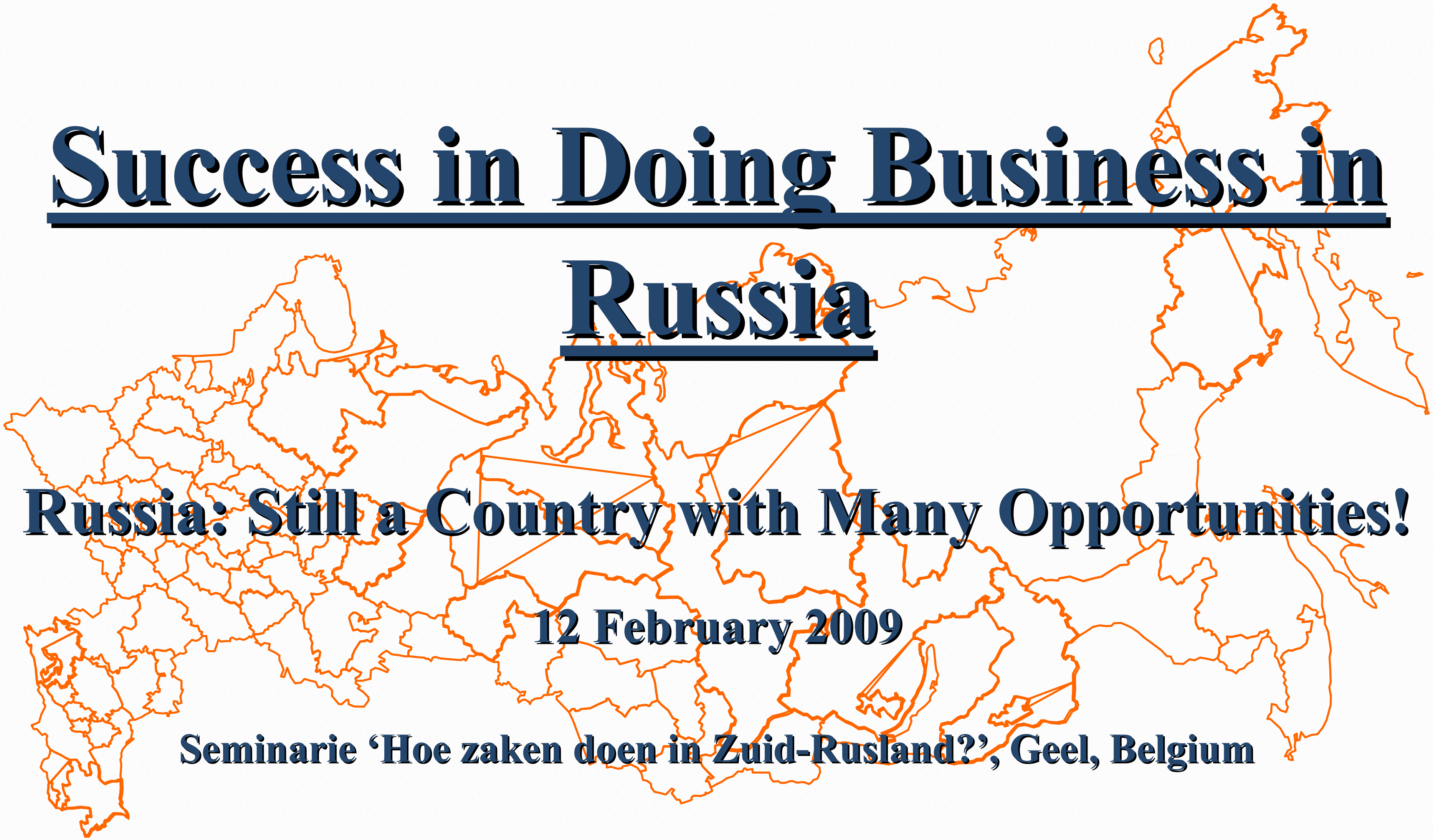

Success in Doing Business in Russia

Russia: Still a Country with Many Opportunities!

