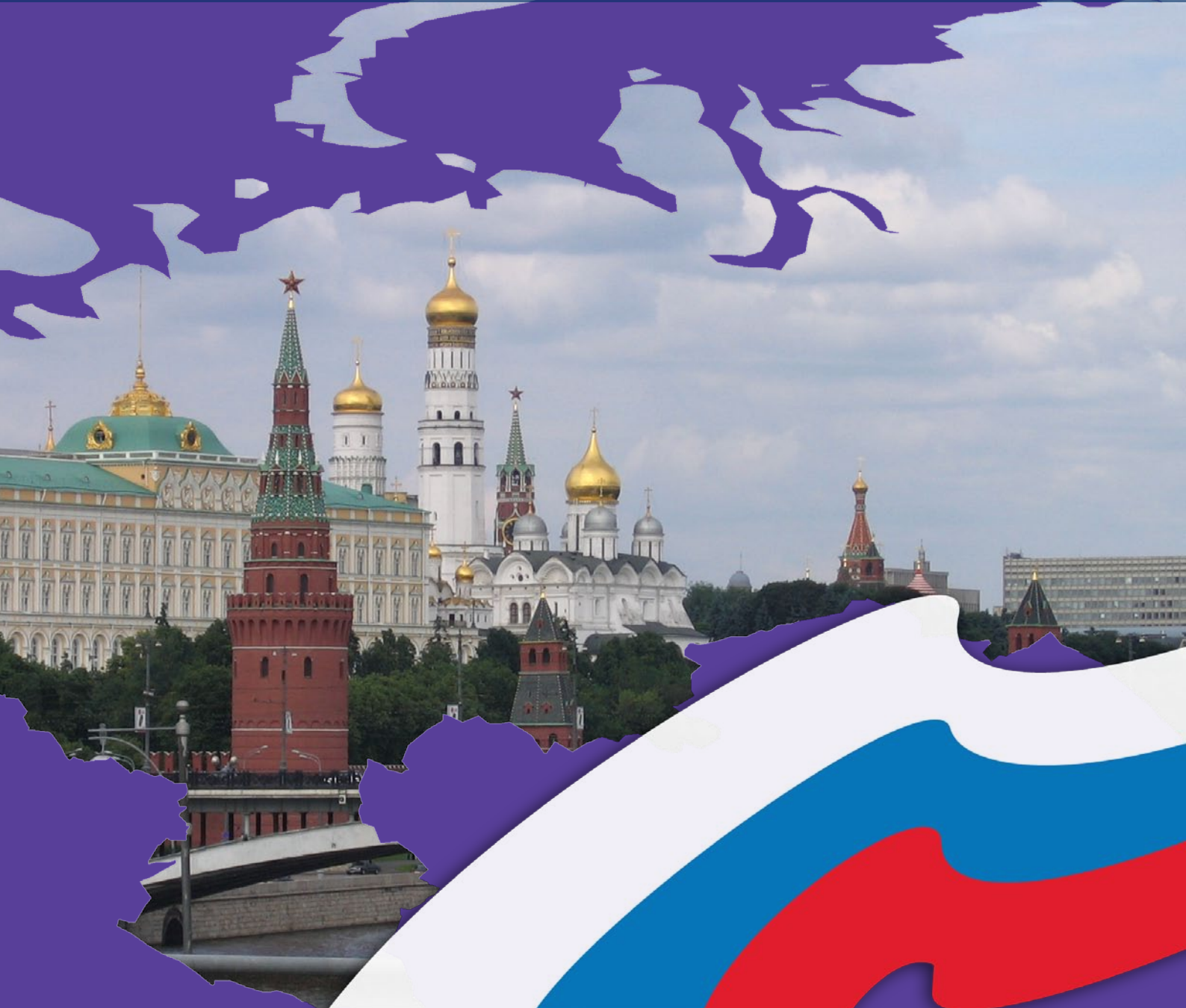


HOW TO INVEST IN RUSSIA

Guide to theory and practical advice for making
an investment in Russia in 2010



AEB

1995-2010

15 years

ASSOCIATION OF EUROPEAN BUSINESSES

LINKING YOUR BUSINESS TO THE RUSSIAN MARKET



BEITEN BURKHARDT · RECHTSANWÄLTE (GERMAN ATTORNEYS-AT-LAW)

OFFICE MOSCOW

TURCHANINOV PER. 6/2
119034 MOSCOW
RUSSIA
TEL.: +7 495 2329635 · FAX: +7 495 2329633

CONTACT:

FALK TISCHENDORF
FALK.TISCHENDORF@BBLAW.COM

OFFICE ST. PETERSBURG

MARATA STR. 47/49 LIT. A, OFFICE 402
191002 ST. PETERSBURG
RUSSIA
TEL.: +7 812 4496000 · FAX: +7 812 4496001

CONTACT:

NATALIA WILKE
NATALIA.WILKE@BBLAW.COM

BEITEN BURKHARDT



Foreword By E.S. Nabiullina, Minister of the Russian Federation for Economic Development

Elvira S. Nabiullina

I am glad to welcome the readers of the “How to Invest in Russia” guide, on behalf of the Ministry of Economic Development of the Russian Federation.

For a number of years this publication has served to provide potential investors with an independent professional evaluation of the business environment existing in our country.

I would like to use this opportunity to thank the Association of European Businesses for its assistance and contribution to the attraction of foreign capital and the improvement of the business environment in Russia.

The last year and a half were a difficult time for the economies of all countries. The Russian economy was no exception. The reduction in export prices and the deterioration in the terms of foreign and domestic borrowings resulted in a considerable slowdown in economic growth, a decline in industrial production and investments, and an increase in unemployment. The crisis revealed a broad range of problems in the Russian economy, having demonstrated the low level of competitiveness of many industries, and the dependence on prices for raw materials and external financial resources.

The structural upgrade and technical renovation of Russia – the transition from a development model based on raw materials to one based on innovation – are currently of critical importance.

The most important pre-requisite for such an upgrade will be large-scale growth in direct foreign investment in the priority sectors of the economy.

We are interested in investors which, through their presence in the Russian market, will strengthen the competition among manufacturers, contribute to the implementation of advanced technologies, introduce innovative components into production and improve managerial experience. High-quality investment projects, undoubtedly including those with the participation of foreign capital, are essential for the Russian economy. We welcome investors which are willing, in cooperation with the Govern-

ment and Russian business, to participate in the development of production infrastructure (power generation; roads and railroads; backbone oil, gas and product pipelines; sea ports; airports; communal services) and social infrastructure.

We invite foreign investors to cooperate in the sphere of development of information & communication technologies; agro-industrial and timber processing complexes; chemical, pharmaceutical and electronic industries; automotive manufacture; agricultural and transportation machine-building; and civil aircraft construction.

For the purpose of attracting foreign investment, the Russian Government follows a consistent policy aimed at improving the investment climate in Russia. Special attention is paid to the elimination of administrative barriers in starting and doing business in our country. The issue of the effective protection of intellectual property rights is also of critical importance. In order to develop competitive “rules of the game” for corporations, the improvement of corporate legislation is underway. Tools are being developed for the protection of ownership rights, including prevention and settlement of corporate conflicts. Efforts are being taken to implement tax mechanisms to stimulate investments and innovation. Different tools are being developed to support investors in project implementation in Russia. The Foreign Investment Advisory Council, where investors in cooperation with the relevant executive authorities discuss the fundamental issues related to investing in Russia and make proposals on their resolution to the Russian Government, has been successfully functioning for 15 years.

We are interested in new proposals and are open for their discussion!

*E.S. Nabiullina,
Minister of the Russian Federation
for Economic Development*



**Statement from Dr. Christian Ziegler,
Chairman of AEB Finance & Investment Committee**

Dr. Christian Ziegler

Dear readers,

The Finance & Investments Committee of the Association of European Businesses in the Russian Federation (AEB FIC) is proud to present to you “How to invest in Russia in 2010”.

Investing in Russia is still different from other countries. Understanding the needs of this extremely challenging but also highly promising market is a must for all investors who want to be successful. As in all emerging markets, opportunities and risks are both higher than European entrepreneurs might be used to in their home countries.

Even in the face of the global financial crisis investors stayed in Russia, still willing to expand their business. While markets in western European countries show destructive competition, Russia is still a country for growth, where products and services are needed, as well as foreign know how. As such, investment in Russia will become even more attractive for players from western markets.

Finding the right, sound information as a basis for decisions is maybe the key issue for getting on track. This publication presents its readers with the remarkable opportunity of gaining access to the best information from experts who live and work in this country and have successfully done so for many years.

This is the fourth consecutive edition. Our focus lies on practical and useful information that should be considered when making business decisions. This should be helpful not only to investors coming to Russia for the first time, but to everyone who has a reason to be in this country at one point in time or another, especially in view of the fact that new issues come up every year, rules change more often than we are used to and well known practices in one year might not be acceptable in the next.

The mission of the Finance and Investment committee of the Association of European Businesses – “to assist in and contribute to the continued improvement of the investment climate in the Russian Federation for European business interests by addressing critical finance issues” was the main motivation behind the creation of this publication. In view of the ever increasing number of foreign investors approaching the Russian market every year and the fact that the AEB is growing significantly with each year, more experts are available to share their views and experiences with our readers.

Special thanks go to the team that worked on this publication, first of all Dr. Vladimir Ismailov, Deputy Chairman of the FIC, CFO, Moscow School of Management SKOLKOVO, Clive Phillips, KPMG Transaction Services and Ksenya Bortnik, AEB FIC Coordinator.

Also we are most grateful for all the articles, written by extremely busy specialists in their fields, writing just to contribute to this project and the mission of the AEB FIC.

We hope this publication will serve its purpose – to bring more investments and reduce the number of surprises while investing in Russia

If you have any comments and points for discussion, please let us know. We want to grow and get better with each year and include as many ideas for our readers as possible.

*Dr. Christian Ziegler, Chairman,
Finance & Investments Committee
of the Association of European Businesses*



Statement from the Chief Editor, Vladimir Ismailov

Vladimir Ismailov

Dear readers of this publication,

The Finance & Investment Committee of the Association of European Businesses in the Russian Federation (“FIC AEB”) is proud to present to you the latest edition of the annual investors’ guide “How to invest in Russia in 2010”.

Since last year’s edition significant changes have taken place in the world and Russian markets. The world economy went through the floor of the biggest recession since World War II. We also received a number of comments and suggestions from readers that have been taken into account in the preparation of this edition. As a result, we decided to update the contents and expand the scope of the publication, and include regional aspects in this issue.

This brochure contains a one-of-a-kind set of articles written by market leaders in each subject. The authors do not just describe well-known business processes focusing on areas specific for Russia, but also support their ideas with real life examples and provide valuable recommendations for existing and future investors.

The entire project of publishing this guide is part of the FIC AEB’s mission – “to assist in and contribute to the continued improvement of the investment climate in the Russian Federation for European business interests by addressing critical finance issues” and is a not-for-profit venture.

It was a challenge to bring together the best people of different nationalities from sometimes competing firms, but I am proud that this extraordinary team of professionals saw the benefit of helping the business community regardless of professional competition. We have left writing style and language almost untouched to ensure the authenticity of the ideas conveyed by the authors. However, a certain extent of editing was performed to make the flow seamless.

I would like to thank the team of writers for their time and contribution to this brochure. I would like to thank Clive Phillips of KPMG Transaction Services in the CIS for tremendous editorial work, and Ksenia Bortnik of the AEB for making the entire process less problematic.

I would also like to thank those who contributed ideas, comments and suggestions to make this edition unique.

We all hope this publication will serve the purpose of helping to bring more investments and reduce the number of surprises while investing in Russia.

*Dr. Vladimir Ismailov, CFO,
Moscow School of Management SKOLKOVO*

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RUSSIA AS A PLACE FOR INVESTING

Why Russia?

(Dr. Vladimir Ismailov, CFO, Moscow School of Management SKOLKOVO)



Dr. Vladimir Ismailov

Dr. Vladimir Ismailov is the CFO at Moscow School of Management SKOLKOVO, supporting a range of corporate business functions of the School, which provides MBA, Executive MBA, Executive Education, Research and Consulting

focused on emerging market business, government agencies and organizations.

Vladimir holds a PhD in Economics, as well as being a Certified Auditor of the Russian Federation (since 1995) and a Member of the American Institute of CPA (exams passed in 2000). Dr. Ismailov has a great deal of financial management and auditing experience in a range of business sectors, having worked in the Public Accounting Media & Information sector, OEM, Telecom services and at not-for-profit organizations.

Vladimir is the author of a number of publications on general economic and investment subjects. Dr. Ismailov also cooperates with major media outlets (BBC Russia Radio, Russia Today TV, City FM Radio, etc.) in Russia and abroad as a member of the panel of experts that opine on investments and the business environment in Russia.

Investing during a crisis becomes more unpredictable than during organic market development. Industrial aspects for investors and those who would like to take advantage of the situation and regional aspects for those who would like to expand their business presence are two dimensions of the same decision making process. Emerging markets will grow at a faster pace than developed markets in the near term; therefore, they are still an attractive place for investing. Many experts expect that the BRIC countries (Brazil, Russia, India and China) will remain the locomotives of growth for the world economy during the crisis and following recession (see Table 1).

Investing in Russia may still present opportunities for significant returns on initial investment. These opportunities are not just long term; the Russian capital market is recovering fast, and in fact faster than many others. On one hand, the country is trying to integrate into the world economy as much

as possible in order to diversify its risks and obtain access to foreign markets. On the other, such integration, in contrast to isolation, leads to greater vulnerability of local economies to changes in the world market. The macroeconomic indicators for the Russian market remain favorable. The Russian government has taken a series of measures to mitigate the impact of the financial crisis and is still committed to supporting the economy in the time of recession. So far, most of the actions taken by the government and lawmakers have been timely in most cases and well intended.

Russia is well known for its vast natural resources. The country is a world leader in proven reserves of natural gas (23.4% of the world total), second in oil production (12.4%), and in proven coal reserves (19.0%)¹. Russia is also famous for advanced technology in certain sectors, especially the defense industry (air and space), and IT (skillful programmers). It is no wonder the government is trying to consolidate these industries and take advantage of the assets to gain an edge, while competing in the global market.

Russia, the world and the EU

The Russian economy is among the twelve largest. Moreover, the average gross domestic product (GDP) growth rate in Russia for the last nine years has substantially exceeded that of other industrially developed countries (see Table 1).

Russia's economy is still substantially dependent on natural resources obtained from mining and processing. Processing is growing faster than mining and is gaining an ever-larger share in GDP. Along with these two sectors of the Russian economy, retail and services, transport and communications, are gaining bigger roles, due to excess liquidity and steady growth in consumer demand (see Chart 1).

Despite the global crisis, in 2008, Russia's GDP grew at a significant rate (+5.6%), sustained by the significant level of internal investments, a positive current account, low level of external borrowing, and significant share of direct foreign investments. After reaching a historical high of \$596.6 billion on August 1, 2008, currency and gold reserves plunged to \$383.9 billion by April 1, 2009 as a result of the

¹ BP Statistical Review of World Energy June 2009

Table 1: Top 12 economies GDP growth/(decline) year on year (%)

		2000	2001	2002	2003	2004	2005	2006	2007	2008	2000–2008 Average
1	China	8.4	8.3	9.1	10.0	10.1	10.4	11.6	13.0	9.0	10.0
2	India	5.7	3.9	4.6	6.9	7.9	9.2	9.8	9.4	7.3	7.2
3	Russia	10.0	5.1	4.7	7.3	7.2	6.4	7.7	8.1	5.6	6.9
4	Brazil	4.3	1.3	2.7	1.1	5.7	3.2	4.0	5.7	5.1	3.7
5	Spain*	5.1	3.6	2.7	3.1	3.3	3.6	4.0	3.6	0.9	3.3
6	Canada	5.2	1.8	2.9	1.9	3.1	3.0	2.9	2.5	0.4	2.6
7	UK*	3.9	2.5	2.1	2.8	3.0	2.2	2.9	2.6	0.7	2.5
8	US	4.1	1.1	1.8	2.5	3.6	3.1	2.7	2.1	0.4	2.4
9	France*	4.1	1.8	1.1	1.1	2.3	1.9	2.4	2.3	0.3	1.9
10	Japan	2.9	0.2	0.3	1.4	2.7	1.9	2.0	2.3	(0.7)	1.5
11	Germany*	3.2	1.2	0.0	(0.2)	1.2	0.7	3.2	2.5	1.2	1.4
12	Italy*	3.7	1.8	0.5	(0.0)	1.5	0.7	2.0	1.6	(1.0)	1.2

* Member of EU.

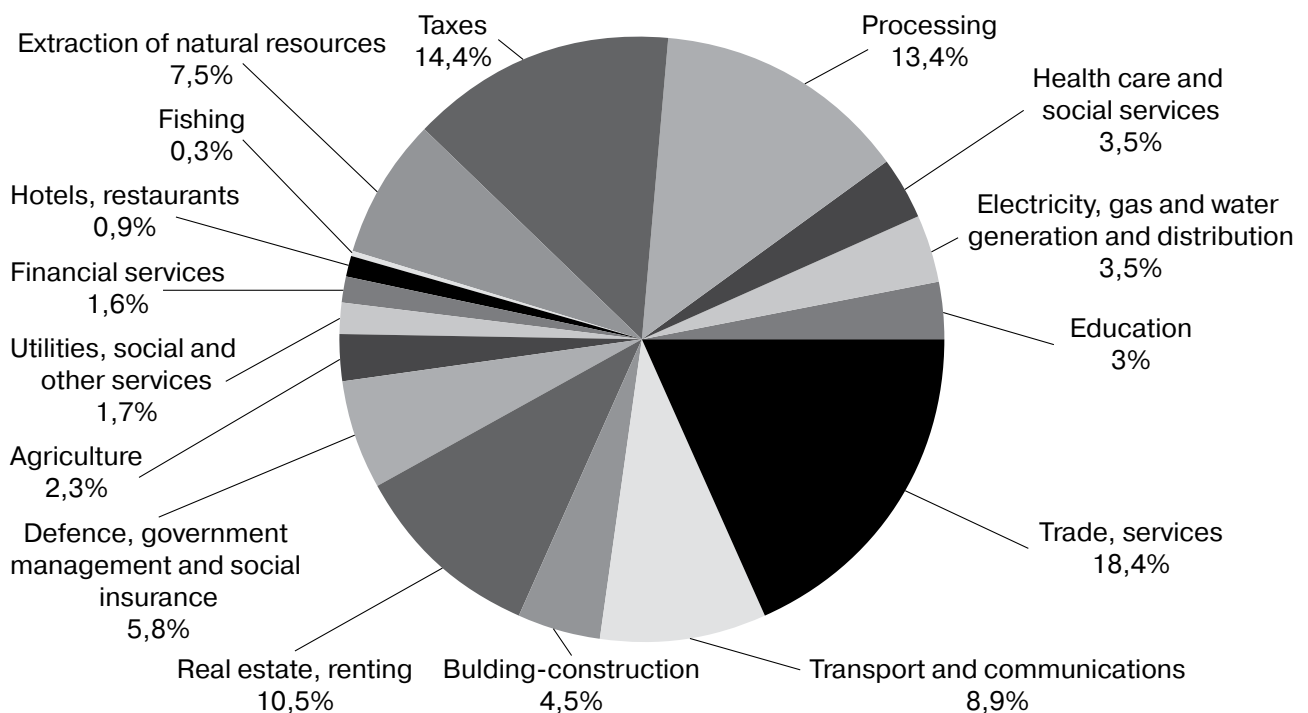
Source: International Monetary Fund, World Economic Outlook Database, October 2009.

government measures in relation to injecting capital from the reserves into the financial market and key companies as a part of its anti-crisis plan. Currency and gold reserves reached \$441.7 billion by November 13, 2009 indicating recovery of commodity markets and improving sales prices for major export goods.

However, the troubles are not over yet. The Industrial Output Index according to the Federal Statistics Service of the Russian Federation has been

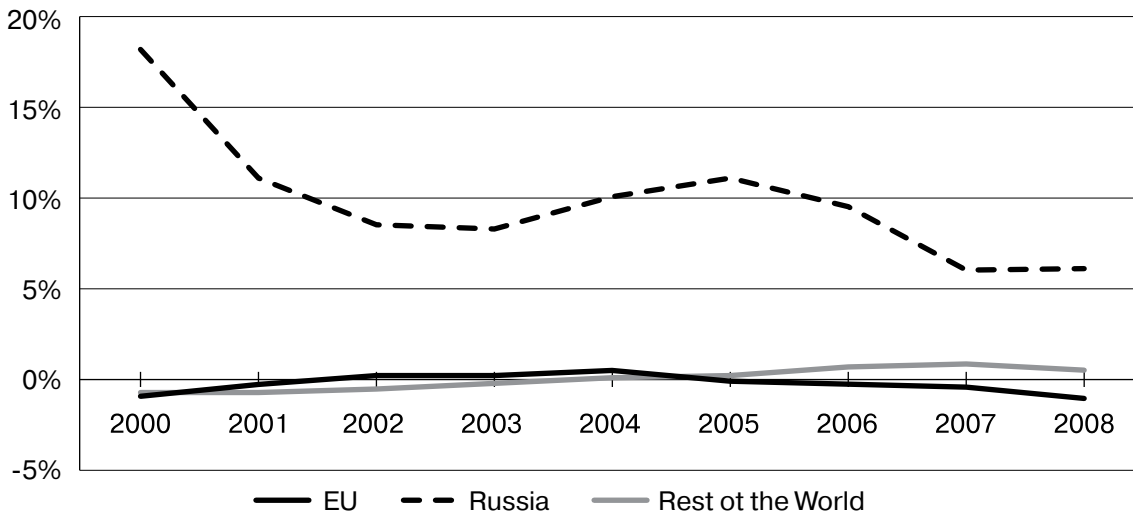
under 100% every month since November 2008. The underperformance gap was the largest in May 2009 (17.1%), since then, the gap has been fluctuating around 10%. Although the Russian economy contracted more than the other leading emerging markets, its recovery is also expected to be fast. For example, the OECD forecasts growth for the Russian GDP in 2010 at 4.9%.

The ruble position against other major currencies is currently vulnerable due to the still unstable

Chart 1: Russian GDP by sector (H1 2009)

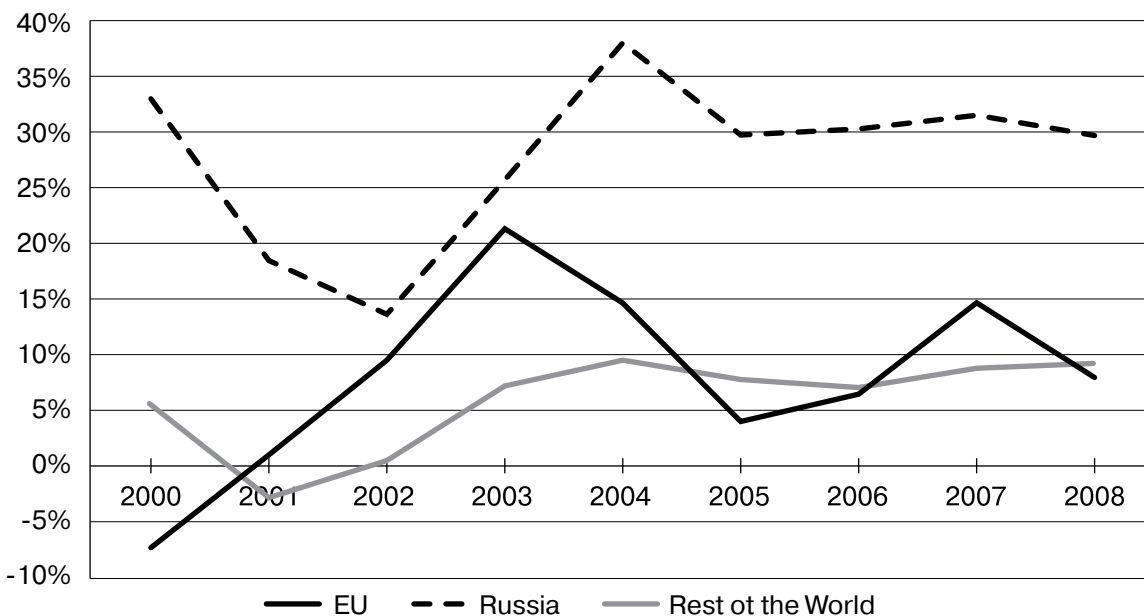
Source: Based on www.gks.ru.

Chart 2: Current account balance to GDP (current prices) ratio, Russia and EU



Source: Based on IMF World Economic Outlook Database, October 2009 Edition.

Chart 3: GDP per capita (USD) growth rate (%) trend, Russia and EU



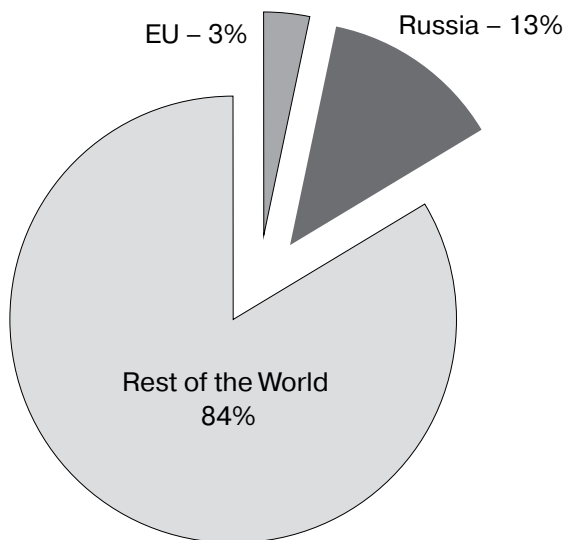
Source: Based on IMF World Economic Outlook Database, October 2009 Edition.

global market conditions, volatile oil prices and a weaker US dollar. However, in the long term, in order to minimize the use of currency and gold reserves, the Central Bank of Russia and the Ministry of Finance will allow the ruble to weaken against other major currencies. It has been declared that this process will be gradual and managed.

The macroeconomic indicators for Russia still look strong. The current account to GDP ratio in Russia looks much healthier than in the EU (see Chart 2 for details).

Although the Russian economy is going through a downturn like the rest of the world, strong macroeconomic fundamentals will allow its national economy to recover and return to above-average growth.

The growth of liquidity in the country has led to a boost in personal income and spending. GDP per capita has been growing faster than in the EU for several years, driving a consumer market boom and rising living standards (see the trend comparison in Chart 3).

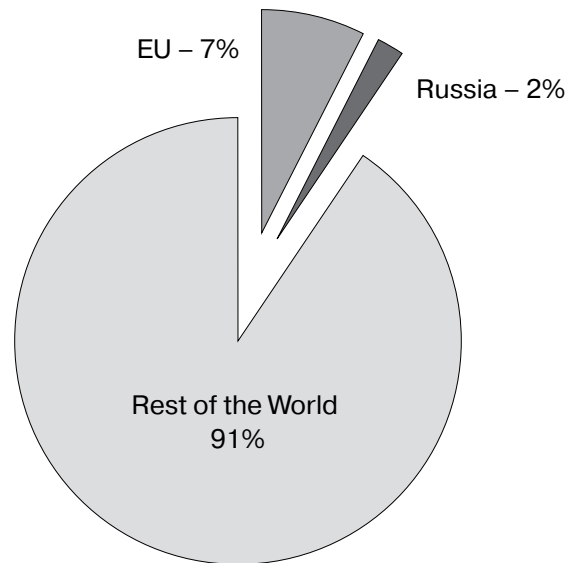
Chart 4: Land mass of Russia and EU as part of world land mass

Source: Based on IMF World Economic Outlook Database, October 2009 Edition.

The EU is a major trade partner for Russia, and the economies of both regions are substantially interdependent. More than half (50.3% in January – September 2009) of Russia's foreign trade is with EU-member countries. The effect of the global crisis on the volume of trade was significant. From January – September 2009, the volume of trade between Russia and the EU decreased by 46.2% and reached USD161.8 billion. However, the trend is improving every month and commodity prices are getting closer to pre-crisis level.

Both regions play a substantial role in the world's geo-political environment (See Charts 4 and 5).

Given the dynamics of the Russian economy, a significant number of European companies see the Russian market as an opportunity to build business value through expansion into new regions and developing localized products. The reasons for this include the size of Russia's population (estimated at 141.4 million as of January 1, 2009²); the lower cost of supply chains, for example prices for oil, electricity, and steel in Russia are still lower than in Europe and North America; the highly qualified and less expensive labor force (the average monthly salary in September 2009 was \$606.61,³ with a literacy level

Chart 5: Population of Russia and EU as part of world population

Source: Based on IMF World Economic Outlook Database, October 2009 Edition.

that remains almost 100%⁴); and the advantageous geo-political location (for example, Russia borders with the EU, the US, China, and Japan).

The investment climate in Russia

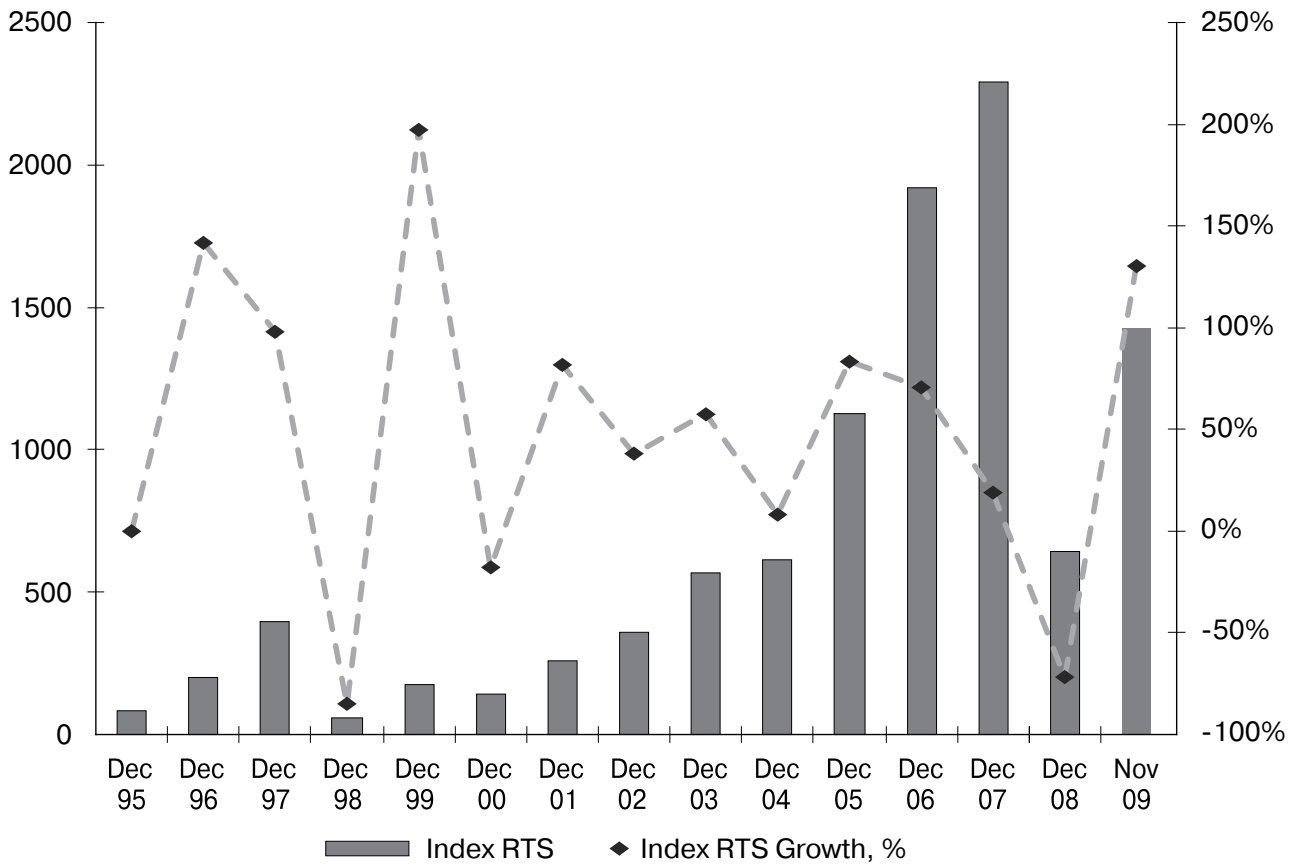
Since 1987, when the former USSR first adopted legislation allowing foreign companies to participate in business (initially only as minority shareholders), foreign business initiatives in the Russian Federation have come a long way. According to the Federal State Statistics Service of the Russian Federation, some \$262.4 billion in foreign capital had accumulated in the Russian economy as of September 30, 2009. This is 4.4% more than as of September 30, 2008⁴, despite the escalation of the crisis between these two dates. Foreign direct investments constituted 39.7% of that amount (down 7.2% compared to 12 months earlier), with portfolio investments making up 4.6% of the total (up 2.2%). During the first nine months of 2009, the inflow of foreign investments into Russia totaled \$54.7 billion (27.8% less than in nine months 2008)⁴. Of course, some of these assets represent repatriation of cash channeled out of Russia before. However, the volume keeps growing, and it is reasonable to assume that more and more foreign businesses and investment

² Estimated equivalent of RUR value according to the Federal State Statistics Service of the Russian Federation website and average monthly CBR RUR/USD rates per CBR web-site.

