

# *Marketmap*

*How emerging markets change the global economy*

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Issue 3

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***The Russian evolution:  
How can foreign businesses  
prepare to prosper?***



**pwc**



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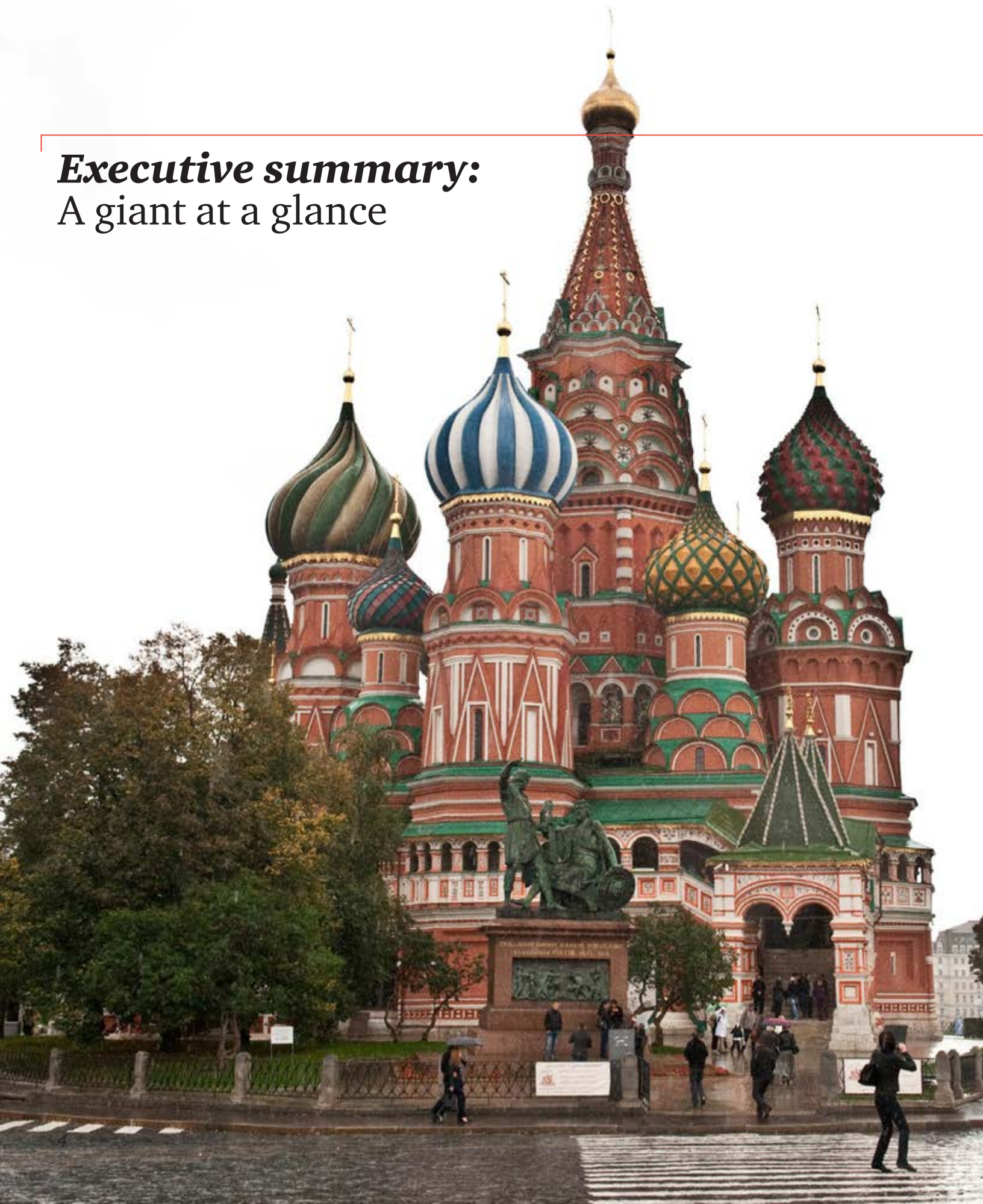
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***Executive summary:***  
A giant at a glance





Between East and West, old and new, traditional and trending, *nyet* and *da*, lies Russia: massive, rich in resources, ripe with potential, and brimming with challenges and opportunities.

Emerging from the global market crisis that punctuated the new millennium's debut decade with a thud, Russia stands poised on the brink of potential significant change. Once focused inward on its bounty of natural resources, today's Russia is growing more interested in reaching out—across its own regions, across a growing variety of sectors, and across the globe. Enabled by technological advances, inspired anew by innovation, and spurred on by an urgency to diversify its economy, Mother Russia is slowly but surely coming of age and increasingly engaging in earnest with foreign investors.

For the last two decades, Russia has been developing a set of economic, legal, and social institutions in an effort to function more effectively in a market economy. Much effort has been devoted to modernizing its system of governance, including legislation and courts, bettering investor protections, developing capital markets, and improving the efficiency of government services.

As the country's governmental authorities, business leaders, workers, and consumers work together to further enhance the maturity level of Russia's institutions, infrastructure, and safeguards in line with ever-escalating global standards and expectations, investors should equip themselves to both understand the new market opportunities that may arise and counter the ill effects associated with this nascent giant's

evolution. They should seek to unravel Russia's changing economic landscape, better understand the dimensions and attributes of the market's risks, and plan accordingly. Inevitably, this means remaining committed to robust due diligence and anti-corruption programs.

As is the case in other emerging markets, the financial and reputational risks of economic crime and disputes can be significant in Russia. Investors should be prepared to respond to law enforcement and regulatory actions and poised to defend their company's interests proactively. If questions of integrity arise, the C-suite should have a realistic view of any potential impropriety—or lack thereof.

While in many ways investment opportunities in Russia have significant upside potential, investors would do well to look out, look around carefully, and look for signs—of business as usual but also business as unusual. Read on for an overview of the promise of Russia's opportunities as well as an assessment of factors that can create challenges for the country's ability to evolve.

***...investors should equip themselves to both understand the new market opportunities that may arise and counter the ill effects associated with this nascent giant's evolution.***



## *Vast land, varied issues*





99%+  
of Russians are literate  
**More than half**  
participate in the workforce

## A key? Perhaps

Many are familiar with Winston Churchill's famed and eloquent World War II-era quote regarding Russia: "It is a riddle, wrapped in a mystery, inside an enigma; but perhaps there is a key. That key is Russian national interest."

Today, we might say: Russia is a quintessential emerging market riddle, a nation wrapped up in growing globalization while confronting the kinds of constraints that typify emerging market countries. But there is a key. When doing business in Russia, companies need to look beyond the obvious growth areas to find specific sectors and other avenues of opportunity formed by Russia's special place in the world, literally and figuratively.

Opportunities and challenges in Russia reflect the country's geographic and demographic profiles. Spanning nine time zones across more than 17 million square kilometers<sup>1</sup> (more than 6.5 million

square miles, compared with the United States' 3,794,100), Russia boasts the largest land mass of any country in the world. With Europe to the west and Asia to the east, it serves as a ground transportation link among its 14 bordering neighbors,<sup>2</sup> despite roadway inadequacies. The other 65% of Russia's boundaries front the Arctic and Pacific coastlines, although most of this waterfront is too inaccessible to function as a major world trade route.

Three quarters<sup>3</sup> of Russia's 143 million people<sup>4</sup> reside in cities, towns, and urban centers, with 82% living near Russia's European region; only 18% have settled east of the Ural Mountains in Siberia or the Far East.<sup>5</sup> The population, the world's ninth largest,<sup>6</sup> reflects its substantial size. But its people power is on the wane. In addition to low birth rates, educated talent tends to look elsewhere, often to the West, for career opportunities.



## Getting to know Russia

Belonging neither strictly to the East nor strictly to the West, Russia stands alone among nations in ways that may be palpable to those who are in the country, but difficult to articulate to those who are not.