12 February 2009

Seminarie 'Hoe zaken doen in Zuid-Rusland?', Geel, Belgium

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Contents of the presentation:

1. What is the **theory** of doing business in Russia;
2. What is the **image** of Russia in the West and what is the **reality**;
3. Russia and the **crisis**;
4. Cultural **peculiarities**;
5. How do you increase your chances of success (**Do’s** and **Don'ts**);
6. Steps to take for a **successful** market entry;
7. Conclusion and answers to your questions.

1

A. The theory of doing business in Russia

1. ?
2. ?
3. ?
4. ?
5. ?
6. ?
7. ?
8. ?
9. ?
10. ?

Умом Россию не понять,

Russia can’t be understood with the mind,

Аршином общим не измерить:

Can’t be measured with a common yardstick:

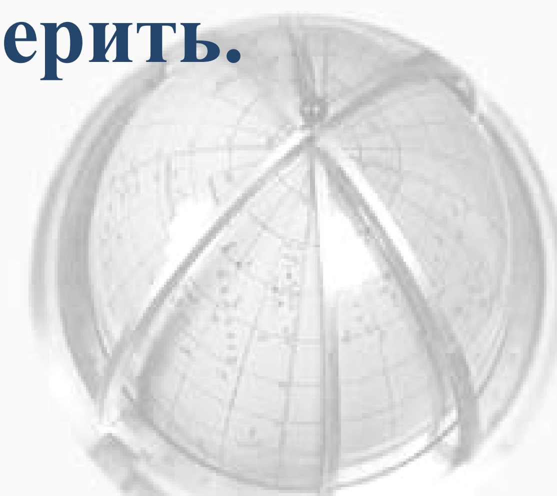
У ней особенная стать -

She has a specific characteristic -

В Россию можно только верить.

In Russia it’s only possible to believe.

1886 Fedor Tiutchev



B. The theory of doing business in Russia

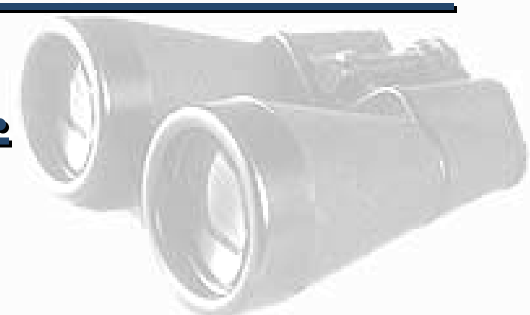
11. ?

12. ?

13. ?

14. So we do it as it’s done back home.

And run into the wall of cultural differences and of lack of understanding.



A. The image of Russia in the West is mainly negative:

1. Mafia – Oligarchs - Polonium (Abramovich, Berezovsky);
2. Cold;
3. Russian bear;
4. Risks and danger;
5. Unreliable;
6. But also positively; culture!

7. However: Fear is leading!

B. Relevant is that Russia is a country with:

1. Population of **142 million**. (8th in the world);
2. More than **50%** of its external trade with the EU;
3. An average GDP growth of 6,8% (1999–2007), but economy **shrank** in Q4 2008 and will continue to do so in 2009;
4. The world's largest natural gas reserves, the second largest coal reserves, and the eighth largest oil reserves **(Oil and Gas:** 20%-30% of GDP) ;
5. 17 million squared kilometres surface / 11 timezones;
6. Specific Eurasiatic **Slavonic culture;**
7. Many **successful foreign businesses**!!
8. **BUT WITH SOME PROBLEMS ......**

A. Russia before the Crisis

1. Rapid economic growth: average **7%** p.a. (1999-2007) ➔ 2007: 6th largest economy in the world: GDP $2.076 trillion (PPP).

   BUT: Growth largely funded by **borrowed** funding ➔ **overleveraged**.

2. Growth was primarily based on:

   a. Oil and gas income: oil reached **record price** of $147 (July 2008) ➔ budget surplus $52 billion / 4% GDP (2008);

   b. Rising **domestic consumption**: consumer spending grew with **10%** per year over the last 10 years;

   c. Increased **foreign investments**: Accumulated foreign investments reached $220 billion in 2008;

   d. Greater **political stability**.