³ www.unisef.org.

⁴ Federal State Statistics Service of the Russian Federation website.

Chart 6: Russian stock market index RTS trends (the index peaked in May, 2008, at 2,487.92)



Source: Based on www.rts.ru

institutions will consider the Russian market as an alternative for their investments.

Attracting foreign direct investment is a top priority for any government. International businesses are always trying to find a way to:

- Broaden their product lines;
- Increase market share in a geographic region;
- Strengthen their company's financial position;
- Stabilize a cyclical or seasonal business;
- Obtain key executive or technical talent.

There is a clear willingness on the part of the Russian government and the business community to develop a mutually beneficial relationship. However, they are still separate parties with their own interests and methods. On the one hand the government is trying to control key industries and is pushing for greater consolidation in areas like natural resources development (oil and gas, diamond mining), the automobile industry, aircraft and ship building. On the other, the government is also trying to attract more investment into the economy and improve the investment climate in general.

Russian companies are open for equity partnerships via direct buy in and/or equity market trading.

The Russian equity market has demonstrated both its integration into world markets and its ability to withstand the challenges of the world financial markets (see Chart 6).

Any investment entails risk. Any businessman making one expects a return and is willing to tolerate that risk. Higher risks occasionally bring higher returns. The Russian market may not currently be the least risky; however, the return-to-risk ratio is attractive to many investors.

Managers of European companies continue to view Russia as an attractive market despite the economic crisis (Hans-Dieter Zaum, Partner at Droege & Comp.)



Hans-Dieter Zaum

Hans-Dieter Zaum is a Partner at Droege & Comp. and heads the company's Moscow office. He has been managing projects in Russia in the retail, logistics and energy sectors since 2006. Previously, Hans-Dieter worked in CIO and SCM positions at several leading international retailers for more than 20 years. He has particular expertise in implementing and developing foreign operations, reinforced through more than 10 years of top management consulting experience.

Introduction

Throughout the boom years of the last decade, Russia's attractiveness and importance to European businesses were constantly increasing. Since the early days of this period of fast growth, the AEB Finance & Investments Committee and Droege & Comp. have been conducting the Investment Climate Russia Survey – "Strategies and Prospects of European Companies in Russia", every two to three years. This collaborative research project has provided regular insights into operational, strategic and broader macroeconomic issues that concern European companies operating on the Russian market. About 300 European companies active in Russia were questioned in connection with the fourth edition of the survey.

The 2009 survey shows that the current general mood remains encouraging: European managers continue to view Russia as an attractive market despite the crisis. This result mainly reflects the optimistic long-term view adopted by many European businesses operating in Russia, their belief in a relatively fast economic recovery of the country, and the fact that the productivity of their Russian operations continues to improve. However, the global economic crisis has in some respects fundamentally changed the economic realities and expectations of managers, and has forced companies to adopt specific strategies to maintain profitability in the crisis.

Market entry, general market attractiveness and challenges

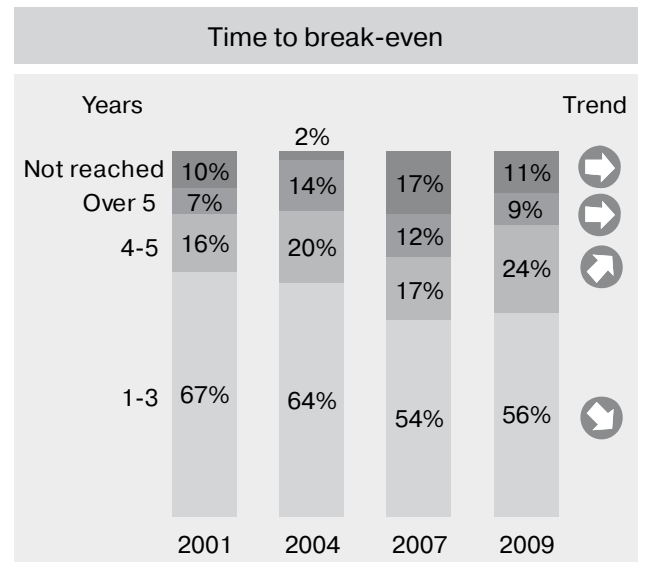
Even in the middle of the economic crisis, a number of the governing pull-factors of Russia of the last

decade continue to lend support to optimists. Particularly notable in the responses is the existence of a strong belief in, and satisfaction with, Russia continuing to hold substantial un-tapped market development opportunities. These opportunities have been indicated by the majority of respondents as being the main reason for originally entering the Russian market. Similarly, positive market development, stated to be the second most important market entry reason, is viewed as still almost having lived up to the high initial expectations.

The availability of technology in the target market, raw material costs and state subsidies/incentives have slightly exceeded expectations – managers have been pleasantly surprised by these operating conditions, as well as by the impact of government initiatives intended to support strategically important industries in response to the economic crisis.

Concerning the investment pay-back duration, indications exist that many of the "low-hanging fruits" may already have been picked. Going forward investments could take somewhat longer to become profitable: whilst the majority of respondents (56%) reported pay-back periods of between one and three years, an increasing share of 24% of respondents (vs. 17% in 2007) reported that their investments took four to five years to break even. The most likely reasons for this development were increasing market saturation and intensifying competition, especially in light of the recent overall reduction in demand.

Bureaucracy and corruption are still the most important challenges to business activity in Russia, and respondents expect little or no improvement in



these areas within the next two years. Moreover, the financial crisis has introduced new influential factors, amongst which financing costs represent the most salient concern.

In line with the 2009 realities, expectations in relation to the macroeconomic situation going forward also deteriorated. Hardly anyone amongst the respondents (3%) saw a stable short-term outlook over the next two years, reflecting a true plunge compared to the buoyant 94% and 83% in the 2004 and 2007 surveys, respectively. In the 2009 survey, around half of the respondents saw the short-term outlook as “unstable”. The three to five year medium-term outlook, however, appeared somewhat more positive and actually enjoyed a clear increase

Economic outlook				
Short-term	Unstable	2%		
	Less stable	4%	17%	51%
	Stable	94%	83%	46%
		2004	2007	2009
Middle-term	Unstable	2%	4%	3%
	Less stable	42%	67%	55%
	Stable	56%	29%	42%
		2004	2007	2009
Long-term	Unstable	6%	3%	0%
	Less stable	55%	77%	28%
	Stable	39%	20%	72%
		2004	2007	2009

Delivery punctuality	
% of on-time deliveries	
100%	8%
>80%	62%
>50%	8%
>25%	4%
<10%	0%
No data	18%

to 42% compared to 29% in 2007. What deserves particular attention is the surge in expectations that the long-term outlook in six to ten years will be stable (72% vs. 20% in 2007). This change may certainly in part be attributed to the natural tendency of looking for the “light at the end of the tunnel” when things are bad. However, the magnitude of this leap makes it quite clear that the respondents must also hold a fundamental belief in the return of sustained growth.

The perception of the most significant business risks has substantially changed in comparison to the 2007 survey. Notably, financial and macroeconomic risks have moved up the ladder from the two last positions in 2007. They occupy the two top spots in 2009, leaving the 2007 number one risk, law and regulation, in third position. Also worth mentioning is the slide of political risks from second place down to the last.

Overall, macroeconomic factors have deteriorated and have affected company operations; and a number of market players have adopted specific response strategies in order to maintain profitability during the crisis. However, there are also several microeconomic developments that bear much significance.

Functional strategies

During recent years, companies have been increasingly paying attention to supplier integration in order to optimize their stock position. They have also attached high priority to improving their pricing to optimize sales, which has become all the more important in the current context of declining demand.

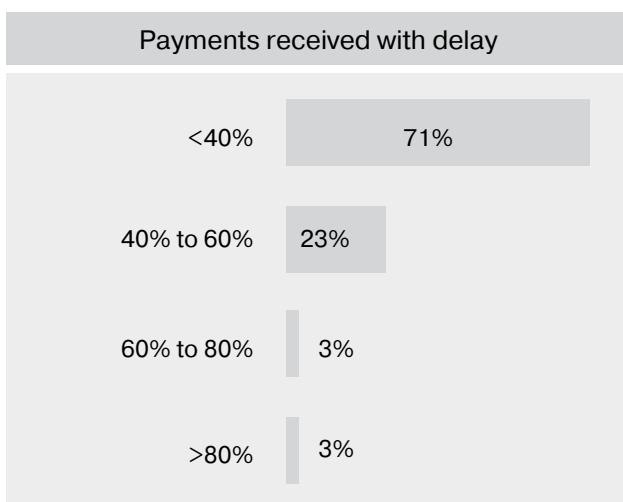
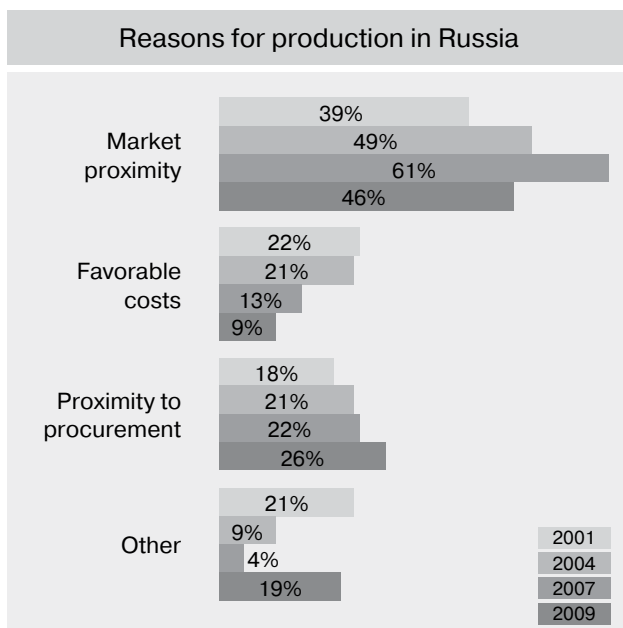
The results of the survey suggest somewhat surprisingly that the timeliness of delivery is approaching

Barriers to optimize stocks ^{a)}	
Inadequate delivery frequency	20%
Long lead times	20%
Lead time reliability	37%
Inaccurate deliveries	9%
Inadequate minimum order quantity	6%
Lack of communication/data synchronization	11%
Product shortages of suppliers	17%
Other	17%

Note:
a) Multiple responses possible

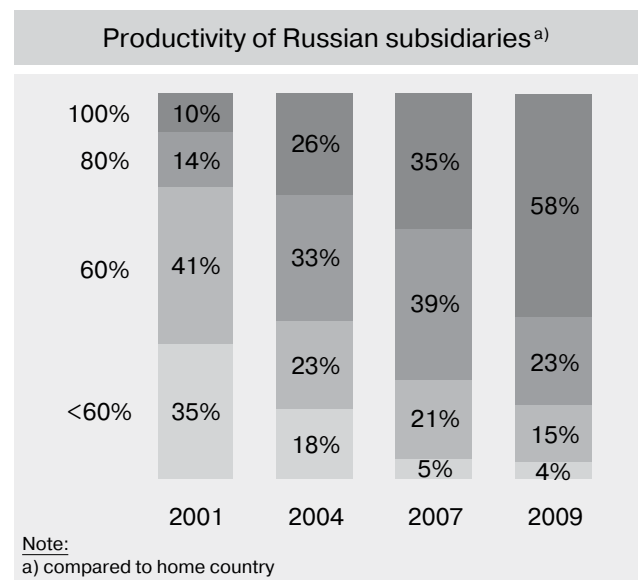
that of Western European standards. According to the respondents, 70% of companies receive at least 80% of deliveries on time. In Western European retail, for instance, the benchmark is 90–95% depending on the category. If the respondents have given these indications based on available facts, this implies that they are far ahead of their Russian competitors in developing a reliable supply chain. Our practical experience in Russian retail is actually different: on-time delivery is often not measurable as orders are not tracked in any system. Furthermore, it needs to be considered that at least 10% of ordered items do not reach their destination with the first delivery. Procurement therefore, remains an important issue for European companies in Russia. This is also confirmed by responses related to the most important barriers to optimizing stock, which show lead-time reliability as the single most important issue, indicated by 37% of participants¹.

¹ Multiple responses possible



Russia's geography, its poor road conditions and frequently underdeveloped capabilities of logistics service providers remain significant constraints on stock optimization and just-in-time delivery concepts. However, obvious potential for improvement of lead time reliability exists through introduction of better supply chain collaboration and adequate technology.

A number of reasons exist for locating production in Russia. Proximity to the target market appears as the most important motivator for 46% of respondents, although experiencing a moderate decrease compared to the level of the previous study (61%). Cost advantages have continued to decline in significance, reflecting the upward tendency of costs in recent years. Also worth noting is the continuously growing significance of proximity to suppliers.



One of the most encouraging findings is that productivity in Russian subsidiaries is stated as having been continuously increasing over the last eight years. In 2009, 58% of the respondent companies indicated that they are working at the same level of productivity



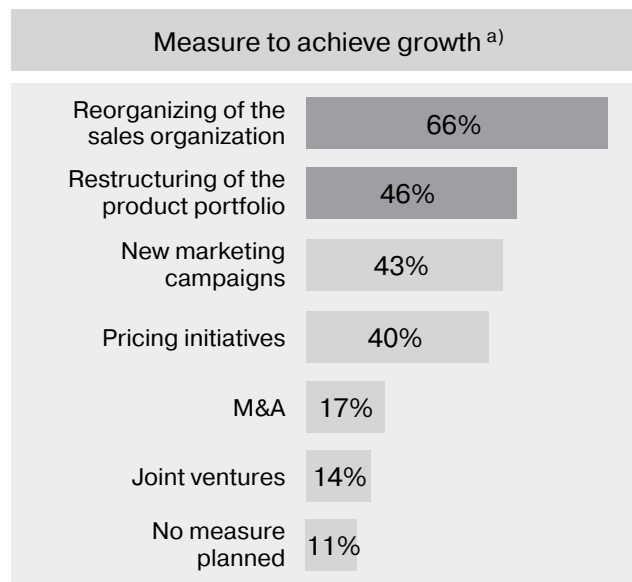
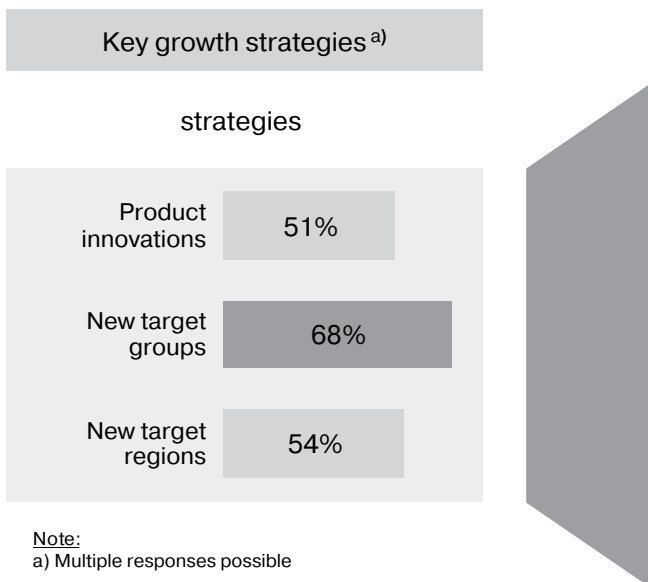
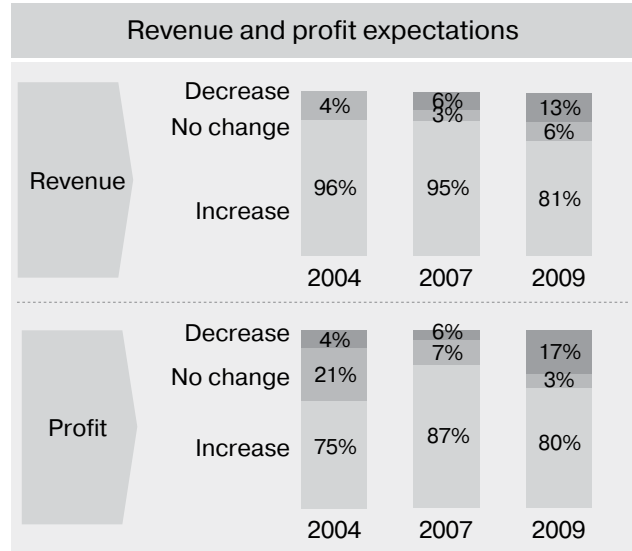
in Russia as in their home countries. In 2001, only 10% of participants demonstrated such performance.

Payment behavior of customers appears to have remained satisfactory despite the crisis. 71% of the respondents reported the share of payments received from customers with a delay to be less than 40%. Furthermore, the average length of delay was significantly less than a month for almost 70% of late payments. This indicates that increasing attention given to receivables management during the crisis seems to be paying off.

According to the respondents the key factor of competitive differentiation of European companies in Russia is quality (product/customer service), followed by product/service range and brand. However, the crisis has also brought price optimization more into focus, which has been indicated as the most important lever to maintain revenues in the current economic environment.

Business outlook and strategy

Around 81% of managers who participated in the 2009 survey stated that they expect an overall positive development of their revenues over the next three years. 80% expected the same for profits. This means a moderate decrease in the share of respondents that hold positive expectations in relation to revenues (-14%) and profits (-7%) as compared to the rather euphoric results of the survey conducted in 2007. However, encouragingly the share of respondents expecting positive bottom line growth was still higher than it was in 2004 (75%). This is all the more remarkable in the current crisis environment.



Key strategies to maintaining profitability in these turbulent times are the improvement of core process efficiency (77% of respondents) and the optimization of marketing campaign effectiveness (57%)².

The development of new customer segments appears as the dominant growth strategy. 68% of survey respondents said that they expected it to play a key role in their companies' development. Key measures to support growth are stated to be reorganizing the sales organization (66%) and restructuring product portfolios (46%)².

Conclusion

In comparison to previous studies carried out, the fourth Investment Climate Russia Survey shows an undoubtedly more complex picture.

On one hand, the short-term business outlook in particular appears in a dimmer light, largely due to the impact of the economic crisis. At the same time a number of familiar problems such as bureaucracy and corruption persist, and no significant improvements are expected on these two scores in the short term. Furthermore, the tendency for pay-back periods to increase indicates that the number of "low-hanging fruits" is becoming less.

On the other hand, the survey results show that a number of the key factors that formed the foundation of Russia's attractiveness over the last decade remain strong. Particularly notable is the almost unanimous belief of the respondents in, and their satisfaction with, Russia continuing to hold enormous un-tapped market development opportunities. Moreover, productivity has continued to show remarkable improvements.

Overall, the 2009 survey results show that the majority of participating managers of European companies remain optimistic that top and bottom-line growth will return within the next few years, and that the overall business outlook will brighten considerably beyond the short term. Thus, in difficult times, these findings reflect a strong degree of confidence in Russia's long-term potential, and the belief that the country will remain an attractive place to do business.

² Multiple responses possible

Why do Due Diligence?

(Simon Foster, Partner, Transactions & Restructuring, KPMG in Russia and the CIS)



Simon Foster

Simon Foster is a partner in KPMG's Transactions & Restructuring team in Russia and the CIS. After seven years' experience of financial due diligence with KPMG in London he moved to KPMG's Moscow office in January 2005. Since then

he has worked with both Russian and non-Russian clients on acquisitions and disposals in Russia and the CIS, as well as for Russian clients raising equity or debt in western capital markets and making acquisitions outside Russia.

The Latin phrase 'Caveat Emptor' ('let the buyer beware') expresses the principle that the buyer alone takes responsibility for assessing the condition and quality of the purchase he makes. Although moderated by legally established concepts of protection, disclosure and implied warranties, these do not provide full protection and the principle remains applicable.

In Russia, while the legal framework is evolving and improving, in some areas doubts remain over the consistency and transparency of its application. The principle of Caveat Emptor is therefore very apposite, and in Russia effective due diligence requires an awareness and understanding of the evolving nature of Russia's legal and corporate environment.

The value of undertaking thorough due diligence on any significant transaction has been increasingly well understood in western merger and acquisition ('M&A') markets. Due diligence is considered as an essential part of pre-deal activity, and widely perceived by most as a key factor in increasing the chances of a successful, value enhancing deal. Due diligence can broadly be considered as satisfying various areas of need for the potential purchaser, including:

- providing a degree of assurance over the fundamentals of the business, including the existence, ownership and completeness of key assets and liabilities, and over trading performance;
- understanding the business model and its commercial and organisational structure; and
- assessing the fair value of the business.

Such needs are as relevant in Russia as they are elsewhere. In Russia, however, in comparison

to more developed business environments and M&A markets, the focus of due diligence work still tends to be more on gaining some assurance over the fundamentals than on operational or integration planning, or on fine tuning the valuation. This is a reflection of the current state of Russia's evolving corporate governance, and the availability and quality of information. In particular, the relative lack of information both public and private, the ambiguities that often cloud ownership, and the rudimentary and sometimes opaque nature of the form and content of Russian companies' financial and tax reporting all make Russian due diligence exercises particularly challenging.

Evolving deal execution practice

The way in which transactions are executed in Russia today reflects the evolution of Russia's corporations since the privatisations of the 1990s and the impact of the growth and development of Russian M&A activity since then. In the early days of Russian M&A the approach to doing deals reflected a deficiency of corporate governance and the dominance of powerful individual shareholders in decision-making in many organisations. Corporate transactions were typically executed through secret negotiations between principal individuals, with little or no access to information or due diligence, and very little transparency over value or price.

The years leading up to 2008, however, saw the volume of Russian M&A grow rapidly. Many deals are now conducted along western lines involving a structured timetable of information and management access, due diligence and international standard sale & purchase agreements, often governed by international or English law. While previously Russian companies had little or no experience or knowledge of western style due diligence processes, a growing number became subject to such processes as they were either bought or invested in by strategic western buyers, or they sought to raise finance in western capital markets. Moreover, since the late 1990s corporate governance has been gradually improving; many companies have recruited lawyers and accountants from professional firms with western qualifications, and many of the larger companies now have dedicated M&A teams. These developments have contributed to a more sophisticated approach being adopted in the execution of Russian deals.

As the financial crisis in 2008 was followed by economic downturn in 2009, Russian M&A levels dropped off sharply. Some sectors saw a number of ‘distressed’ deals which were concluded quickly with little or no due diligence due to the lack of time and relevant data in the circumstances. This, however, is not a long-term trend; going forward, the impact of the downturn will have made investors more risk aware and more insistent on rigour and diligence in the deal process.

Limitations in financial reporting

Despite steady development in corporate governance and reporting, there remain some aspects of the Russian corporate environment which make due diligence somewhat different and more challenging than in the West.

The perception of the role of financial reporting and accountants, though much developed over recent years, still reflects the orientations and attitudes of the past. In the days of the USSR the emphasis of financial reporting, such as it existed, was on the achievement of planned production levels and compliance with state regulation, rather than profitability. Most Russian companies have now integrated accounting functions and are improving their financial reporting systems. The majority of Russia’s top 100 companies now issue audited financial statements under IFRS or US GAAP.

Gaining access to a target, however, can be difficult, as its management can be suspicious that the process may only serve to inform a competitor (or the authorities) about their business. There is still relatively little reliable publicly available information. Better intelligence on individuals and companies can be obtained with access to private networks of tried and trusted contacts with credible connections. The prevalence of ‘related party’ entities, often offshore, which may be used to implement transfer pricing or royalty schemes in order to move profits and minimise tax, also serves to obscure the beneficial ownership of businesses. Once access is gained, a general reluctance to provide information or explanations again stems partly from unfamiliarity with, or misconceptions of, a consultant’s role in due diligence. A due diligence team’s opening dialogue with the target’s management often needs to emphasise that they are not auditors and are not there in any sort of compliance role. Information gathering can be a difficult and time-consuming process. It helps if the target’s senior management fully brief and authorise those with whom the due diligence team have to work; otherwise fear and caution can

cause middle management (especially if unfamiliar with such a process) to stall the information provision and continually refer the investigators back to senior management.

Assessing a business’s historic financial track record is usually complicated by the existence of more than one set of accounts, which are often not reconciled to one another. All Russian companies prepare accounts under Russian Accounting Principles (‘RAP’) as required by local law and mainly as a basis for tax accounts. These RAP accounts, however, often do not provide a complete or representative picture of the company’s trading as they differ from IFRS and US GAAP and can be impacted by various tax minimisation schemes. In order to produce IFRS or US GAAP financial statements the RAP accounts typically undergo a transformation process, which should, inter alia, incorporate any unofficial transactions related to such schemes. Some companies maintain a separate set of internal management accounts, which can include the unofficial transactions, but these will often not be reconciled to the audited financial statements. Management accounts are often rather rudimentary, with income statements sometimes comprising cash receipts and expenses (gross of VAT) instead of an accruals based profit and loss account. Other companies do not prepare any single set of accounts which regularly record the whole performance and position of the business in any detail. Transfer pricing arrangements set up within groups to manage profits (either between different tax authorities or according to other legal, finance or ownership related factors) can also obscure the true or ‘arm’s length’ profitability of some businesses. In the assessment of a business’s financial track record, all this makes due diligence more important, as well as a more difficult and lengthy exercise, than might be expected in other environments.

Evolving taxation system

Due diligence on Russian companies’ tax position also brings its own particular challenges. The Russian taxation system was created in 1992, and is subject to fairly frequent changes in legislation, official pronouncements and court decisions that are not always clear, sometimes contradictory, and open to differing interpretation by the various tax authorities. Russian companies use a spectrum of techniques to reduce taxes, ranging from tax planning of varying degrees of aggressiveness to avoidance schemes, sometimes of questionable legality. The former include arguable interpretations of legis-

lation that can be challenged by the tax authorities in court. The latter can include schemes that involve complex and opaque ownership and organisational structures.

Assessing the risks attached to such tax schemes is difficult, because the risk of discovery by the tax authorities is hard to gauge. The Yukos affair seems to have marked the start of an era of renewed resolve on the part of the tax authorities, and it demonstrated the range of techniques and methods at their disposal. Events since Yukos suggest that the tax authorities are taking a more assertive approach in their interpretation and enforcement of tax legislation. They are applying new analytical techniques to detect evasion, and a wider range of concepts to supplement the statute in enforcement. This is having an effect: a growing number of companies are reviewing their tax positions and exiting the more aggressive schemes – particularly those looking for new finance or ownership.

Summary and outlook

In addition to the financial and tax related aspects outlined above, the Russian environment includes many other characteristics which can cause the unaccustomed investor trouble if they are not addressed during due diligence. These are explored in more detail in the various articles in this publication, but the more significant among them include:

- Corruption – especially given the increasing applicability of US and European laws and regulations to foreign investments in respect of bribery and money-laundering;
- The broader and more intricate stakeholder environment of many Russian businesses, involving various authorities, local individuals and dependencies, and the often private nature of relationships with key customers and suppliers;
- Rather different styles and standards of governance, management structure and operating style to western businesses;
- High levels of bureaucracy and administrative barriers, such as the need to obtain any number of permits, certificates, licences and other approvals;
- Specific economic factors such as the highly uneven distribution of wealth and income, and high labour cost inflation, especially in certain regions;
- Ageing infrastructure and related capacity bottlenecks;
- Other remaining legacies of the 1990s transition period and the changeable social and political environment.

The severity of the global downturn's impact on the Russian economy (which contracted by some 10% in the first half of 2009, according to the Federal State Statistics Service 'RosStat') took many by surprise and highlighted its continued high degree of dependence on hydrocarbons and minerals. The speed and shape of Russia's economic recovery is subject to a higher degree of uncertainty than most other economies. But with other more mature and more leveraged economies expected to endure a period of lower growth post recession, the relative scale of the opportunities for investors in Russia in comparison to more mature markets may have been accentuated. So the risks and barriers should continue to be outweighed for many investors by potentially very large rewards.

Effective due diligence will continue to be critical to successfully tackling the risks and barriers, and to maximizing the chances of realizing those rewards. While some deals have been executed during this recessionary period on an accelerated basis with less due diligence, in the recovery period and beyond due diligence on Russian investments is likely to be considered as more important. Both Russian and foreign investors will be more risk aware. The downturn exposed the relatively limited cash and working capital management, and scant governance, of many Russian companies. The financial difficulties encountered woke many Russian companies up to risks of which they were either previously unaware or to which they thought they were immune – including those who had assumed the ultimate support of the Kremlin. In the near term, due diligence in Russia will have an added focus on governance, transparency and perhaps cash management, and a shift in focus from growth related factors to more structural facets of value such as customer bases, market shares and business models.

The Russian M&A market can be expected to recover during 2010, with an accrual of both in-bound and domestic deals emanating from corporate strategic reviews for the post-recession period across a broad range of sectors. Some Russian groups may be moved to restructure and dispose of non-core assets, and with valuation expectations realigned, renewed interest may be forthcoming from cash rich groups and private equity. Other Russian companies will continue to need to seek financing to bolster their balance sheets or fund development or expansion, as already in evidence with several IPO plans announced.

A significant proportion of Russian companies will be expecting to participate in sell side M&A at some point in the near or medium term future – ei-

ther to raise finance or to exit investments of non-core businesses – and therefore will be subject to some form of due diligence. This will continue to help to drive the gradual improvement in governance, financial reporting and general business transparency across corporate Russia. As Russian companies become increasingly familiar with M&A processes and due diligence requirements, due diligence processes in Russia should over time become easier, if no less important.



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Your contacts for the Russian Federation:

Dr. Andreas Knaul, LL.M.
Attorney-at-law, Partner
E-Mail: andreas.knaul@roedl.pro

André Scholz
CPA, Tax Consultant and Partner
E-Mail: andre.scholz@roedl.pro

Manfred Janoschka
CPA, Tax Consultant and Partner
E-Mail: manfred.janoschka@roedl.pro

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Rödl & Partner St. Petersburg | Vasiljevskij Ostrov | Liniya 14 / 7 | 199034 St. Petersburg | Tel.: +7 (812) 320 66 93
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PERFORMING DUE DILIGENCE

Integrity due diligence in Russia

(Ian Colebourne, Partner, Head of Risk & Compliance, KPMG in Russia and the CIS)



Ian Colebourne

Ian heads KPMG's Risk & Compliance practice in Russia and the CIS. He has over eleven years experience with KPMG Forensic, with seven years experience leading projects in Russia and the CIS. He has led a large number of investigations, corporate intelligence and fraud risk management assignments, and was responsible for one of the largest forensic investigations undertaken to date in Russia.