Countries and companies seeking to do business in Russia will have to be open and tolerant of some of the country's long-standing quirks. Entering the market can be a challenge.

But you also can turn the country's inherent vulnerabilities and challenges into market strengths and growth potential by viewing problems as undeveloped resources that imply potential.

In addition to concentrated urban populations, other fundamental factors bode well for investors: More than 99% of the population is literate, and women, many of them working mothers, are well represented in the workforce.<sup>7</sup>

Russia covers a massive amount of real estate and includes multiple regions that are home to disparate peoples who are deeply committed to retaining their distinct languages and cultures. The overall culture tends toward profound pride and resiliency among the populace, which is characterized by a far more communal spirit relative to the individualistic ideal embraced by the West.

### **Taking it literally: Russia hits the books, the road, and the office**

More than half the population participates in the workforce;<sup>8</sup> some seven million are enrolled in higher education programs.<sup>9</sup> More than 700,000 hold a postgraduate degree.<sup>10</sup>

Russia's unemployment rate stood at 6.6% in 2011,<sup>11</sup> with regional variations. The central and northeast regions have experienced relatively low unemployment rates, while the southern regions, particularly the North Caucasus, have seen higher jobless rates.

The post-Soviet education system, which replicated major components of the Soviet system, is capable of creating world-class specialists in exact sciences such as mathematics, physics, chemistry, biology, engineering, and the like. A handful of universities have recently introduced high-quality socioeconomic science programs, which can potentially build a talent pipeline for fields such as economics, management, law, politics, and sociology. It can also spur and support innovation, which will be crucial to boosting entrepreneurship, venture capital, and Russia's future viability as a more developed, robust market.





The talent-retention puzzle is just one of many questions Russia and investors will grapple with as the fledgling market reaches for the next rung on the global economic ladder. Others stem from a clash between the emergent and the entrenched, including not only deeply ingrained cultural tendencies and affinities, but also heavy bureaucracy and a still-developing infrastructure.

The stakes these days are high, not only for Russia, but also for business leaders eyeing emerging markets generally. With the advent of—and intensive universal focus on—the Foreign Corrupt Practices Act (FCPA) in the United States, the United Kingdom’s Bribery Act (UKBA), and numerous, similarly spirited efforts worldwide on behalf of governments and organizations, such as Transparency International and The World Bank, it’s important that Russia be seen as actively engaged in the anti-corruption initiative.

Within this context, you’re likely asking: How can Russia transcend the challenges that can try patience and erode margins, trust, reputation, and allure? Will investments be safe? What about intellectual property rights, which are not guaranteed? When will corruption be corralled? When will the wall of bureaucratic barriers be torn down?

The Russian government has started to answer these questions in an effort to mitigate concerns and unlock potential, but much room remains for revision and progression. Over the past decade, Russia undertook reform in nine out of ten areas covered since 2004 by Doing Business analysts, according to the 2012 report.<sup>12</sup> Significantly, however, ‘protecting investors’ was the one omission.

As Russia works to bring the maturity level of its institutions, infrastructure, and safeguards in line with ever-

escalating global standards and expectations, business leaders can equip themselves to counter the ill effects associated with this nascent giant’s evolution. They should know the landscape; know the risks; plan accordingly; and remain committed to businesses’ best friends: rock-solid anti-corruption and due diligence programs. Approached with smarts and a balanced view of risks and opportunities, well-thought-out approaches for entering the market, and adequate due diligence, governance, and controls, these growing pains can launch soaring potential. As Churchill also said, “Kites rise highest against the wind, not with it.”

## ***Compliance challenges and rewards***

With Russians increasingly exploring the world through global travel, studies abroad, and access to the Internet and foreign publications, people are generally curious and hungry for new ideas, goods, and services. And they’re growing more willing to accept new ways of doing business. Still, you can’t assume that every Western concept will be embraced in Russia, which remains steeped in tradition, history, and hierarchy.

A new generation of Russian managers is emerging, and many have Western experience. As this new wave of

corporate leaders begins to tackle Russia’s long history of ineffective compliance functions within individual companies and the country itself, those who can demonstrate change agility and compliance ability tend to be rewarded by the markets.

As this duality between past and future continues to evolve, investors should guard against corrupt influences and keep their sights set on opportunities to contribute to the maturation of the market.

# 28

Russia's Corruption Perception Index score, equaling that of Iran, Kazakhstan, and Honduras.

## Doing business in Russia: *Nyet* and *da*, opportunities and challenges

Some of Russia's regulatory challenges are abating as the country finds ways to be more welcoming to businesses, as reflected in its 2011 World Trade Organization (WTO) accession. In its 2013 report, The World Bank ranked the country as 112 out of 185 economies for ease of doing business—a better showing than in 2012, when the country was ranked 120 out of 183 countries.<sup>13</sup> Even then, however, Russia was cited among 30 countries where regulation has grown friendlier to businesses.

### ***Russia through the eyes of the world— and The World Bank***

The World Bank captures an overall sense of the quality of governance in various countries by aggregating the views of a large number of enterprises, as well as those of citizen and expert survey respondents in industrial and developing countries. Country-specific percentiles are assigned for various characteristics, with 0 corresponding to the lowest ranking and 100 to the highest.

Similarly, Transparency International's (TI) Corruption Perceptions Index (CPI) surveys representatives from countries around the world to assess corruption exposure, with 0 indicating that a country is perceived as highly corrupt and 100 indicating that the country is perceived as very clean.

TI reports that two-thirds of the countries in its most recent report failed to rise above the halfway point.

According to TI, Russia recently scored a 28, as did countries such as Iran, Kazakhstan, and Honduras, among others. Brazil and South Africa scored

43, China 39, and India 36. Denmark, Finland, and New Zealand sit atop the list with scores of 90.<sup>14</sup>

Russia's 2011 WTO accession recently broke the record for the longest WTO accession negotiations in history. The process lasted 18 years,<sup>15</sup> three years longer than it took China,<sup>16</sup> which joined in 2001, and Ukraine, which joined in 2008. It wouldn't be an overstatement to say that the Russia that knocked on the WTO's door nearly two decades ago and Russia today are two different countries.

Despite an uptick in protectionism amid the 2008 global economic crisis, the Russian market has become significantly more open. With WTO accession, the fight for the deep and not-so-deep pockets of Russian consumers is expected to grow fierce.



## There's an old Russian saying: Trust but verify

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When it comes to doing business in Russia, time often is not on your side. There is a vast gulf between a New York minute and a Moscow minute, and it transcends the nine-plus hours of air travel and eight-hour time difference between the two cities.

Heavy bureaucracy and efficiency challenges, stemming from limited access to modern technology in administrative procedures, can freeze progress to Siberian winter lows. Regulatory hurdles resulting from complicated rules and procedures and heavy government involvement can be a particular issue for small- and medium-sized businesses in industries including construction, insurance, and utilities. Many laws and regulations remain ambiguous; courts too often remain ineffective; and intellectual and other property protection rights remain vulnerable.

For the last two decades, Russia has been creating and developing a set of economic, legal, and social institutions in an effort to function effectively in a free market economy. Much work has been devoted to modernizing the legal system, including legislation and courts, bettering investor protections, developing capital markets, and improving the efficiency of government services.

Already, arbitration courts are more evolved than are courts of general jurisdiction. Similarly, the property rights protection system tends to function more effectively for larger economic players, aided by greater access to political and administrative resources. These measures are crucial to enabling Russia to grow and mature, rather than simply grow. And growing it is, as businesses continue to look at

emerging markets to provide the kind of growth mature markets can't eke out.

Still, it's crucial in Russia to know your customers and your third-party agents. Characteristically, the degree of development varies by region, economic segment, and institution, so it's vitally important to consider the role that location and local traditions and culture can play in the way business gets done. In Russia's Southern region, for example, formal rules might hold less sway than informal ties such as family relationships, group affiliation, and ingrained behaviors, attitudes, and assumptions.