3. Russia held the **third largest** foreign exchange reserves in the world ($581.5 billion in August 2008).

A. Russia before the Crisis

1. **Retail:** Rapid growth in consumer spending and underdeveloped local production ➔ **market** for foreign consumer products.
2. Strong demand for foreign equipment, technology and know-how in **Industry**, **Agriculture** and **Oil & Gas:**
   a. Poor quality of locally produced equipment and technology;
   b. Government policy;
   c. Availability of capital.
3. **Construction / Real Estate**: Boomed to address shortage of quality housing, retail real estate, offices and underdeveloped transport and logistics network
4. **Investments** in these various sectors were funded by easy available capital, both foreign and domestic.
5. Strengthening of **ruble** vis-à-vis especially the dollar made imports relatively cheap.

B. Effects of the Crisis

1. GDP growth for 2008 5.6%, 6.8% previously forecast. 2009: **-3%**, 2010: +1.7%.
2. The crisis has swept away the three economic pillars on which Russia's growth was based:
   a. Oil price fell by 70% and currently hovers around **$40 / barrel** ➔ budget deficit 8% GDP (2009E);
   b. Decrease in consumer spending **4%** (2009E);
   c. Foreign investments: Investors withdrew **$211 billion** (Aug – Dec 2008);
3. The Russian Central Bank used its reserves for a **managed devaluation** of the Ruble (Ruble / $ = -30% (Aug 2008 – Jan 2009) ➔

   Foreign exchange reserves fell by around **a third** to $386.5 billion at the end of January 2009.

B. Effects of the Crisis

1. **Retail:** Period of uninterrupted growth (annually 13% from 2003-07) will end in 2009 as sales are expected to fall (particularly in services and non-food items). Domestic retail chains, heavily leveraged, are experiencing a liquidity crisis since April 2008 ➔ longer credit terms or bigger cash discounts.

2. **Industry, Agriculture** and **Oil & Gas**: Reduced growth rates primarily due to the decrease in demand. Also, demand for foreign equipment will fall due to the fact that imports will become more expensive.

3. **Construction / Real Estate**: Is suffering from a lack of capital and decrease in demand (e.g. Moscow City).

4. Lack of available capital ➔ **break on investments**.

5. Weakening of ruble will make imports relatively **less competitive**.

B. Effects of the Crisis

1. **Political:**
   a. Increasing **nationalization** of the economy;
   b. $50 billion facility for troubled companies to refinance foreign debts;
   c. Money is channeled through the VEB (Vnesheconombank);
   d. VEB took shares in the companies it provided loans to and in some cases a seat on the board of directors.
2. **Social:**
   a. Growing **social unrest** (unemployment 7.7% (2008) 12% (2009), inflation 13.3% (2008) 17% (2009));
   b. Protests in several Russian cities.
   c. Bread over democracy, but what about **bread** in the time to come?

B. Effects of the Crisis

1. Russian companies are adapting to a **new reality** that the crisis has brought about:
    1. Drop in demand;
    2. Lower margins;
    3. Weaker Ruble;
    4. Uncertainty about the exact effects of the crisis.
2. In reaction to this new reality, companies are:
    1. Cutting **costs** (e.g. laying off staff);
    2. Reluctant to expand business activities ➔ focus on **optimizing existing activities**;
    3. Switching from Contracts Ex Works / foreign currency ➔ **DDP** Russia (thus Ruble).

C. Opportunities

1. The Russian market still has the **same opportunities** as before the crisis:
   a. Local production continues to be **insufficient** to meet local demand for consumer goods and equipment.
   b. Shift to (cheaper) products will occur, but Russians will continue to **consume**.
   c. Companies in many sectors will continue to require **foreign** equipment, technology and know-how to operate.
2. Difference is it will require more **flexibility** and **commitment** to be successful.
3. In some ways, it has become easier to do business in Russia: Costs are **falling** (office rents, wages, land) ➔ easier to find office, staff and production sites.

D. Interesting markets:

1. Retail sector (consumer goods);
2. Oil & gas, energy;
3. Agribusiness;
4. Aerospace;
5. Automotive and automobile;
6. Packaging;
7. Construction materials;
8. Telecom;
9. IT;
10. Manufacturing;
11. Logistics;
12. Trade;
13. And so on.