The integrity due diligence process aims to identify significant risk areas for the prospective investor, which are not typically covered by the more traditional aspects of the due diligence exercise, such as financial, tax or legal due diligence. Typically these include red flags such as reputational, undisclosed commercial and political risks. In the current worldwide economic turmoil, being aware of such risks has only increased in importance. Russia is no exception to this.

If these risks are not anticipated and managed prior to the start of business operations, the result can be financial loss, legal liabilities, or damage to reputation. Exposure to negative media coverage resulting from affiliation with a questionable partner, a partner's default on financial obligations or politically motivated prosecution are all good examples of such risks.

The recent financial turbulence is also playing a role. Increasingly, responsible companies with existing business partnerships are implementing regular 'health checks' on their partners, as the nature of these relationships can be severely impacted by changes to ownership or management, lack of access to credit, or corporate and financial restructuring, for example.

Investors that are unfamiliar with the local market can feel more exposed. While offering lucrative investment opportunities, Russia, due to generally lower levels of corporate governance and transparency, the legacies of the 1990s transition period and the general political and socio-economic environ-

ment, has a higher risk profile. Therefore, investors should adopt appropriate measures to limit this risk.

In its Corruption Perceptions Index surveys, Transparency International reports that the perception of corruption within Russian society remains high. In its latest survey, published in November 2009, the civil society organisation's score for Russia improved marginally and the country moved up a single place in the rankings, from 147th place in 2008 to 146th place in 2009. This is interpreted as a 'mildly positive' development, and a response to recently adopted anti-corruption legislation. The World Bank has previously quoted sources that suggest Russia has been losing up to \$10 billion per year in potential foreign investments because of corruption, inadequate accounting procedures, weaknesses in its legal system and the lack of reliable financial information. Even President Dmitry Medvedev has publicly acknowledged that corruption remains endemic in Russia.

Now considered a mainstream 'must-have' in M&A and other investment processes, an integrity due diligence is driven both by the potential investor's genuine wish to understand her partner better and by the increased attention of US and European regulators on bribery and money laundering¹. Under anti-money laundering regulations, an investor's failure to gather enough information about his partner may result in prosecution by the regulatory authorities and, ultimately, extensive fines.

Such issues are, however, not insurmountable. As part of an integrity review, to gain comfort over a counterparty, an investor may typically seek information in relation to a range of questions, such as:

- Who is the ultimate beneficiary owner of the business? Is the listed shareholder the ultimate beneficiary or merely a nominee? Are there any hidden interests influencing the decision-making of the business, such as organised criminal groups?
- What is the modus operandi of the beneficial owner and/or the key management? Do they act legally, ethically and responsibly in their business dealings? Are there any indications that they may abuse their partners or default on financial obligations?

¹ E.g., trends towards stricter enforcement of the US Foreign Corrupt Practices Act; introduction of the 3rd EU Anti-Money Laundering Directive.

- What is their track record? Is the source of their wealth associated with questionable or illegal conduct? Have they been involved in litigation or disputes? Have they been or are they now the subject of an investigation by the authorities? Have they, or businesses with which they are associated, been subject to insolvency or bankruptcy proceedings, or disqualifications?
- Do they hold relevant licences and title to key assets? Can their declared capabilities be verified?
- Do they have particular social or political associations? What is the impact of such associations? Do they generate any additional risk?
- How have they been affected by the recent financial crisis? Are they still considered a good credit risk by other business partners? Are there indications of impending financial crisis, such as laying-off workers or moving to smaller premises?

Integrity due diligence specialists gather information from a variety of sources, both publicly available and those restricted to the general public. A distinct feature of integrity due diligence is strict adherence to privacy and data protection legislation and high ethical standards of conduct. The information is then collated and analysed to identify potential areas of concern.

Sources of information

Typical publicly available sources of information include:

Corporate information	Online and locally sourced company filings, including copies of original filings, directorship and shareholder records
Insolvency and credit information	Credit and bankruptcy records for companies and individuals
Media and press	International and local language press and media coverage; online profiles provided by blogs, chat rooms and social media
Asset registers	Vehicle, land, ships, planes and artwork registers
Litigation and regulatory action	Details of criminal and civil litigation and regulatory actions
Specialist high risk individuals/entities databases	Identification of high risk individuals or entities from international sources such as OFAC, UNI, EU, FSA, AFAC, UNO and Interpol, and local sources such as the Central Bank of Russia
Telephone directory and electoral roll records	

Source: KPMG

It is generally accepted amongst practitioners that human source intelligence (essentially, human contacts in a variety of fields ranging from industry experts to investigative journalists) plays a higher role in integrity due diligence performed in emerging markets, as the desktop research infrastructure in such countries is underdeveloped and the environment is generally opaque. Russia is no excep-

tion, although there is a clear if somewhat slow tendency for improvement.

Transparency levels vary by industry. Notwithstanding a number of recent high profile cases that would appear to indicate a return to former non-transparent practices, there is a general trend towards increasing transparency driven in part by Initial Public Offerings by Russian companies and growing investor demand for high quality information. In some sectors where there is a higher level of international participation, such as oil and gas, notable improvements are perceived in the levels of corporate governance as a result of pressure from foreign investors.

Despite a number of inadequacies, public data is becoming more available in Russia. State and regional authorities are gradually disclosing more and more information to the public. Importantly, new commercial databases holding public records are emerging with differing levels of searchability, completeness and relevance. The large number of commercial providers of pay-for-access databases is stirring up competition, leading to better availability and access to data.

This does not necessarily mean that public domain sources are as comprehensive, complete or reliable as in more developed markets and it is important to appreciate the extent of information that is available, as well as some of the inherent limitations that apply.

That said, information gathered is typically evaluated across three dimensions:

- the source of information
- the channel through which the IDD specialist accessed it
- the information itself (relevance, completeness, etc.)

This assessment is essential to assess the reliability of information.

Media sources

Media information encompasses the printed press, broadcast material and, increasingly, internet-based resources. Background investigations of companies or individuals typically involve a thorough review of such sources, with particular focus on adverse issues that may indicate areas that require further investigation.

Press information in Russia does have inherent limitations. Although it is widely available, the breadth of reporting itself is limited and there has been systematic pressure on 'independent' press sources from the state. In its most recent survey, Freedom House (an organisation that monitors the relative levels of press freedom across the world) concluded that the press in Russia was 'not free', ranking it 170th of 195 countries surveyed (on a par with Kazakhstan, Sudan and Yemen).² Some of the notable features of the low rating included political and economic pressure on the mass media, such as encroachment on the press by the state.

In contrast, online resources that do not have an equivalent printed publication, such as Gazeta.ru, have grown rapidly in recent years. There has also been a rise in independent media agencies dealing with business and economic issues, such as RosBusinessConsulting (RBC.ru), that have grown in popularity among internet users. To date the state appears to have interfered less with such information outlets which, in part, has given them a reputation for greater independence and impartiality. Blogs, chat rooms and other forms of social media can provide other sources of background information on companies and individuals which may identify issues not covered by more traditional media sources.

As with many countries, some degree of challenge or healthy scepticism must be applied to media sourced information. It is not unknown for business disputes in Russia to spill over into articles 'placed' in newspapers or other media outlets. An awareness of local editorial affiliations and the background of the journalist can, therefore, be vital to checking and sifting the information obtained.

Public records

In general terms, corporate information is more sporadic and difficult to obtain than in developed jurisdictions. Although laws exist requiring corporations to file information, in reality the penalties for

failing to do so are trivial and consequently the level of actual filings remains relatively low. Anecdotal evidence suggests that approximately 40% of businesses trading in Russia regularly file information at a corporate registry. This can cause issues for prospective investors looking to obtain current, accurate filings since such filings may be incomplete or out of date. In order to obtain a more thorough understanding of a company's actual standing it is therefore often necessary to obtain information from a number of separate sources.

The Federal Commission for Securities Markets ('FCSM' – restructured as the Federal Service for Financial Markets 'FSFM') Regulation on Disclosure of Information by Issuers of Emissive Securities (No. 05-5/p2-N of 16 March 2005 and updated on 12 April 2007) is the principal legislation relating to company information disclosure, but mainly affects larger companies that issue shares to the public. Even among these companies, timely and relevant compliance can be a problem, since it is generally perceived that fines for breaching the disclosure regulations are inadequately low.

A number of corporate databases do exist in Russia, such as SPARK (System of Professional Analysis of Markets and Companies), that provide comprehensive databases of collated official information, as is available. Underlying information is sourced directly from organisations including the FSFM, the Federal Statistics Service, the Federal Tax Service and the Central Bank of the Russian Federation. Such sources provide information relating to the General State Register of Enterprises, financial statements, prospectuses, company reports, securities, registration numbers, addresses and ownership information.

A thorough review of these sources is an important starting point for any integrity investigation. Among other reasons, it may permit confirmation of reported ownership of a business; corporate structures; key executives or relevant addresses; and the incorporation status of the company. Concerns may be raised if there appears to be a complex group structure (including the use of offshore vehicles in jurisdictions with a low level of transparency) or if the listed shareholders appear to have little in common with those who exercise executive control over the business (the use of nominees remains prevalent).

Legal filings

Legal filings, such as records of court actions or litigation, insolvency and bankruptcy records, and

² <http://www.freedomhouse.org/uploads/fop08/FOTP2008Tables.pdf>

other regulatory filings can be challenging to obtain in Russia. This is due to a lack of any comprehensive database system, the fact such records tend to be held manually, and the decentralised nature of the court system. Press searches may reveal certain information; however, it would be necessary to access records at a local level.

Real estate records

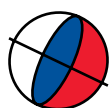
The primary source of information on real estate holdings and transactions is the Uniform State Registry of Titles to Real Estate and Transactions. Excerpts from the registry are available upon application and typically take between 1 and 5 days to obtain. However, the content of publicly available information is very restricted.

Human source intelligence

Reflecting the weaknesses in corporate filings, integrity investigations often call for any available formal information to be enhanced by intelligence gathered through informal channels. Commonly this

requires an ability to turn to a network of contacts drawn from a variety of backgrounds including, for example, journalism, the civil service or those with relevant industry expertise. Naturally a distinction must be drawn between the two types of information and steps should be taken to corroborate the intelligence gathered through informal channels. Nonetheless, such information can be a valuable addition to the formal corporate filings and can assist an investor to better understand or assess a prospective business partner.

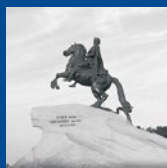
In summary, the integrity due diligence investigation is an important element of the overall due diligence process. Recent developments in the economy and uncertainty over continued financial stability of business partners only serve to underscore the importance of this process. Undertaking such investigations at an early stage of a transaction allows adequate measures to be taken to limit any risks that arise. However, while public source information continues to increase in terms of variety and reliability in Russia, a local network of knowledgeable contacts remains vital to conducting thorough investigations in the country.



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Finlyandskiy pr. 4a
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Commercial due diligence: Secure growth – Russia’s place in your growth portfolio

(Stefan Dierks, Partner, Transactions & Restructuring, KPMG in Russia and the CIS)



Stefan Dierks

Stefan Dierks heads the Strategy Group of KPMG’s Transactions & Restructuring practice in Moscow. He holds a degree as Diplom-Kaufmann and an MBA from the University of St. Gallen HSG and the Haas Business School/University of

California at Berkeley.

Since 1995 Stefan has focused on strategy and market-related issues in the field of mergers & acquisitions, with particular emphasis on internal and external growth strategies, as well as regional market expansions. He has also gained significant experience in industry consolidations.

Stefan’s clients include Private Equity houses and refinancing banks, as well as large and medium size corporations. Stefan has helped a large number of international clients to develop and implement their market entry strategy for Russia.

In the 2007 edition of this publication, we mentioned the first dark clouds we saw gathering in the bright sky of Russian growth. In 2008 we analyzed the potential negative impact of the financial crisis on the Russian economy – and unfortunately the reality turned out even worse than expected, resulting in a sharp decline in industrial production and consumer spending, and an increase in unemployment. These negative statistics have been responsible for massive capital outflows which have further aggravated the situation.

There is no question that the Russian economy is undergoing difficult times and a strong effort will be required from private market players and the government to oil the Russian economic machine and to get it up to speed again. This may take a while and we doubt anyone can tell the exact timing.

However, we believe that the fundamentals of the Russian economy remain strong, and will produce growth again. The high volatility we have seen and will be seeing should be regarded as an inherent part of an emerging market anyway.

Russian economy: despite the downturn, large with attractive growth potential, but with more uncertainty than before

When writing this we were expecting the real GDP in 2009 to drop by 7.8%, which is one of the largest contractions in the emerging markets. However, growth of 2.5% is already expected for 2010, and post 2011 we assume growth rates above 4%. Other factors are also causing uncertainty, including inflation and the development of the rouble. Oil prices have in fact seen a significant recovery after a drastic decline and have certainly preserved the Russian economy from more severe damage.

What makes the Russian economy attractive for international investors in our view is the vast resource base with low domestic value creation, the large and growing consumer market and Russia’s thirst for advanced technologies. However, for every commercial assessment of investments in Russia the overall economy requires detailed analysis. The situation is highly volatile and is likely to remain this way for the foreseeable future. Hence, the timing and pricing of investments needs to be aligned with the actual position of the target company in the cycle. It is not wise to try to catch a falling knife – neither in Russia nor the rest of the world.

Russian customers: appetite and income to spend

The real growth in consumer spending in Russia had reached an unprecedented level of above 11% p.a. prior to the financial crisis. This consumption boom was fuelled by a similar growth in real disposable incomes.

Although we will see a consumer spending contraction of above 6% in 2009 with much slower growth rates going forward, the Russian consumer market will remain large and growing. Unlike in many other countries, the disposable income of the Russian consumer primarily goes into consumption: 70% is spent on goods and services, only 15% is transferred to savings.

However, there are still enormous – and sad – disparities in living conditions between rich and poor. While purchasing power is rising rapidly, income remains unevenly distributed and is characterised by regional disparities. The highest incomes

are concentrated in Moscow and St. Petersburg, in large regional centres such as Yekaterinburg, Samara, Kazan, etc. and in smaller cities where mineral extraction industries are located.

For a commercial assessment this means you need to look at least at two areas: Moscow and the 'other Russia'. In our opinion Samara can be seen as a good proxy for this 'other Russia' when it comes to target groups.

Russian growth: a pure growth case becomes a strategic management case

The growth fundamentals indicated above are still appealing. Accessing these opportunities, however, is a challenge for international players entering the region. Competition from local players is intense and Russian firms have mastered the art of protecting their market shares.

The clock speed of most industries is very high and does not leave much room for greenfield projects. Acquisitions are therefore likely to be a key strategic tool of choice when entering Russia.

These 'buy' or 'external' market entries have to be planned in a very diligent manner, ensuring that a detailed understanding of the local rules of the game is obtained. This also includes determining what the application of the acquirer's governance and ethical standards will mean for the competitive position in the future.

In particular, switching from 'black' value chains (non-compliant, highly profitable) to 'white' value chains (fully compliant) can have a significant cost impact. We have observed market share losses of up to 50% within only six months due to compliance driven cost increases.

This all comes together with a notable increase in pressure on margins. One key challenge is productivity gains. Skilled labour cost inflation, high staff turnover, in particular, in the fast-developing regions, and poor technology and management keep productivity at comparatively low levels and make the implementation of improvements a difficult and lengthy process.

Acquirers therefore need to carefully analyse how the target compares with its market peers in terms of balancing cost increases and growth.

A different magnitude within the strategic framework

What distinguishes successful from less successful market entry strategies in Russia? The dynamic of the Russian market and the differences between

segments and acquirers make it difficult – if not impossible – to provide a scientific answer to this question. But based on our experience on the ground we can provide a number of insights that should help investors get the strategy for Russia right.

First of all, and we consider this crucial to note, we believe that economic rules are as true in Russia as elsewhere. Russia should not be seen as a 'New Economy' where these rules do not apply. Various factors, however, have a different significance that needs to be considered.

When compared to established markets, the key differences in the magnitude of strategic significance appear to be the relative importance of stakeholders, of demand, of the value chain and the ability to implement.

Stakeholders: a key area of investigation

In established markets it seems reasonable to assume (based on limited research) at least a moderate degree of transparency about the stakeholders in a market, their key interests and the way they influence the behaviour of other stakeholders or the market. Stakeholder assessment in Russia, however, requires a much wider approach.

This is not only because the interaction and relations between the authorities and companies are closer in Russia. But also because the secure supply of raw materials or goods (in particular in the 'regions') can be highly dependent on the support of a very limited number of individuals. Furthermore, relationships with key clients or suppliers are often not legally established but are based on a loyal network of friends and family.

The importance of friends and family highlights a significant issue. Business in Russia is much more relationship based than in most mature economies. Therefore, the group of stakeholders to be assessed is usually much wider than in established markets. And the circle that requires consideration during an assessment can widen significantly.

Finally, some stakeholders may have a more or less dubious background with which acquirers may not want to be associated. Every entrant faced with this issue should prepare specific communication plans to be executed if things become public that were meant to remain private.

Demand: not even close to saturation

Identifying the marginal differences in regional demand patterns and growth rates is a key success factor in mature markets and established regions. Finding these golden nuggets is less of a criti-

cal success factor in Russia. Markets can often be made by pushing products into the market, as most of the categories are underpenetrated.

Similar demand assumptions are true for most of the b2b and industrial markets. Significant capacity additions in downstream activities require not only the supply of raw materials (e.g. oil and gas) but also the availability of high-end engineering and construction capacity. Furthermore, the government is still focusing on increasing the added value in the country. This is often implemented by introducing new duty structures that support the production of more sophisticated products instead of exporting raw materials. An example is the wood industry where the export of logs is likely to be substituted by logs being used for in-country production of, for example, glued laminated timber.

Getting the demand assessment absolutely right is usually not the key focus of a market entry strategy for Russia. A practical 80/20 approach appears sufficient given the current environment. It goes without saying that the Russian customer (if the Russian customer exists at all) is not to be underestimated. Lifecycles in Russia seem to be even shorter than in other countries and success requires a good understanding of customer behaviour.

What we see becoming more important though is target group definition. Not only important from a regional perspective, as discussed above, but also in order to reflect the trends towards brands and the change in demographics. In the last four years the market has changed significantly, with consumers now demanding more from products in terms of quality/innovation or price. Consumers clearly identify high prices with high quality, leading to the emergence of a clear premium segment. On the other hand price-focused retail concepts have become available. This leaves less space for 'medium priced' products. Furthermore, the Russian population itself is changing. Overall it is decreasing, but state programmes seem to be having a positive impact on the birth rate. The target group of young and wealthy families is becoming more important.

Value chain and business model: the things you need to get right

The distribution of growth throughout the country is increasing the importance of a crucial element of any market entry in Russia: the value chain. Unlike in more mature markets, the value chain in Russia may be far from defined.

There is the obvious challenge that comes with the size and the weather conditions of Russia. Dis-

tances to be covered – even between the key growth cities – are very large and fast transportation capacity is limited. This is not only a challenge for retailers with a requirement for efficient distribution of fresh goods: the chilled supply chain is often characterised by significant interruptions, where the required temperature cannot be maintained at the appropriate level. The impact: either high investments in own supply chain capacity or uncertainty about a crucial quality issue.

This is also significant for service-based models like the commercial vehicle industry. The demand for modern commercial vehicles is evident and import numbers are rising. Key for the breakthrough, however, will be the establishment of an appropriate service and repair network. This is probably the largest challenge in a country used to simpler commercial vehicles which can be serviced and repaired by experienced drivers and do not require the highest fuel quality.

Another challenge, limited supply chain capacity, appears to be a by-product of the size, growth and the break-up of historic Soviet structures. In particular, bulk transportation suffers from the limited availability of railway and port capacity. Although private investors, as well as the government, are addressing these bottlenecks, it will take a while before sufficient capacity is available.

Control of the supply chain can prove particularly challenging for sensitive industries like chemicals and pharmaceuticals. A lack of control can lead to unauthorised trade (fraud), abuse of products, insufficient management of expiry dates, or repackaging and labelling.

Another issue to consider is the fast changes occurring in the structure and ownership of the value chain. Players with a historically upstream focus are now increasingly moving toward downstream activities. A good example is again the oil and gas industry, which is moving its focus from pure oil extraction to the petrochemical segment and last-mile distribution. These shifts have a significant impact on the level of access to individual value chain steps available, as well as on the competitive position.

The issues mentioned above are important but far from exhaustive in describing the critical nature of the value chain in Russia. As a result of this a high number of different business models have emerged – even in the smallest industries. We have seen industries where the operating margin varies between 1% and 25% – purely driven by the business model.

Picking the right business model and building it as flexible is the key success factor for an entry into Russia. What are the value chain steps to be occupied? Where to cooperate, where to control? How to remain flexible? All of this needs to be considered.

Being so focused on growth a number of companies did not do their homework on optimizing value creation or operations. The corresponding low productivity plus cost increases that cannot be passed on to the customer, plus high leverage with short-term debt, leaves these companies in a very unpleasant position. If this builds up we may see a further postponement of the modernisation of Russian supply chain infrastructure.

Be able to implement

It may appear to be stating the obvious, but there is no lack of ideas in Russia; there is a lack of execution and implementation capability. There are great benefits to be gained from combining excellent Russian know-how and resources with experience from mature markets.

However, this appears to be one of the most difficult things to do and it takes too long. Our analysis of mergers and cooperation between Russian and international firms has shown that there are plenty of differences. And these differences are vital to success. But there is one area you need to tackle right from the beginning: the operating style.

With respect to this issue we have seen that three areas require significant management attention in order to be resolved:

Centralisation: Russian companies tend to operate in a relatively centralised manner, which may often conflict with the management principles of investors

Management decisions: Decisions in Russian companies are often achieved via a top-down approach. Consensus-driven decision processes can be seen as a management weakness

Result focus: While investors often focus on results, Russian corporate behaviour is often focused on activities (form over substance)

If not addressed properly, these differences can lead to significant delays in decision making and a lack of implementation focus.

Russia needs to be a star in your growth portfolio

As we have seen, the growth fundamentals of Russia are still valid even

in these difficult times. Despite the recent GDP contraction, the economy remains large and a number of markets are far below saturation, customers are willing and able to spend, and the political situation remains stable.

Economic laws are as true in Russia as everywhere else in the world. Russia is not anything like a new economy bubble. But the magnitude of individual components is very different from in established markets. You need to focus on stakeholders and the value chain, as well as having a flexible business model and managing a number of cultural challenges.

On the other hand, we have the significant impact of the global crisis: limited liquidity, decreasing consumer confidence, margin pressure and inflation, as well as currency challenges.

We stick by our conclusion from last year: Russia is not an easy or fast entry market, but performed with diligence, expansion in or into Russia will deliver a large part of your future growth. However, we must add that timing and strategic management capabilities require more attention than one year ago.



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Financial due diligence (Thomas Dix, Partner, Head of Transactions & Restructuring, KPMG in Russia and the CIS)



Thomas Dix

Thomas Dix leads KPMG's Transactions & Restructuring practice in the CIS, and has extensive transaction advisory experience in Western Europe and the CIS. Thomas has solely focused on transaction support for the last ten years. His

experience includes pre-deal evaluation, acquisition and vendor due diligence, vendor assistance for the sale of businesses, assistance in contract drafting and review for acquisitions, and stock exchange reporting for equity and debt listings. In the last eight years Thomas has led numerous assignments in Russia, Ukraine and Kazakhstan, working with both corporate clients and private equity investors in various industry sectors.

Financial due diligence in Russia can represent a significant challenge for investors. Statutory financial information may be significantly impacted by tax-motivated business practices, and reliable financial data is often difficult to obtain. Some companies have recently returned to less transparent financing and trading schemes in order to weather the macroeconomic downturn. Due to the pace and extent of the changes currently taking place in the economic environment, historical financial information is of limited use in assessing the current standing and prospects of a company. More focus is required on recent trading and short-term forecasts, as well as on current and future liquidity. A thorough understanding of the specific business model and accounting practices of a Russian business is essential in order to interpret financial information correctly and to understand and properly evaluate the value drivers.

Lack of reliable financial information

Russian companies are required to keep statutory financial accounts in accordance with local Russian accounting principles ('RAP'). These accounting principles have moved towards International Financial Reporting Standards ('IFRS') over recent years and now include concepts such as substance over form, prudence and the accruals principle. In practice, however, these concepts are not thoroughly

applied, not least because RAP explicitly allow for certain departures from the concepts.

Moreover, statutory RAP financial accounts are primarily used by many companies to provide a basis for tax accounting, rather than as an instrument for measuring and controlling the financial sphere of the business. Therefore the accounting policies applied may be tax driven, rather than providing a true and fair view of the financial performance and position of a business.

Revenues and costs, but also assets and liabilities, are typically recorded in Russian statutory accounts only once their formal documentation (such as dispatch notes, invoices, acts of completion of services) is complete. The resulting prevalence of documented form over economic substance means that revenues, costs, receivables and payables as reflected in the statutory accounts may not be complete, especially at interim dates, or take a long time to become finalised.

In addition to the inherent shortcomings of RAP, local Russian audit practices and standards must also be considered. Local law requires that Russian statutory financial statements of all open joint stock companies, specific types of businesses (e.g. financial institutions, insurance businesses) and entities exceeding certain thresholds in terms of revenues or total assets, be audited annually by an independent auditor. However, the audit practices and techniques applied by many local audit firms do not meet internationally recognised auditing standards. Statutory audits tend to focus on formal compliance with bookkeeping rules rather than on the provision of a true and fair reflection of the economic substance of a company's business. As a result, a statutory audit opinion generally provides very little comfort over the numbers and does not replace the need for thorough and detailed analysis.

To overcome the limitations of RAP financial statements and provide useful information to both external and internal stakeholders, a growing number of Russian companies prepare financial statements in accordance with IFRS or US GAAP on a voluntary basis. Moreover, financial institutions are required by Russian law to prepare quarterly IFRS accounts in addition to their statutory accounts. Although IFRS or US GAAP financial statements generally provide a better basis for financial due diligence, in practice their quality and reliability varies significantly.

In the current environment, even audited financial statements under IFRS or US GAAP are of lim-

ited use if they do not cover recent months, given the ongoing developments in the economy. Historic financial information should therefore be analysed in conjunction with current and forecast financial and operational data. Alternative sources of information, including from outside the target entity, can be used to challenge the provided financial information. A comparison with the company's competitors may help to distinguish between the effect of market deterioration and relative underperformance. An analysis of the financial information should also be accompanied by an assessment of the relevant internal controls, as they can mitigate or amplify the effects of distress.

Impact of opaque schemes

In the course of the macroeconomic crisis, certain opaque business practices which were frequently used in Russia until some years ago have seen a revival among companies in distress.

A frequent issue which impacts the statutory financial accounts is the company's tax practice. Companies which are engaged in various types of tax minimisation or tax avoidance schemes may frequently buy from and sell to changing special purpose vehicles ('SPVs'). Such SPVs themselves may be involved in VAT and profits tax evasion. Their legal ownership often disguises their effective control by the company, its management or shareholders.

Transactions with these SPVs are typically made at artificially high or low prices, or even involve fictitious invoices for services which the SPVs do not actually render. The cash received under fictitious billings is returned to the company or its shareholders without recording the receipt in any official books. Such cash is used, for example, as a sort of dividend or to pay part of remuneration unofficially, thereby avoiding payroll taxes. The statutory accounts of the companies involved in such schemes are also often rendered quite meaningless as a result of them. In order to obtain a complete picture of a company's financial performance and position, it is necessary to understand the consolidated profit generated by SPVs.

Another example of an opaque business practice is the use of promissory note schemes within a group of related entities. Such note schemes are largely driven by the need to overcome cash shortages but also have tax implications. It is important to understand the rationale for transactions involving promissory notes, and to assess the value and liquidity of notes receivable, the liabilities arising from issued promissory notes and their total potential future cash flow impact.

Other opaque related party transactions are aimed at bringing assets out of the reach of creditors or business partners.

For the assessment of the sustainable performance of a business going forward, it is necessary to understand in detail the direct and indirect financial implications of its opaque business practices. Direct implications include the additional tax costs which will be incurred if the business and its suppliers and customers are to operate on a fully tax-compliant basis, abandoning trading through SPVs or the use of other questionable schemes. Indirect expenses may include, for example, the additional payroll cost required to compensate employees and management sufficiently for the impact of the additional personal income tax they will incur on previously undeclared income.

In addition, one needs to understand the commercial implications of transforming the business to a legitimately operating and fully tax compliant entity. Such a transformation is likely to impact relationships with customers and suppliers if the latter have been previously involved in tax minimisation schemes. It may not be possible to pass the additional cost of being tax compliant onto customers, impacting future profitability.

But even if a company is not engaged in unlawful/legally questionable transactions, trading through complex structures of legal entities is a widespread phenomenon. RAP, however, do not require the publication of consolidated financial statements; consequently they are often not prepared. An understanding of the entities through which a business operates, and the economic relationships and cash flows between them, suppliers and customers, is essential for the assessment of a business's financial performance and position, as well as the financial risks to which it is exposed.

Management accounts as a means of measuring financial performance

In the absence of reliable or recent statutory financial accounts, or IFRS or US GAAP financial statements, the only source of useful information for financial due diligence may be the company's management accounts. Whilst management accounts may provide a more complete and relevant picture of the company's trading, they are often prepared on a cash rather than an accrual basis, or represent a mix of the two approaches. They are also typically limited to an income or cash flow statement, while no balance sheet is prepared, therefore providing limited or no information on the business's financial position.

It is quite typical for internal management accounts that VAT receipts and payment are included within income and expense items; payroll, taxes and interest are accounted for on a cash basis; fixed asset purchases are written off as expenses; and no provisions or write-downs are made in respect of impaired assets or future expenses such as environmental commitments, product warranties or employee-related obligations. Management accounts require thorough analysis and adjustment for accruals, provisions, tax and others, using all available information, to obtain an approximation of the financial performance in accordance with IFRS or US GAAP.

Assessment of a company's financing and capital structure

Due to the current turmoil in the financial sector, most Russian companies are experiencing difficulty in raising debt finance, especially if the majority of their assets are already pledged. Most Russian corporate debt revolves on a relatively short-term basis, which in times of decreased availability of credit puts the business under extreme liquidity pressure. Besides checking payment schedules against cash flow forecasts, an important area of focus is reviewing compliance with the covenants of borrowing agreements.

Attention should be paid to companies with negative net assets. Under Russian law, a company which has negative assets under RAP for two consecutive years can be subject to forced liquidation, which can be initiated by creditors and/or the state authorities. This has been somewhat of a technical risk in the past, but in the tougher environment this may become a tool for creditors and the tax authorities to exert pressure on companies

Working capital issues

The approach to working capital management is somewhat different in Russia. Many Russian companies have traditionally not been very proactive in their control of inventory levels or chasing of receivables, which resulted in high stock levels and extended working capital cycles. In light of general liquidity issues, the settlement of trade debt is currently being increasingly deferred and the number of defaults is rising. The consequences of late payment are frequently underrated by companies. There have been several cases of major corporates which thought that they had achieved some breathing space through reaching agreements with their main creditors, only to then be caught out by a claim from a small supplier which had been overseen.

In the unstable economic environment of the late 1990s, it was common for Russian companies to require their customers to pay in advance. Such payment terms have recently seen a comeback as companies that made sales to their customers on credit experience working capital constraints.

Assessment of the recoverability of receivables is often difficult due to the lack of ageing profiles. In Russian statutory accounts a provision for bad or doubtful debts is often not created and unrecoverable receivables are only written off after they have been overdue for three years.

In the course of the downturn, stock has typically been accumulating. Although subject to physical stocktakes and despite the RAP requirement to create provisions, inventory is generally not assessed for slow moving or obsolete items, which are often included on the balance sheet at a cost which may not be recoverable.

Financial impact of VAT

Unlike in other European countries, input VAT on services, raw materials and fixed assets acquired by a Russian company is generally not automatically repaid by the tax authorities. To obtain repayment in cash a company will often need to claim such a refund, even through the court. In most cases receivables from input VAT are offset against tax payables. Although VAT receivable balances can be offset against other federal taxes such as profits tax, this practice can have a serious cash flow impact, especially for companies which undertake significant investments and which are in the start-up phase.

