

Russia 2010:

Renewed Opportunities in a New Reality

“Crisis ne udalsya” – “De crisis is mislukt”!

Factfindingmissie Logistiek Moskou en bezoek beurs

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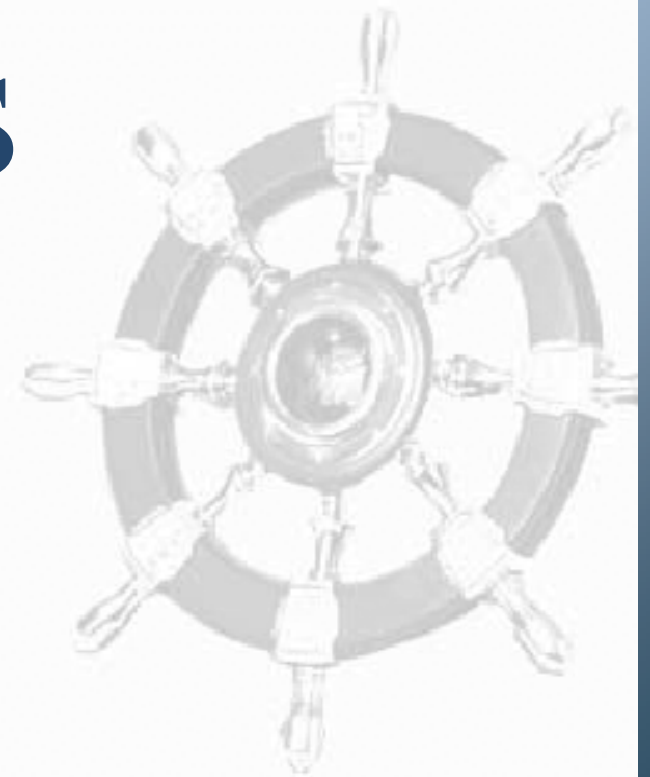


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The crisis



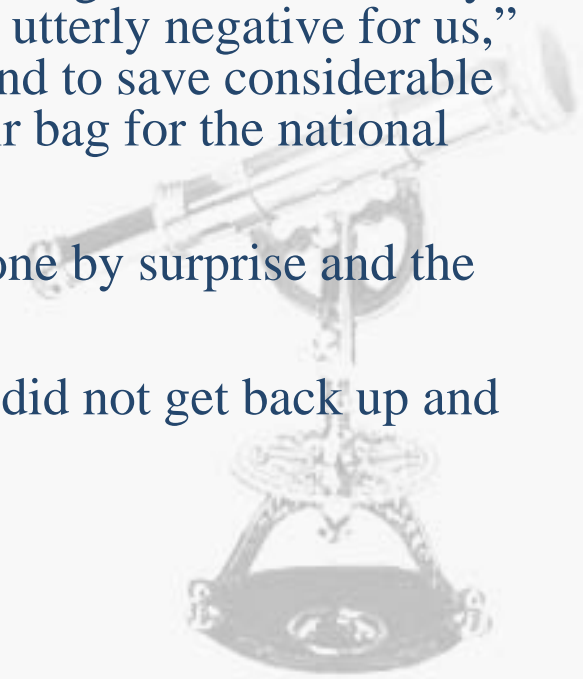
Introduction:

1. **“Russian miracle”**: 9 years of rapid growth; third largest foreign currency reserves; newfound confidence and assertiveness.

Finance Minister Kudrin at the World Economic Forum, Davos, January 2008 offered to mitigate the world credit crisis with the help of Russia’s reserves. Kudrin stated that Russia was an “island of stability in the sea of the world crisis.”

“Investors will continue to invest billions of dollars in the rising Russian economy. Stock market crises and their consequences will not be utterly negative for us,”
“Our country managed to achieve economic stability and to save considerable gold and currency reserves which play the role of an air bag for the national economy.”

2. **Crisis**: In Q4 2008 the bubble burst which took everyone by surprise and the ensuing 12 months were all but easy.
3. **Recovery**: Russia would not be Russia if after a fall it did not get back up and start over again.
4. **New reality**: Now there is a new reality in Russia.
5. The question is: **How to work in that new reality?**



What happened in 2008 / 2009?