E. Risks:

Political:

1. The system is firmly in control. Increasing nationalization. Bread over democracy.

Regulative and administrative:

1. Changing and ambiguous legislation and regulations;
2. Difficult but not impossible to enforce contractual and ownership rights;

Economic and financial:

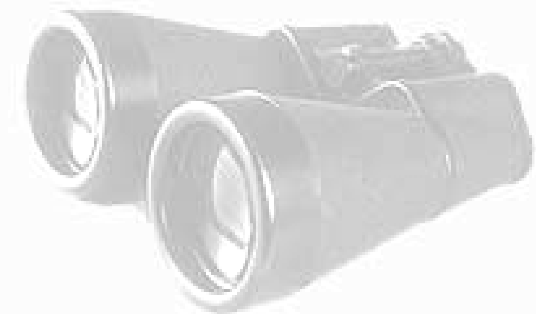
1. High dependence of volatile oil, gas and commodity prices (80% of exports);
2. Underdeveloped financial sector. Financing is costly and scarce. Liquidity crisis;
3. Consumer spending may fluctuate;
4. Underdeveloped SME and absence of strong bourgeoisie / middle class;
5. High and increasing costs (10+ % per year). Moscow is now the most expensive city in the world. Inflation around 15% in 2008;
6. Underdeveloped infrastructure (gas, electricity, water and heat).

HR:

1. Difficult to find good staff. Check backgrounds, networks and loyalties.

F. Russia's Balance Sheet!!

1. Assets;
    1. Natural resources 25% gas / 11% oil;
    2. Stabilization funds > 160 billion $;
    3. International reserves > 550 billion $.
2. Liabilities;
    1. Poor healthcare;
    2. Worsening education;
    3. Deteriorating infrastructure;
    4. Widening poverty gap.



G. But Actually: >>>>Russia’s Balance Sheet!!

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    2. **Worsening education;**
    3. **Deteriorating infrastructure;**
    4. **Widening poverty gap.**

H. Case-study: The Russian Retail Sector

1. Retailers becoming increasingly **price sensitive** due to **decreased consumer spending** ➔ difficulty to **finance** current (relatively expensive) assortment.

2. Insufficient **local production** means the retailers are forced to look for **cheaper** imported goods to fill their shelves.

3. Retailers are facing difficult times ➔ demands on suppliers:

   a. **Suppliers** should shift their brand positioning from the end user to the retailers in order to convince the retailers to stock their products;

   b. Offer low prices, BTL promotion and merchandising ideas in order to allow retailers to **attract sufficient customers**.

   c. Foreign companies should be **flexible**. Retailers expect their suppliers to be prepared to work closely together in optimizing logistics schemes, promotion campaigns and developing the assortment and type of packaging.

I. Do’s and Don’ts during the Crisis

1. Russian companies might be **reluctant** to start (or expand) their business activities, but the present period can be used to build up or expand your business network.

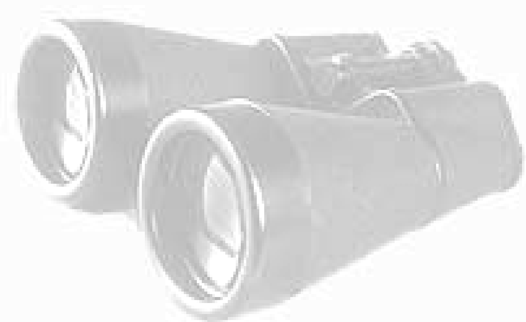
2. **Presence**: Crucial to remain present on the Russian market and invest in brand awareness and the relationship with your business partners. By doing so, you will be ready to seize the opportunities as soon as the crisis ends.

3. Be **flexible** in order to adjust to the new reality on the Russian market ➔ Russian companies expect a commitment in order to get through these tough times together (e.g.: minimize time to market for their product in order to reduce the credit period).

4. Loyalty and resilience in times of crisis will be **rewarded** as the previous crisis in 1998 has proven.

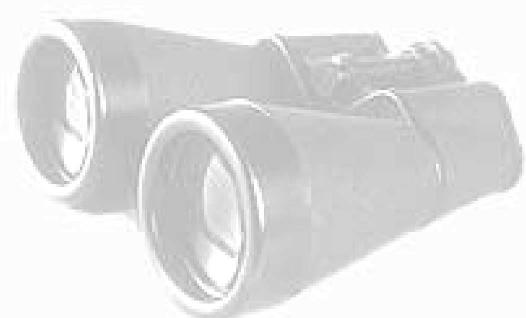
J. What is the secret of success of foreign companies in Russia?