You can't take for granted that you'll know third-party agents' backgrounds and how they conduct their business, nor can customers' lifestyles and values be assumed. By focusing on these issues and building understanding, company leaders place themselves in a better position to set a strategy for growth in the market while mitigating risks. It helps to cushion project timelines to account for unforeseen slowdowns.



*Showing Russia the money*







## Things are looking up: Foreign direct investment

So, (to quote another politician of another era),\* how is Russia doing?

After sliding down on the gravitational pull of the world financial crisis in 2008, Russia's inbound foreign direct investment (FDI) volume started to pick up in 2010, when the country's economic growth lifted its FDI activity above that of India to land in third place among the BRICS,\*\* behind China and Brazil.<sup>17</sup> Business leaders are taking note. CEOs worldwide placed Russia among the top ten countries for 2012 growth prospects, with one-third of them indicating that they plan to invest there, according to PwC's 15th Annual Global CEO Survey.

As the map illustrates, traditional hubs, such as Moscow and St. Petersburg, with their more sophisticated business infrastructures and large reserves of financial, administrative, and talent resources, remain a top draw for international investors, as do regions rich in oil, gas, coal, metals, and energy.

Increasingly, heretofore quieter, lesser known regions, blessed with neither Moscow's modern leanings nor Sakha's mineral gleanings, are coming into their own, attracting investors with sound

economic development programs;<sup>18</sup> cooperative, accessible governments; investors' rights protection; clear-cut policies and regulations; and a commitment to promoting fair competition.<sup>19</sup>

For example, the Kaluga region has been successful thanks to state support, tax benefits, efficient development institutions, and industrial parks. Similarly, Tatarstan, located amid numerous strategic trade routes that connect northern and southern Russia, as well as Asia and Europe, also benefits from the regionally supported Tatarstan Investment Development Agency and special economic zones for industrial and technology parks.

While in many ways things are looking up, businesses need to look out, look around carefully, and look for signs of business as unusual. Read on for an overview of this intriguing, sometimes beguiling market and a look at the factors that can create challenges for Russia's ability to evolve; these same factors can hold back your business and open the entity to legal entanglements and reputational damage.

\* Edward Irving Koch, New York City Mayor, 1978–1989

\*\* Brazil, Russia, India, China, South Africa

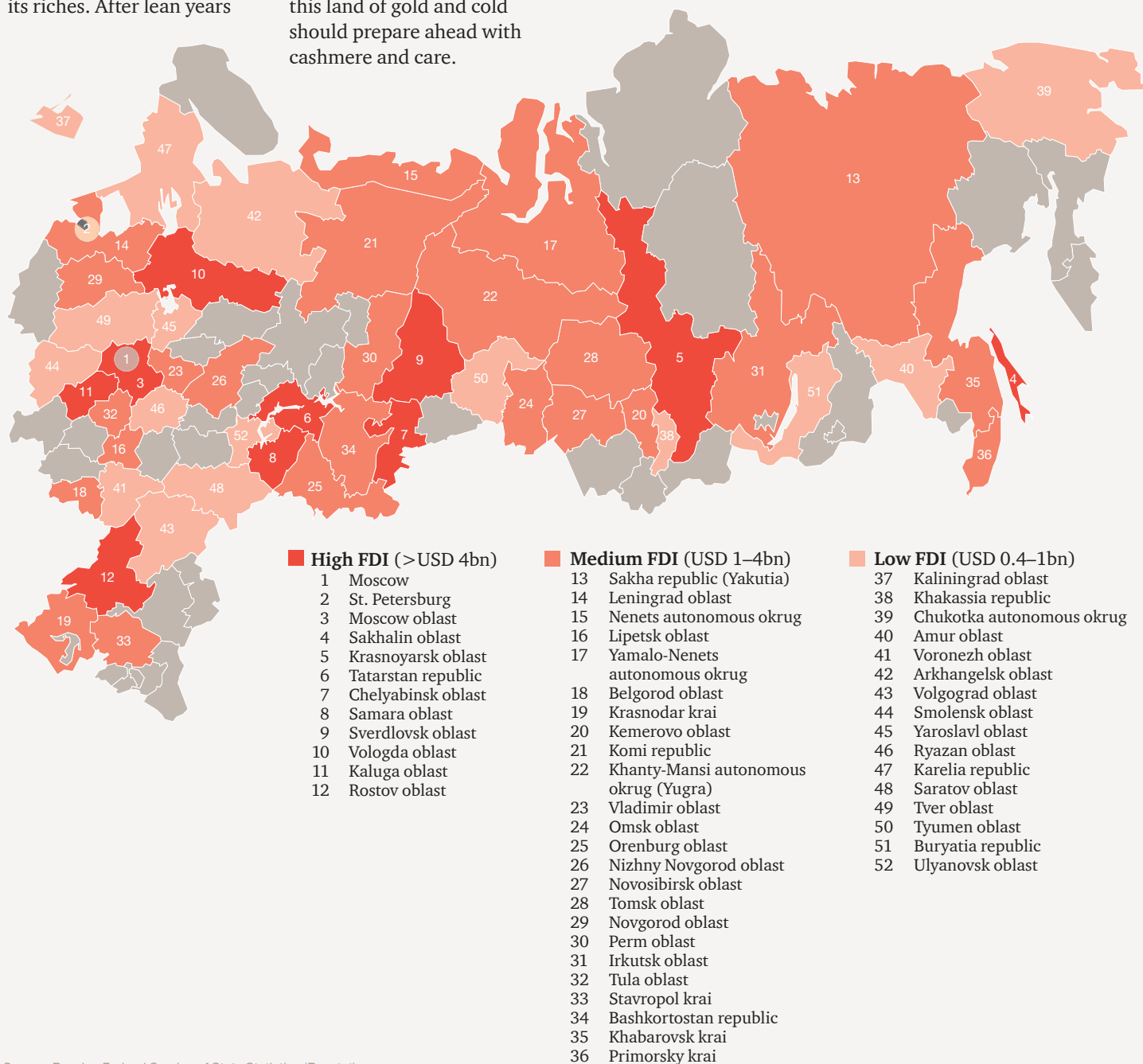
## Geographical distribution of FDI in Russia by investment size

On a per capita basis, gold-rich Chukotka, deep in the northeast corner of the country, got a significant boost around the turn of the millennium, when its then-governor gave investors secure property rights and access to the rare earth and its riches. After lean years

under Soviet rule, it's now home to one of Russia's highest per capita income populations, thanks to a small population and Midas-touch resources and despite an environment that's literally chilling. Enterprises interested in venturing into this land of gold and cold should prepare ahead with cashmere and care.

Also evolving are the oil and gas regions of Siberia's Tyumen (including Yamalo-Nenets and Khanty-Mansi autonomous okrugs) and the Far East's Sakhalin, a sparsely populated island developed mainly because of

international investments in offshore gas extraction projects known as Sakhalin-1 and Sakhalin-2. The densely populated city of Moscow comes in fourth, with per capita income just short of USD 25,000 per year.



Source: Russian Federal Service of State Statistics (Rosstat)



*Most manufacturing companies are privately owned, while about one-third remain under federal, state, or municipal ownership.*

## Russia's industrial identity

We see evidence of the old and the new in the contrast between Russia's traditional industries, which remain very much tied to the land and its resources, and the country's embrace of innovation. Russia is home to numerous industries that turn out a wide variety of goods for domestic consumption and export. Most manufacturing companies are privately owned, while about one-third remain under federal, state, or municipal ownership.