Assessment of the value of fixed assets

The book value of fixed assets in the statutory accounts can be affected by a number of specific issues like inflation and frequent revaluations, or the absence of the latter. Depreciation rates which are lower than economically justified can lead to net book values which are not recoverable from future cash flows. Assets which have been taken out of operation and 'conserved' are often accounted for at their last net book value without further depreciation or write-off.

In practice, impairment reviews of fixed assets are rarely performed, and this can often lead to net book values which are higher than recoverable values. In many cases, only an assessment by a technical specialist can provide comfort over the value of fixed assets and identify potential write-downs.

In Russia, especially in Moscow, land is often not owned but rather leased by companies from the municipality for a 49 year term. Lease payments are not always clearly defined in lease agreements, and this can lead to uncertainty about future lease expenses.

Financial instruments

Under RAP, only investments classified as 'marketable' need to be accounted for at market value: other investments must be reviewed for impairment. Since impairment reviews are often neglected, due diligence should assess whether investments carried on the balance sheet can be liquidated and/or justify their book values.

The use of financial instruments for hedging purposes is currently limited in Russia, partly due to administrative difficulties and ambiguities in tax legislation. Companies which have foreign currency exposures may not have many tools at their disposal to hedge them.

Long-term liabilities and contingencies

Russian statutory accounts generally do not reflect provisions for long-term liabilities. This is particularly important for those companies which provide guarantees for their products or which operate in extractive industries. The future costs of legally required site restoration, for example, are not continuously accrued during the extraction work, but only expensed as the restoration work is performed. Consequently companies rarely assess the expected cost in advance. The financial impact of such a liability on future cash flows should be considered, as well as for the assessment of current profitability.

Similarly, the statutory financial statements often do not account for contingent liabilities which are considered more likely than not to be realised. Such liabilities are only recognised in the accounts when the related documentation, such as a court order, is received.

Prospective financial information and budgets

Many Russian businesses do not prepare any detailed financial projections beyond an annual budget.

Budgets are often limited to monthly cash flows and rarely include balance sheet projections or an accrual based income statement. Budget variances are often not analysed in any detail.

Mid- or long-term projections are often prepared based on high level parameters rather than

on a detailed analysis of the underlying drivers for future performance and a robust financial model. Moreover, they are often heavily influenced by an overly optimistic view of future developments, while insufficiently reflecting investment and financing needs and the impact of market trends and the economic downturn.

Summary

The assessment of the value drivers, risks and opportunities to which a business in Russia is exposed requires a detailed knowledge of the Russian economic environment, together with a thorough and careful financial due diligence, in particular in times of increased uncertainty about the economic prospects of the Russian market. Available financial information is often limited and can be misleading if not interpreted in the context of the specific environment and business practices under which a company operates. The examples provided above can only give a flavour of the challenges which an investor may face when evaluating a transaction involving the acquisition of a Russian business, or setting up a business jointly with a Russian partner.

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e-mail: office@eastconsult.eu

The credit rating as a tool for effective investing (Dr. Vladimir Ismailov, CFO, Moscow School of Management SKOLKOVO)



Dr. Vladimir Ismailov

Dr. Vladimir Ismailov is the CFO at Moscow School of Management SKOLKOVO, supporting a range of corporate business functions of the School, which provides MBA, Executive MBA, Executive Education, Research and Consulting

focused on emerging market business, government agencies and organizations.

Vladimir holds a PhD in Economics, as well as being a Certified Auditor of the Russian Federation (since 1995) and a Member of the American Institute of CPA (exams passed in 2000). Dr. Ismailov has a great deal of financial management and auditing experience in a range of business sectors, having worked in the Public Accounting Media & Information sector, OEM, Telecom services and at not-for-profit organizations.

Vladimir is the author of a number of publications on general economic and investment subjects. Dr. Ismailov also cooperates with major media outlets (BBC Russia Radio, Russia Today TV, City FM Radio, etc.) in Russia and abroad as a member of the panel of experts that opine on investments and the business environment in Russia.

This is probably not the best time to praise the usefulness of credit ratings. The United States capital market regulators are trying to determine the role of the credit rating firms in causing the liquidity crisis. The crisis that started in summer 2008 in the USA with the realization that structured financial instruments backed by pools of proceeds from sub-prime mortgages and rated relatively high by the rating analysts, were more risky than the agencies thought they were. European capital market regulators are trying to define to what extent the agencies are really independent from their opinion about their clients' ability and willingness to pay their debts. Regulators doubt the true independence of rating analysts' opinions from their clients who pay for analytical services. Even Russian capital market regulators are trying to get a better understanding of the role that rating agencies are playing and put some level of oversight over the rating firms' activities. All capital participants and regulators are scrutinizing rating methodologies and making a number of recommendations to the firms. The general public is simply relying on those

who take an active stand in this process. Some banks are considering switching their risk credit assessment policies away from credit ratings to credit default swaps (CDS) based systems, given the current state of the world capital markets. But this does not look like a permanent solution, simply because CDS have a different nature and there are currently no market instruments available to build a system around this.

Despite the above, credit ratings have been and continue to be a source of detailed analytical information about a company. The information is not served as a sales pitch, like in the case of equity research and recommendations by a banker who is simply trying to sell what he has to his/her equity investor. Also, rating firms have substantial analytical resources and methodology that have been used for decades. These rating agencies have data on the performance of companies over decades. This data represents a unique platform for trend analysis and various studies. It would be careless to just throw this away without putting in the effort to fine tune the existing system and make the necessary adjustments. Most of the market participants are confident that credit ratings serve the needs of the complicated mechanism called a financial market.

Investors should take into account every aspect of the businesses that assists them in making the most informed decision. One aspect that can play a useful role in the decision-making process is a company's credit rating.

What is a credit rating and what it is not?

A credit rating is usually "the current opinion of the credit worthiness of an obligor with respect to a specific financial obligation, a specific class of financial obligations, or a specific financial program (including ratings on medium-term note programs and commercial paper programs)"¹. When considering the benefits of using credit ratings in the due diligence process, it is important to understand what a credit rating is not: it is not an audit opinion; it is not a recommendation to buy/sell; and it is not a ranking.

Often, an investor may use a credit rating in order to:

- Evaluate an independent opinion about credit risks related to a particular company or a financial institution, or

¹ According to Standard & Poor's Ratings Definitions published on December 10, 2002

- Compare one credit risk to another worldwide using global scale ratings, or within the same country using national scale ratings.

All of the above lead to risk premium evaluation. However, when a Russian company has a credit rating or has its financial instruments rated, it could also be a preliminary indication of:

- The level of sophistication of the company's management;
- The extent of the company's transparency;
- How much information the company is willing to disclose;
- The reliability of the information that the company provides to the investment community; or
- The company's key risk areas.

It also helps investors in certain analytical efforts. A credit rating can be:

- An instrument of debt market trend analysis;
- A database for a specific industry trend analysis; or
- An attempt by the management of an investing company to manage its investment portfolio.

All of the above may substantially affect an investment decision.

How to take advantage of a credit rating

There are a number of attributes of a credit rating assigned by a respectable international rating agency that are very useful for decision making.

Companies, financial institutions and the investment community know that, in most cases, a credit rating is *public*, meaning it can be obtained from a public source. This makes the process transparent and increases the level of data reliability.

There are companies that have *confidential credit ratings*; however, this is only until a company feels comfortable in sharing its rating with the investment community. After that, a credit rating becomes public and the company will usually not choose to make it confidential again. A credit rating agency may withdraw a credit rating that was made public; however, the investment community usually reacts negatively to such an action. It takes a lot of explanation, reasoning, and demonstration of hard evidence to persuade the investment community that the withdrawal of the rating was not related to the issuer's credit worthiness.

A credit rating assigned by a respectable international credit agency is always *up to date*. Standard & Poor's (S&P), for example, regularly monitors every credit rating it has assigned. S&P promptly reacts to any significant change in the business and/or credit risk of an issuer and/or an issue in question. S&P performs surveillance of a credit rating,

which includes daily monitoring of changes that may affect an issuer. Such changes may take place in the relevant industry or country, in relation to a holding company (-ies), key vendor(s), and/or customer(s), etc. Any development that could affect the issuer is analyzed by a credit rating agency and, if the findings are significant, will be reflected immediately in the credit rating.

Credit ratings assigned by a respectable agency represent an *independent view*. A credit rating committee normally decides on the rating. As a rule, a credit committee has several people from different offices to assure objectivity and eliminate any possible influence from an issuer.

A credit rating agency's credit rating methodology is also public knowledge. Most international credit rating agencies have their methodologies and criteria available on their websites. This ensures a *unified approach* to the rating process, as well as *transparency*.

The public availability of and unified approach to rating allow an investor to easily understand what areas are currently challenging an issuer. It can also *assist the management* of a target company in:

- Constructing an action plan for improving the company's credit worthiness;
- Benchmarking against peers;
- Developing an action plan to mitigate and manage business and credit risks; and
- Developing a financing plan to mesh with the details of the above.

Normally this information can be found in the credit rating research reports available to the issuers' management.

A credit rating helps understand the *credit history* of an issuer.

What is the use of a sovereign rating?

While considering due diligence in Russia, an investor should consider the business environment surrounding the target company. Business-related issues to consider may include:

- The country's current sovereign debt rating;
- Current local and regional authorities' credit ratings;
- Industry credit ratings research papers; and
- The level of transparency and disclosure among the companies in the country.

A credit rating agency usually provides its opinion on these.

S&P has assigned a global scale² credit rating for Russian sovereign debt obligations at 'BBB/

² According to www.ratingsdirect.com

Negative/A-3'. In other words, "...an obligor rated 'BBB' has adequate capacity to meet its financial commitments. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligated to meet their financial commitments."³ Given the level of influence that the government may exercise over the issuer operating in that country, it is hard to expect that a company can have higher credit strength than the government. However, there may be a few exceptions, such as the rating of a securitized obligation with a special finance vehicle registered in another jurisdiction with a credit rating higher than the sovereign. A credit rating report on sovereign debt obligations can provide some useful insight into risks and opportunities in the country. It may even discuss in more detail a specific industry, if the industry has played a role in the credit rating assessment process.

Default studies

Default studies present research about the average probability of default by an issuer who is assigned a credit rating over a certain horizon – up to fifteen years. Using this information helps a potential investor, who may not be familiar with various credit rating scales, to qualify the risks associated with a target company.

It will be interesting to see this year's study and find out more about performance of companies during the crisis and the recession.

According to S&P, the "credit deterioration took on a dramatically fierce tone in 2008. Default occurrences picked up sharply in 2008, in each progressive quarter, in contrast with the ultra-lows seen a year earlier. The annual tally was 125; with a quarterly distribution of 18, 20, 27, and 60 in the first through fourth quarters, respectively. Expressed as a percentage of the total issuer count, the default rate rose globally to 1.69% in 2008 from 0.36% a year earlier. All regions experienced a visible increase, with the U.S. leading the charge at 2.41%. The investment-grade default rate rose to 0.41%, its highest annual rate since 2002."

It is interesting to note that amongst speculative-grade ratings, the smallest growth in default was in Europe, from 0.99% to 2.54%, followed by an increase in the US from 0.98% to 4.02%, with the most significant growth in the emerging markets, from 0.18% to 1.96%.

This statistical instrument still provides us with an objective picture on the depth of the crisis.

Other aspects of using a credit rating

To find out more about a local jurisdiction, one can use the benefit of a credit rating report for one of 85 plus⁴ jurisdictions and about 100 local authorities in Russia that have the constitutional right to impose local regulations that may affect businesses. It is therefore beneficial to read about a local authority's affairs as an indirect indication of the region's investment climate.

Because international rating agencies have a large database of financial figures, they have the ability to perform periodic Russian industry-specific sector research. An investor can familiarize him/herself with the contents of such reports, reading about key trends (from a business and credit risk perspective) in the industry of interest.

Some international credit rating agencies periodically conduct an assessment of the level of transparency and disclosure among companies in Russia. Such studies are useful in order to obtain a better understanding of what one can expect in day-to-day life while requesting a critical piece of information from a target company and/or customer, vendor, banking institution, or other organization.

Some rating agencies provide companies with *eco-ratings*.

As you can see, a credit rating assigned to an issuer (company, bank, insurance company, fund etc.) can be a very valuable tool for making investment decisions in Russia. Of course, credit ratings may be assigned by any credit agency and therefore, an investor needs to understand what is behind the credit rating methodology and assess the credit rating agency's reputation (historical track record).

³ Standard & Poor's Ratings Definitions published on December 10, 2002

⁴ The number of jurisdictions in the Russian Federation is currently declining due to a process of consolidation of some of them based on referendum results in those jurisdictions. There were initially 89 jurisdictions.

Legal Due Diligence

(Olga Koniuhova, International Partner, Chadbourne & Park LLP)



Olga Koniuhova

Olga Koniuhova has over 16 years of experience in complex international transactions. Ms. Koniuhova's practice focuses on corporate, mergers and acquisitions, restructuring, private funds and labor law. She has significant experience in implementing complicated corporate projects that require an unconventional approach and industry knowledge. She has an extensive background in project development requiring a full range of legal services, such as structuring related license and sales agreements, transnational mergers and acquisitions, and organizing private investment limited partnerships and registered investment companies. Olga's work in relation to labor includes creating stock option plans and structuring labor relationships with top management of client companies. Her clients include a variety of individual entrepreneurs, western, CIS-based, private and state-owned companies. Prior to her work at Chadbourne & Parke, Olga worked for a number of major international legal and consulting firms.

Whether considering an equity investment or corporate restructuring, buying or selling specific assets, seeking trade credit or another type of financing, it is essential to quantify and understand the risks involved.

Due diligence ensures that the complete range of information required to make a decision is available and detects the relevant risks which may have a fundamental impact on the decisions taken by a prospective buyer or investor.

While a financial due diligence determines how much a business project can cost and predicts when the first revenue can be expected, a thorough legal due diligence provides an investor with insight into the potential acquisition target before binding commitments are made. Taking into account the specific issues of each industry, due diligence helps to determine the optimal terms and value of expected transactions, adjust long-term strategic plans and, if justified, withdraw from the proposed investment.

Often a Russian company may have "hidden" liabilities such as sureties, guarantees, or other contingent liabilities. Even if a proposed partner or

acquisition target adheres to good corporate governance principles in Russia and is upfront about any possible legal violations, there may still be issues of concern to an investor that may not be at all apparent or problematic to a Russian company. Such issues often arise in connection with environmental, labour, tax, and currency matters.

Due diligence in Russia is slowly but steadily picking up pace. This is caused not only by access to international capital markets and the increasing requirements of investors to disclose information on target companies, but also by changes that have been introduced to a number of legislative acts that will be described later.

It has even become common for the management of a company to have a 'fresh look' at the company's operations from a legal perspective in order to identify areas containing concealed risks and elaborate on ways to minimise or eliminate them.

Making a decision on whether to invest in a company requires that a wide range of issues be included in a due diligence exercise. Every aspect is important: how realistic are the expectations of further growth and development of the target company; will the current level coupled with the anticipated investments allow the company to reach the target growth indicators; is the title to the company's assets and the title of the company's owners good; is there any weakness which could be used by raiders to take over or destroy the business; how strong is the management team.

A proper due diligence of any transaction would typically contain three stages

The first stage is to determine the legal status of the Russian company and to review whether the foundation documents correspond to the requirements of current legislation and to ensure that the charter of the company complies with Russian law and does not contain any restrictions on foreign ownership. Situations frequently arise where the charter is in conflict with the law or with the company's day-to-day practice. For instance, the terms of the charter may stipulate the existence of a board of directors, but a board may not have been elected, or its composition may not be sufficient for a quorum for making decisions. These violations can lead to disputes over company transactions or the removal of a director as having been illegally elected.

If, for example, the shares of the company were originally issued through the privatisation of a state-owned enterprise, the privatisation documents must be reviewed to ensure that the initial transaction conveying title to the purchaser complied with the tender/auction requirements.

The proper issuance of shares of a Russian company generally requires shareholder approval and registration of the shares, typically with the local branch of the Federal Commission on the Securities Market. Additionally, any licences issued with respect to certain industries (particularly those involved in the exploitation of natural resources) must be reviewed carefully to ensure that the company has the proper authority to carry out its activities. Licences may also contain restrictions on foreign ownership. This issue is especially relevant in light of the new law “On the Procedure for Implementing Foreign Investment in Commercial Enterprises Having Strategic Importance for Securing National Defence and Security of the State” № 57-FZ (the “Strategic Companies Law”), which requires foreign investors to obtain the prior consent of a special government commission, headed by the Prime Minister and called the Governmental Commission for Control Over Foreign Investment in the Russian Federation (the “Commission”). The Commission’s consent is required for the acquisition of “control” over Russian companies engaged in 42 activities that are listed in Article 6 of the Strategic Companies Law as having strategic importance for Russia’s defence and national security. In the absence of the required consent, the relevant transaction is deemed null and void. The list of strategic activities, although exhaustive, is broadly drafted and, as a result, covers entities that are unlikely, under any reasonable interpretation of the nature of the activities they are engaged in, to have strategic importance for Russia’s national security.

In addition, the Strategic Companies Law appears to imply that, as long as a company has a licence to conduct activities having strategic importance for national security, it is considered strategic even if the business activities it is actually engaged in are not of strategic importance.

The second stage is to perform due diligence on the title of ownership of the company. Legal due diligence reviews the legality of the purchase to avoid disputes in the future. For example, sometimes the transfer of property was not duly formalised. In addition, the forms and terms of the charter capital formation are reviewed. Violations in relation to charter payments are frequent.

Incomplete payment of the charter capital within the term set by the law of the Russian Federation results in the transfer of the unpaid shares to the joint stock company. The so-called owner, the party negotiating a sale, may not be the legal holder of the title. If the charter capital was increased, the following issues are also analysed: the method by which payment was made and whether any breach related to the payment procedure took place.

The third stage of the due diligence is a comprehensive analysis of the company’s business activity. The due diligence reviews the legality of major transactions and transactions made with interested parties, and whether those transactions comply with antimonopoly and currency laws.

It is also important to review whether concluded contracts were performed, in order to avoid any litigation with the contracting party or the state authorities.

In addition to the legal review of the acquisition of the business, legal due diligence evaluates the rights transferred by the legal entity. Quite often the seller’s ownership title does not correspond to the one declared and may be disputed. This can be due to several reasons, for instance non-payment of the charter capital or violation of the legislative limits set for prior transactions in connection with the sale of purchased assets.

The initial due diligence helps to collect very important information regarding a business. First of all, it is necessary to decide if there are any advantages in a transaction with this specific business. In addition, it is important to determine the form of the transaction.

A detailed due diligence review is case based and depends on the type of planned transaction. Based on current Russian legislation, there are three main ways to acquire a business project:

- Purchase of shares (participatory interest) of a legal entity managing the activity of the whole holding directly or indirectly;
- Purchase of the property utilised for the purposes of the current business project;
- Purchase of the company as a property complex.

The most common way is the purchase of shares (participatory interest) of a legal entity managing the activity of the whole holding directly or indirectly.

If a legal entity is being purchased by redemption of shares (participatory interest), the new participant gets not only the assets, but also the accounts payable and risks related to prior transactions. The concern while conducting legal due diligence should be to focus on confirming the proper

transfer and registration of the title of the shares and rights to the assets, reviewing contractual work, and compliance with tax and antimonopoly rules.

Recent amendments to the Russian Federation Civil Code and Federal Law “On Limited Liability Companies” №14-FZ of 8 February 1998 (the “LLC Law”) and to the legislation regulating state registration of legal entities and the notariat (notarial activity) have addressed some flaws in the procedure governing the transfer and registration of rights to and encumbrances over participatory interests.

For example, agreements on the transfer of shares now need to be notarised. Certification by notary determines the moment the share is transferred to the buyer. Failure to comply with the requirements in relation to this form of transaction shall render it invalid. Since the charter of the company may provide for the pre-emptive right of the participants and the LLC to purchase a share sold by other participants to third parties and to set the price at which it will be sold to persons exercising their pre-emptive right, it is very important to determine all possible restrictions at the due diligence stage.

According to the new version of the LLC Law, the names of a company’s participants must be set out not in the charter (which now becomes the sole constitutive document of an LLC), but rather in a list of participants (LLC Register) to be kept by the LLC itself. That said, the information contained in the State Register (the unified state register of legal entities, a document containing most of the information of legal significance about a company’s participants) will still take precedence over the information in the LLC Register. In a case where information in the State Register on the ownership of a participatory interest is disputed, the rights to the participatory interest will be established on the basis of the agreement or other document confirming the respective participant’s right to the participatory interest in question.

The appearance of a public element, i.e., involving a notary public in the transfer of rights to participatory interests, can prevent, for example, the transfer of unpaid shares of the company. The so-called owner, the party negotiating a sale, may not be the legal holder of the title. Therefore, it is crucial to check during the due diligence that the charter capital was formed without a violation of the legislative requirements.

If only a portion of the shares (participatory interest) is purchased and the investor is planning to act in cooperation with the remaining owners, additional factors become important for investors. For instance, when looking into the existing manage-

ment structure and the executive team of a target company, a potential acquirer should more closely investigate the risk of loss of clients due to the key managers quitting or the risk of the current owners creating a competing business, and evaluate its own capability to create a new team or retain the existing team in the target company.

In addition, there might be concerns specifically resulting from the acquisition of voting rights under the shareholders agreements (the “SHA”). While SHAs have never been prohibited under Russian law, their enforceability has proved to be extremely difficult and has always been subject to restrictions imposed under Federal Law “On Joint Stock Companies” №115-FZ (the “JSC Law”).

Under the amended JSC Law, a person who, pursuant to an SHA, has obtained a “right to determine voting” above a certain ownership threshold in a JSC that has a registered prospectus, has to notify the JSC and the Russian Securities Regulator. If the necessary notifications are not made, there is a risk that any votes at a shareholder meeting made pursuant to specific voting arrangements stipulated in an SHA will be invalidated by a court. Consequently, this may lead to corporate decisions being challenged as invalid on the grounds that they were passed only due to votes that should not have been counted or at a meeting that in fact was not technically quorate.

Another example of such an issue is that an agreement with a third party that is in violation of the terms of an SHA may only be invalidated under Russian law if the third party was aware that the relevant agreement constituted a breach of an SHA.

In acquisitions of separate assets (land, buildings, equipment, etc.), due diligence as a rule includes:

- verification of the technical characteristics of the target declared by the seller (land plot area and its specific features, building area and its layout, equipment performance and age, etc.);
- verification of the good title to the assets and the seller’s powers;
- verification of the liens and risk of third party claims in respect of the target asset (pledge, preliminary arrangements with other purchasers, legal claims, etc.) and the title history based on the sequence of transactions leading to the procession.

The purchase of property has the advantage that the purchaser obtains the assets free from any other liabilities. However, a business project is not only property. It can consist of different types of intellectual property, technical documentation, trademarks, and know-how. It is possible to purchase a

part of this property, but there are some assets that are difficult to transfer, or the transmission itself will make the purchase of the property complicated. For instance, the transfer of trademarks requires re-registration, and this procedure can last up to a year. In addition, a company could own a licence which is either not permitted to be sold or is so difficult to sell that it is practically impossible.

If the future owner intends to purchase property, it is necessary to verify the legality of the seller's title to the property and the title history based on the sequence of transactions leading to the procession. The legality of each transaction, its form and terms are also reviewed. If an investor is considering an asset acquisition (as well as certain large share purchases from the issuer), it is necessary to confirm that additional corporate approvals have been obtained. For example, any transaction involving assets in excess of 50% of the balance sheet value of a Russian company's assets requires a qualified majority vote at a general meeting of shareholders. Transactions between the company and an "interested person" (including managers, directors, and shareholders with stakes of 20% or more) must be submitted for approval to the board of directors and the company's shareholders' meeting.

In order for a property transaction to be valid, all immovable property, including land, and any transactions involving immovable property or land must be registered with the appropriate registering body, which in most cases will be the local registry for immovable property. Therefore, where real estate is involved, most due diligence will require a review of title certificates, purchase contracts, leases, and mortgages to ensure that they have been registered and, for mortgages, notarised. It is also important to verify with the registering body whether any liens have been filed and to confirm that the use of the real property is permitted, especially with regard to land use.

Purchase of a property complex is a rather complicated process. It is necessary to perform certain actions in addition to the standard due diligence: organisation of a complete inventory, preparation of an interim balance sheet and conducting of an independent audit (Article 561 of the Civil Code of the Russian Federation). From a financing perspective, purchasing a company as a property complex is also quite complicated and, therefore, is rarely used in practice.

Analysis of various business acquisition methods

Purchase of shares (participatory interest) is a multi-stage procedure, but the form and duration of the registration is not that complicated. In the case of an acquisition, to ensure that the shareholders have good title to the shares of the target company, the due diligence should confirm that all necessary corporate actions – including special approvals that may be necessary if the state owns a stake in the enterprise – have been taken. Almost all Russian shares are "paperless," and ownership is recorded in book-entry form in the shareholder register. If newly-issued shares are acquired, investors should check whether the issuer's charter grants the existing shareholders pre-emptive rights to participate in the purchase of the shares. Closed joint stock companies and limited liability companies always grant pre-emptive rights, and they may also grant the right of first refusal.

It is easier to buy the legal entity's property than a property complex. When buying a legal entity's property, first the parties make a contract and then the property should be transferred. If such a transaction is for immovable property, the transfer of the title is subject to state registration. The registration process takes more than 30 days.

The purchase of a property complex is a rather complicated process which is not common in practice.

The systematic nature of a legal due diligence in connection with an asset transaction will allow negative surprises related to purchasing new assets to be avoided.

In practice, foreign investors often choose a combination of the above scenarios. However, if such combinations are performed without consultation with local advisors, they may potentially lead to the transaction being recognised as void.

In conclusion, the due diligence process in Russia is never easy, but recognising and resolving fundamental issues early on could save a great deal of time, expense, and headache in the future.

Technical due diligence

(Vladimir Ovcharov, Head of the SGS Competence Centre for Russian Product Certification; Tatiana Apatovskaya, Marketing Manager for Russia, SGS Vostok Limited, Moscow)



Vladimir Ovcharov

Vladimir Ovcharov, based in Moscow, is Head of the SGS Competence Centre for Russian Product Certification and Industrial Safety Expertise, a global role he has filled since 2005. Within SGS Russia he manages the accredited Product Certification Body since 2005, the accredited Metrological Expert Organization since 2007 and the licensed Industrial Safety Expert Organization since 2008. Previously he held key positions in a number of Russian Research Institutes for Conformity Assessment. Vladimir graduated from the Moscow Institute for Chemical Technology in 1977. In 2000, he was awarded a Doctor of Science, and in 2004 he was enlisted as a Corresponding Member of the Russian Metrological Academy.

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Tatiana Apatovskaya

Tatiana Apatovskaya is the Marketing Manager for SGS Vostok Limited, the Russian subsidiary of SGS, the world's leading inspection, verification, testing and certification company. Before joining SGS in early 2005, she had been engaged in the market research industry, in particular managing consultancy projects for international clientele focusing on Russian market entry and investment development.

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outline is not intended to be exhaustive and aims to highlight the key topics for consideration when investing in Russia.

Feasibility study and design phase

Status quo due diligence

When concluding an M&A deal, a technical audit is required to obtain a clear understanding of the asset's status quo, its real value and pitfalls. The following questions are traditionally to be answered at this stage:

a) Are all statutory technical requirements followed and approvals in place to legally and safely operate the site?

Conformity to Russian regulations regarding health and safety of employees in the workplace, sanitary and hygiene conditions, as well as environmental impact are often the goals of a "status quo" technical due diligence. Operating without proper documentation is possible but risky in the sense that at any time the issue can be raised by the relevant state authorities, especially as a result of changes in ownership of the assets or staff rotation in the supervising bodies. In some cases production may be stopped and the gates of the plant may be locked.

Audit reports for ISO 14001 (Environment), OHSAS 18001 (Occupational Health & Safety) or HACCP (Food Safety) certification purposes may ease the task of such a diagnosis, since these standards pre-suppose verification against local norms and regulations, i.e. Russian ones for a Russian organization. But the quality of such reports depends

During industrial project implementation the investor is usually dealing with a whole array of technical concerns. In Russia, many parties are traditionally involved in the investment process apart from the investor (financial institutions, property developers, designers, construction contractors, suppliers, and the authorities, to name just the key participants in the process), which can result in conflicts of interest. The investor's primary interest is to ensure that the project remains on schedule and within the projected budget, and naturally quality and cost-effectiveness also have to be ensured. Safety for both workers on site and for operators later on when the installation is in operation are a major concern. At the same time, with state authorities playing a decisive role in the approval process in the Russian context, conformity to their requirements is to be taken into serious consideration. Technical due diligence is one of the tools at an investor's disposal to minimize investment risks related to technical aspects of the project in question.

Technical due diligence may entail various types of scope and objectives depending primarily on the industry concerned and the stage of the investment process:

- Feasibility study and design phase;
- Procurement and construction phase.

A brief outline of the issues to be investigated is provided below for each of these phases. This

to a large extent on the auditor's qualification and the impartiality of the certification body; references should be collected about both. There are specific issues in Russian occupational safety and environmental legislation that differ from European laws, and only an auditor with a good understanding of Russian practices and extensive experience can identify all cases of non-compliance.

b) Is the facility duly equipped and infrastructure available to ensure reliable performance and achieve the plant's business and operational goals?

Plant integrity, safety and reliability are a major concern for all asset owners. By recognizing that risks and efficiency represent the "other side" of profit, it becomes imperative to fully identify and understand equipment's potential degradation mechanisms. Technical due diligence on this particular aspect may involve inspection of pressurized equipment and systems, high and low voltage installations, buildings and lifts, lifting and hoisting equipment, other tools and machinery, and coating systems. Risk Based Inspection (RBI) technologies allow the audit to be carried out without interrupting daily operations.

c) Are there management systems in place to enable sustainable performance of the facility?

The availability of certificates of conformity to ISO 9001 (Quality), ISO 14001 (Environment), OHSAS 18001 (Occupational Health & Safety) etc. is a good indicator for assessing an organization's sustainability. However, it is important to note that there is the risk of being faced with a mere piece of paper without proper grounds. Technical due diligence should bring to light the real scope of the certification (for example, it could be the case that the ISO 9001 certificate covers just a storage facility and not the quality management system of the whole plant); the accreditation under which the certificate has been issued (the Russian accreditation system is called GOST R); and the name of the certification body. The reputation of the latter can provide an indication of the certificate's reliability.

Pre-project due diligence

Greenfield investments or renovation of an existing industrial site in Russia imply the need to obtain a combination of permits, certificates, licenses and other approvals from different national and local authorities required to undertake engineering, construction and other technical activities. Technical due diligence is advisable at an early stage of the project to identify potential non-compliance and to

take corrective measures well in advance, so as to avoid problems at later stages when undergoing official procedures and expert examination.

Firstly, an Investment Justification (formerly called a Technical-Economic Justification) has to be prepared. The goal of this document is to assess the technical, commercial, economic and social feasibility of the investment. The most complicated part of this phase consists of obtaining numerous approvals of the authorities and relevant surveying bodies: the local Administration; the Architecture and Municipal Building Committee; the Ministry of Economics (for industrial sites); the Forestry Committee (if located on state agricultural or municipal land); the State Environmental Expertise Committee; the State Sanitary-Epidemiological Control Center; the State Fire-Fighting Department; the Historical and Cultural Heritage Preservation Inspectorate; the Civil Defense and Emergency Prevention Department, among others. In some cases public hearings have to be arranged to clarify the local environmental and social impact of the considered project.