1. They are there and they are **committed**;
2. They **like** it ☺;
3. They **understand** Russia’s market potential;
4. They are ready to be **flexible**;
5. They are **entrepreneurial**
6. They **understand** and **respect** Russia’s cultural peculiarities and understand the Russian **perspective**!



A. What are the Russian's main Cultural Characteristics:

1. Building of **trust** and personal relationships is key;
2. Informal communication **networks** are most important;
3. The **Micro Cosmos** (almost clan);
4. Different sense of public **individual** responsibility;
5. **Pride**;
6. **Practical** vs. formalistic approach of things;
7. **Short term** (positively fatalistic) vision.

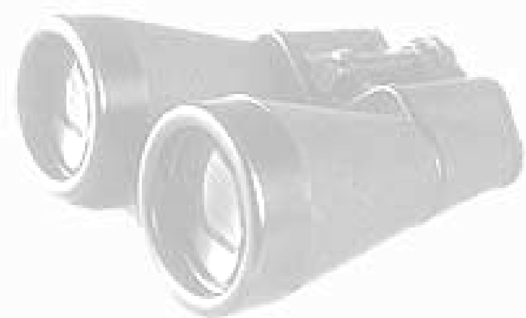


B. Russian Business Culture

1. Vertical **authority**;
2. Staff, partners and distributors require continuous **management**;
3. During first contacts the Russian partner may **promise** more than can be delivered (without bad intent!);
4. Russian businessmen can be **imposing**. Weakness is not shown;
5. The external **appearance** is very important / content vs. context;
6. Russians **pay** better than Europeans;
7. Russians have their own way of thinking and reasoning and are **reliable** within the boundaries of their own logic;
8. Russian businessmen think, speak and act **fast**!

C. The language barrier

1. Be critical of **interpreters** as they make mistakes;
2. Be critical of written **translations** (don’t use internet);
3. Many Russians know English but are not **comfortable** speaking it;
4. Have your **brochures** in Russian;
5. Have a **business card** in Russian (and check pronunciation);
6. Learn **alphabet** and a few words.



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D. Market Specifics

1. Young market with **underdeveloped** logistics, marketing, merchandising and sales;
2. Poor **logistics** infrastructure (transport, customs, warehousing);
3. **Distributors** vs. agents;
4. Geographic market **differences**;
5. Incomplete **Value Chain**;
6. Much more **paperwork**;
7. Peculiar purchasing **motivations** (price motivated);
8. Big quantitative **potential** but strong qualitative **competition**.

A. Do:

1. **Enjoy** Russia!
2. Do your homework and **know** your market;
3. Gain some knowledge of the Russian language and **culture**;
4. Stay in **control** (of finances and management);
5. Divide the shares/interests off-shore and agree on foreign arbitration and create **win-win** situation;
6. Use experienced local (general, tax and legal) **advisors**;
7. Limit your **exposure** and risks;
8. Dedicate and commit sufficient **financial & human resources**;
9. Be **flexible** and **patient** (e.g. bureaucracy, market development);
10. Think well about the **location** of your office, warehouse, and production;

B. Don’t:

1. Be **afraid** of Russia;
2. **Underestimate** the market or your Russian business partner;
3. Think Russia is **Europe**;
4. Think Russia is **cheap**;
5. Think it is easy to find the right **staff**;
6. Let yourself in with **corruption** (payments on the basis of contracts or through third parties);
7. Give immediate **exclusivity** to distributors and put **certificate** on your company’s name;
8. Forget to register your **trademark**;
9. Forget your **visa** and do not forget to have your passport on you;
10. Think **transfer** of goods and money is easy.