Government plans for additional privatization of remaining state-owned enterprises can create attractive targets for local and foreign investors. Pivotal enterprises tagged for full or partial privatization include Sovkomflot, Russia's largest state-owned ship builder; VTB, a Russian state-owned bank; and Alrosa, a major diamond producer. The country's five-year plan further cites privatization in whole or in part, among others, for Aeroflot (Russian Airlines), Sheremetyevo airport, RosTeleCom (Russia's largest telecom operator), RZD (Russian Railways), and RosAgroLeasing (the country's largest agro leasing company).

**Manufacturing is vital to Russia's economy**, with petroleum products, metals, and food and beverages leading the way. The government is also backing increased efforts to reinvigorate the aviation and automotive industries and to boost the production of new composite

materials. Construction also is on the rise, fueled by infrastructure development needs, demand for quality housing, and plans for Russia to host major international events such as the Sochi 2014 Winter Olympic Games and the 2018 Football World Cup.

**A major exporter of oil and natural gas**, Russia's economic growth over the past decade has been based largely on energy exports, boosted by increased oil production and high oil prices globally. Transneft, the state-owned pipeline monopoly, handles most of Russia's oil exports. Russia has 30-plus oil refineries,<sup>20</sup> with more under construction and plans for continued growth that would bring the total closer to 50.<sup>21</sup>

**Metals** also figure prominently in the Russian economy. The country was the world's fifth largest producer of steel in 2011, turning out nearly 70 million tons,<sup>22</sup> and the third largest producer of iron, with close to 50 million tons.<sup>23</sup> Major producers Magnitogorsk Iron & Steel Works (MMK) and Severstal are among the world's top 30 steel manufacturers.<sup>24</sup> The majority of the country's metals production is exported; in 2012, metals accounted for more than 10% of total exports.<sup>25</sup>

**The country's food and beverage industry** primarily serves the domestic market. Numerous large international food companies have already established a solid footprint in Russia, amid high demand and a good base of input resources. After Pepsi acquired Wimm-Bill-Dann in 2010, it became the largest food company in Russia. However, the overall food market is not yet saturated with quality products.

**The aviation industry**, quite active in Soviet times, is reawakening, drawing on Russia's rich technological heritage, new technologies, and state support. After the consolidation of Russian aviation companies under the umbrella of wholly state-owned OAK (Obyedniennaya Aviastroitelnaya Korporaciya), industry sights are set on renovating a national aviation park and competing in the global market with aircraft such as the Sukhoy Superjet and the MS-21.

**Russia's automotive industry** has opened for major car makers, most of which have already placed production facilities or created joint ventures (JVs) in Russia. The extent of production localization ranges from large aggregate assembly to completely knocked down (CKD) manufacturing, the latter of which the government tends to prefer. However, component supplier quality often fails to meet high enough standards to suit

## *Infrastructure: Push and pull, progression and challenges*

Infrastructure is central to Russia's economic and social development. Despite some persistent challenges, the country seems to be making slow but steady progress in some regards.

Russia's sizeable population and area demand an extensive infrastructure network of transportation, energy grids, telecommunications, and urbanized territories. But these facilities and functions are not always up to the task of meeting increasing market requirements.

The majority of infrastructure components was inherited from the Soviet Union and currently remains in rather poor condition. As in many other emerging markets, the Russian economy requires significant investment to advance its infrastructure in many sectors. The government has demonstrated a commitment to maturing in this regard, undertaking a number of strategic programs and initiatives and allocating budgetary funding.

Communication can be disrupted by unevenly distributed resources. Despite its more than 40 million Internet users,<sup>26</sup> more than 225 million cellular subscribers,<sup>27</sup> and about 45 million land lines,<sup>28</sup> communication can still be vexing in some distant locations, where at least one of the three largest telecoms does not provide sufficient coverage and bandwidth, a

reminder that amenities mature markets take for granted can be burdensome in emerging regions.

Railroads are far reaching and well developed, offering cost savings and reduced carbon benefits. Rail travel stands out as Russia's most important means of transportation between the Western, Siberian, and Far East regions, carrying a significant proportion of domestic passengers and most bulk cargo. The country's railway company, Russian Railways (RZD), is focused on enhancing the potential benefits of Russia's geographical position. One of its prime tasks is thorough integration of the Russian railway system into the Eurasian transport network, specifically expanding east-west and north-south Eurasian transport corridors to increase revenue and integrate Russia into the global economy.

Significant investment goes toward network expansion, including the addition of new high-speed railways for major routes in the West and the development of new rail lines throughout the country. By 2030, RZD plans to invest more than 10 trillion rubles (approximately USD 380bn) in this pursuit.<sup>29</sup>

Despite its history of state ownership, Russian Railways is a state privatization priority—and an attractive bidding target for international

investors. In 2012, the government issued an order to expedite privatization of 25% of RZD ownership through private placements among multiple bidders.<sup>30</sup>

Major companies have been striking deals with RZD. Germany's Siemens, France's Alstom, and Spain's Talgo, for example, are involved in renovating and restocking Russia's train fleet, including new high-speed and double-decker trains.

Major international airports can be found in most large cities, especially in western Russia, with construction under way to convert some of these, such as Moscow's Sheremetyevo, to substantial international transport hubs. Although only about half of the country's 1,200-plus airports are paved and conducive to international air travel,<sup>31</sup> cities of regional importance and most major cities offer airports. Russian air carriers are dominated by a few large companies covering most international and domestic routes, with some smaller companies also operating in the region.

Russian seaports serve as export outlets, channeling coal and other products to various markets, including Europe, North and South America, and Asia. Novorossiysk at the Black Sea is the largest, with a capacity of nearly 157 million tons of cargo per year.<sup>32</sup> Others include Primorsk, St. Peters-

burg, and Murmansk, located in the northwest, as well as Vanino, Nakhodka, and Vladivostok in the Far East.

Russian roadways present significant traffic challenges stemming from the rapidly growing number of vehicles in large cities. Cars became more accessible in recent decades due to available financing and growing personal incomes. Moscow's roadways alone carry more than four million registered cars,<sup>33</sup> creating substantial traffic congestion. Other large and small cities often experience similar problems for the same reasons. Both federal and municipal authorities seek to find solutions to this challenge, drawing on international as well as local experience.

While establishing an industrial foundation can be trying, investors might be intrigued by the potential presented by brownfield investment opportunities, through which they can take advantage of existing enterprises via acquisition. Numerous abandoned, under-capacity, and poorly managed industrial entities can be found throughout Russia.



*The government has demonstrated a commitment to maturing in this regard, undertaking a number of strategic programs and initiatives and allocating budgetary funding.*

today's car makers, thereby limiting localization. At the same time, a few domestic automakers such as VAZ (cars), GAZ (trucks and buses), and KAMAZ (trucks) are finding their way to Russian customers on the basis of favorable pricing and services, along with improved quality achieved in partnership with international manufacturers.

**The new materials industry** illustrates Russia's efforts to render traditional industries more competitive. For example, new composite materials such as carbon fiber in the aircraft and auto industries enable better fuel economy, lighter-weight vehicles, and improved service periods. Still, the current level of production (less than 1% of the global market<sup>34</sup>) remains low compared with that of mature economies. To stimulate internal demand, the government has introduced regulatory measures for standardization and classification of composites so that engineers can include the materials in their designs for manufacturing and construction projects.

**Construction** has landed in the spotlight thanks to modernization and expansion of the transportation infrastructure, demand for quality housing, and the upcoming Olympics and World Cup events. Investment has come from the state and the private sectors. Although competition for general contracts is intense and often dominated by Russian

incumbents, a larger pool of investors might find opportunities in subcontracting, construction services, and construction materials production.

**The Russian service sector**, particularly in the retail, wholesale, and real estate markets, also has shown growth, fueled by per capita income growth.

**Russia's retail market** is actively growing and not yet saturated with quality retail services. With Moscow and St. Petersburg relatively well covered through global and local retail networks, expansion into other regions is gathering momentum. Some of global retail's largest companies remain absent from the Russian market, awaiting promising entry opportunities.