1. Global credit crunch: No capital and credits available for businesses and consumers.
2. Global drop in demand because of decreased consumer confidence.
3. Global decline in industrial output.
4. Oil price collapsed from \$140 per barrel to \$40 (Russia needed \$70 for a balanced budget).
5. Russian budget deficit and credit crunch.
6. Russian fall in demand and industrial output.
7. Imports, Exports and FDI down by 40% to 50%.
8. GDP down by 9% over that period.
9. Russia worse off than other BRIC countries and only Baltic States, Ukraine, Armenia and Moldova performed worse in Central and Eastern Europe.
10. Crisis bottomed out in Q4 2009.
11. Result: A reality check.



Why did the crisis hit Russia so hard?

The crisis revealed a number of structural weaknesses of the Russian economy:

1. Natural Resource dependency.
2. Lack of diversification of the economy.
3. Concentrated (oligarchic) ownership.
4. Overleveraged businesses.
5. Underdeveloped SME sector.
6. Flawed business environment.
7. Institutional weakness.
8. Poor management.
9. No capacity for import substitution.



Reactions to the crisis.



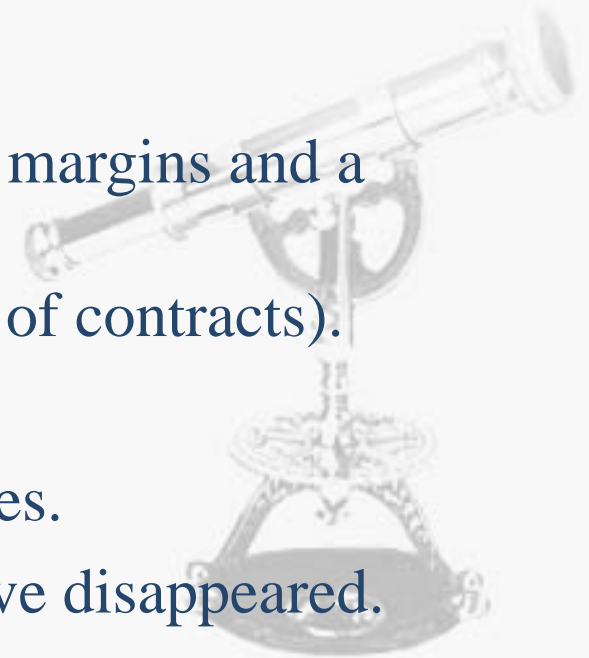
Reactions of:

1. Consumers:

1. Stopped buying expensive goods (cars, houses).
2. Started noticing price tags (on average a 50% cut in expenses on entertainment, large household purchases and holidays).
3. Mentally remarkably resilient (1998).

2. Companies:

1. Had to deal with a drop in demand, lower margins and a weakening Ruble.
2. Cutting costs (e.g. laying off staff, revisal of contracts).
3. Increase efficiency.
4. Increase in competition between companies.
5. Consolidation: Many weak companies have disappeared.



Reactions of:

1. Banks:

1. 43 banks closed down.
2. Deposit rates down.
3. Interest rates rose to around 20%.
4. Credits down.

2. Foreign investors:

1. End of speculative opportunities.
2. Risk (Russia) averse.
3. Projects put on hold.



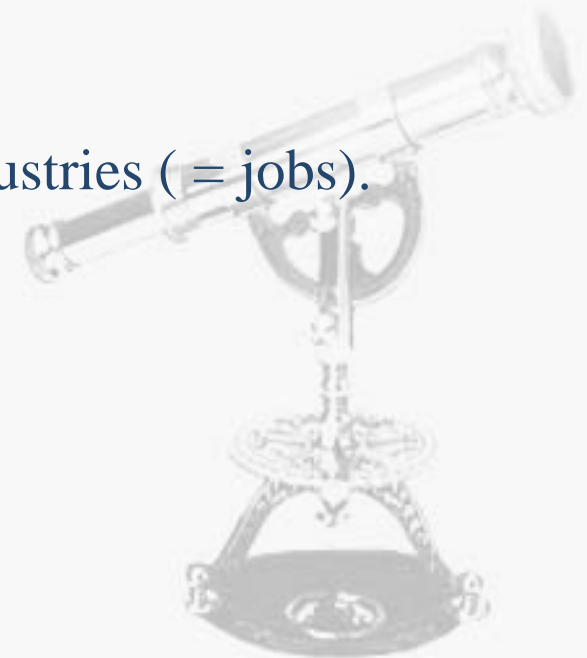
Reactions of:

Government:

1. Bailed out banks and large companies.
2. Very costly support of the Ruble (1/3 of foreign reserves depleted) → national reserves dropped from \$600 bn to \$180 bn.
3. Interest rate cuts (lending support).
4. Increase in protectionism to support local industries (= jobs).