Secondly, project documentation has to be developed, taking into account the adaptation of the engineering process to local conditions, including its positioning on the construction site, planning of building structures, provision of required resources, etc. The key points to be audited here are the correct application of technical requirements and norms; receipt of approval of the project documentation from the inspecting and official institutions such as an Industrial Safety Expert Examination Conclusion, an Environmental Impact Expert Examination (OVOS) Conclusion, a Labor Conditions Expert Examination and others. The final stage relates to the analysis of the compliance of the project documentation with the requirements of Glavgosexpertiza (General Expert Examination Body) of the Russian Federation, in order to obtain a consolidated State Expert Examination Conclusion.

A negative conclusion could potentially lead to the termination of the project. As soon as the positive State Expert Examination Conclusion has been obtained the investor may apply for bank loans, sign the relevant contracts with subcontractors and commence construction work on the site.

Procurement & construction phase

Certification due diligence

In accordance with Russian law, a wide range of products require mandatory certification in order to be used in Russia. This means that they should be ap-

proved by the relevant Russian authorities in terms of compliance with national standards, mostly focusing on safety characteristics. This concerns both locally produced and imported goods. Depending on the nature of the materials, machinery or equipment intended for constructing a new production facility, it may be necessary to comply with one or more certification requirements. There are a number of mandatory certification systems regulated by laws of the Russian Federation (“GOST R”, “Telecom”, “Fire Safety” etc), not to mention the 522 voluntary certification systems (registered by 1.01.2008), some of which are de facto compulsory. Moreover, a special procedure is established for devices to be operated at hazardous industrial facilities (e.g. at plants producing alloys of ferrous and non-ferrous metals) and for hazardous equipment (e.g. cableways, lifts, equipment for mining activities, pressure vessels), which requires receipt of a Rostekhnadzor Permit to Use. Rostekhnadzor is the abbreviation for the Federal Service for Ecological, Technological and Nuclear Supervision, which is responsible for industrial safety issues in Russia.

Many effective Russian standards are different from and not harmonised with European, other international or national standards. Verification methods also often differ considerably from those applied in Western Europe. Namely, different standards, rules and norms are set for machine-building and construction designs and specifications; denomination; grading and classification of steels and alloys; plastic materials and rubbers; methods of non-destructive testing (NDT); methods of material testing, strength, stability and oscillation analysis; etc. To cite some examples: in Russia, transformers have to be tested at a temperature of -40°C , i.e. in conditions twice as cold as in Europe; according to Russian safety norms, 100% of joints have to be inspected by NDT methods, whereas there is no such need according to ASME in Europe due to different welding control methods. Therefore, even if a product is well-known throughout the world and recognized as safe in the EU or any other country, it may still be necessary to prove that it complies with Russian requirements in accordance with Russian methodology. The availability of some conformity certificates might facilitate the procedure of obtaining the appropriate Russian approvals, but these certificates alone would not be sufficient to bring the equipment across the Russian border and to commission the installation in Russia.

In view of the above, technical due diligence for the procurement phase focuses on performing an analysis of certification requirements for all project supplies so as to clearly formulate the terms of reference for subcontractors. This is particularly im-

portant if orders are to be placed with non-Russian manufacturers, which may face GOST R or Rostekhnadzor procedures for the first time. This analysis can identify methods for process optimization.

Thus, it is notable that a complex industrial installation or a complete plant (e.g. a gas turbine power station to be installed at an oilfield) requires one single Permit to Use if there is evidence that all of its components perform interconnected technological functions and that each of those components meets industrial safety requirements. Moreover, the plant cannot be commissioned unless the Permit to Use has been obtained for the entire installation. Still, quite often we face the situation where, due to the lack of coordination within the project team and also due to misunderstanding of Russian laws, each supplier of minor devices and components (e.g. rectification column, pressure vessels, valves) is obliged by the project contractor to obtain a Permit to Use for his device. Finally, when a permit for the entire plant needs to be obtained, the Industrial Safety Expertise process will be duplicated.

For measuring instruments that are components of the installation (e.g. pressure transmitters, temperature sensors, vibration detectors) so called Pattern Approval Certificates need to be obtained. These are issued by Rostekhnadzor based on the results of tests performed by accredited State Scientific Metrological Centers. To avoid excess testing expenditure during the approval procedure, a metrological assessment of the project should be performed and detailed process documentation should be generated. Such an assessment enables the investor to select the most rational and optimal range of measurement devices and methods. For example, instead of purchasing a measuring device that has never been used in Russia and therefore is not listed in the State Register, it may prove to be more cost-effective to choose a supplier which has already passed through this timely and costly procedure.

For electrical ex-proof equipment, the GOST R Ex-Proof Certificate of Conformity should be obtained. It is issued by certification bodies that are properly accredited by Rostekhnadzor. If the device has already been certified according to e.g. ATEX or CSA, the verification process to obtain a Russian Ex-Proof Certificate can be limited to the review of documentation without any additional laboratory testing. If a range of ex-proof devices is to be delivered for a specific project, all those devices could be grouped by application scope. Thereby only a single Ex-Proof Certificate could be issued for the entire group.

The purpose of the Federal Law on Technical Regulation passed in 2002 was to make technical legislation in Russia more consistent. It was initially planned that in 2010, when the transition should have been completed, that all mandatory requirements would be integrated into the so-called “tekhnicheskiye reglamenti” or technical regulations (the equivalent of European Directives), whereas standards, rules and other regulatory documents would be just recommended.

So far, eleven technical regulations have been adopted. In accordance with Governmental Decree № 445-p dated April 1, 2009, seventeen other technical regulations should come into force before January 1, 2010, including the following regulations that directly influence industrial investments:

- On safety of construction materials and devices;
- On safety of buildings;
- On safety of electric stations and networks;
- On safety of pressure equipment;
- On electromagnetic compatibility;
- On safety of personal protective equipment;
- On safety of chemical products;
- On safety of equipment burning gaseous fuel;
- On safety of equipment in potentially explosive environment.

In addition, seventeen more regulations have been under development and are to be considered by the Russian State Duma in the near future, including following:

- On safety of glass and glass products used in buildings;
- On safety of devices and systems used in production, storage, transportation and use of hydrogen
- On safety of high voltage electrical equipment;
- On safety of electrical installations.

Practically all technical regulations that have taken effect to date contain weaknesses already acknowledged by the Russian authorities. The bad news for investors is that most regulations have not made the conformity verification procedures easier, on the contrary, they make them more complex. For example, some regulations forbid a foreign legal entity from being the applicant for certification in Russia. In the new regulation on safety of machinery and equipment all certification procedures imply mandatory testing, even if a single product is supplied, whereas this was not previously necessary. Taking into consideration the changing regulatory environment, monitoring of the Russian certification requirements is advised throughout the project implementation to avoid discrepancies with effective laws.

When is it the right moment to review certification and permit issues with regard to project equipment?

Until recently, investors in Russia used to require Certificates and Permits to Use from their suppliers at the delivery stage. However, following Governmental Decree №87 dated 16.02.2008 modifications have been introduced to the content of capital investment project documentation that should be submitted for State Expert Examination. In particular, a new requirement concerning the availability of Certificates and Permits to Use was added allowing ambiguous interpretation. It is unclear whether this requirement applies to all process equipment used at an industrial facility or just for underground mining work. As a result, some of the non-mining projects submitted for Expert Examination in 2008 and 2009 received a negative Examination Conclusion due to the absence of GOST R Certificates of Conformity and Rostekhnadzor Permits to Use as part of the project documentation. In such circumstances, unless there are revisions in the text of the directive, certification due diligence is recommended for implementation at an earlier project stage.

Construction budget due diligence

When it comes to construction budgeting, a number of critical questions arise for an investor:

a) Is the estimate correct in terms of work volume, allocated resources and prices? Which proposal should be chosen as a result of the tender?

On the one hand, the estimate should not be over-valued so that the investor does not have to pay more than the project is worth. This is the case when some activities are budgeted although they are not supposed to be conducted since they are required neither by law, nor by technology.

On the other hand, the budget should not be under-valued so that real costs do not appear after start-up. Such situations occur when a contractor wishing to win a tender by cost criteria, budgets the cheapest materials or does not include some necessary work in the estimate. Sooner or later these hidden costs will show up, but it will be too late to change the contractor.

b) Do actual expenses comply with the approved budget? Are unforeseen expenditures justified?

Some deviations from the initially approved budget can arise in specific situations due to force-major or other reasons. However, the investor wants to be sure that the increase is really needed.

To answer the above questions, construction budget verification is to be conducted either at the stage of tender proposal evaluation or at the moment

of considering a budget increase request from the contractor and paying invoices. A documentary check and visual inspection of the site are required here. The judgment is usually based on comparison of the project data with best practices, taking into account similar jobs and market prices, as well as on the physical need for specific construction work and materials, versus design documentation and technical requirements. Timely and professional analysis of construction budget documentation may reduce costs allocated to construction work in Russia by up to 30%.

Construction performance due diligence

Throughout the project implementation, the following questions have to be answered to minimize the investor's risks related to quality, safety and the progress of construction:

a) Is the project progressing according to the schedule? What should be done to complete the project in time?

Work can stop unexpectedly due to equipment breakages, material shortages, a lack of labor force or documentation. Anticipation enables the project to move on in line with the established timeline.

b) Do work volumes comply with the approved designs and plans? Do actual resources (materials, equipment, manpower), methods, technologies and work quality correspond to standards and regulations?

Investors want to be sure that the investment realization conforms to the technical documentation and is in accordance with the construction permit. A typical example is when high quality materials have been budgeted, but the cheapest are actually used. To avoid a shutdown of operations in relation to quality or safety problems emerging after the building is commissioned, certainty about the quality of the building is required.

Technical due diligence focusing on construction performance verification includes on-site supervision, comparison of actual construction to the design, verification of the proper use of procedures and materials, technical inspection of the structure and supervision of (sub-)contractors, verification and acceptance of "hidden work". The installations (electrical, heating, air conditioning, etc.) of a building can also be subject to inspection and testing. Such audits are typically based on Russian construction industry standards (SNIps), design and other normative documents, product documentation (technical passports, certificates, test protocols) and benchmarking.

The critical issue when delivering construction performance due diligence is the supervisor's qualification. To control the building site he needs to be a professional in the construction business, well aware of construction processes and technologies, experienced and competent enough to make the construction team respect and treat him accordingly. He should also be able to not just identify a case of non-conformity, but give practical recommendations on what should be done in order to comply: changes in design, use of some technical solutions, organizational changes, etc.

HR due diligence

(Tim Carty, Partner, Human Capital, Ernst & Young, Moscow)



Tim Carty

Tim Carty is a Partner with Ernst & Young, one of the leading international professional services firms. He is one of two partners focusing on services in connection with personnel related matters in Russia, including individual taxation and other employee related taxes, immigration, compensation, performance management and Human Resource effectiveness. Since his arrival in Moscow in 1998, Tim has been involved in the HR Committee of the AEB, initially as a core group member, then as co-Chair from 2002, becoming Chair in 2003. The Committee has been one of the more active within the AEB, with regular meetings at a variety of levels from core group, through open meetings, sub-committees in compensation and benefits and recruitment, to an annual day long conference instituted under Tim's leadership.

It is often stated that not all mergers and acquisitions achieve the objectives set out for the transaction, and failure is most commonly put down to people issues. However, more often than not, the analysis of HR issues features as little more than a footnote in a due diligence exercise, and items such as "culture change" and "reworking the values" within an organisation are viewed more as a post transaction exercise for HR to co-ordinate rather than something that requires genuine viability analysis during due diligence. Clearly due diligence programs will (by force of painful experience) have a good look at pension and equity plan related liabilities, but beyond this and some brief evaluations of headcount and savings this can be "HR" done and dusted.

This approach is of course dangerous anywhere, but in Russia there are a number of additional pitfalls which should serve to bring HR matters under a greater level of scrutiny in a due diligence process. Making sure that a due diligence team can source a suitable range of professional expertise and experience in the HR area (often sat outside a formal transaction advisory group in many consultancies) is one element to be considered. The second is what the approach should be in HR related matters and it is to this issue that the remainder of this article is devoted.

Organisations conducting an HR due diligence should focus on the following areas:

Technical reviews

- Degree of technical compliance with obligations in terms of labour relations administration;
- Degree of technical compliance with obligations in terms of payroll and compensation payments;
- Degree of technical compliance with obligations in terms of payroll taxes;
- Degree of technical compliance with labour safety regulations.

Benchmark reviews

- Comparisons of compensation levels of staff in the target with market;
- Benchmarking of staffing levels compared to international norms, adjusted for the Russian environment;
- Analysis of effectiveness of HR policies and practices.

Cultural reviews

- Analysis of leadership and management structure;
- Analysis of metric data with regard to employee satisfaction, level of employee absenteeism and turnover;
- Analysis of effectiveness of trade union or similar activity.

Now this is a very wide ranging selection of topics, and it is entirely possible that not all of the areas will get covered, either due to time or financial constraints. Upon first glance, a reader might also think that they would dearly like to get this information, but be sceptical as to how. However, whilst it may be unfeasible to do a survey of how employees in a target organisation feel about their jobs, there are a number of methodologies that can be used to elicit a considerable degree of feel with regard to each of the above issues.

Technical reviews

This involves having someone go through, on a sample audit basis, the documentation in all these areas. Firstly, there should be an evaluation of how the target deals with contractual terms and conditions. Do these comply with labour law? Are policies which are

referred to in contracts actually in place? Are labour books properly maintained? How are terminations documented? What policies are there on performance management? Is a health & safety policy in place? In particular, scrutiny should be focused on terms and conditions of management in the target, as this tends to be where the most money is at stake, and where the most noise will result in the event of a dispute. The second step is to see whether the rules are actually being followed, even if they are documented correctly, by means of a process review. Is sickness properly reported? Is sickness pay accurately calculated? Are accidents properly reported, and the requisite funding obtained from the social fund? Are documents signed off on a timely basis by the persons authorised to make such sign offs? The third element is to examine payroll records to check whether taxes, social security and various other employer liabilities are being calculated and settled correctly.

The purpose of the technical review is primarily to establish risk in terms of liabilities that might be attached to a failure to comply in any of these areas. Russian labour law is not that restrictive in terms of the maximum payout for redundancy (five months for an ordinary employee, which is a lot less than in many western European jurisdictions). But the major problem is that a proven failure to comply means employees are reinstated and receive back pay. In organisations with significant turnover, or with significant internal movement, there may be many exposures with financial implications attached to them. Whilst disgruntled employees (or former employees) might not raise these with the existing owners, they may do so with new ones, and hence a good understanding of whether compliance is in order is required. Also, specific rules on termination exist for executives (with potentially very material notice period), thus the terms and conditions of their employment agreements should be carefully analysed.

Aside from the terms and conditions, another issue which typically gets on the HR due diligence agenda is vacation. It is not uncommon for employees not to use all of their annual vacation, and thus to carry large vacation balances. This in itself may create a significant liability for the company (in particular, if any redundancy is planned as a result of the transaction). But also, unless vacations are properly documented, employees may potentially claim that they have never had any vacation and request respective compensation upon employment termination.

Whilst much of this review can be done in a data room environment, the preference is obviously to dig a little deeper than this. Experience tends to show

that many Russian organisations actually handle this element of their HR work really very well indeed from a formal perspective. Rather it tends to be issues that do not go through the formal HR reporting that are the problem, and identifying these comes elsewhere in the process.

Benchmark reviews

This is where a review moves out of the technical area and into a more commercial analysis of the situation of the workforce at the target. Reviewing compensation levels against market tends to have two main objectives. On the one hand there is a need to identify whether the compensation levels at the target are appropriate or not. However, material levels of shortfall against market, particularly in executive positions, may be a good indicator that remuneration is being delivered through alternate structures which do not feature in payroll. This can help qualify both the risk assessment arising from the technical review (above) but also give a better feel for the size of the change exercise that may be needed to bring the culture in line with the purchaser's ethical standards. The most detailed compensation benchmarking should be focused on key positions, or indeed individuals.

It is also important to evaluate staffing levels to see whether assumptions in the financial modelling are accurate. But, if significant redundancy may be required, to understand the size and cost of the exercise and the potential resources that would have to be devoted to it. Each of these elements should be capable of delivering a feel of potential levels of financing that might be involved in the HR space going forward as a result of the transaction.

Another point for consideration is the effectiveness and efficiency of the HR function and the level of fit of the HR policies and practices of the target to international standards and the local market.

In Russia, of course, there is a problem with availability of data, both in terms of the level of compensation in any given market, but also with regard to appropriate staffing levels. This situation is improving, particularly in Moscow, with four or five professional level surveys available, each with their own good and bad points, but data in more remote locations remains sparse and closely guarded.

Cultural reviews

This is perhaps the most difficult area in which to try to produce any degree of accurate financial output in terms of risk or potential necessary expenditure,

but is also cited by many organisations as being the most important in terms of plans for post transaction activity. First, this involves identification of the main resources of the target. Who are the key personnel, and what is the impact of the transaction on the ability to retain them? Identification of those employees such as senior executives, key relationship holders, key knowledge/skill holders, key roles, top performers, etc. whose retention is likely to be key to the transaction itself, or the future success of the business. Obviously, it is quite difficult to work out who the key players are through a data room review, aside from a summary of the organizational structure, reporting lines, job descriptions, etc. The key findings in this area typically come out of the structured interviews, which allow a lot of people related issues that may have a significant impact on the transaction to be revealed.

Clearly it is also important to determine employee attitude to the target, but direct solicitation of this will be tricky. There are metrics that should be available however, including turnover statistics, sickness and other absentee levels, timing of returns from maternity leave, numbers of accidents; all of which give a feel of the attitude. The role of the unions should also be examined, together with the results of and reason for any formal employee disputes in recent years. Outside the target itself, there should be at least some attempt made to determine the state of the local market, including the likelihood that staff may rapidly find alternative work.

Beyond these items, which can be addressed in a due diligence situation, there is a host of other types of cultural analysis, particularly in terms of skills evaluations, competency reviews, and performance which are vital to any change exercise but are much more difficult to do prior to a transaction. However, even at the due diligence stage the purchaser may be able to sense what the main areas of focus in the post transaction stage will be.

Occasionally organisations can get scared of the complexity of dealing with HR related matters in a due diligence in Russia, and it is all too easy to simply state that the area is of limited materiality in making investment decisions. However, the degree of potential risk in the personnel area can be considerable, the degree and variance of financial effort also significant, and the ultimate success of the transaction will be substantially dependent upon getting the people aspects right. Whilst far from perfect, it is increasingly possible to more easily quantify some of these risks and costs, and HR is likely to feature more and more often as an important element of any properly structured due diligence in this country.

Environmental, Social and Health & Safety (EHSS) Due Diligence in Russia (Valery Kucherov, Head of the Performance & Assurance Services, ERM Eurasia, Elena Amirkhanova, Head of Impact Assessment and Planning Services, ERM Eurasia)



Valery Kucherov

Valery Kucherov is the Head of Performance & Assurance Services of ERM Eurasia and Principal Consultant/Project Manager in the Moscow office, with experience in managing and implementing Environmental, Health and Safety and Social

Management Systems (EHSS MS) projects and EHSS Due Diligence projects in accordance with international and Russian requirements, as well as other complex assignments across different industries (oil & gas, manufacturing, power etc.).

Mr Kucherov has recognized international experience in implementation of multiple EHSS projects for large multinational clients. Valery is also a recognized expert in implementation of projects for international development agencies (USAID, EBRD, IFC).

As a Certified Trainer/Lead Auditor in Environmental Management Systems he has conducted relevant training courses for a large number of Russian and international companies.

Valery graduated from the Lomonosov Moscow State University and prior to joining ERM he worked in the Ministry of Foreign Affairs of the Russian Federation and joint projects of the MSU and the Federal Agency of Atomic Energy in the field of management of radioactive waste.

Valery is a current member of different international professional and business associations, including the International Register of Certificated Auditors (IRCA) of the Chartered Quality Institute (UK) and the Association of European Businesses (AEB) in Russia.

Issue

The results of multiple M&A deals conducted in the last 15 years in Russia show that transactions undertaken by international and domestic companies have frequently resulted in a number of environmental and social liabilities, mainly due to the fact that companies contemplating deals tend to ignore environmental and social issues as they do not consider them material.

This article focuses on typical environmental, health & safety and social challenges, which may



Elena Amirkhanova

Elena Amirkhanova is the Head of Impact Assessment and Planning Services in ERM Eurasia and Principal Consultant/Project Manager in the Moscow office, with experience in managing and implementing environmental and social assess-

ments and stakeholder engagement procedures, as well as Environmental, Health and Safety and Social Due Diligence (EHSS DD) projects in accordance with international and Russian requirements. Elena has managed and implemented projects for international financial institutions (EBRD, IFC, EIB etc.) and multinational companies in different industries (metals, mining, infrastructure etc.).

Elena graduated from the Lomonosov Moscow State University and prior to joining ERM she worked for UNDP, the Ministry of Natural Resources of the Russian Federation and Trans-Siberian Gold Management. Elena is Social Systems Auditor/Lead Auditor in Social Accountability SA 8000, she has also successfully completed a training course on IFC/World Bank Environmental and Social Performance Standards executed by the IFC Department of Environment and Social Development in Moscow, Russia.

represent a material or reputational risk to the deal or in the course of the on-going operations of a company in Russia and can be identified as the result of Environmental, Social and Health & Safety (EHSS) Due Diligence.

Challenges

The key challenges in the course of EHSS Due Diligence are as follows:

- Specific permitting issues,
- Requirements in relation to sanitary protection zones around industrial facilities and associated potential liabilities in relation to resettlement,
- Historical soil & groundwater contamination,
- Use of asbestos-containing materials,
- Key operational health & safety issues,
- Fire safety,

- Health & safety culture,
- Social issues,
- Community and public relations,
- Supply chain issues,
- Energy efficiency.

Permitting issues

All production facilities in Russia are subject to environmental permitting and require authorization /licenses, regardless of their size or their nature. However, there are no integrated environmental permitting regulations in Russia. When obtaining permits for air emissions, wastewater discharge, waste disposal, each type of impact on environmental media (air, water, soil) is reviewed and considered separately by the authorities (there is no integrated pollution prevention control). In the case of any process or engineering alterations the permits and supporting documentation shall be revised by the authorized bodies, taking into account the modifications made. Non-compliance with modifications to permit conditions may result in administrative fines and the closure of the plant for up to 90 days, which may entail material costs for the business.

It should also be noted that Russian sanitary and hygienic requirements in relation to the quality of the environment (emissions, discharges, noise levels, etc.) are, in many cases, more stringent than standards applied by the World Health Organization.

Sanitary protection zones

Sanitary protection zones (SPZs) are required for facilities which emit pollutants into the atmosphere or have other environmental impacts. An SPZ is a physical barrier between the site (a plant) and surrounding residential areas, in order to protect the population from the impact of industrial hazards (noise, dust, emissions). The size of the SPZ depends on the type of operations and is determined on the basis of relevant sanitary rules and norms. The main conditions determining an emission rating in the Russian Federation is the compliance with air quality and noise level requirements at the boundary of the SPZ. It is prohibited for residential areas, recreational zones, schools, hospitals or food production facilities to be located within the boundaries of an SPZ of an industrial enterprise. Based on extensive experience of international companies in Russia, if an industrial site is acquired with a significant number of sensitive receptors (e.g. residential areas, summer houses, schools, hospitals, food industries) within the SPZ, there is a risk that the future owner may become liable for re-settlement of residents from within the SPZ area.

Historical soil & groundwater contamination

According to article 14 of the Land Code of the Russian Federation, liabilities for soil contamination are to be borne by the polluter, and he should make the necessary compensation payments. There is currently a gap in legislation concerning the transfer of environmental liabilities during the purchase of land, and in the case of any legal proceedings it could be hard for the new owner to prove that soil contamination was not caused by him. It should also be noted that according to the Russian Law “On Mineral Resources” the groundwater underneath any site is state property, so there is a risk that fines and enforcement letters from regulatory authorities for groundwater clean-up could be imposed upon the site owner for damage of state property.

Asbestos-containing materials

The use of asbestos-containing materials (ACMs) is not prohibited in Russia. ACMs should be appropriately handled as hazardous waste (ACMs are classified under Hazard Class 4, with Class 1 being the most hazardous) during dismantling operations. There are no legal requirements obliging companies to undertake asbestos surveys, keep records of ACMs or remove them from the site. In accordance with international environmental law and the corporate standards of multinational companies, the use of asbestos in construction materials and/or equipment is restricted and this may result in material costs related to removing asbestos or even dismantling asbestos-containing buildings.

Key operational health & safety issues

The most severe operational health & safety issues are usually related to the exposure of workers to inadequate levels of physical factors such as noise, vibration, fumes, and lighting, primarily due to the use of old or inappropriate equipment. This also leads to frequent breakdowns and the necessity to perform manual operations, therefore increasing operator risk and the likelihood of operator error. These issues usually result from the lack of management and leadership strategies in industrial companies in relation to the achievement of health & safety goals, low investment in ageing plants and reduction of financial resources spent on safety in the course of the economic recession. The cost of mitigation of health & safety risks may result in significant expenditures for the site owner due to the necessity to invest in engineering solutions and development of specific

management systems aimed at risk assessment and implementation of modern control measures.

Fire safety

Enforcement of fire safety standards is notoriously lax in Russia and has been blamed for fatal fires at various public places, such as orphanages, hospitals, nursing homes and night clubs. The consideration of fire safety issues during the due diligence process may help to identify foreseeable fire risks, including those which require considerable investment (purchase of sprinkler systems, reconstruction of buildings, installation of fire-proof walls and doors, allocation of emergency response resources).

Health & safety culture

The existing health & safety culture can be challenging for the purchaser of an operating industrial facility and entail additional expenses related to integration of the new asset and mitigation of risks to reputation. In the course of the due diligence the health & safety culture can be assessed through diagnostic interviews with focus groups of workers, operators, supervisors, contractors and senior managers in order to identify key risks in relation to leadership, planning, effectiveness of the operation's management systems, health & safety performance and motivation. Based on ERM's experience the high level of risk tolerance in Russia is leading to blindness to hazards and a 'heroic' worker culture, which could undermine attempts to prioritise safe production. Another problem is the lack of H&S training and competence among line management, which results in the failure to ensure that workers are put to work safely in a manner that enables them to understand and manage risks.

Social performance

Historically social issues were not considered as key in the course of the due diligence process. The situation started changing with identification and increase of awareness about the potential severity of reputational risks, especially for large-scale multinational companies operating in the global arena. The following issues are assessed in the course of the due diligence: working conditions, discrimination, freedom of association, accommodation for workers, relationships with local communities, community dependence on the energy resources provided by the industrial facility (hot water, electricity etc.), grievance procedures for the public and employees, impact on indigenous groups (if applicable), and NGO rela-

tions. Due to the lack of an established approach for the assessment of social performance in Russia and absence of established legislative requirements the standards of the International Finance Corporation and requirements of the international standard Social Accountability 8000 are applied as common practice.

Community and public relations

It is quite common in Russia for industrial facilities to continue to be town-forming enterprises providing water, electricity, heating, housing, gas and/or medical infrastructure to the local community, which creates additional liabilities and requires special attention due to the sensitivity of the issues. A timely assessment of such issues helps the investor or the owner of an industrial facility to identify and quantitatively assess the cost of obligations and measures required to mitigate reputational risks.

Supply chain

Another big risk is associated with the supply chain and other contractors used by the site. Frequently in Russia attention is not given to the EHSS practices of contractors and suppliers since they are separate legal entities. However, they could cause significant delays in the production process, damage the reputation of their customers and affect the safety performance of the site.

Energy efficiency

According to publicly available information, the energy intensity of Russia's economy is three times higher than that of EU countries. Although climatic conditions are an important contributor to this, the key reasons are the high share of energy intensive industries and the substantial amount of outdated energy equipment. Assessment of energy efficiency issues during environmental due diligence may help to identify opportunities for further implementation of energy efficiency projects (particularly the upgrade of equipment) and reduction of energy consumption.

Recommendations

The cost for mitigation of the aforementioned environmental, health & safety and social risks may significantly impact the deal value. Such risks can be identified and handled in a timely manner as a result of EHSS Due Diligence. Based on the results of the EHSS DD, the investor may quantify the financial impact of EHSS risks and create a "safe harbor" by agreeing liability thresholds in the purchase/rental agreement.

Information Technology (IT) Due Diligence in Russia

(Mike Smith, Director, PricewaterhouseCoopers)



Mike Smith

Mike is a Director in the Advisory practice, leading the Regional Technology Due Diligence practice in Eastern Europe and the Moscow Technology Consulting team.

He has more than 20 years of experience in information technology and, until the end of 2008, spent nine years as a London-based specialist resource leading over 300 technology due diligence assignments in over 30 countries including Russia, Poland, Ukraine, Kazakhstan, Slovenia, Macedonia, Estonia, most Western European countries, the Americas, Africa, the Middle East, the Far East and Australia. Mike has helped over 30 companies list on the London Stock Exchanges (including the South African Investec Bank and Kazakhmys).

Prior to working for Big 4 Firms, Mike worked in a major British bank (Standard Chartered) with responsibility for leading IT audits in Africa and the UK. He also spent over 10 years working as an IT auditor for UK government organizations.

Mike is a Fellow of the Chartered Institute of Certified Accountants.

Introduction

Historically, the majority of mergers and acquisitions in Russia have recognized the risks associated with the financial and tax positions of a target not being stated correctly and accordingly been preceded by financial and tax due diligence, but other forms of due diligence that might be considered as the norm for an acquisition in some other territories have typically been performed on an exceptions basis.

In Western Europe, the presumption for due diligence for many transactions would be that an assessment of the core (IT) would be a standard part of the scope. In Russia, an assessment of the ability of IT to meet the requirements of the business pre and post transaction has more often than not, been largely ignored.

Why is an assessment of IT important?

IT is seen by many as a support function, one which rarely is considered in business unless it goes wrong

in a very obvious manner. When working well, IT can, for example:

- support the delivery of business strategy
- provide competitive advantage
- enhance the quality of decision making by senior managers
- enhance customer experience
- result in operational efficiencies
- improve business processes via the use of technology
- facilitate legal and regulatory compliance
- protect commercially sensitive information.

Just as the majority of Western European companies are highly dependent on IT to support key business processes, many Russian companies that will be the subject of mergers and acquisitions will also rely very extensively on IT. In Russia, the standards to which IT systems are managed and the extent to which they have the required functionality can vary from company to company, but investors may be surprised to find that:

- IT is not always represented at Board level, so on occasions, modest IT investments that could help to improve company performance are typically not considered by the Board, nor are the Board members aware of the potential improvement opportunity. One recent project involved a utilities company with a clear strategy of controlling internal costs in order to improve margins. IT team members were aware of different IT systems that could have provided senior management with detailed information concerning the company's internal costs that would have provided the opportunity to manage these costs more effectively, but did not believe that expenditure on new systems would be approved. As a result, the Board was not made aware of the potential investment opportunity that could have significantly improved margins.
- IT strategy is sometimes not aligned to business strategy and may even be contrary to the strategic objectives of the organization. IT teams comprising highly experienced personnel that are technically strong but that are not engaged by senior management will sometimes create and deliver their own plans for enhancing parts of the IT environment that have no long-term future in the organization.
- Some IT teams are not consulted by senior management when new IT systems are acquired, leaving them in the unenviable position of integrating

solutions (sometimes that are inconsistent with the current IT landscape and that may struggle to deliver claimed benefits). A Russian mining company we looked at on behalf of a western investor had instructed its small internal IT team to implement an Enterprise Resource Planning (ERP) solution without any external support, within a time-frame that was clearly unachievable even for the most experienced systems implementers who would have a significant number of expert resources at their disposal.