**The wholesale market** is often characterized by a few dominant players in each product segment, including food products, beverages, tobacco, and non-food products. However, that doesn't mean the market is closed to new entrants who are willing to put in some extra effort, time, and monetary investment to get to play in one of the established wholesale market segments.

**The country's real estate market** has developed over the course of the last decade, spurred by 2001 legislation that enabled private owners to snap up land in Russia. Property prices vary dramatically

by city and region, with Moscow and St. Petersburg the largest and priciest markets. Moscow, as the capital and major financial center, saw property prices soar from 2002 to 2008, with average price per square meter increasing nearly sevenfold for residential and commercial properties.<sup>35</sup> The market is poised for continued growth on the strength of an expanding economy, increasing demand for housing in mineral- and oil-rich regions, and a rising abundance of home loans.



## Russia's entrepreneurial profile

The recent global economic crisis has cast an air of urgency over many world economic challenges, and Russia is no exception. The fragile nature of Russia's economic growth, tied as it has been to exploiting natural resources rather than on developing vibrant entrepreneurial industries, may not carry the country into a leading or sustainable role on the world economic stage. To set itself on a more strategic, stable growth path, the country needs to shift its focus while overcoming some long-standing, deeply entrenched obstacles.

Years of unpredictable legislative changes and concerns as to whether public officials will wield power and law fairly and appropriately have laid down deep seeds of doubt. Some experts also question the adequacy of mechanisms for defending entrepreneurs in disputes with the state, although the recent appointment of an independent investor ombudsman (commissioner for the rights of entrepreneurs) is a positive step. Nevertheless, despite such positive moves, a residual lack of optimism continues to permeate the culture, disproportionately impeding growth of small businesses.

Despite these long-standing challenges, Russia has started on a path toward diversifying its economy and stimulating the growth of the small and medium enterprise (SME) sector. Look for these signs to chart progress and identify emerging opportunities:

- Removal of bureaucratic barriers
- Loosened legislative restrictions on pension funds, mutual funds, and incorporated investment funds

- Establishment of adequate intellectual property (IP) protection laws and capital insurance mechanisms
- Creation of tax stimuli
- Simplified immigration rules
- Improved business climate among the regions
- Corrections to infrastructure shortcomings

Russia's leaders have demonstrated that they understand the need to facilitate the transition to self-sustaining investment and innovation-led growth. The government has embraced the race to reduce economic dependence on raw materials and to invest instead in innovation, improve the country's legal framework, and fight corruption. Steps toward improving the overall business environment and supporting entrepreneurial activity include the following:

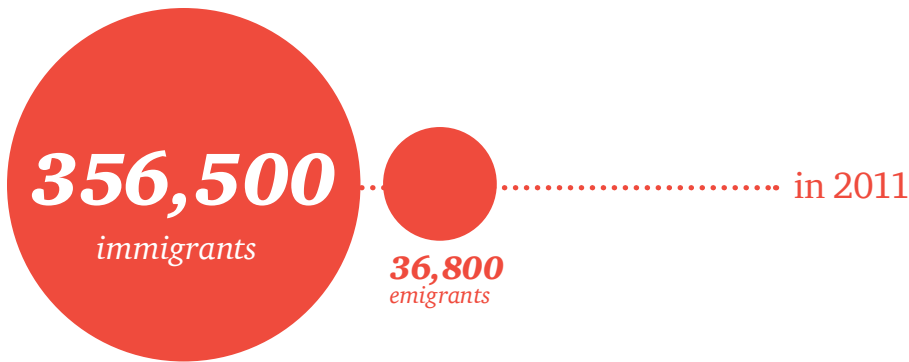
- Developing SME lending through measures such as the establishment of a dedicated SME bank.

- Simplifying workflow and reducing bureaucracy, for example, with the introduction of e-government services to allow for electronic filing of tax returns and accounts, and other business automation and special software use
- Providing a more favorable business environment through efforts such as the creation of 25 Special Economic Zones, which are responsible for infrastructure, free customs areas, tax benefits, and other advantages<sup>36</sup>

Officials also recognize the importance of positioning small businesses to build momentum and reach their potential by quickly getting them the funds they need to launch their operations. Continued backing by Russian leadership will be crucial to enabling the country to successfully complete the transformation to a sustainable, innovation-based economy.

*The government has embraced the race to reduce economic dependence on raw materials and to invest instead in innovation, improve the country's legal framework, and fight corruption.*





### ***Making the most of Russia's demographics***

Immigration numbers reflect a net population increase, with more than 356,500 immigrants moving to Russia in 2011 and only about 36,800 emigrants striking out in search of new vistas and opportunities abroad.<sup>37</sup> But the country looks to be losing valuable talent, skill, and knowledge; those who are leaving tend to be well educated and highly skilled, while the incoming population hails predominantly from poorer neighboring countries with limited access to adequate education.

Intra-regional migration remains low (only about 1.3%) in comparison with other countries, with Russia's Central and Siberian regions the most popular destinations.<sup>38</sup> By contrast, migration to more prestigious cities, such as Moscow, St. Petersburg, Yekaterinburg, and Novosibirsk, comes with a higher cost of living, which tends to dampen enthusiasm for relocating to these cities in search of career growth.

Today, inbound investors might see an opportunity to benefit from the insights that often can be tapped through local talent, which also can be a relative bargain in terms of compensation compared with human capital in more mature markets. Working under sophisticated management in an environment that emphasizes the value of teamwork and workplace ethics can be a win-win-win for Russian employees, foreign investors, and Russia itself. Indeed, companies can vie for the best and brightest by offering competitive compensation, training, growth, and professional recognition.



share of local search traffic of Yandex, Russia's leading search engine

## Innovation: Another way of life

Innovation is not a new notion for Russia. Soviet times saw the development of numerous scientific towns, which were created to house enterprises and applied research institutions for the aerospace, defense, and nuclear industries. Research and development (R&D) flourished, supported by well-staffed institutions. Inventors garnered tens of thousands of patents and licenses.

But economic challenges in the 1990s severely undermined these institutions, as many of them struggled to replace previously government-provided resources to sustain their operations. Many top scientists, engineers, and academicians left the country in search of opportunity elsewhere, causing significant brain drain.

Still, the country's valuable innovation heritage and academic focus have not evaporated. Russia remains among the foremost countries in the world in terms of higher and scientific education, with many academic institutions, such as the Moscow Institute of Physics and Technology, retaining worldwide prestige.

After years of stagnation, innovation is starting to make a comeback as the country looks to diversify and sustain economic expansion. Related policies, while early in their development, are a significant component of an agenda focused on spurring technological dynamism, increasing productivity, and enabling Russia to regain its ground as a producer of highly sophisticated products and services, poised to advance on the strength of venture capital.

The number of small and micro-enterprises engaged in scientific research is on the rise. Although historically Russia had been strong in areas such as space, nuclear, and defense, the focus changed post-*perestroika* and the country started to build a new technology profile. The late 1990s and early 2000s witnessed the gradual rise of IT as one of the country's core industries to accommodate an engineering talent pool.

IT and the Internet became the fastest-growing tech industry in Russia, showing signs of early success, with some companies successfully making their way into international markets and local players copying Western business models and making fortunes on the booming Russian Internet. Amid rapid growth, some have outpaced their global competitors, dominating the local language-specific market.

Russia's leading search engine, Yandex, a multibillion-dollar Nasdaq-listed company, was able to maintain its more than 60% share of local search traffic as of 2012,<sup>39</sup> even after a US giant in the field made numerous attempts to make inroads into local search, as it had in other territories around the world.

The country's major social network, VK (vKontakte), has maintained its popularity, recently being deemed by the US government as one of the five most frequently visited sites in Russia<sup>40</sup> and one of the top 40 globally.<sup>41</sup> But this distinction is a double-edged sword, as the site has also raised concerns that it's associated with providing users access to pirated content, a significant Internet IP issue.