Government understands that Russia needs:

1. Real reforms.
2. Modernization.
3. Localization.



Russia Today



What is the situation now?

The situation seems to have stabilized:

1. Oil price: \$80 compared to \$45 in 2008.
2. Inflation under control (under 9%).
3. Ruble rate under control (€= 39R).
4. Official unemployment under control 8% (but much higher when including unofficial unemployment).
5. Interest rates are down (but still high) at 15%.
6. Industrial production: +2.7% in Dec. 2009 compared to Dec. 2008.
7. Consumer confidence index: +5% in Q4 2009 compared to Q3 2009.
8. RTS is the fastest growing index in the world nearly 150% in 2009 and growing.
9. S&P rating from negative to stable.
10. Grey economy increased.
11. “Bad assets” for banks: 6,7%.



What is the new reality?

1. Consumers:

1. Austerity is the new chicue.
2. Consumer credits hardly developed so no big problems.

2. Companies:

1. Reluctant to expand business activities → focus on optimizing existing activities
2. Switched from Ex Works / foreign currency → DDP Russia (thus: Ruble).
3. Longer payment terms.
4. Production, labour and energy efficiency.



What is the new reality (II)?

1. Banks:

1. Interest rates indirectly controlled by the government.
2. Development of new lending opportunities: express credits.
3. Restructuring 'bad loans'.

2. Foreign investors:

1. Shift from financial markets to industry and trade.
2. Large investment programs in the energy sector.
3. Increase in other investments (trade credits, cash operations, loans).

3. **Government** is playing a more active role in the economy (anti-crisis manager)

1. Manages depreciation, inflation and interest rates.



What will happen
in Russia in
2010/2011?



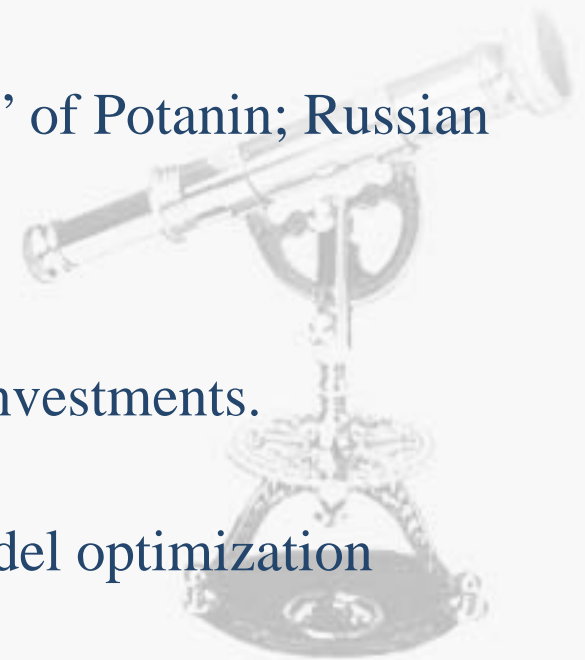
What will happen in 2010?

Economy:

1. Better global conditions (stability on the global stock exchange markets).
2. Bigger global risk appetite.
3. High commodity (oil and metal) prices and increasing demand.
4. Consumption growth (household expenditures grew by an average of 10% during 2H2009; pensions were increased starting from 1 December 2009).

Private sector:

1. New funding sources: internal, IPO (“Prof Media” of Potanin; Russian Railways; OGC-1; RUSAL).
2. M&A activity esp. from middle sized companies.
3. Investing into existing projects (re-equipment).
4. Tight control on costs, finances, purchasing and investments.
5. Stable cash flow over assets.
6. Efficiency management systems and business model optimization



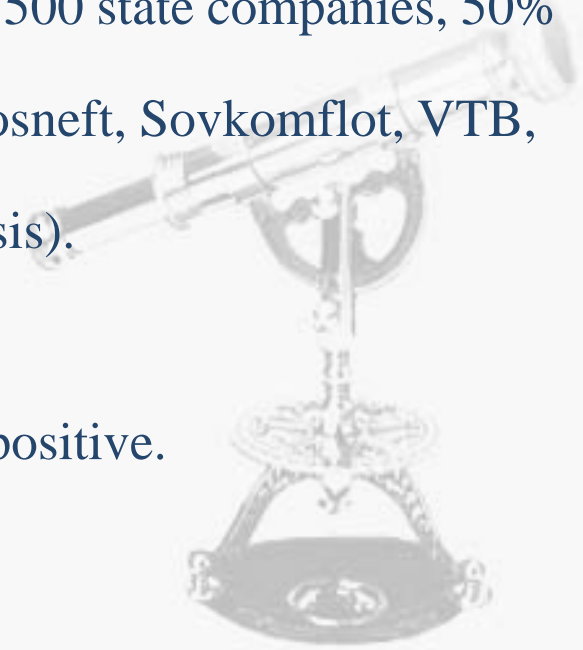
What will happen in 2010 (II)?