- The approach to managing and controlling the IT environment (including information security and business resumption planning) is frequently inconsistent with standards in operation in Western Europe. On occasions, even the most basic levels of expected controls are not in place (for example the use of password and other logical access controls to restrict access to sensitive information, the ability to recover essential systems and data in the event of hardware failure), potentially exposing the company to the significant reputational and financial loss that could follow a breakdown of controls.
- Management information at the level of granularity expected for a similar Western European company may not be available. The historical position within some companies in Russia is that as long as revenues are increasing, there is no real need to understand profitability of certain products or locations in order to maximize revenues or minimize costs. Additionally, it is not uncommon for the opportunity to capture data on existing customers in order to offer them additional goods or services to have never been exploited.
- The financial reporting process may be a time-consuming and inefficient process. This may not be a major issue in a cash-rich business but it becomes increasingly important as cost pressures increase, and perhaps as banks providing finance seek timely updates on a company's financial position.
- Cost-cutting in response to the current economic crisis may be of an arbitrary nature for the IT function, partly as a result of the low-level of prominence of information technology within the business. Such arbitrary reductions in cost are unlikely to be the most appropriate decisions for a company that relies on IT and for which IT requirements may have changed substantially over the past 12–18 months, with substantial growth being replaced with the realities of the current economic climate.
- A 'flexible' approach may be adopted towards the use of unlicensed software. Some Western companies have found, to their cost, that use of

unlicensed software can be an extremely expensive issue to resolve with software houses. One US-based client had a multi-million dollar 'out of court' settlement with a software house following the discovery of unlicensed systems in use in South America. The use of unlicensed software in Russia remains a 'hot topic' and is one that leads to financial exposure for an investor.

- On occasion, senior members of staff have a totally unrealistic perception of the role of IT within their organization. During a recent transaction, the person responsible for managing corporate risk stated that IT was not a risk issue as his business could operate without any information systems. Aside from the obvious issues of trying to obtain management and financial information without the underlying computer systems (this company, of course, had IT systems providing this functionality), a significant part of the company's revenues were generated from billing a large number of customers on a monthly basis. Monthly billing without the underlying billing computer systems and accurate billing information would have been a significant challenge. The individual concerned was confusing his organisation's ability to cope with the short term absence of IT systems with the business impact of total, long term loss of such systems.

Resolving issues such as those listed above will require investment. Some investors will always take the view that allocating a sufficient amount of money for IT should solve any problems, and as a result, an assessment of IT pre-transaction is not important. However, this can be without basis as there are situations in which no amount of resource can resolve issues before significant financial or reputation damage results (for example an events management company that was the subject of a transaction relied entirely on an in-house developed solution that took a sizeable team years to develop. No commercial alternative was available and to rebuild the system, should the need arise, would have taken many months, or even years, during which the enterprise would have struggled to operate). Other investors would prefer to have advance warning of major issues, of recommended remedial action, and of associated costs in advance of deal completion and in particular so that investment requirements can be reflected in cost forecasts and price negotiations.

The current economic climate

Predictably, the current economic climate has had an impact on both the requirements of core IT systems, and the manner in which they are managed

and controlled. Pre-crisis, many companies enjoyed healthy revenue flows and so did not pay significant attention to areas such as costs of providing IT services or the need for management information at the level of granularity that would facilitate a detailed assessment of performance at a business unit level. For many IT departments, the impact of the crisis included suspension of all IT projects, a freeze on all IT investments and headcount reductions as cost-saving measures. Some of these measures cannot be sustainable in the medium to long term, but it appears that few IT departments have been subject to an assessment of the IT systems and underlying IT organisation that is required to support the post-crisis business environment.

What does IT due diligence typically focus on?

IT due diligence means different things to different people. At one end of the scale, it is entirely reasonable to expect that the Chief Information Officer (CIO) of an acquiring business may want as much information as possible about the target IT environment for which he or she will soon be responsible. As the CIO will, in all probability, have overall responsibility for IT operations in the target from day one post-transaction, information requirements could include:

- a detailed analysis of all the computer hardware in place (including desktop and laptop computers, servers, network equipment, printers etc.)
- preparation of an inventory of all software in use (which for many organizations can include many hundreds of different software packages and tools, few of which would be considered as vital for the continued operation of the business in the short term)
- an understanding of all the IT processes and procedures in use
- detail on the network protocols and password standards in use
- identification and comprehensive review of all software licenses in use and all IT-related contracts
- understanding whether all personal computers have had USB ports disabled to prevent the use of unauthorized memory sticks
- a detailed understanding of the background, skills, experience and contract conditions of every member of the IT team
- understanding the standards for labeling cables, ports, hardware etc.

At the other end of the spectrum, many deal teams have the equally reasonable expectation that technology due diligence will be designed to assess the commercial impact of information technology

on the transaction by answering a small number of important questions such as:

- ‘what were the business drivers leading to the selection of the current IT systems?’
- ‘what are the core IT systems that support key business processes?’
- ‘what shortcomings exist within the IT environment, and what is the commercial impact of these shortcomings?’
- ‘how scalable / sustainable is the current IT environment?’
- ‘is the current IT team capable of maintaining an IT environment in the manner required by the acquiring business, and its regulators?’
- ‘what needs to be fixed or changed, and what are the one-off and recurring costs of delivering this change? Furthermore, does the current IT team have the expertise and resource to implement such change within acceptable timeframes, or will additional resource be required for the duration of any change projects?’
- ‘what changes to the IT environment could result in financial upsides, and what are the costs / likely upsides in doing so?’ This could include IT-related changes (for example consolidation of data centres, outsourcing or renegotiating the costs of external services etc.) or using IT to enhance business processes.
- ‘how relevant are current IT projects for the post-transaction business environment? Will they deliver anticipated benefits on time and within budget?’
- ‘what are the major barriers / enablers to achieving IT separation or integration? How robust are the plans for delivering separation / integration? How robust are the associated cost estimates?’

Whilst the former could take literally months to complete and may not result in the production of information on a timely enough basis to impact the transaction, the latter should typically be completed over a much shorter period of time. If performed well, the technology due diligence will provide the deal team with valuable information that can provide assurance, identify one off and recurring costs that may impact pricing and that can influence negotiations.

In addition, the due diligence exercise should identify the technology issues that need to be addressed post-transaction and, if required, can provide the foundation for separation or integration activities via an assessment of the proposed approach, a review of the robustness of the cost estimates and who will be responsible for bearing these.

Occasionally, there can be the expectation that the technology due diligence will require little more than a conference call or two, but understanding

from the seller of a business whether systems are as good as claimed takes a while to substantiate. This is typically achieved through a combination of interviews, observation of systems and processes in operation, review and analysis of supporting information such as the number and nature of helpdesk calls etc. Therefore, the greatest value for the deal teams is often obtained following a period of access to the target company's business and IT management via face to face meetings, with the opportunity to observe key systems in operation. Experienced transaction practitioners will know that no form of due diligence is an exercise in dictation.

Conclusion

It will always be the prerogative of investors to take risks when considering acquisitions. Whatever level of due diligence is performed, and whatever legal safeguards are in place to protect the investor there will always be a degree of risk. In the current economic climate it may be tempting for investors to reduce deal support costs by deciding not to assess the IT environment. Or to use internal IT personnel who may or may not have the time, the expertise, the language skills or sufficient familiarity with the Russian IT environment to be able to perform a commercial assessment of technology. However, a wise investor will take an informed decision relating to the level of risk arising from failing to assess IT prior to investment.

ISSUES DURING AN ACQUISITION

Structuring a transaction on the acquisition of a Russian business

(Irina Suvorova, KPMG Partner, M&A Tax)



Irina Suvorova

Irina Suvorova specialises in investigations of tax issues in potential acquisitions, review of tax elements and modeling of tax charges in financial projections, transaction planning and structuring. Irina has

lead a large number of vendor due diligence and vendor assistance projects, including major projects in the industrial markets area. Irina's experience includes the review of the tax element of working capital for Lukoil's London listing, assistance with the preparation of working capital models for oil and gas companies, including comparison of tax charges under the PSA regime and general tax regime in Russia. Irina graduated from the Moscow Institute of Steel and Alloys and the Financial Academy (taxes and taxation). She is also a certified translator (Moscow State Linguistic University). Irina is a Certified Public Accountant in the State of Oregon and a Russian Certified Auditor (RAP general audit).

2009 saw an overall decline in M&A activity in Russia. However, Russia remains strategically attractive to foreign investors, as it offers a large local market with as yet low penetration. Despite the unfavorable global market conditions, many foreign investors have a long-term strategic interest in Russia and the current environment may provide a unique opportunity to acquire a local company at a reasonable price.

The main characteristics of transactions have changed significantly as a result of the economic crisis. Sales processes generally involve a much lower number of buyers, with multi-stage auctions being replaced by a single-phase process. The key objective for many sellers is to close a transaction at a reasonable price, while buyers tend to be much more selective. Potential sellers are only entering the market if there is an urgency to sell and they cannot wait for better times and valuations. What was a seller's market two years ago, has fundamentally changed to a buyer's market.

Market prices are currently very difficult to predict. This has resulted from the decrease in the

number of transactions – which reduces the reliability of average prices. There have also been a large number of transactions with troubled assets and transactions aimed at strengthening market position (e.g., by taking over competitors and/or effective market players), prices for which could be below the expected future earnings from the acquired businesses.

Business valuations, which declined during the dramatic fall in stock indexes in 2008, are unlikely to recover immediately despite the positive trends demonstrated by the stock market in 2009. As the global financial and economic crisis wears on, many companies are still struggling. Due to profitability pressures and tight financing conditions, cash remains scarce.

The current high level of uncertainty about the future economic development, the increase in risk adversity, and the lack of funding have resulted in a gap in valuation expectations between buyers and sellers. This, in our opinion, is the major factor which is currently causing the freeze in the M&A market. Consequently, investors are likely to follow behavioral patterns formed during the crisis when establishing deal conditions.

This article addresses some of the obstacles that foreign investors face when acquiring a Russian business and the corresponding solutions.

Pre-deal issues

Operational transparency and effectiveness, and the ability of the Russian target company to adapt to a changing environment have become some of the key factors affecting acquisition decisions.

As in previous years, the lack of reliable financial information and the tax minimisation schemes used by Russian companies (predominantly small- and medium-sized ones) may be considered as the two main problem areas. They can even be deal breakers for foreign investors considering an acquisition in Russia.

Foreign investors can compensate for such risks either by involving an independent guarantor (for example, an investment bank) or proposing transaction structures that mitigate such risks and envisage post deal adjustments to the transaction price based on the performance of the Russian target company.

Valuations and financial modeling

Starting from 2008, many transactions have been negotiated and signed within tough timeframes with very broad financial and tax risk assessment. This can entail an inability to properly restructure the business prior to the acquisition.

Therefore, it is important for foreign investors to be able to navigate in a turbulent environment in order to obtain an adequate understanding of the fair value of the Russian target company and to be able to negotiate a good price.

Currently the reliability of business valuations has significantly deteriorated due to a lack of information on comparable prices and asset fair values, as well as reliable cash flow forecasts required to estimate the present value of cash generating items. In this situation, it may be necessary to revise discounting rates and other assumptions upon which cash flow forecasts are based. This could mean that projections should be made for a longer period in order to account for the crisis, the recession and possible subsequent growth.

Uncertainty in relation to market trends could result in management lacking a clear business strategy. Consequently, foreign investors have started to demonstrate increasing interest in the financial and operational forecasts of Russian target companies. Although such forecasts cannot provide foreign investors with guarantees, they can give an indication of whether or not management has a clear vision of its company's future business development and top priorities.

Furthermore, forecasts can provide the insight into the Russian target's operations needed to take a decision on whether the sales price of the business is appropriate.

Financing

Attracting bank financing has become problematic for the majority of investors, as banks have become more cautious in their lending activities and financing terms have become less favorable for potential borrowers. Therefore, investors tend to use internal resources to finance transactions, typically through inter-group loans or equity contributions.

If a transaction is to be financed through intra-group loans, the Russian borrower could face additional profits tax charges due to its inability to deduct interest expenses for profits tax purposes, as well as additional withholding taxes due to the application of Russian thin capitalisation rules.

To mitigate tax risks and extra costs relating to Russian thin capitalisation rules, intra-group bor-

rowings should be structured so as to maximise the deductibility of interest expenses by the Russian borrower. This can be rather complicated in practice and requires a careful analysis and consideration of the facts and circumstances of the transaction.

Financing through an equity contribution does not have negative tax consequences in Russia. However, this financing option is not possible where the Russian target company is in a negative net assets position, as current legislation prohibits a share capital increase in this situation. The business community has been lobbying for the respective changes to civil legislation and the amendments are expected to be made in 2010.

Before the crisis the seller and the buyer would agree on the settlement of debts of the Russian target company as a condition precedent to the transaction: currently debt refinancing is typically performed by the buyer post deal. Therefore, foreign investors now need to raise funds not only to finance the deal itself, but also to settle or refinance existing debts of the acquired Russian company.

Acquisition through a share deal

Share deals, accounting for the major part of the Russian M&A market, have new features today. Buyers tend to be in a stronger position than sellers and transactions are being structured so as to meet the demands of the former.

Abandoning complex structures

Where a business has a complex structure with multiple cross shareholdings, foreign investors normally insist on carving out only the part of the structure they are interested in (excluding dormant and redundant companies, as well as non-core business segments). In doing this buyers consider how much of the redundant structure can be left behind, ensuring that such companies are not the actual asset owners, brand holders or could otherwise significantly influence the business.

Generally Russian businesses with complex or non-transparent legal and operational structures are unlikely to be a desirable target, as carving out the targeted segment could require a significant amount of time (and cost). Furthermore, a foreign investor may abandon the acquisition if the Russian target company's related companies have questionable reputations and non-transparent business structures.

To overcome such obstacles, the business could be transferred to a new entity which is free from his-

torical risks and then the buyer can purchase shares in the new entity. This transaction structure helps to mitigate, although does not fully eliminate the buyer's exposure to historical risks. However, it requires administrative work as well as the buyer's involvement in monitoring the process of establishment of the new company and the transfer of the assets.

Choice of the proper holding company

Russian sellers frequently still expect a low value transaction to be reported within Russia, with the balance of the purchase price (often the majority) to be settled offshore. This may be achieved by an acquisition via a foreign holding company, which allows the seller to realise the gain outside Russia and could also be beneficial for the buyer as an alternative to off-balance sheet or black cash payments for the business.

It is generally easier to manage an offshore holding company than a Russian one; administrative costs and effort required, in particular, can be significantly reduced. However, antimonopoly requirements must still be considered when performing offshore transactions.

Structures involving a Russian holding company could be inefficient from a tax standpoint where the business model presumes profit flows out of Russia as dividends. The tax cost of dividends paid through a Russian group structure is quite high (dividends are paid out of post-tax profits (after 20% profits tax), less 9% withholding tax, less further withholding tax upon payment offshore). Recently an exemption from the 9% withholding tax was introduced for large investments (over RUR500 million) by companies incorporated in countries other than offshore jurisdictions with a holding period exceeding one year. Therefore, currently only a few investors are entitled to this exemption.

In addition, due to the absence of tax consolidation in Russia, the recharging of costs by a Russian holding company to its subsidiaries often makes deductibility problematic and results in lost VAT for recovery at the level of the subsidiaries. These risks can be managed if planned properly, but a significant tax risk remains for the Russian subsidiaries.

It should be noted that tax risks relating to subsidiaries could be up-streamed (shifted) by the tax authorities to the level of the Russian holding company. In particular, under the unjustified tax benefit doctrine, the holding company could be subject to tax liabilities which originated from operations with and decisions obligatory for its subsidiaries, which were aimed exclusively at gaining unjustified tax benefits.

The above disadvantages of Russian holdings could be mitigated by establishing consolidated and vertically integrated structures. For example, a merger of a Russian holding company with its subsidiaries could reduce administrative costs and mitigate the risks resulting from related party transactions.

Cleaning up the target's balance sheet

Prior to the crisis, equity investors seldom questioned the balance sheets of target companies; today the analysis of major balance sheet items and working capital components is common practice.

In particular, where a foreign investor is planning to acquire a distressed asset, it is advisable that certain procedures aimed at cleaning up the balance sheet of the Russian target company be performed prior to the deal.

This can be achieved by writing off impaired assets and bad debts, offsetting payables and receivables (to the extent possible), claiming refunds of reported tax assets and disposing of all items not required for the planned business. In this case the buyer receives assurance that it is paying only for those items which are required to run the business and will not incur excessive costs, including tax costs, when performing the clean-up process post deal.

Furthermore, cleaning up the balance sheet can be useful for establishing the fair value, and consequently, the sales price of the business. In this regard, the cleaning up of the balance sheet can be viewed as an essential part of the pre-sale preparation of the Russian target company.

Acquisition in the form of an asset deal

Currently the market is demonstrating increasing interest towards asset deals, where companies which are unsuccessful in debt restructuring may be forced to sell a significant part or even all of their assets. Even those companies which are successful may have to sell non-core assets as part of the restructuring. Foreign investors may be interested in acquisitions while prices are relatively low; however, they could be unwilling to assume the historical and current business risk attributable to Russian asset holders and, therefore, may prefer an asset deal to a share deal.

Asset deals appear more attractive to the buyer as potential claims and historical liabilities (including tax) may be left behind with the former owners (subject to certain limitations). For the same reason, asset deals are often less favorable for the seller.

Identifying transferable risks

The buyer should be aware of the tax and business risks which could transfer with an asset. Such risks could lead to the impairment of the asset's value through the generation of significant cash outflows, or the impossibility to use it as intended, for example where the state authorities are successful in confiscating the asset.

The tax authorities can seek to confiscate assets from a buyer in order to settle the seller's tax liabilities, where the seller is not able to settle its tax liabilities with its remaining assets. The customs authorities can also attempt to confiscate the asset from the buyer, if the historic asset holder has deliberately underpaid customs duties with regards to the asset.

In addition, if the parties agree to the sale of all assets of a Russian company, the tax authorities could treat this transaction as the sale of a property complex and, in extreme cases, insist on the full inheritance of tax liabilities by the buyer.

Allocating sales price

Like a share deal, an asset deal could be structured through the establishment of a new company by the seller and the transfer of the target assets to such a company, typically through a sale with a minimal mark-up. Shares in the new company are then sold to the buyer at the fair market price less the mark-up reported in Russia.

This structure is commonly applied as it allows the main portion of the sales price to be paid offshore, where the new company is owned by a foreign holding company (this is driven by the seller's preference to report profits outside Russia). However, reporting part of the transaction value outside Russia (as a consideration for the shares of a newly established company) is unfavorable for the buyer as it means that the acquired assets are undervalued in the tax books of the new company and, therefore, the buyer loses the part of the profits tax deductions in Russia which correspond to the undervaluation of assets.

Non-cash acquisitions

With the start of the crisis, the M&A market demonstrated increasing interest in non-cash acquisitions, such as share exchanges without cash settlements (on a pure equity swap basis) and conversion (restructuring) of debts in exchange for shares.

These transactions could represent strategic mergers aimed at obtaining a better competitive position, as well as the consolidation of small- and

medium-sized companies which are not able to survive in the current business environment. As a result, larger players are likely to benefit from consolidation by acquiring assets at favorable prices and taking over the client base.

It should be noted that mergers entail direct inheritance by the survivor of the merged companies' historical liabilities. Therefore, it is important to envisage proper guarantees for such liabilities from the shareholders of the merged company. It is also desirable to actively involve the merged companies' top management, which have relevant knowledge of past operations and can retain communication channels (including with the state authorities) when trouble shooting and facilitating the integration process.

Certain types of non-cash acquisitions are virtually unknown in the Russian market, and foreign investors could face legal and technical difficulties when structuring an acquisition in Russia this way. For example, unlike in many European countries, in Russia it is not permitted to directly convert debt into equity. The business community is currently lobbying for the necessary changes to be introduced into Russian legislation; however, the state authorities have yet to make a clear statement on these changes.

To overcome such weaknesses in current legislation, non-cash acquisitions could be executed outside Russia at the level of a foreign holding company which would own the Russian target company, where legislation allows for direct debt to equity conversions.

Post acquisition issues

After the deal is signed, a number of issues could arise, significantly reducing the effect from the transaction expected by the buyer. To avoid such situations the buyer should focus on the key business aspects of the acquired Russian company immediately after the deal.

Refinancing and restructuring

As soon as the Russian company is acquired, the foreign investor should work out a robust business plan aimed at stabilising the business and ensuring its subsequent growth.

Currently, restructuring is predominantly viewed as a number of measures aimed at increasing business effectiveness (in particular, by focusing on core activities), improving management efficiency and financial results.

One area where immediate action could be needed is debt restructuring (refinancing), allowing the acquired Russian company pay off existing

and new obligations in a timely manner and raise the capital needed for its strategic development.

Financial improvement programmes typically focus on working capital, treasury and capital expenditure. Few companies seek improvements in the areas of indirect tax and duties, property tax and pension contributions, all of which could provide much needed cash flow. Tax is one of the biggest cash flow items for many Russian companies and a review of a company's tax components could yield significant results.

Adjustments to sales price

Overall market uncertainty has given rise to increasing interest in the post deal revision of the sales price of a business.

If the seller and the buyer are uncertain of the business's market price at the date of signing the deal, they could envisage mechanisms for subsequent price adjustments based on the performance indicators of the acquired Russian company (such as working capital, cash flows, profitability, etc.).

In this regard, the foreign investor should pay special attention to the proper drafting of the sales-purchase agreement in order to mitigate undisclosed business risks related to the acquired Russian company and its underperformance after the deal.

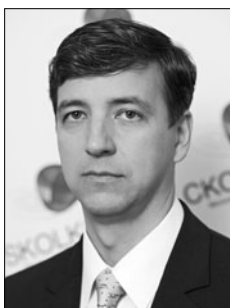
In view of the high degree of uncertainty currently affecting the Russian M&A market, more than ever foreign investors require a deep understanding of the Russian market and the industry in which an acquisition is planned.

A key element of the transaction process is ensuring an accurate valuation of the Russian target business and the negotiation of a favorable price for it, while accounting for the anticipated financial and operational performance.

To achieve the desired economic effect from the investment it is vital to properly structure the acquisition so as to leave behind the historical business and tax risks of the acquired Russian company, and also to thoroughly monitor its performance post deal.

Financing a transaction

(Dr. Vladimir Ismailov, CFO, Moscow School of Management SKOLKOVO)



Dr. Vladimir Ismailov

Dr. Vladimir Ismailov is the CFO at Moscow School of Management SKOLKOVO, supporting a range of corporate business functions of the School, which provides MBA, Executive MBA, Executive Education, Research and Consulting

focused on emerging market business, government agencies and organizations.

Vladimir holds a PhD in Economics, as well as being a Certified Auditor of the Russian Federation (since 1995) and a Member of the American Institute of CPA (exams passed in 2000). Dr. Ismailov has a great deal of financial management and auditing experience in a range of business sectors, having worked in the Public Accounting Media & Information sector, OEM, Telecom services and at not-for-profit organizations.

Vladimir is the author of a number of publications on general economic and investment subjects. Dr. Ismailov also cooperates with major media outlets (BBC Russia Radio, Russia Today TV, City FM Radio, etc.) in Russia and abroad as a member of the panel of experts that opine on investments and the business environment in Russia.

While developing business plans for your new or expanding business, it is important to have a clear understanding about the sources of financing that are available to companies in Russia and the “local” specifics associated with some of them.

Limited cash resources may restrict a company’s ability to meet its business objectives and, therefore, may lower returns, damage public image and negatively impact the company’s value. Excess cash and/or access to inexpensive capital may represent an opportunity to increase the effectiveness of the business through a balanced investment program, ability to seize an attractive business opportunity that may present itself in the market, improve a business image and may become a good leverage tool in internal discussions amongst top managers, the board and shareholders.

Most companies in Russia are similar to companies throughout the world in trying to find a balance between various funding options and the advantages and disadvantages related to them.

Types of short-term financing tools

Examples of short-term funding instruments may include: Cash; Short-term investments (deposits, loans given, shares bought for sale etc.); Accounts receivable; Accounts payable; Bank overdraft facilities; Factoring arrangements, etc.

Most companies in Russia use only the first two instruments extensively, thus overlooking the great potential for additional cash flow through other types of short-term financing. For example, it is hard for managers of companies working in Russia (similarly to in other parts of the world) to appreciate the advantages of micromanagement of receivables and payables. Some financing options may not be very well known to the market and/or there may be no legal infrastructure to support them. For example, factoring is still a relatively new tool in Russia and the legal framework for this instrument is still in the developmental stage.

On the other hand, the banking industry in Russia is very heavily regulated. The prime regulator for all banks is the Central Bank of Russia (“CBR”). The CBR dictates industry rules, monitors compliance, issues and revokes banking licenses, controls cross border and capital transactions, and micromanages the foreign exchange mechanism, including exchange rates.

Bank overdraft facilities are very uncommon in Russia, primarily due to the underdeveloped credit risk system in Russian banks. Some local banks are not keen on implementing financial instruments that are uncommon due to a lack of internal culture and unclear regulation from the CBR. Therefore, before choosing a short-term instrument for financing a business it is important to assess the capabilities of internal resources (not just financial, but also HR, IT etc.), the capability of local management who will have to carry out daily micromanagement of the situation, and external factors such as the capabilities of counterparties (banks, clients, vendors etc.) and level of risk that the company is willing to tolerate.

Types of long-term financing tools

Examples of long-term funding options may include: Bank loans; Fixed income financial instruments (bonds etc.); Derivatives (futures, swaps, hedging contracts etc.); Leasing arrangements; Retained earnings and reserves; Quasi-equity financing tools (convertible debentures, subordinated debentures etc.); Equity financing (preferred shares, common shares, options and warrants etc.).

Again, only some are commonly used in Russia. Others are still a “premier league” attribute that are used by companies that have the resources to set up the relevant legal and tax structure, hire skilful finance and executive staff who can micromanage these instruments on a daily basis.

Bank loans are probably the most common long-term financing tool. However, interest rates for bank loans are marginally higher than those in Europe and the United States. Another factor to consider when using a loan from a Russian bank is the requirement in relation to the accrual for bad debts that any bank in Russia must adhere to at the risk of losing its banking license. Any change in a business’s viability or sharp negative deviation in revenue and/or profitability may raise doubts on the bank’s side and/or result in a breach of loan covenants, and the bank will have to provide for such a loan in its balance sheet. This requirement imposed by Central Bank of Russia requires banks to act swiftly and thus limits their flexibility in loan restructuring. These specifics were the most interesting aspects of the loan market during the liquidity crisis in Russia in late 2008 – early 2009.

The bond market in Russia has developed into a sizable tool for less expensive funding and less risky investments. Despite the crisis, or maybe because of it, the market expanded. The FinamBonds index (FB-Total) grew from 196,5722 on November 1, 2008 to 253,7847 on October 30, 2009. Unfortunately, the number of defaults has also increased significantly.

Quasy-equity financing instruments, such as convertible debentures and subordinated debentures are still rather new to Russian companies. These instruments do not have a specific definition in legislative documents. This means that such instruments can be regulated either in Russia by a contract or be arranged for and regulated by the foreign jurisdiction legislative. Although the use of such instruments is possible it entails substantial fixed costs in the case of the involvement of a foreign legal entity and is quite cumbersome to manage in Russia based on a contract.

Before making a decision on the preferred type of funding one should carefully consider various aspects of the project:

- The existence of a developed market for the particular type of funding. For example, RMBS (residential mortgage-backed securities) and CMBS (commercial mortgage-backed securities) deals are just entering the Russian fixed income market.
- The existing legal framework (licensing, compliance with cross border funding regulations etc.).
- The time required to arrange the receipt of funds (some types of funding, for example increasing the share capital, may take several months to arrange).

- The availability of internal non-cash resources to support the project (a legal department to draft the necessary documents, a finance team which can work closely with banks, a business model and strategy that supports assumptions and scenarios, etc.).
- The presence of qualified consultants (investment bankers, lawyers, etc.) who may support the need for funding.
- The availability of a credit history, ideally supported by a credit rating and corporate governance score from a well recognised agency.

Despite the fact that equity and debt financing are very complicated areas of business management, Russian companies and even local subsidiaries of multinational companies are moving into the corporate debt market very swiftly. Most companies used equity financing as their prime source of funding in previous years. An equity infusion normally requires substantial paperwork. A company needs to execute not just documents in order to comply with the needs of corporate governance, but also ensure that the necessary tax filings are performed. In the case of cross-border funding (for example, a parent company providing funding to its subsidiary in Russia to finance a transaction) the corporation needs to take into account the currency control regulations set by the CBR that banks are required to rigorously observe. However, mature capital markets in Russia demand that participants be more creative than before in order to access capital markets and find financial instruments that suit their needs.

Local companies usually place debt and equity instruments at local exchanges (RTS and MICEX) and/or international debt and equity markets. The European capital markets were attracting a significantly larger number of equity placements than the US or any other markets before the crisis. This is due primarily to the more rigorous regulations at NYSE and NASDAQ introduced by the SEC after the well-known series of corporate fraud scandals. However, European countries are actively discussing restrictive measures against extremely active foreign investors. This primarily concerns government investments from emerging markets and Russian companies with international business interests. This may eventually divert the interest of Russian companies to Asian markets, particularly Hong Kong and Singapore.

Financing your business in Russia is just as challenging as in other market. Before making a decision in favour of a particular strategy one should fully assess the pros and cons of each scenario. Even though there are plenty of skilful advisors available in the market, the ultimate decision will be left for the owner(s) of the business.

Investments within the framework of the Russian Competition Law (Nadezhda Drobilko, Associate, Chadbourne & Parke LLP)



Nadezhda Drobilko

Nadezhda Drobilko is an associate with the St. Petersburg office of Chadbourne & Parke LLP. Her practice focuses on corporate, regulatory and transactional matters. Nadezhda has handled various regulatory matters, ranging

from establishing a legal presence in Russia, to antimonopoly, securities compliance, licensing, telecommunications and regulation of state secrets. Ms. Drobilko has extensive experience conducting due diligence reviews. She has worked on a number of transactions involving different types of real property: office and residential premises, industrial buildings, hotels and shopping centers. She serves clients conducting business in a variety of industries, such as consumer goods, construction, banking, aviation, telecommunications, and transportation.

In developing the regulatory framework governing competition, the Russian authorities have tended to look to the precedential value provided by the best international experience and practices. Following the examples established in practices of the leading European economies, the Russian legislature created rules for protecting competition in the financial and commodity markets and preventing abuse resulting from market players obtaining a dominant market position.

As a step forward in antitrust and fair competition regulation, regulation of natural monopolies and restriction of monopolistic activities, the Federal Law on Protection of Competition was signed into law on July 26, 2006 (the "Competition Law"). In July 2009 the Competition Law was amended to clarify and elaborate on certain provisions. The Competition Law has extraterritorial effect and applies, inter alia, to the relationship between Russian and/or foreign investors when assets in Russia or shares (interests) in Russian companies are involved, or the relationship is otherwise capable of affecting competition in Russia.

Competition Law

The Competition Law superseded the 1991 Federal Law on Competition and Restriction of Monopolistic

Activities in Commodity Markets and the 1999 Federal Law on Protection of Competition in the Financial Services Market. The Competition Law codifies at the federal level the requirements relating to monopolies and fair competition among businesses. It also sets out the scope of authority of the Federal Antimonopoly Service of the Russian Federation (the "FAS").

Antimonopoly matters are also addressed in the Law on Natural Monopolies, the Law on Advertising, governmental decisions and FAS regulations, just to name a few.

The Competition Law introduces restrictions with respect to, and control over, (i) economic concentration; (ii) monopolistic activities; (iii) unfair competition; (iv) acts of public authorities and regulators; (v) natural monopolies; and (vi) advertising. Below we provide details of those Competition Law rules which may be of most interest to investors.

State Control over Economic Concentration

Whether an investor structures his investment as a share deal or an asset deal, or a combination of both, he should give due regard to Russian antitrust rules. In certain circumstances, both share and asset deals may be subject to antimonopoly approval. In some other cases, post-notification of the FAS about qualifying transactions may be required.