*The country's major social network, vKontakte, has recently been deemed by the US government as one of the five most frequently visited sites in Russia and one of the top 40 globally.*



## Anything but 'nyet' for the Internet

Where infrastructure and cultural disconnects create fissures and impede growth, the Internet is drawing Russia's nine time zones together and drawing its people from far-reaching corners toward a cyber-center like never before, pointing toward potential for serious online retail opportunities going forward.

With domain names available in Cyrillic and other non-Latin alphabets since 2009, cyber-life and the world it represents have become far more accessible to Russians, some of whom, primarily those who are middle-aged and older, have never learned English.

Russians have rushed like a flash mob onto the Web. The new millennium saw Internet use among the world's Russian-speaking community grow by more than 1,800%,<sup>42</sup> an indication that Russia's Internet could support the sales of goods and services, given a viable entrepreneurial market.

The number of Russian domain names surpassed 500,000 just one week after the Russian domain (.рф) opened for general registration.<sup>43</sup> Two years later, more than 60 million Russian Internet users composed Europe's most substantial cyber-population.<sup>44</sup> Their language ranks among the Web's top ten.<sup>45</sup>

The Internet has also penetrated beyond major cities, notably into the country's central region. Dominated by Moscow, the area now represents more than 30% of Russia's online population,<sup>46</sup> indicating potential for further Web-based interaction in more remote parts of Russia. Already, despite limited competition and pricey activation and access, a significant number of new Internet users is reaching into cyberspace from regional centers and small towns.

Mobility plays a role, with an estimated 43-plus million Russian citizens tapping and typing into Internet-enabled smartphones, laptops, and tablets.<sup>47</sup> Continued ability to reach beyond major markets will depend in part on the development of wireless access; without it, expansion will be determined by regional operators' abilities and interest.

### Making the most of Russia's cyber-buzz

Social networking, bolstered by an estimated 60 million or more Internet users, continues to dominate the Russian Internet experience, placing Russia among the top countries for social network usage.

Although social networking currently eclipses online news and shopping, online marketing can develop into a significant opportunity in the vast stretches of regional Russia. Most of the Russian public appears to be open to the concept, but to date, online sales have languished, with a dearth of secure, convenient payment options and pick-up sites, obscure or non-existent return policies, and backordering quashing potential.

The 35 to 44 age group is the most active among Russia's Internet buyers, purchasing mostly movie, theater, and concert tickets.

Vkontakte dominates Russia's market, despite spam and hacking complaints among its 35 million users.<sup>48</sup> It's followed in popularity by Odnoklassniki.ru ("classmates"). Facebook yields a leading market share to both VKontakte and Odnoklassniki. Similarly, Google's market share is second to Russia's Yandex.ru, while PE firm ru-Net dominates Russia's domestic companies despite the presence of international Internet giants; LinkedIn: Moikrug ("my circle") is Russia's answer to LinkedIn.

The blog site LiveJournal, which uses social media features to promote member content creation, has emerged as the favored platform for Russian journalists and intellectuals seeking free expression, so much so that Russian media company SUP bought it in 2007. LiveJournal's Russian segment has five million Cyrillic accounts and 250 million posts.<sup>49</sup> Although it's a dotcom site as opposed to a dotru site, many of its more than 30 million monthly users<sup>50</sup> fondly refer to the site by its Russian initials, жж. In other recent deals:

- AOL sold the world's largest instant messaging service, ICQ, in 2010 to Russian Internet holding Digital Sky Technologies for USD 187m, a fraction of its original cost.<sup>51</sup> It remains the most popular instant messaging service in Russian-speaking countries, with more than 11 million users in Russia alone,<sup>52</sup> where sought-after six-digit identification numbers can fetch hundreds of dollars.
- Groupon acquired a majority stake in Darberry.ru, an online group-shopping portal operating in seven Russian cities.<sup>52</sup> The site went live in March 2010. Darberry, which boasts some 180,000 regular users and more than 26,000 unique visitors per day,<sup>53</sup> has grown into a multimillion-dollar company.
- Search engine Yandex and Internet group Mail.ru recently went public to raise nearly USD 2.5bn in New York and London to capitalize and reinvest in social networking and Web searching popularity and potential.<sup>54</sup>
- Amazon's Russian prototype, ozon.ru, which launched in 1998 as an online bookstore, has grown significantly through acquisition in size and offerings.

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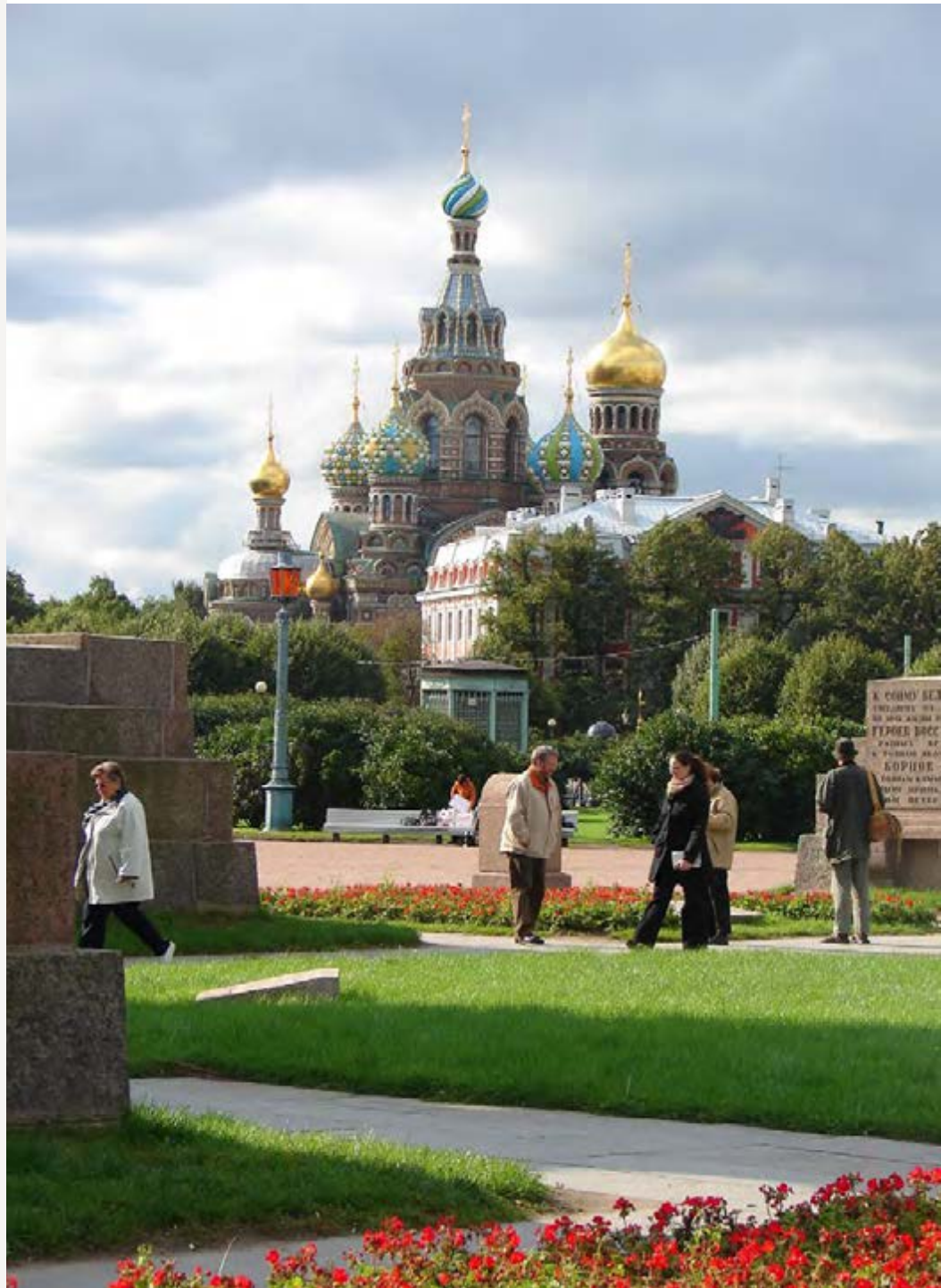
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Despite much progress, the lack of language fluidity evident in Russia's early online explorations indicates that it will be a while before the full potential of the country's Internet use will be reached. Businesses looking to use the Web to gain growth in this market will need to hit the books and learn their way around Cyrillic, at least for the foreseeable future.