Government:

1. Continuing government stimulus measures:
 1. Restructuring of business debts.
 2. Support through long-term lending programs (mortgages).
 3. State procurement programs.
 4. Investment into modernization of economy (EE, re-equipment).
2. Government will start a new wave of privatisations (5500 state companies, 50% of the economy is in state hands):
 1. State companies sell core and non core assets (Rosneft, Sovkomflot, VTB, Svyasinvest, Russian Technologies, etc).
 2. Government holdings (partly acquired during crisis).
 3. Utility sector.

Society:

1. The mood went from very pessimistic to moderately positive.
2. No risk of social unrest.
3. Political leadership still popular.



What will happen in 2010 (III)?

Overall, these tendencies will result in:

1. 2% economic growth.
2. Consumption growth.
3. Inflation around 8%.
4. Increase in FDI.

MAIN RISKS:

1. Slow recovery in the rest of the world.
2. Low oil price.
3. NPLs
4. Mass lay-offs in one-factory towns



What will happen in 2011?

1. 3-4% economic growth.
2. Stable import (limited import substitution).
3. State Corporations: Some will be incorporated (e.g. Rosnano, Russian Technologies and Vneshekonombank) while others will be restructured or liquidated.
4. Risk of political unrest in the run-up to the 2012 presidential elections.
5. Q4 may see risk of overheating.
6. The economy always booms leading up to an election and shows a drop directly after an election.



Opportunities on the Russian market



Opportunities on the Russian market for Dutch companies:

1. Distressed assets.
2. New services.
3. Modernization investment programs → demand for equipment.
4. The regions: Rapid development of the Krasnodar region (Olympic Winter Games 2014) → new geographical markets for Dutch companies.
5. Localization of production → drop in imports, but opportunities for Dutch companies (equipment, know-how).
6. New hi-tech markets (IT, telecommunications) still far from saturation.
7. Retail remains interesting + Project development in retail will take up again.



Crisis Advice



Crisis advice:

1. Understand Russia and its cultural characteristics.
2. Study and **know** your market more than ever before (volume, segments, regions, sales channels, price levels).
3. Clarify your **transaction costs** (travel, brochures, certification, exhibitions, logistics, management time).
4. Know your **opportunity cost**.
5. Prepare yourself (travel, brochures, certification, exhibitions, logistics, management time and present added value / USP, references).
6. Prepare yourself for the medium- to long-term.
7. Financing is an issue again (back to the nineties!).
8. Be present.



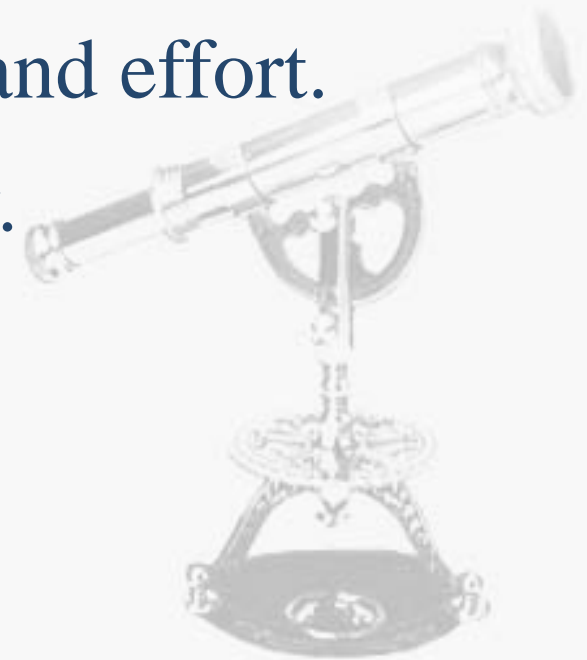
Crisis advice:

1. Test the water **step by step**:
 1. Exhibition / mission.
 2. Understanding of Russia and its market.
 3. Strategy.
 4. Partner search.
2. Come with a **full cycle** approach / a total solution.
3. Think of **localization**.
4. Take and keep the **initiative**.
5. Help in **implementing**.