For instance, in accordance with Russian antimonopoly legislation, the acquisition of shares or assets may be subject to preliminary approval by the FAS depending on a number of factors, e.g., the value of the acquired assets, the aggregate value of the assets of the seller, purchaser and their respective groups, gross revenues of the seller and the purchaser during the year preceding the transaction, etc. Current thresholds are established at 7 bln. rubles for combined assets or 10 bln. rubles for total annual gross revenues of the purchaser, the target company and their respective groups of companies, and 250 mln. rubles for combined assets of the target company and its group of companies. Antimonopoly clearance of a transaction is also required if a party to the transaction is included in the register of companies which have a dominant market share.

An application for antimonopoly approval should be reviewed by the antimonopoly authorities within 30 days from the date of submission of the applica-

tion with all necessary documents, including those with respect to the proposed transaction, the parties and their respective groups of companies. However, the antimonopoly authority may extend its review period up to 90 days. The antimonopoly approval, if granted, is valid for one year from the date it was issued.

Failure to obtain antimonopoly approval when required may result in invalidation of a transaction by the courts in the event that such a transaction adversely affects or may adversely affect market competition.

Mergers of companies may also require antimonopoly clearance. If the companies involved in a merger exceed the thresholds established by law for assets or gross revenues, they will be required to obtain authorization from the antimonopoly authorities for the merger. Current thresholds are established at 3 bln. rubles for combined assets or 6 bln. rubles for total annual gross revenues of the companies involved in the merger.

The Competition Law provides for a simplified procedure for antimonopoly clearance of a transaction among members of the same group of companies. If the list of companies of the group was submitted to the FAS in the established format one month prior to the date of the transaction, the purchaser is required to notify the FAS about the transaction rather than obtain prior antimonopoly approval.

Control over Monopolistic Activities

The Russian Competition Law does not contain an exhaustive list of actions which are considered to be monopolistic activities. The latter, however, include the abuse of a dominant market position and agreements or coordinated actions which restrict competition.

The Competition Law presumes that a company dominates a market if its share in the market exceeds 50%, unless the FAS determines that such a market share does not result in dominance, or if its share in the market is less than 50% but the FAS determines dominance based on other factors, or if it is a natural monopoly. The FAS has a discretionary right to determine dominance in other cases specified by law. Proper identification of a market is important for accurate qualification of a market position as dominant. It should be noted that the FAS practices of defining the boundaries of a particular market have not always been consistent.

In addition to stand-alone dominance, the Competition Law recognizes collective dominance. Collective dominance is deemed to exist when (i) up to three top market players hold a combined market

share exceeding 50% or up to five top market players hold a combined market share exceeding 70% (provided each of them holds a share not less than 8% of the market), and (ii) the market shares remain unchanged or fluctuate insignificantly during a long period of time and access of new competitors to the market is complicated, and (iii) the goods or services sold, purchased or rendered by these market players may not be substituted by other goods or services, price increases are not proportionate to the reduction in demand for such goods (services) and information about the price and other terms on which the goods or services are sold, purchased or rendered is publicly available.

The Competition Law prohibits companies (or groups of companies) that dominate a market from abusing their dominant market position. Dominance itself is not prohibited, but dominating companies are banned from abusing their dominant market position. Abuse of a dominant market position is understood as being specific actions which may prevent or restrict competition, such as establishment of monopoly prices, withdrawal of goods from circulation with a view to increasing their price, forcing unfavorable terms and other contract conditions on customers, creating discriminatory restrictions for other market players, among others.

Furthermore, agreements among business entities or their coordinated actions are prohibited by law, if such agreements or coordinated actions may result in the division of a commodity market among the parties or result in unjustified refusals to enter into contracts with suppliers or customers, prevent other companies from accessing the market, or introduce conditions of membership in associations that may prevent or restrict competition. The Competition Law specifies instances when such agreements and coordinated actions are permitted, in particular, when they do not restrict competition or they promote technical or economic progress or increase the competitiveness of locally produced goods in the world market.

Prohibition of Unfair Competition

Actions by business entities (or groups of entities) that are aimed at securing privileges in the conduct of business, and contradict Russian law, customary business practices and principles of fairness, reasonableness and equity, and cause or may cause damage to other companies or their business reputations are deemed to constitute acts of unfair competition and, therefore, are prohibited by law. The Competition Law provides examples of unfair com-

petition, among which are dissemination of false or inaccurate information that may cause damage to a company or its reputation, misrepresentation of the nature, quality or characteristics of goods, improper comparison of one's goods with the goods of other manufacturers or sellers, sale of goods involving the illegal use of intellectual property; and the illegal use or disclosure of information constituting trade secrets or other protected information.

Scope of Authority of the FAS

The role of the FAS, the Russian antimonopoly regulator, is of vital importance for the enforcement of the Competition Law and related regulations. The legislature generally tends to act in a manner that expands and sets out in greater detail the scope of the FAS's authority. The FAS is currently in charge of enforcing compliance with the antimonopoly law, taking measures towards eliminating breaches thereof and bringing actions against parties committing breaches, preventing unfair competition and monopolistic activities, granting approvals of qualifying mergers and acquisitions and exercising other forms of state control over economic concentration. The FAS acts through its departments in Moscow and various regional offices.

In order to perform its duties the FAS is vested with a wide range of powers. In particular, it is authorized to initiate proceedings and consider on the merits of cases relating to breaches of antimonopoly law, issue orders to private businesses and federal, regional and municipal authorities to discontinue and remedy breaches, conduct checks and verify compliance with the antimonopoly laws, issue regulations with respect to designated antimonopoly matters and provide clarifications and recommendations on competition laws, bring claims in court, and maintain the register of companies which have a dominant market share. The FAS is entitled to conduct scheduled and unscheduled on-site inspections. For the purposes of antimonopoly control, the law allows FAS officers free access to premises of public authorities, banks and companies, and gives them the right to obtain any documents and information that they deem necessary, and, in the course of performing their duties, allows them to seek the help of law enforcement agencies.

Liability for Breach of the Competition Law

The rules establishing liability for breaches of the Competition Law are contained in a number of laws,

such as the Competition Law, the Code of Administrative Violations and the Criminal Code.

For instance, failure to obtain antimonopoly clearance for a transaction may result in the invalidation of the transaction by a court. A party that committed an act of unfair competition is required to reimburse the damages caused by such an act. Furthermore, the FAS may require a party that violated the antimonopoly laws to disgorge into the federal treasury the proceeds gained by such a party as a result of the violation. In the event of repeated monopolistic activities by a company that has a dominant market position, the FAS may require the judicial split-up or spin-off of such a market player.

Breach of the Competition Law may be subject to administrative penalties, in which case a fine may be imposed on the relevant companies and their officers. The officers may also be disqualified for up to three years. The amount of the fine may vary from a fixed sum established by law to a percentage of the proceeds received by the breaching party from the sale of goods or the provision of services involving the breach. For example, the fines which may currently be imposed for the abuse of a dominant market position or unfair competition vary from 12,000 rubles to 15% of the proceeds. An administrative penalty may not be imposed after the expiration of the statute of limitations, which is equal to one year from the date when the administrative offense was committed.

A party which commits a breach constituting a particular offense to public interests may be held criminally liable in a limited number of circumstances specified in the Criminal Code. In particular, maintenance of a monopoly price, division of the market and restriction of access to a market for other companies are deemed to be criminal offenses if these acts restrict competition and cause significant damage. Damage is deemed to be significant if it exceeds one million rubles. A person found guilty by the court may be subject to a fine in the amount of up to two times his annual income or imprisonment for up to two years and, in addition, a professional disqualification for up to three years.

When considering an investment in Russia, it is important to take note of the restrictions imposed by Russian Competition Law. Receipt of prior approval from the FAS may be a prerequisite to consummating a transaction. Therefore, it is advisable to investigate well in advance the antimonopoly clearance requirements applicable to the transactions being considered, particularly in time sensitive projects.

Business Valuation: Key specifics of price negotiations when acquiring a business in Russia (Andrei Mikhailov, Associate Director, Ernst & Young)



Andrei Mikhailov

Andrei Mikhailov is an Associate Director in Ernst & Young's Lead Advisory practice in Moscow. He focuses on mergers and acquisitions and equity finance raising. Andrei has advised on a significant number of closed and potential deals in Russia, the CIS and the UK.

A good price is always a desired goal for any deal across countries, cultures and industries. M&As in Russia, however, often have specifics that need to be accounted for and reflected when valuing an acquired business. We would suggest splitting Russian-specific issues into two major categories: asset quality issues and pricing & deal structure issues.

Asset quality issues

- **Poor business case**

It is quite common, especially in the current market, for Russian companies trying to look attractive to have much weaker businesses than it seems initially. There may be various reasons for this, but there are usually just two consequences: either the deal is aborted or the gap between the price expectations of the buyer and the seller gets wider, leading to more difficult price negotiations. Suggestion: try to deal with several targets right from the start in order to avoid a situation where you consider only one and it turns out not to be attractive after several months of work, leaving you where you started.

- **Serious impact of the crisis on the business model**

The crisis has hit almost every Russian company, with the Russian economy declining more than any other G20 economy. Major effects on individual businesses are a drop in consumer demand and higher cost of debt. Each of these two effects reduces company value while not necessarily being fully reflected in historic results. Suggestion: current performance and short-term budgets are now much more relevant and important in determining a company's value than historic results or long-term forecasts. Historic results are no longer relevant, while long-term forecasts are often based on historic results that are no longer relevant.

- **Low transparency – asset quality is often unclear before a due diligence is completed**

The transparency of even many large Russian businesses is quite low, which means that any valuation is misleading before a due diligence is completed. Thus due diligence of a Russian company is not just a “confirmation exercise”, but rather an analytical investigation, which can change the preliminarily agreed terms of the deal completely.

Suggestion: try to avoid, if possible, fixing a price in monetary terms before having a due diligence done, and always make any valuation discussed before a due diligence conditional on the results of the due diligence.

- **Frequent lack of projections – buyers have to develop these together with sellers and current management**

Business valuation in Russia should not be considered a purely technical procedure. Most companies do not have clear projections, and the projections that exist are often not agreed between owners and management.

Suggestion: try to use the valuation procedure as a mechanism for getting current owners and management to compile projections that they all agree with.

- **Hidden obligations**

Though having more to do with due diligence and deal agreement structure, hidden obligations, when uncovered, will obviously decrease the value of an acquired business.

Suggestion: have a thorough due diligence done, and use representations, warranties, indemnities, deferred payments and escrow accounts in the final agreements to mitigate the risks of losses from hidden obligations.

- **Tax optimization schemes**

Again, as with hidden obligations, thorough due diligence is key. Tax optimization schemes and related risks, however, are much easier to quantify, and the value estimate can be adjusted accordingly.

Suggestion: adjust the value of the deal to account for potential tax-related losses identified at the due diligence stage.

- **Transaction and integration costs**

There are often significant direct deal-related and subsequent costs that are not accounted for when formal business valuation is done and a price is negotiated. A few examples:

- Direct transaction costs: financial, tax, legal, technical and other advisors

- Carve-out expenses – will need to be incurred if the purchased asset is integrated into a larger entity
 - Integration expenses – to align the business processes of the acquired entity with those of the acquirer
 - “Group expenses”: Russian companies acquired by foreign ones will often have to change their auditors and other advisors to those used by the Group, which are usually more expensive
- Suggestion: many of these costs can be estimated if analysed; the key here is not to forget that there are significant costs other than the value of the deal.

Pricing and deal structure issues

- Unrealistic expectations on the part of sellers
Sellers in Russia are often too simplistic in their expectations, taking the highest multiple seen in the press and applying it to the highest arbitrarily selected indicator. The real problem is that they can be very stubborn as well, even in times of crisis.
Suggestion: develop alternatives by looking at more than one target, thus creating competitive tension between them. Polite explanations of your valuation methodology, even using an independent appraiser, often do not work.
- Price discussed: gross or net? Better to clarify this before reaching an agreement, as many Russian sellers regard all prices as net after taxes.
Suggestion: be clear about what you discuss, and make it clear that the price you quote is gross before taxes, with sellers having to deal with taxes themselves.
- Escrows and other forms of deferred payments: the concept of deferring a payment is unknown to many Russian sellers.
Suggestion: if deferring payments is important to you, agree on the price and deferred payments simultaneously, since, once the price is fixed, the sellers will try to pressure you into dropping or minimizing the deferred part.
- Earn-outs: the devil is in the details.
Structuring an earn-out often seems simple: take a few numbers, do a bit of math and you have the figure to be paid. Experience shows that, when the earn-out payment date comes, it may be very unclear as to which particular numbers to use. There are usually two reasons for this:
 - Unclear definitions of the earn-out calculation base in deal agreements
 - One party believes that the earn-out calculation base has been manipulated by the other

party, and the deal agreements allow the earn-out calculation to be challenged.

Suggestion: try to be as thorough as possible when agreeing how and on what basis the earn-out payments are calculated, and think of all possible items that must and must not be included in the earn-out calculation.

- In smaller deals, sellers sometimes require a non-refundable cash deposit before having a due diligence done

Such practice is common in smaller real estate deals but sometimes spills over to larger and/or non-real estate transactions.

Suggestion: in cross-border deals, we have not seen any remedy for this other than just saying no to such a deposit. They are usually demanded by unsophisticated sellers; when they deal with international companies, such demands are often dropped.

- Many sellers are not used to representations and warranties, guarantees and indemnities; a lot of effort to educate and convince them will be needed, which will extend the deal’s timeline

Representations, warranties, guarantees and indemnities are either not allowed at all under Russian law or have serious limitations, as compared to English law, for example. This means that many Russian sellers are unfamiliar with such concepts, which may take them by surprise at the negotiation stage.

As a result, the agreement discussions will obviously take longer than planned, and the buyers will often have weaker final positions on these clauses than initially expected.

Summarising the above, we would like to stress several key factors that make objective business valuation and price negotiations in Russia a challenging exercise:

- Unclear underlying business perspectives
- Hidden obligations and tax optimization schemes not seen until after due diligence is performed
- Additional deal-related expenses often hard to estimate at the preliminary stages of the deal
- Unrealistic price expectations on the part of many sellers
- Many sellers’ opposition to legal instruments that mitigate buyers’ risks, such as escrows, representations, warranties, guarantees and indemnities.

We believe that the best approach to reaching a good deal is to do thorough research at all stages of the deal, consider all expenses related to the deal and subsequent integration, and stimulate competition among sellers by talking to several targets simultaneously.

Practical insight: 6 things European investors need to look at differently on the tax side when closing deals in Russia (Artem Petrukhin, Partner, M&A Tax; Andrey Shpak, Director, M&A Tax, PricewaterhouseCoopers, Russia)



Artem Petrukhin

Artem is a Tax Partner in the Tax M&A Group. Artem has 15 years of experience in providing tax advice to large Russian and multinational companies, as well as to representative offices of foreign legal entities operating in Russia.

Artem has advised clients on a wide range of tax and related issues. In particular, he has a strong background in advising clients on international investment structuring, as well as in coordinating approaches on Russian tax planning projects. He has the rare quality of being able to conduct deals not only from a tax advisory perspective, but also paying proper attention to all the other aspects of the deal process, including due diligence, client negotiations and the structuring and finalizing of the transaction.



Andrey Shpak

Andrey Shpak is a Director at PricewaterhouseCoopers Tax M&A Group, with 13 years of experience, primarily focusing on assisting both buyers and sellers in large and complex multi-territory transactions. Andrey is also one of the leading expert

on advising clients on the tax aspects of SPAs, suggesting the right level of tax warranties and indemnities to be written into the SPA, as well suggesting ways to achieve a tax favourable result on any payments envisioned by the SPA.

Over the past years, Russia has attracted many European investors looking for exciting profit opportunities with potentially less competition as compared to more established markets.

What they tend to find is that closing deals in Russia is very different not only from Western European countries, but also from most Central and Eastern European (CEE) countries, where European investors have been operating for quite a long time and generally have good experience.

Based on our more than a decade of helping clients do deals in the Russian environment, we have distilled 5 key areas on the tax side that European investors who plan to invest into Russia should focus on if they want their Russian deals to run smoothly.

Anticipate a higher level of uncertainty

Tax legislation in Russia is relatively new. It took shape only less than 20 years ago and is still developing.

Official guidelines and precedents are lacking, which adds to the uncertainty in assessing tax risks associated with investments in Russia. Binding rulings (and even upfront discussion with the tax authorities), which are widely used in Western Europe (and even in some CEE countries), are not available in Russia. Therefore, to keep risk at an acceptable level it is very important to understand both the wor-

ding of the law (which often is ambiguous) and the approach of the tax authorities, as well as the trends in legislation and court and market practice.

In Russia tax risks are an important area of focus during the due diligence process. This is especially true where the Target is a small or medium-sized non-public company, where use of doubtful “tax optimization” methods historically has been an issue (for example, it has not been uncommon in such companies for some part of remuneration to be paid unofficially to decrease payroll tax charges).

The nature and level of tax risks identified in the course of a due diligence may result in a need for significant pre-acquisition restructuring. If the buyer and the seller are working together it is often possible to achieve the level of restructuring necessary to make the deal happen.

With all the above precautions tax risks are still likely to be a feature in any Russian deal European investors will be making in Russia, and in most cases are difficult to eliminate completely. Therefore, extensive use of the Sale Purchase Agreement covenants, warranties and indemnities is helpful in this process.

Manage cash flows with more care

While the deal structure usually does not directly affect how much cash is generated from operations, it may be critical for the possibility to move cash quickly both for the purposes of repatriating the profit and servicing the debt.

The legal and accounting restrictions on paying dividends and making other cash transfers from

operational subsidiaries to the parent company also need to be taken into account. For example, in many cases it is not possible to distribute cash from a Russian subsidiary if it does not report any profits in its Russian books (i.e. making distribution from capital or reserve is often not legally possible).

Wise use of double tax treaties to properly utilise reduced withholding tax rates on interest and dividend payments is very important while developing holding and financing structures. This ensures minimal tax leakage at completion, during the life of the investment and upon exit (if planned). Popular locations for intermediary holding and financing companies in Russia are Cyprus, the Netherlands and Luxembourg due to their beneficial holding regimes. However, many other European jurisdictions may also be an acceptable choice, depending on circumstances.

Small and medium-sized Russian businesses tend to prefer complex multi-entity structures, which they often see as a way to reduce miscellaneous regulatory and operational risks, or as part of miscellaneous tax “optimization” schemes. In this context, European investors typically need to expect that significant pre- or post-deal restructuring of the Target will be required to minimise any tax leakage going forward.

Presume complex debt push-down strategies

Tax grouping is known to be one of the most straightforward methods for achieving tax deduction of interest on acquisition debt in Western Europe. This, however, does not yet exist in Russia. Although the tax grouping was expected to be introduced as early as 2010, as of October 2009, it was not yet fully clear whether this will be the case.

Other traditional debt push-down techniques (e.g. merger of the acquisition and the target companies) also tend to not work, mainly for accounting and legal reasons (for example, technical insolvency as the result of absence of concept of goodwill in case of such a merger). However, debt push-down is sometimes possible using alternative techniques, such as reorganisation of the target group, mainly limited to sale of shares between group companies. Such alternative structures may significantly affect the timing of the transaction and may increase overall risk.

The interest deduction is also subject to interest rate and thin-capitalisation limits. Moreover, in Russia, cross-guarantees within the group expose some loans from third parties to thin-capitalisation restrictions, whereas normally this would not be the

case in European jurisdiction. Therefore, you should be careful in selecting the lending entity, as well as in managing the mechanics of the deductible interest calculation.

Obtaining tax deduction for transaction expenses incurred in arranging the deal is sometimes a challenge, since for Russian purposes it is important to demonstrate the link of these to income-generating activities, which may be difficult if these expenses are pushed to the level of the acquired companies. For these reasons, the tax treatment of transaction costs, including bank commissions, legal and consultancy fees, and insurance premiums, needs to be analyzed on an item-by-item basis to attempt to ensure favourable tax treatment and minimal VAT leakage.

Expect asset deals to be more complex

Many European investors making their first acquisition in Russia attempt making an acquisition as an asset deal only to find out that this is not as simple as they expect based on their prior European experience.

The main driver for this complexity is that the Russian tax law does not allow deduction of goodwill on an asset deal, unless it is structured through a so called “sale of a business as a property complex”. Such “sale of a business as a property complex”, however, is something which very rarely happens. Probably the primary reason is that the concept of a “property complex” was introduced more than 20 years ago, but the implementation mechanisms are still not clear. For example, in order to effect such sale you first need to register the “property complex” as a piece of real estate – and it is not clear what would happen should you wish to dispose parts of the “property complex” afterwards. We have yet to see this implemented in practice in a transaction.

In the absence of a sale of “property complex” any goodwill will likely be treated as non-deductible (unless the sales price for individual assets can be effectively increased to account for such “goodwill” – though this approach has some transfer pricing risks). Any VAT incurred in this respect will likely follow the profits tax treatment – i.e. will be not recoverable if the expense is not deductible.

As a result, asset deals in Russia typically take the form of “quasi-asset” deals, where the vendor transfers (sells) assets and transfers employees to a newly established company, and re-signs contracts into its name, with the foreign investor purchasing shares in this new company.

The decision to use the approach is greatly affected by the existence of critical licenses that may be difficult or impossible to transfer within a reason-

nable timeframe to a new entity. Also, this may significantly affect the timing of the transaction.

Expect local business practice and culture to significantly influence the structure and timing of the deal

An understanding of “soft” or cultural differences is often a key to success in negotiations with vendors in Russia. Many targets are unfamiliar with the due diligence process and are often surprised at the detailed list of documents they have to provide.

The format of information provided for due diligence in the majority of cases also differs substantially from what you would expect to receive based on your experience in Western Europe or even CEE, e.g. statutory accounts often may not reflect the true financial performance of the target’s business, management accounts are often set out as individual reports, rather than a full set of financial statements, policies used for preparation of the management reports are frequently based on management/shareholders needs (often focused on managing movement of cash) rather than under US GAAP/IFRS or even Russian accounting standards.

Inexperienced vendors often do not have quality advisors, or any advisors at all. They may even rely on the purchaser to arrange advice on the transaction structure as well as on how to address historical tax risks identified during the due diligence. This can be a tricky exercise considering the buyer and the seller are arm’s-length third parties prior to deal signing.

The timing of deal completion and pre/post-deal restructuring is also greatly affected by the regulatory process, e.g. reorganizations, antimonopoly clearances, creation of companies, registration of loans and increase of share capital, performance of independent appraisals, and audits. For example, the merger process can take three to nine months and even longer. Coordinating all the steps is crucial.

Overall, you need to be prepared that the deal process often takes more time as compared to some other CEE jurisdictions.

Start planning post-deal integration earlier

The difference in the business practice and culture mentioned above will influence not only the deal negotiation and structuring, but in most cases will also be very important in successful integration of the target once the deal is closed.

There is typically a steep learning curve for many Russian businesses to get fully intergrated into European procedures and systems after acquisition. This goes both ways – not only employees of the Russian targets need to learn new, often more efficient ways of performing their day-to-day tasks, but Europeans also need to learn that many of the tax concepts, which are common for European multinationals (e.g. OECD-guidelines-compliant transfer pricing or receiving charges for the headquarters support etc.) are not that developed in Russia, work differently in Russia and require substantial amendment in order to be successfully implemented by the newly acquired target without creating new tax risks.

As Russian tax authorities tend to place a lot more emphasis on compliance to the form as compared to their European colleagues, tax compliance typically requires a lot more effort (and headcount) than in Europe. This needs to be properly planned and related cost efficiencies should not be overestimated using European benchmarks.

Integration of the accounting systems may also require substantial effort both to satisfy the management requirements and to comply with ever-changing Russian tax legislation.

In this context, we typically recommend to start negotiating possible integration issues and planning as early as possible in order to ensure that on Day 1 post-closing the newly acquired business runs smoothly.

Challenging, but possible

European investors coming to Russia should be prepared for unusual risks and challenges and the absence of well-tested solutions for tax structuring. Each deal should be considered on its merits to ensure an efficient tax structure, optimal cash flow management, and proper protection against historical tax risks. More time should be allocated for negotiating, structuring and closing the deal, as compared even to many other CEE jurisdictions.

Difficulties, however, should not be overestimated. Experience of many European investors as well as our own experience assisting them shows that if properly managed you can make successful deals in this promising market and take part in the enormous upside growth potential.

8 Steps to facilitate better protection against tax risks in share purchase agreements when making an acquisition in Russia

(Andrey Shpak, Director, M&A Tax, PricewaterhouseCoopers Russia)



Andrey Shpak

Andrey Shpak is a Director at PricewaterhouseCoopers Tax M&A Group, with 13 years of experience, primarily focusing on assisting both buyers and sellers in large and complex multi-territory transactions. Andrey is also one of the leading expert

on advising clients on the tax aspects of SPAs, suggesting the right level of tax warranties and indemnities to be written into the SPA, as well suggesting ways to achieve a tax favourable result on any payments envisioned by the SPA.

Introduction

Even if every precaution is taken, tax risks are still likely to feature in any Russian deal made by European investors in Russia. In most cases, the risks involved are difficult to eliminate completely; therefore, extensive use of proper sale purchase agreement covenants, warranties and indemnities is crucial.

Although it is not possible to outline all the potential nuances of obtaining contractual protection against tax risks in deals, I have tried to summarise below certain core elements of such protection in share purchase agreements (SPA) that are essential when making acquisitions in Russia.

These comments are primarily based with regard to SPAs made under English law (the use of which is common in many large- and medium-sized deals in Russia), but with some modifications may also apply to SPAs made within the framework of a different law.

Start with structural protection

The first step in protecting your new acquisition from tax risks is to try to minimise the number of potential risks you take when acquiring a business.

This may potentially include excluding some legal entities from the target structure, requiring the transfer of some parts of the acquired business to new legal entities prior to acquisition, or requiring the vendor to discontinue dubious tax practices prior to acquisition.

This will reduce and limit the number of potential problems. In my experience, a significant number of acquisitions of non-public Russian companies include implementing some form of the above measures prior to acquisition; indeed, these steps are often given as “conditions precedent” in SPAs.

Ask for explicit “euro-for-euro” tax indemnity

You should always try to obtain an explicit tax indemnity for all tax risks that may crystallise post-completion as a result of events occurring or deemed to have occurred prior to completion. Such indemnity should give you “euro-for-euro” compensation for any tax costs that crystallise post-completion – with minimal exceptions. Such tax indemnity should be the focal point of any proper contractual protection against pre-completion tax risks.

It is important to understand that having a set of tax warranties does not constitute a substitute for proper indemnity for two reasons: (1) making claims under warranties is more difficult procedurally; and (2) warranties can typically be limited by disclosure of information prior to signing/completion; such limitation by disclosure should generally not apply to indemnity.

Limitation period for tax indemnity

Russian tax law allows tax authorities to perform an audit three calendar years preceding the year when the audit is initiated. This means that, for example, for a deal completed in October 2009, the tax authorities may initiate a tax audit as late as 31 December 2012, covering some periods pre-completion. In addition, related tax audit proceedings may extend into 2013 (and occasionally even further).

It is also important to understand that, in the majority of cases, periods already audited may technically be audited again in the future by a higher level tax authority. Therefore, having a particular tax period already covered by a tax audit does not necessarily give you, as the purchaser, complete protection.

For this reason, it is market practice to request that any tax indemnity should apply to at least four calendar years post-completion.

Be selective as to who gives indemnity and properly choose the compensation (indemnity) mechanism

It is not uncommon for Russian vendors to have holding structures that include foreign vehicles. Such a foreign holding vehicle may be the formal party to the deal but own no assets post-completion, and may therefore have insufficient funds to cover any potential tax claims.

Therefore, in many cases the indemnity mechanism in a Russian deal is more comprehensive and diverse compared to deals in certain other jurisdictions. It often uses several elements—for example, deferred compensation, escrow accounts, and personal guarantees from the ultimate owners etc. as additional protection.

Ensure that proper tax gross-up clauses are included

Russian tax law does not specifically address how payment under indemnities should be treated. Therefore, it is important to make sure that you, as the purchaser, are properly compensated on an after-tax basis. In order to achieve this, you should place on the vendor the burden of any potential tax costs related to paying compensation for post-completion tax claims. This may be achieved by including an appropriate tax gross-up clause into the SPA applicable to payments under indemnities.

Ask for a comprehensive and detailed set of tax warranties

Although as mentioned above you should always try to obtain proper tax indemnity (covenant) in an SPA (with minimal limitations and exceptions), it is still advisable to have the vendor give an extensive set of tax warranties as additional protection.

A sophisticated Russian vendor would typically try to have tax warranties that concentrate on confirming only that the tax returns are true and accurate and that tax has been fully paid under these tax returns, rather than accepting full responsibility for tax relating to pre-completion periods.

Such a narrow approach potentially allows the vendor to attempt to rely on formalistic arguments in resisting warranty claims, and thus exposes the purchaser to risk in a variety of situations, for example:

(a) Russian tax law is notorious for being open to interpretation; there may be situations where a tax assessment is made but arguments to support

the vendor's position nevertheless remain (and thus constitute a basis for the vendor to dispute any warranty claims);

(b) the tax assessment can be initiated directly by the tax office rather than by the taxpayer through a tax return (as may be the case with transfer pricing or the reclassification of aggressive tax schemes), in which case there will be no technical breach of warranty; or

(c) tax for the pre-completion period may arise as a result of a post-completion event (e.g., as a result of the allocation of revenue under a multi-period contract).

Insist that disclosures be specific and quantifiable

It is common for Russian vendors and their lawyers to attempt to provide numerous documents as disclosures prior to completion that are often only vaguely relevant, not sufficiently explicit, not necessarily quantifiable, or which include very general references to “areas of exposure”.

It is important to resist such disclosures, and insist that only disclosures that are sufficiently specific and quantifiable will be accepted.

Some sophisticated vendors also try to include provisions limiting any liability under tax indemnity with disclosures. Such an approach should be resisted: by definition, only tax warranties should be subject to limitation by disclosures.

Make collection against tax claims under indemnity easy for you

Tax assessments issued by Russian tax authorities are often disputed in court, and court proceedings may take a year or more.

In this context, it is important to ensure that if such a tax assessment is raised, you as the purchaser are entitled to bring a claim against the vendor immediately upon receipt of such assessment—you are not required to wait until the issue is finally settled in court.

INDUSTRY SPECIFIC ASPECTS OF INVESTING IN RUSSIA

Investing in the Russian insurance industry

(Tom Manson, Manson McCall International Ltd.)



Tom Manson

Tom Manson began his insurance career in Lloyd's of London where he became managing director of a number of Lloyd's syndicates, specializing in most types of insurance and reinsurance. He first visited Russia to discuss the development

of insurance in 1989 and since then has followed closely the growth of the insurance industry and is now acknowledged as one of the leading analysts of the insurance market, not only in Russia but in other countries of the former Soviet Union. In recent years he has identified the need to raise capital as one of the key problems facing the insurance market and has helped a number of insurance and reinsurance companies find investment partners. He has worked closely with these companies through the whole process, from the initial preparation of information to the conclusion of the final contracts.

The Russian insurance industry in 2009 faced substantial financial problems – problems that are largely the result of over rapid growth and inexperienced management. Paradoxically, these conditions are much more favourable for investors into this industry since company valuations are much less over valued than they were in the 'bubble' conditions of the last few years.

Despite these more favourable pricing conditions, investment in Russian insurance requires a detailed understanding of many specific features of the Russian market. The purpose of this article is to show what sort of steps need to be taken before making the decision to enter one of the most promising insurance markets in the world.

The country has a large population which, despite recent growth, still currently buys few insurance products. However, when economic growth resumes, more Russians will have the financial security that will encourage them to insure their property and to obtain financial protection from life insurance and pension products.

The numbers are large. In 2006, UFG, the investment bank that is now owned by Deutsche Bank,

forecast that non-life insurance alone would grow from about \$12.5 billion in 2006 to over \$100 billion in 2016. It seems that there is no reason to change this estimate based on 2009 experience, despite the fact that the current crisis has dramatically slowed the rate of growth. Growth will resume and the market will continue to 'catch up' its Eastern European neighbours in terms of insurance penetration.

