes in 1996 to 450 million tonnes currently)
 - Modern exploration and production technologies have become common-place in the Russian oil industry
 - It should also be noted that the Russian oil industry has a large pool of highly qualified personnel at all levels of responsibility. The hydrocarbon industry is one of the main pillars of the Russian economy as a whole
- Generally Russians learn and copy western management techniques and tools quickly
- New layer of well trained managers emerged in recent years
- Growing number of companies majority owned by private capital, with impressive performance, e.g. Tinkoff breweries (exit), Pyaterochka food retailer, VSMPO (titanium producer and supplier of GE, Boeing and Airbus)

Performance
impact





Asset Capital Partners GmbH

Bauerstrasse 20

80796 Munich, Germany

p: +49 89 242 246 910

f: +49 89 242 246 990

munich@assetcapitalpartners.com

www.assetcapitalpartners.com



Asset Capital Partners GmbH

Prechistensky per. 14/1

119034 Moscow, Russia

p: +7 095 981 0791

f: +7 095 981 0792

moscow@assetcapitalpartners.com

www.assetcapitalpartners.com