The government's ability to keep collusion at bay will also be critical. On a promising note, the Federal Antimonopoly Service in 2011 penalized Russia's three largest mobile operators for excessive roaming charges. Additional crackdowns in response to any future allegations will indicate a momentum boost for additional regional penetration.

Russian officials say the country doesn't plan to introduce Internet censorship measures, maintaining that any rules for Internet use should be adopted at the international level, so that no one country can close down websites unilaterally. In fact, Russia's political leaders are using the Web to get their messages out; a lot of politicians at various levels tweet or blog, with hundreds of thousands of followers around the world.

Former President Medvedev, who has referred to the Internet as a democratizing engine, is behind the development of e-Government, a special-purpose federal program intended to establish an electronic infrastructure for the multitude of agencies at the federal, state, and municipal levels. If such efforts can revitalize outdated bureaucratic processes and eradicate red tape, it might signal an improved business environment in which online business opportunities can flourish.





# \$2 billion

total estimated venture capital in 2011, with 85 venture funds

## Breaking through barriers: Venture capital fits and starts

To date, the perception of Russia among the global private equity community covers the spectrum, from extremely cautious to highly enthusiastic and rapidly evolving. Individual viewpoints also run the gamut, depending on whether the vantage point is from within Russia or from the outside and what kind of experience the person in question may have had, if any; those who have spent time in the country and have done business there tend to be more optimistic. The number of global private equity players physically present in Russia, however, remains low.

Still, a growing number of foreign companies are showing interest in the Russian innovation market, with high-profile companies such as Microsoft, IBM, Cisco Systems, and Intel committing funds to R&D and venture capital investments.

Microsoft has pledged to distribute, over a ten-year period, USD 100m among Russian high-tech start-ups,<sup>55</sup> including those in Skolkovo Innovation Park, a Medvedev-era initiative intended to attract local and foreign up-and-comers through tax incentives, foreign worker visa privileges, and other government perks. The US software giant also launched technological entrepreneurial training, led by Russian Microsoft

specialists and IT venture capitalists, to boost skills among academically inclined IT experts, engineers, and developers.

The total number of venture funds in Russia increased in recent years, from 40 in 2001 to 85 in 2011, with total venture capital estimated at USD 2bn.<sup>56</sup> At least 15 private equity and venture capital funds were established in 2011 alone.<sup>57</sup> And although the number of Russian banks and public companies in the venture investment market remains low, several large Russian finance institutions and credit corporations maintain their own venture funds.

In a bid to attract more private Russian and foreign investors, the government is establishing state institutions such as the Skolkovo Foundation, Russian Venture Company, and RUSNANO. Tax incentives aimed at building venture capital investment include access to a simplified taxation system, investment tax credit, potential income tax breaks, and the benefits of double-taxation treaties with multiple countries.

Several large Russia-based finance institutions and credit corporations maintain their own venture funds, including Gazprom, Bank for Development and Foreign Economic Affairs, SME Bank (formerly Russian

*The positive trends in the innovation sector and the venture capital industry that supports it place Russia high on the list of many multinationals as a destination for innovative industrial R&D outsourcing.*

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## **Skolkovo innovation**

Russia's own version of Silicon Valley, the tech hub is slated to include IT, as well as biotechnology, energy, space, and nuclear technology.

The Skolkovo Fund has provided USD 185m in grants to 70 innovation companies,<sup>58</sup> a record high for a single venture fund in the history of venture investments in Russia.

The country is also reaching out to innovation leaders around the world in an effort to draw on the knowledge and expertise of countries and companies that might invest in or buy the technologies. Numerous foreign sponsors and companies are getting onboard.

MIT's president in 2011 signed an agreement to collaborate in education, research, and entrepreneurship programs at SkTech, the new graduate research university in Skolkovo.

IBM and the Skolkovo Foundation have signed two agreements: one to establish a Science and Technology Center within the future Skolkovo Innovation Center in Moscow, the other to enable IBM to license to the foundation intellectual property management information, including methods for identifying and evaluating technologies that have significant potential for commercial value.

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Bank for Development), and Finam, among others. But the number of Russian banks and public companies on the venture investment market remains low.

Financing for start-ups comes predominantly from foreign firms such as Runa Capital, a technology-focused venture capital fund, investing in computing, virtualization, and mobile applications. However, since the latter half of 2010, smaller Russian venture funds such as Fast Lane Ventures, Bricolage, Techdrive, and Almaz Capital Partners have been looking for opportunities to bring promising start-ups to investment maturity by providing management expertise to business incubators, accelerators, and to project factories. Some Russian VCs are looking to participate in late-stage deals in the West, primarily to gain experience. But the majority remain focused on Russian opportunities.

Several signs bode well for the future of Russia's venture capital market, including the creation of appropriate legislative guidance, the development of technology parks, successful efforts to attract competent management, and greater availability of capital, thanks to improvements in the banking system. Continued maturation will likely inspire large businesses to devote more venture capital to start-ups in high-tech industries, media companies, niche retail businesses, IT, software, and the service sector.

The positive trends in the innovation sector and the venture capital industry that supports it place Russia high on the list of many multinationals as a destination for innovative industrial R&D outsourcing. Many multinationals have taken note and have already penetrated this growing market. Increased private and government spending will likely continue to raise high-tech production potential and attract foreign investment; but that is not all the Russian state needs

to achieve, as some fundamental hurdles remain.

The volume of the venture capital market suggests that Russia's high-tech businesses are primed to compete on the global scene; its venture capital market in the last decade has shown a growing number of ambitious high-tech start-ups challenging established industries and even creating new ones.

The earliest players in the industry came up against a dearth of capital, an undeveloped finance market, and a lack of skilled, forward-looking managers who could lead venture capital funds in a removed but supportive manner.

Today, venture capital firms still bemoan a shortage of viable projects. This doesn't necessarily reflect a shortage of ideas. At issue is a gulf between inventors' ability to innovate and their ability to pitch and sell their innovations. One potential solution and opportunity: Bring together leaders from science and industry to generate attractive goods and services and capture market share. A greater focus on encouraging entrepreneurship among Russian high-tech specialists, combined with the establishment of exceptional corporate governance standards among small businesses, can help attract capital.

To bring to fruition the increasing foreign investment in Russian research and development and to reach its potential as a serious source of scientific innovation, the country will have to raise awareness of venture capital opportunities among Russian companies. It will also have to override some common misperceptions of the venture capital concept by actively engaging the media, launching advertising campaigns, conducting public talks, and delivering other presentations on the topic of the venture capital market and its emerging role in supporting growth and innovation.