C. Don’t forget the regions:

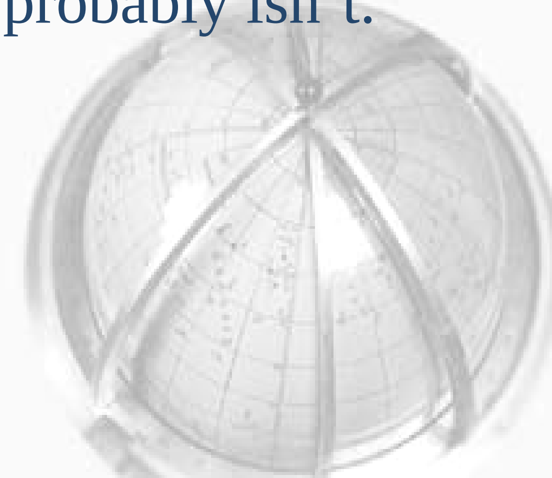
1. There’s a whole **market** out there that can’t be covered from Moscow;
2. **Support** from local administration. Willingness for cooperation and openness for contacts and communication;
3. **Tax incentives** for investors;
4. Lower **costs** of resources compared to Moscow and Moscow region (on average 20% cheaper);
5. **Comparable** infrastructure and facilities;
6. Young, educated, eager and relatively cheap **workforce**;
7. Facilitating fast document transaction. **Fast** preparation and execution of decisions, resolutions and documents.

A. Steps to take for a successful market entry

1. **Study the market**
2. Understand your value chain
3. Brochures in Russian
4. Visa
5. Exhibition visits
6. Partner search
7. Certification
8. Contracting & payment conditions
9. Transport & Logistics
10. **Start your business!**

B. Russian Partner

1. Choose your partner carefully:
    1. Good **management**;
    2. Strategy and growth **prospects**;
    3. Decent company **infrastructure**;
    4. Sufficient **transparency** (tax, legal, finance, etc.);
    5. Common **sense**; if it doesn't seem right it probably isn't.
2. <u>When in doubt</u>: use advisor;
3. <u>When still in doubt</u>: Don't continue!!

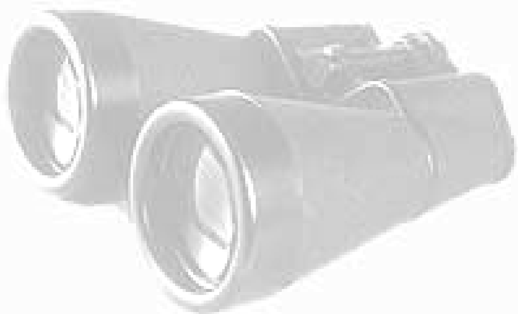


C. Problems with exports

1. Customs;
2. Certification (on your company’s name) and documents;
3. DDP-deliveries without local representation;
4. Need to compete with grey imports.

Therefore important:

1. Good and trustworthy agent/partner/consultant;
2. Good transport company experienced in working with Russia;
3. Solid preparation and uniformity of documents;
4. Conservative payment conditions.



Conclusion and Questions – Why Russia??

1. The effects of the financial crisis have brought about a **new reality** on the Russian market;

2. Despite this new reality, Russia still offers plenty of opportunities for **flexible** foreign companies with a clear **added value**;

3. Companies that remain present on the Russian market will be able to reap the **advantages** during and after the crisis.

BUT

4. Traditional problems will continue to exist so prudence and good preparation is advisable.

Tax Environment

1.	Profit tax	20%	over profit (17.5% to regional budget, 2.5% to federal budget)
2.	Income tax	13%	over personal income (to be withheld by the employer)
3.	Social taxes	26% (max)	over pay-roll (medical, social, pension) planned from 2010 – 34%
4.	VAT	18%	over turnover
5.	Property tax	2.2% (max)	over property
6.	Dividend tax	15% for non-residents, 9% for residents	

Profit repatriation

Dividends (or distributions of net profit for Limited Liability Companies) are payable annually, semi-annually or quarterly. In practice, profits are often repatriated through a number of techniques such as: transfer pricing mechanisms, service charges, royalties and interest payments. This is, however, coming under increasing official scrutiny.

Since 1999 Lighthouse assists Western companies in doing business in Russia. Throughout the years, Lighthouse has successfully assisted hundreds of companies from a wide range of sectors with their business development in Russia. Whether you need to start or increase your sales, set up production or do an acquisition, Lighthouse has the experience, the network and the team to help you reach your goals faster, cheaper and with less business risks. We are always happy to exchange thoughts with you about your business in Russia.

For further information you can contact us by using the coordinates below.

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