Understand that Russia requires:

1. Twice the **time** to manage.
2. Continuous **attention**.
3. A **personal** hands-on approach.
4. More investment of time, money and effort.
5. A **medium- to long-term** strategy.



Do:

1. Understand and respect each others cultural peculiarities and perspectives!
2. **Enjoy** Russia 😊!
3. Be committed;
4. Do your homework and **know** your market;
5. Gain some knowledge of the Russian language and **culture** (learn (alphabet and) a few words);
6. Be **entrepreneurial, flexible** and **patient** (e.g. bureaucracy, market development);
7. Stay in **control** and keep the **initiative**;
8. Create **win-win** situations in which all parties have a clear added value;
9. Use experienced local (general, tax and legal) **advisors**;
10. Limit your **exposure** and risks;
11. Dedicate and commit sufficient **financial & human resources**;
12. Be open.



Don't:

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



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**!



Cultural Differences



The main cultural differences between Russia and EU:

1. Building of **trust** and personal relationships is **vs. formal relations in EU**;
2. **Informal** communication **networks vs. formal (official) networks in EU**;
3. The **Micro Cosmos** (almost clan) **vs. low interpersonal cohesion in EU**;
4. **Testing** the rules **vs. abiding** by the rules;
5. Responsibility for close ones only **vs. responsibility for society**;
6. **Pride and Power vs. modesty**; Extreme vs. Average; Emotions vs. Ratio;
7. Surprising vs. predictability;
8. **Practical vs. formalistic** approach of things;
9. **Short term** (positively fatalistic) vision **vs. long term vision**;
10. Separating **business** and **personal**;
11. Single-focus thinking – holistic thinking.



Russian vs. EU Business Culture:

1. Vertical **authority vs. consensus**;
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!) - **Intent vs. agreement**;
4. Russian businessmen can be **imposing**. Weakness is not shown and one always negotiates from a position of power;
5. The external **appearance** is very important **vs. substance in EU** / context vs content;
6. Russians have their own way of thinking and reasoning and are **reliable** within their own logic;
7. Russian businessmen think, speak and act **fast!**
8. Quantity vs. Quality / Capacity vs. Efficiency / Purpose vs. Comfort;



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.



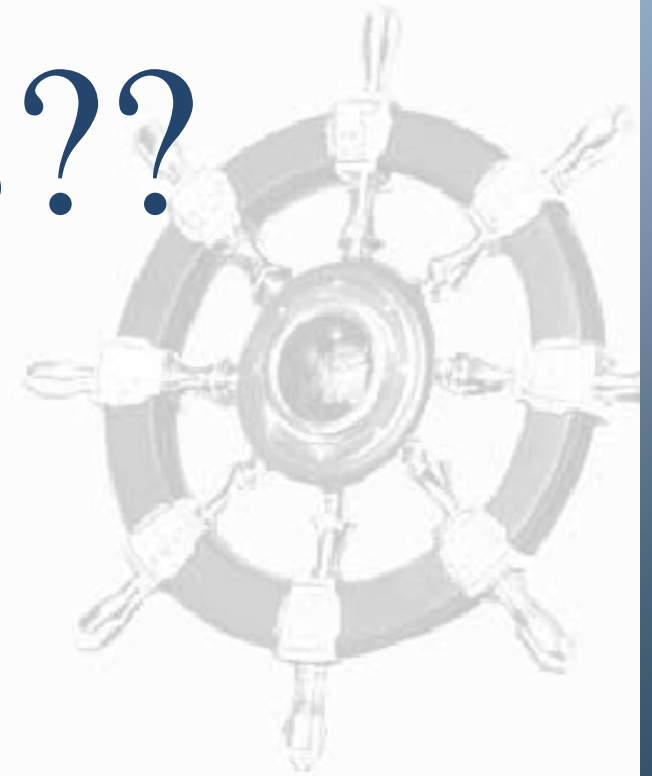
Conclusion



Conclusion:

- The crisis revealed structural weaknesses of the Russian economy.
- The Russian people, companies and government quickly adapted to the new reality created by the crisis.
- Policy of reform and modernization!
- The economic recovery, both in Russia and its export markets, and the modernization of the Russian economy create opportunities for foreign companies.
- The 1st decade of the 21st century will not be repeated in the 2nd decade.
- Foreign companies that remain committed to Russia and understand the new reality will be able to profit from these opportunities.
- “Crisis ne udalsya” – “De crisis is mislukt”!

Questions??



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)
34% (planned for 2011) | over pay-roll (medical, social, pension) |
| 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 through the coordinates below or visit our website: www.thelighthousegroup.ru

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