## *A look at RUSNANO*

Rusnano is a state-owned investment fund with \$6 bn assets under management, which invests primarily in nanotechnology projects with a high potential for growth. Rusnano's mission is to support a competitive nanotechnology industry through implementing advances made by Russian high-tech firms and through incorporating cutting-edge technologies developed abroad.<sup>59</sup>

The state-owned fund will also invest up to USD 26m over four years to develop Panacela Labs Inc., a subsidiary of the Buffalo Company (NASDAQ: CBLI), which focuses on developing treatments for cancer and acute radiation syndrome.<sup>60</sup> The partnership followed a USD 5m investment by the Russian government in another CBLI subsidiary company, Incuron LLC.<sup>61</sup>

Russian Venture Company (RVC) is a government fund and Russia's development institute, one of the country's primary tools for building its own national innovation system. In all, RVC has backed 12 funds, including two funds in foreign jurisdictions, with a total capitalization of nearly USD 1bn.<sup>62</sup> As of January 2013, RVC-backed funds ran a portfolio of 139 companies, invested capital totaling more than RUB 12.1 bn, or about US\$ 400m.<sup>63</sup>





## Starting a business: Up, but running?

Depending on the nature and scale of their operations, foreign companies can establish new representative offices, branches, or legal entities in Russia without prior approval. They will have to submit specific documents to open a representative office or to receive branch accreditation. Typically, the opening of a representative office or branch of a foreign entity requires submission of numerous application documents and related red tape.

Registration procedures for local legal entities and Russian businesses are the same. While a bit slower than top-performing Doing Business countries, processes such as opening a simple LLC can be relatively streamlined compared with others described here.

Economically strategic businesses and large M&As will have to endure some more rigorous paper-chasing.

Entities that fall among the 42 economic strategic industries as set by law require federal government approval; investment in industries such as power and gas,

banking, insurance, mass media, diamond mining, and civil aviation is subject to a 50% limit in foreign ownership.<sup>64</sup> Companies that want to control more than 50% need to secure a special permit from the committee, which is headed by the prime minister. Industries such as banks and insurance companies must obtain licenses from regulators, as well.

M&A deals in which the acquirer stands to gain a stake exceeding 25% of the target must have an anti-monopoly green light from the Federal Anti-Monopoly Service (FAS).<sup>65</sup> Share purchases must be registered with the Federal Service on Financial Markets, which oversees Russia's financial markets. This includes regulation and supervision of insurance providers, credit cooperation and microfinance, commodity markets, exchange intermediaries, and brokers (but excludes banking and audit activities); it's also the government agency charged with controlling compliance with Russian insider trading and market manipulation laws.

**Getting your hands on land.** Foreign individuals and companies can buy and lease land in Russia with certain restrictions; agricultural land can be leased by foreigners, but not purchased, while non-agricultural land can be purchased, leased, or attained via joint venture. Land also can be used as collateral for loans and mortgages.

Most companies are granted temporary land-use rights under short-term or long-term leases, with the maximum lease period often restricted to 49 years.<sup>66</sup> Land rights can be claimed only after they are registered with the state in the Unified Register of Rights; plots are subject to state cadastral registration, so boundaries must be officially recorded before any transactions can take place.

Land can be used only for its designated purpose; if the intended purpose differs, the plot must be transferred to the appropriate category. When land is leased for a designated use, that designation will be specified in the lease agreement.

Companies that use land for natural resources must observe environment protection regulations that set standards, limitations, and rules for mining activities. Compliance has become increasingly important in recent years as more companies strive to attain ISO 14000 certification from the International Organization for Standardization to demonstrate environmentally sound business practices.

The process for registering property, which is the same for domestic and foreign companies, was expedited in recent years with the introduction of new documentation requirements, for





limit in foreign ownership in industries such as power and gas, banking, insurance, mass media, diamond mining, and civil aviation

example, the use of cadastral passports rather than inventory documents and cadastral maps. Still, the number of steps and time frame remain relatively attenuated and bottled up in bureaucracy.

**Obtaining licenses and permits.** Lining up licenses and permits can be managed effectively and with integrity, but business leaders should prime themselves to cope with a process that often can be complex, time-consuming, and vulnerable to corrupt influences.

The cumbersome permitting process, which requires a multitude of approvals and state inspections, can be especially daunting for those new to the market. Requirements vary widely by city, compounding complexities. Businesses seeking to build a warehouse and connect to utilities in Moscow face a 47-step process, while in Murmansk, regulations call for 16 steps.<sup>67</sup>

Delays, however, are routine across the board. Agencies often handle the work slowly and inefficiently, fueling expectations that facilitation payments can clear the clogs in the system.

Russia's construction-related rules and regulations, established in the interest of safety, security, quality, and environmental protection, can be complicated and challenging for incoming businesses to understand. Advance knowledge, preparation, and planning can help them allocate appropriate time and resources to ease the way forward.

**Accessing the electrical grid.** For large new consumers, gaining access to the electrical grid is not as easy as turning on a light. Although the government recently privatized and deregulated its electricity market, connecting to the grid remains a slow, inefficient, serpentine, and expensive process reflective of the country's overall infrastructure challenges.

**Getting credit.** Lacking a public credit registry and with private credit registries covering only 36% of the population,<sup>68</sup> credit is tight. The problem is exacerbated because credit history information is hard to come by, as are legal protections, increasing risk in the credit market and pushing rates higher amid heightened risk premiums. Along with limited credit availability, higher costs and fewer investment projects are additional hurdles businesses face.

**Paying taxes.** Having cut its corporate income tax rate in 2009 from 24% to 20%,<sup>69</sup> Russia has been able to remain tax competitive despite the recent increase of employers' social security contribution rate from 26% to 34%.<sup>70</sup> The tax code is quite advanced and under constant revision to keep pace with changing business requirements. Numerous position papers and other official documents, such as official explanations and letters, complement tax regulation.

**Trading across borders.** The vast geographical spread of consumers, remoteness of manufacturers, state railroad monopoly, high fuel prices, and

poor infrastructure render inland transportation and handling the costliest import/export component, representing up to half of related expense. Similarly, document preparation can take a significant amount of time and energy, representing as much as 70% of import/export activities.<sup>71</sup>

Russia eased cross-border trade in 2011 by reducing the number of documents needed for each transaction to 10 and lowering associated costs. With its recent admission to the WTO, more changes should be on the way.<sup>72</sup>

Customs clearance can be a challenge, involving as it does complicated regulations that are frequently subject to change; slow-moving, technology-poor processes; excessive paperwork scrutiny; requirements for translation of foreign language documents; goods inspection; measurement routines; and inconsistent operating methods, efficiency, and transparency from post to post. Wherever there is excess bureaucracy, there is also an opportunity for corruption and the need for a watchful eye.



*When the walls come  
tumbling down*







*To be among those who will succeed, you'll need to enter business in Russia with a strong and unwavering focus on corruption-related challenges.*

Those who seek to grow with Russia will likely experience growing pains, just as others in the international community have already done, including navigating corrupting influences; bureaucratic and regulatory complexities; slow-moving, outmoded systems; inadequate infrastructure; and the sheer size of the land and complexity of cultural variance among the people.

If you're among the many business leaders contemplating a foray into this land of duality—between yesterday and tomorrow, open doors and back-door dealings, maturing and established, innovative and retrograde—you certainly are not alone. To be among those who will succeed, you'll need to enter business in Russia with a strong and unwavering focus on corruption-related challenges, and an understanding that additional efforts and frustrations will join you along the way. Establishing an effective, integrated, vigorous anti-corruption campaign is a must if you're to safeguard your enterprise, growth prospects, and brand and emerge as a solid corporate citizen. Despite all the challenges, companies that successfully fight corrupt tendencies tend to be rewarded, and may just leave the others behind.

Understand where you're working, and what its particular and singular vistas, customs, and cultures imply; know with whom you're doing business; and know the market in which you're playing. It's crucial to remember that St. Petersburg, Russia can be as removed from distant Siberia as it is from St. Petersburg, Florida. Business strategies and practices should reflect those numerous local distinctions. They also should take into account the potential to tap local talent, which can bring tremendous skill, know-how, and on-the-ground perspective to your operations.

Solid due diligence, a learned approach to third-party dealings, and a good dose of patience are in order. *Da*. Explore whether Russia makes sense for you and your business goals. Fly a kite. Who wouldn't be energized by this notion: You were there when this massive vessel successfully turned this pivotal, precarious, and promising corner.

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