On the face of it, this potential for substantial long-term growth should attract international investors. Yet the amount of international investment that the insurance industry in Russia has attracted so far is relatively small and the investments that have almost all been made by major international insurance companies – strategic investors.

The difficulties facing all investors

The first set of explanations for the current low level of investment and its dominance by strategic investors relate to features in the post-Soviet economy that have hindered the development of an insurance industry. Under the Soviet Union, no commercial property was insured: this means that there is still little experience of many important classes of non-life property/casualty business. This has clearly hampered growth in the past and continues to result in a shortage of specialists in the industry.

More importantly, the life insurance industry in Russia hardly exists even today. The hyperinflation of the early 1990s wiped out the value of millions of life insurance policies and the mistrust in financial institutions remains to this day. There are signs that long-term life insurance is beginning to grow, but premium volumes are, as yet, not significant.

These issues can and will be overcome in time, but clearly the lack of experience and the slow growth in the past have led to potential investors delaying entry into the market.

Further long-lasting problems result from the way in which the industry has developed in Russia since the end of the Soviet Union. As the financial sector developed, insurance companies carried out a number of functions for clients which were not insurance as it is recognised outside Russia. Most of these functions related to tax minimisation and the figures were substantial: in the early 2000s, it was estimated that well over 60% of total industry pre-

mium was derived from such schemes. In addition, most major industrial groups had their own insurance company to carry out these schemes. Some of these 'captives' were amongst the largest insurance companies in the country and some still are today.

From an investor's point of view, this development history has led to substantial difficulties in assessing potential investment partners. Many of the companies that appear to be the largest have only a relatively small proportion of their 'business' derived from standard insurance products. This problem is exacerbated by the Russian accounting system, which makes it difficult to assess accurately all financial information provided by insurance companies.

Investment in non-life insurance

As already noted, non-life (property/casualty) insurance predominates since life insurance hardly exists today in Russia.

Strategic investors are well aware that the class of business that invariably dominates a 'developing' insurance market is motor insurance. In all Eastern European countries, motor insurance is the largest non-life class and in many countries, motor insurance premiums account for over 60% of the total. Strategic investors are also well aware that developing markets have difficulties in pricing motor insurance and controlling claims: as a result motor insurance is often unprofitable in these markets in the early years of their development.

Russia is no exception to the rule that motor insurance dominates developing markets and the caution of strategic investors has meant that they have either tended to hesitate before entering the non-life market or have entered in a small way, minimising their exposure to types of motor insurance that could lead to underwriting losses.

Long-term life insurance

Given the perceived unattractiveness of non-life business, the majority of strategic investor interest has been in the long-term life sector. Here, the absence of any real competitors has meant that a 'greenfield' approach has been the norm: there are in reality very few life insurance companies to buy!

Strategic investors have the experience of developing markets and can import trained staff into a region where few locals have the necessary skills. Strategic investors also have deep pockets and are able to take a longer term view of an investment that is unlikely to show a profit in the short term, but where the long-term growth prospects are so substantial.

Developing an investment strategy

There are a number of possible ways in which investors can enter the Russian insurance market. At the moment it is not possible simply to buy shares through a stock market since no Russian insurance company has yet gone through the hurdles of an IPO. As a result, all available strategies will involve a private purchase of shares in a Russian company and this will inevitably require a more 'hands on' approach by a cautious investor. It is simply not prudent to invest in companies at their current stage of development without exercising some degree of control over their operation.

People are vital

It has already been noted that it will be difficult to determine exactly what business any potential partner has generated. The assumption must be that in both life insurance and non-life insurance, the quality of business is likely not to be high, given the current state of development of the market. For this reason, the reliability and ability of the people with whom the investor is proposing to do business becomes absolutely vital. The investor (financial or strategic) must either be comfortable with the current management team or must be confident that it can be strengthened enough to make the business successful.

All insurance skills are in short supply in Russia, and experienced high level insurance executives are almost non-existent, especially in the area of financial control, underwriting control and actuarial work. Assessment of current skills and recruitment in areas where experience is lacking must be an integral part of any investment strategy.

Questions to ask

At the outset, there are two vital questions that must be answered before any rational investment decision can be made. The first question is 'how much scheme business is there?'. If the potential partner is not prepared to address the question as to how much of the recorded premium income is business that would be recognised as insurance outside Russia, then an investor must begin to be concerned about the possibility of reputation risk: tax reduction schemes will always lead to the possibility of falling foul of the tax authorities.

A second question relates to the real value of assets in the balance sheet of the potential partner. Many Russian companies have in their balance

sheets assets that would not be considered assets under international accounting methods. Sometimes these assets form a large proportion of the total capital (net assets) of the company and therefore a revaluation, using international methodology, would make a considerable difference to the financial position of the partner. Again, a failure to discuss the real financial position of the company could cause problems, since a lack of capital could lead to future solvency problems if the business is not profitable.

How profitable is the business?

Russian accounting methods do not encourage companies to report on the profitability of their business using standard international methods. The standard Russian loss ratio calculation merely compares cash received against cash paid out, and in a market that is growing strongly, these figures underestimate the actual loss ratios, which include premium and claims reserves.

Financial investors should learn from strategic investors who are fully aware of the danger that the largest component of almost every non-life insurance company in Russia – the motor account – could well cause losses, now or in the future. For this reason, no investment should be made without a clear assessment of profit trends in all major classes of business using standard international methodology.

Insurance reserves

In a developed insurance market, investors pay considerable attention to the adequacy of claims reserves. There have been a number of examples of investments being made in companies that subsequently turned out to be significantly under reserved, usually because of problems in the liability/casualty account.

In Russia, the adequacy of claims reserves is not normally a major problem, largely because liability/casualty business is underdeveloped. Motor business in particular is very 'short tail' and there is little evidence that outstanding claims reserves need to be a significant proportion of premium. The key areas where problems can arise are in the assets, as noted above.

Distribution

One issue that will undoubtedly be raised is the distribution network that the company has established.

In general, these networks have been established relatively recently and the result is that companies often have not developed methods of controlling the work of branches, which may be far away from the head office. The local staff are likely to be inexperienced and yet there is competition for these employees as many companies attempt to establish branch networks at the same time.

This lack of control is often made worse by the poor quality of the IT systems available to most companies. Most have been developed in house and are based on Russian accounting requirements rather than the need to impose management controls. Any investor should be cautious about assessing the value of the distribution system and should also bear in mind that it is highly likely that in the medium term, improving the IT system will be essential.

Valuation of the company

Once the questions noted above have been satisfactorily answered, the investor will have some idea about the real business of the potential partner, the real value of its assets and how profitable it is using international methodology. Using these figures, the investor will be able to make a first assessment of the value of the company. It should be realised that this initial assessment is unlikely to be based on an IFRS audit: few companies undergo such an audit and whilst there are plans to make the industry move towards international audits (as in banking) nothing concrete has yet emerged from the insurance supervisor.

As has already been noted, the number of deals that have taken place in Russia is small and since all have been private deals, real concrete information about them is hard to obtain: no one is certain how the companies were valued or how the deals were structured.

This means that the valuation of companies can lead to very substantial differences between the parties. Clearly, the seller will try to base the current value on future cash flows and given the substantial growth possibilities, high multiples of future earnings (or even of future premium income!) will be used. Using a multiple of net assets is likely to lead to a substantially lower valuation.

Because of these types of differences, most investment deals are based on staged payments based on actual performance of the company over a period of time. In this way, not only is a vast overvaluation of the company avoided, but also a mechanism can be put in place to tie in key staff who will be vital to the future prospects of the company.

Financial due diligence

If the above strategy has been followed, financial due diligence will be confirming answers to the key questions that have already been asked. Here experience shows that companies are not used to providing detailed information rapidly, especially where current systems need to be changed to provide data in a format based on international methodology. For this reason, a potential investor should foresee the possibility of delays at this stage. It is also important to choose the advisor carefully since the advisor should be fully aware of the problems and ideally should have had experience in insurance due diligence.

Legal due diligence

Legal due diligence in insurance is also likely to require the appointment of a legal advisor with experience of the specifics of Russian insurance so that some of the substantial potential pitfalls can be avoided. There are not many Russian or international companies with such concrete experience.

Conclusion: developing a strategy

All investors should have a strategy. To invest in a company without having a clear idea how that company will flourish and grow in the context of its specific market is highly short-sighted.

Investing in insurance in a developing market requires a strategy that holds out long-term profitable growth. Strategic investors are well aware that in insurance it is simple to increase premium volumes: all that is required is for the company to reduce its prices and the business will flood in. Yet strategic investors know that such a strategy results in disaster. In the short term premiums increase, but over time claims also increase and because of inadequate pricing, losses result and the company either has to inject more capital or goes out of business. In other words, an investment strategy that aims for 'market share' or just 'growth' is a recipe for disaster in insurance.

At all times, the investor must bear in mind that the objective is to achieve profitable underwriting and that requires more than distribution: it requires choice and selection of business.

In Russia today, there is little evidence that this fundamental rule of insurance investment is widely appreciated, but that gives a substantial advantage to a wise investor who does realise that to obtain long-term growth, profitable underwriting is more likely to be successful than aiming for market share and for 'growth at all costs'.

Russian banking sector: to arrive at the bottom

(Philippe Delpal, Ex- Global Head of BNP Paribas Retail Banking in Russia)



Philippe Delpal

Philippe Delpal has over 14 years of banking industry experience, having garnered extensive knowledge in various business lines in leading banks. Philippe Delpal entered BNP Paribas in October 2006, when he held the position of Chief

Executive Officer of Cetelem, a Greenfield project. From November 2007 he was appointed President of “BNP Paribas Vostok” and Global Head of Retail Banking of BNP Paribas Group in Russia. In 2010 Philippe Delpal decided to leave BNP Paribas Group to pursue a different career opportunity. Prior to joining BNP Paribas Group Philippe Delpal worked for Société Générale Group (1996–2006), Bank Indosuez in Hong-Kong and the European Organization for Nuclear Research in Geneva (1996). In 2007 Philippe Delpal acted as the Banking Committee Chairman of the Association of European Businesses in Russia. Philippe is a graduate from the École Nationale Supérieure des Télécommunications – Telecom Paris (1994), he is fluent in English, French and German, and speaks Russian.

After the 1998 financial crisis, the Russian banking sector grew at a rapid pace, but remained quite weak and unbalanced

From 2000, the Russian banking sector enjoyed rapid growth (albeit from a very low base) during the years preceding the current crisis (+38 % in 2008, but -1 % in H1 2009), benefiting from record oil inflows and from the rising involvement of global investors in emerging markets. As a result, the total volume of banking assets multiplied by 15 (in ruble and in dollar terms) over the past eight years, rising from 36% of GDP in early 2000 to 67% of GDP in 2008. Credit outstanding increased from 24% of GDP to 45% of GDP¹, reflecting a rapid financial deepening.

A constantly growing share of the banking sector’s growth was based on borrowing from abroad. Although the stock of foreign borrowing is not particularly large in an international comparison, it grew very rapidly and the loans are relatively short-term. The interbank market was very limited and highly dependent on foreign financial resources: over half of the transactions on the interbank market involved foreign financial institutions as a counterparty, indicating that the banking system is very open and dependent on the risk-taking propensity of foreign financial institutions.

Russia is back on the growth path

Russia has been strongly affected by the crisis and, although at the beginning of the ‘Russian version’ everybody tended to believe in a ‘soft landing’, it soon became obvious that the country is suffering from a decline not seen over the last decade. The economy, highly dependent on oil and commodity prices, has plunged, showing poor macroeconomic performance. It is no secret that the Russian economy has fallen deeper than that of other G20 countries or the majority of emerging markets.

According to the Russian Ministry for Economic Development of the Russian Federation, the preliminary estimates for Q3 2009 indicate that GDP contracted by 10%, YoY, in January-September 2009. However, more detailed data show that quarterly seasonal-adjusted GDP grew 0.6% QoQ, which corresponds to an annual figure at 2.4%. Therefore, de-jure, the recession in Russia was over in Q3 2009.

The banking sector sees the end of the tunnel

In autumn 2008, due to the financial turmoil, the supply of foreign refinancing dried up and the already weak confidence in the banking sector became an outright lack of confidence. The fear of devaluation caused the financial markets to freeze. At that time, government intervention helped prevent the collapse of both the banking system and the national currency. However, several banks have not been able to meet their obligations and have collapsed, including investment giant KIT Finance, Sviaz-bank, Globex Bank, Sobinbank, and Bank Soyuz. Some of the cash-strapped banks have been nationalized, while others changed hands.

State measures include significant liquidity injections provided through an enhanced refinancing system, the bail-out of several problem banks, the provision of subordinated loans to some major

¹ BNP Paribas Eco Overview: Russia-Brazil, November 2009, p. 20

state-owned and private banks, interbank guarantees, recapitalization and various support initiatives for companies, municipalities and individuals. This support allowed most domestic banks to withstand the liquidity crunch and deposit outflow and to meet their refinancing requirements in 2008 and the early months of 2009. We believe that these measures, together with efforts of regulators to bail out insolvent banks, helped to normalize the functioning of the banking system in 2009.

The regulators have also undertaken some measures which allow banks to maintain stability by disregarding some of the strict regulative requirements: for example, the Central Bank of Russia ('CBR') currently does not recall licenses for deposit attraction from banks which show losses two quarters in succession. This allows the stability of and confidence in the market to be maintained, as even some major banks remain loss making (mainly due to growth in allocated capital).

The stabilization of the general economic situation is also helping the banking system to recover and improve its indicators. This is evident in Q3 2009 results: over this period, according to the CBR, banks have earned 3.6 times more than in H1 2009. This is linked to some improvement in the situation with non-repayments of loans, as banks can now dismiss a part of allocated capital. September became the first month when the non-repayment dwindled: for corporate borrowers the figure was a decrease from 5.7% to 5.6% and for individuals it grew slower than expected (+2%).

Another positive factor which can support the further recovery of the banking system is the fact that the crisis has forced many banks to reconsider their development strategies, choosing more moderate and balanced scenarios. Banks have started to pay special attention to risk control, which was not a priority during the boom years. Many of the large banks have managed to develop conventional core banking businesses, and have moved away from opportunistic development and from specialized to universal business models. In particular, Russian banks have started to distribute a much wider range of products, have actively moved into retail banking and some have widened their presence in the economically developed regions.

There would therefore appear to be substantial latent demand to be met in the future. Drivers of demand for corporate banking services will include increased expenditure on infrastructure and reinvestment in aging industrial plant and equipment. Retail demand will be driven by gradual improvement in real disposable incomes (the Ministry for Economic

Development forecasts 2.8 growth in 2011) and realization of deferred demand for lending.

Although for the moment the reviewed strategies can lead to a reduction in loan portfolios of many banks, this is likely to become a long-term positive factor for the banking system's health and stability.

It's time for recovery

As we can see, the fall in the economy and the banking sector is turning into a recovery and, as many experts believe, potentially stable growth. Obviously, the economic situation in Russia in the months to come will depend on commodities prices and government policy. Oil prices directly impact budget revenues, and at the same time determine Russia's attractiveness for foreign investors. The second factor – government measures – has become crucial for maintaining the stability and flexibility of the financial system in the current situation.

Russia has a considerable demand for banking services as their penetration is low compared to Western countries. Deposit inflow (and, even more important, the avoidance of deposit outflow in the hard times) demonstrates the growing confidence of the population in the banking sector (state guarantees for deposits play a huge role). According to DIA forecasts the deposit portfolio of the banking system will grow by 20% by the end of 2009. Deposits are an important source of liquidity for banks and although deposit growth has not yet been followed by credit growth, it still helps the banking sector to reduce the debt burden. The creation of a stable deposit base in the banking system can be an additional factor contributing to the further recovery and development of the sector.

The crisis has negatively impacted the business activities of many players and some even had to leave the market, which means that competition has temporarily decreased, and the time may have come for new leaders to take their share of the banking market pie.

The potential of the Russian banking sphere is confirmed by the entry of some major Western players, both in retail and corporate banking sectors. Alexey Ulyukaev, Deputy Chairman of the CBR, attests that Russian banks will again become interesting for investors already in 2011².

At the same time, in order to increase its attractiveness for investors the Russian banking system longs for further modernization and an improvement in labor productivity. In the Russian banking system

² Vedomosti, "Growth is promised to banks", 26 October 2009

labor efficiency represents 23% of the US level. Growth of this indicator can give an additional push to the development of the banking system.

Thus, due to all of the factors and areas for improvement mentioned above, the Russian banking sector still remains a promising one. In comparison with developed economies, the Russian banking sector remains relatively underdeveloped. For this reason, during the crisis period the majority of foreign players have not seriously reduced their activities and some have considered the crisis as an opportune moment to expand their business or enter the market.

No one can guarantee a 'happy end' for the Russian or the global economy. Every day we hear pessimistic forecasts in relation to further developments, and not all signs are positive. However, the Russian economy has a strong resilience and the Russian authorities have proved able to quickly implement efficient measures in order to prevent a banking and economic collapse. This gives a certain level of confidence to investors.

To summarize, we can consider the Russian banking market as not necessarily the safest, but continuously improving and promising in the long-term perspective. This also applies to the Russian economy in general. This makes the market attractive for foreign investments and I believe that we will soon see new leaders emerging in different sectors of the banking business, as well as new players entering.

Russian Commercial Real Estate: Appealing Investment Destination. Is now the right time to invest in real estate?

(Svetlana Kara, CCIM Head of Capital Markets Praedium ONCOR International)



Svetlana Kara

Svetlana has a degree of Investment Adviser from the American Commercial Investment Real Estate Institute. Prior to joining Praedium ONCOR International she worked at Jones Lang LaSalle as Investment Adviser on Russia and the

CIS for three years. Svetlana is responsible for coordination of M&A transactions in real estate, working with institutional and private investors, international investment funds and large corporations. Svetlana has taught courses on macroeconomics and capital markets at JLL Real Estate Academy.

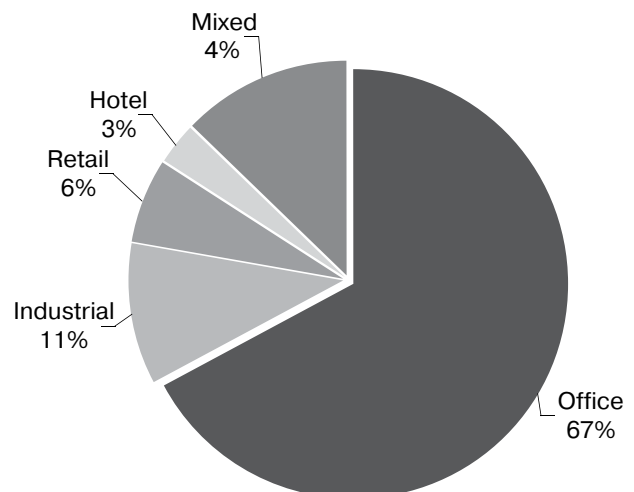
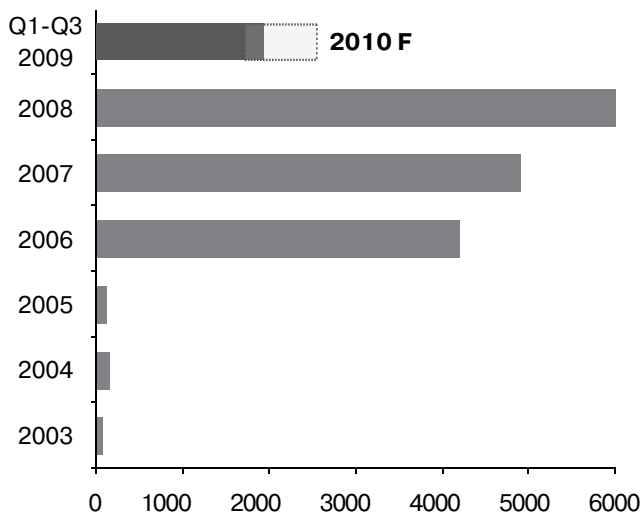
The Russian market continues to suffer from a negative media bias, suggesting that investment risks are high. However, the growing market transparency has continued to improve since the first institutional investment deal in 2003. Since that time, economic fundamentals and a growing exposure to western and international institutional players has reduced many concerns and abated the gap between perceived and actual market risk.

Russia's real estate investment market has grown significantly in recent years. Until 2006 commercial real estate investment activity was low. While this period saw a few small investment deals,

it was also characterized by low transparency, reducing the ability to accurately capture market transactions. It is believed that a significantly larger number of deals were transacted than is reflected in the data. In addition, off-market deals (those transacted without an agent and not announced publicly) comprised a significant portion of investment transactions.

In the third quarter of 2009 the commercial real estate investment market demonstrated growth in activity. The total investment volume reached \$1.94 bln in Q1-Q3 of 2009. Moscow remained the center of investment activity with a share of 94% of the total volume of capital invested in Russia. The share of regional transactions reduced significantly compared to the same period of 2008. However, investors are still interested in high quality regional projects, located in cities with a population over 1 mln people. From the beginning of 2009, following the 2009 trend, the office segment remained the priority destination of investment capital, with \$1.31 bln invested in Moscow assets. The retail sector demonstrated lower activity with only \$125.5 mln invested in Moscow assets. With growing investor interest in high quality real estate assets we estimate a stabilization of the current prime capitalization rates for quality office and retail assets in Moscow at the level of 10.5-11.0%. For high quality warehouse projects this figure stands at 12.5-13.5%. The level of capitalization rates in St. Petersburg is approximately 50 basic points higher than in Moscow.

Russian Real Estate Investment Volume Q1-Q3 2009, \$ mln



Source: Praedium ONCOR Int.

Despite the global financial crisis, the activity of foreign capital remains high, European and Asian investors continue considering investments into the Russian commercial real estate market as one of the main directions of the investment strategy. In Q3 2009 Chinese investment company Tsinghua announced their plans to invest around \$1 bln into Russian commercial real estate. Investment fund Heitman European Property Partners also announced about exceptional investment opportunities on the Russian real estate market in the current conditions. Whereas in 2007–2008 the share of cross-border transactions in the total investment volume reached 80%, in 2009–2010 year this figure will be significantly lower.

The cultural gap between international investors and domestic developers is narrowing. Despite this, the value of 'local expertise' remains high when navigating through Moscow's investment and development markets. Institutional investors usually commission extensive due diligence reviews from leading global accounting, consulting and legal firms and place high value on the transparency of assets and sellers. It also requires in depth market research and an understanding of the factors influencing future supply and demand is also critical.

Currently, investment levels in Russia have become comparable with the country's Eastern European neighbors. In 2008 the domestic real estate investment market saw more than \$6 bln in transactions, representing the largest investment volume to date. For 2009 current forecasts suggest that

this investment volume will significantly decrease to \$2.5 bln. Given the broader appearance of investment-grade assets and improving market accessibility, international investors are expected to play a more significant role in the near future, injecting investment capital at levels more commonly found in Western European markets.

With improving macro indicators, the Russian real estate investment markets are proving to be increasingly attractive to international and domestic investors alike. With the arrival of professional investors interested in institutional quality premises, local developers are quickly adapting. This has encouraged the implementation of best practices and has led to the standardization of lease agreements, increasing transparency of cash flows and higher quality of construction.

As a result, the attractiveness of the Russian real estate market is growing. Some international investors are increasingly considering higher risk alternatives to competing for standing investment grade assets, such as conducting development themselves or making investment acquisitions at the construction stage.

Selected Direct Investment Transactions in Russia, 2009

PROPERTY NAME	CITY	DATE	Investment Volume (\$ mln)	VENDOR	INVESTOR
Yuzhny Port business center	Moscow	Q1 2009	300,00	Midland Group	Sberbank
AC-Bureau warehouse complex	Ekaterinburg	Q1 2009	5,00	AC-Bureau	Protek
Tryapka shopping center	Moscow	Q1 2009	30,00	Avenue Group	Tashir Group
380 stores of Eldorado chain of supermarkets		Q1 2009	22,50	PPF Group	RTK
Griffon House business center	St. Petersburg	Q1 2009	17,00	Russian Real Estate Company	Storm Real Estate Fund
55 % of shares of Budapest hotel	Moscow	Q1 2009	60,00	15% – VTB 40% – MC Ko Hotels Management Ltd	Mos City Group (MCG)
Espace business center	Moscow	Q3 2009	195,00	AFI Developmnet	Private investor
Domnikov business center	Moscow	Q3 2009	350,00	OPIN	Private investors

Source: Praedium ONCOR International

Investments into Strategic Sectors of the Russian Economy – guidelines and perspective (Alex Stoljarskij, Associate, BEITEN BURKHARDT)



Alex Stoljarskij

Alex Stoljarskij joined BEITEN BURKHARDT Moscow as an Associate in 2006. After graduating from the University of Bayreuth with a degree in Law (2002) and in Economics (2003) he completed a traineeship at the Higher Regional Court of Berlin

and worked with the German Embassy in Tashkent and the German Consulate General in New York City. In 2006 he was admitted as an attorney at the District Court of Berlin. Alex is an active member of the German-Russian Chamber of Commerce. As deputy chairman of the Legal Committee of the Association of European Businesses in Russia, Alex participated in the legislative process of drafting the law regulating foreign investments in strategic sectors in Russia at the State Duma and published numerous articles related to foreign investments in Russia. He advises clients during market entries, in M&A and joint venture projects, as well as on trade and contract law. Alex is fluent in German, Russian and English.

Introduction

Regardless of the current economic crisis, the protection of national economies from foreign investors has long been a much discussed topic in many countries. Especially under the spotlight are so-called state funds and organizations under state control. There is a perceived threat that the purchase of control and management by these organizations harbors more than just economic reasons. With this in mind, it is hardly surprising that states are interested in preventing a range of sensitive sectors of their economy from being accessed by foreign investors. However, just how far control may extend is debatable.

Globally, many states already have corresponding law enforcement regulations¹, while others are discussing their introduction².

¹ For example, in the USA the Foreign Investment and National Security Act of 2007 amending the Exon-Florio-Act; in France the "Décret n° 2005-1739 du 30 décembre 2005 réglementant les relations financières avec l'étranger et portant application de l'article L. 151-3 du code monétaire et financier".

² The EU also plans to introduce corresponding rules of conduct for Sovereign Wealth Funds, see http://ec.europa.eu/commission_barroso/president/pdf/COM2008_115_en.pdf.

In May 2008, the Russian Federation also introduced a legal instrument to control foreign investments in sensitive sectors. Since then, it has been repeatedly invoked.

The legislative process

Special law enforcement regulations restricting foreign investments existed in Russia before 2008 only in relation to separate sectors, e.g. for banking activity, insurance, or investments in agricultural land areas³. In his address⁴ to the Federal Assembly in 2005, then-President Putin demanded legislative regulation for strategic sectors in order to protect the domestic economy on the one hand, and to provide for legal transparency for foreign investors on the other hand.

Due to the lack of consensus within the government⁵, a draft law was brought before parliament only in July 2007. The bill did not pass before the election of the new State Duma in spring 2008. Insofar as Russian constitutional law lacks the principle of discontinuity, the newly elected State Duma was able to continue its work on the old draft bill, so it passed the second reading on 21 March 2008. The AEB Legal Committee and other representatives of foreign investors were engaged in consultations with the Duma. Finally, on 2 April 2008, the State Duma passed the bill with a third reading in a substantially identical version to that of the second reading.

The Federation Council gave its approval on 16 April 2008, and the Federal Law "On Procedures for Foreign Investments in the Business Entities of Strategic Importance for Russian National Defense and State Security" (hereinafter the "**Law on Strategic Sectors**" or the "**Law**") was signed by President Putin as one of his last acts as president on 29 April

³ cf. article 18 of Federal Law No. 395-I of 02.12.1990 "On Banks and Banking Activity" published in "Sobranie Zakonodatel'stva" No. 6 dated 05.02.1996, position 492; clause 3 of article 6 of Federal Law No. 4015-1 dated 27.11.1992 "On the Organization of Insurance Activities in the Russian Federation" published in "Vedomosti s'esda narodnykh deputatov RSFSR" and "verchovno soveta RSFSR" No. 2 dated 14.1.1993, Position 56.

⁴ http://www.kremlin.ru/appears/2005/04/25/1223_ty-pe63372type63374type82634_87049.shtml.

⁵ According to the press (see Kommersant dated 02.03.2006), the liberal fraction, which wanted to bring in the least amount of restrictions on foreign investors, opposed those who strove to impose as many restrictions as possible. See also the reply of the Ministry of Industry and Trade <http://www.minprom.gov.ru/press/release/173>.

2008. A few days later, on 7 May 2008, the Law was published⁶ and entered into force.

The basic principle of the Law

The purpose of the Law pursuant to article 1 is “ensuring Russian national defense and state security”. However, a specific definition of this concept is lacking in the Law. Organizations which carry out activity in one of the defined “strategic sectors” are subject to protection, and although the purchase of control is not prohibited per se, it is necessary to pass through a formalized agreement procedure with the participation of several government agencies.

Applicable sphere – strategic sectors

Article 6 of the Law on Strategic Sectors specifies 42 sectors which are considered strategic and subject to the procedure set out by the Law. These sectors can be categorized as follows⁷:

- activity actively influencing hydrometeorological and geophysical processes and phenomena, as well as activity connected with use of infectious agents;
- nuclear industry, as well as handling of radioactive materials;
- cryptology;
- military arms and technologies;
- aviation;
- astronautics;
- natural monopolies (i.e. services and infrastructure corresponding to Federal Law No. 147-FZ “On Natural Monopolies”, dated 17.08.1995);
- geological study of subsoil and (or) survey and extraction of useful minerals on subsoil plots of federal importance;

Also, during the legislative process, a few further sectors were introduced, including organizations engaged in printing and publishing⁸, commercial fishing, and radio and TV broadcasting.

While certain sectors obviously develop a clearly sensitive nature, doubt still surrounds how far they shall be interpreted. Some issues regarding the applicability of the Law lack clarity: Why, for example, is radio broadcasting a strategic sector (see subclause 34 of clause 1 of article 6 of the Law), if the radio broadcaster reaches more than half of the populace of one single constitutive territory⁹ of the Russian Federation? During the legislative process there was fierce disagreement over the amount of sectors¹⁰.

Subclause 2 of clause 1 of article 3 of the Law clearly sets out that a target company is considered strategic when it conducts activities in at least one of the named sectors. The actual degree of activity does not play a role. Clause 1 of article 10 of the Law states that the mere presence of a license to carry out a “strategic” activity serves as an indicator of strategic importance. In practice, and for the avoidance of doubt, the foreign buyer will regularly undergo the approval procedure during the purchase, if the target company has such license.

Purchase of control

The purchase of control over an enterprise in a strategic sector is the key criteria of the Law. In response to the issue of when control is present, it is important to discern between foreign private and foreign state investors:

For foreign state investors (which include organizations controlled by a foreign state), the purchase of control is considered as participation in an amount greater than 25%, in accordance with clause 3 of article 2 of the Law on Strategic Sectors. The purchase of participation greater than 50%, in accordance with clause 2 of article 2 of the Law, is prohibited. In addition, in connection with parallel changes in the Law “On Foreign Investments in the Russian Federation”¹¹, every purchase by a foreign state investor resulting in participation of 25% or

⁶ Federal Law N 57-FZ dated 29 April 2008 “On Procedures for Foreign Investments in the Business Entities of Strategic Importance for Russian National Defense and State Security”, published in “Sobranie Zakonodatel'stva” No. 18 dated 05.02.2009, Position 1940.

⁷ The list of sectors is not convincing. An attempt by the authors of the Law to give as much detail as possible to the definitions gave rise to rather artificial divisions to the sectors: so, for instance, the Law identifies differences between the use of nuclear materials, handling of radioactive waste, production of nuclear machinery, design of such machinery and construction of such machinery. This needlessly complicates the number of sectors, cf. the detailed survey of Pritzkow/Schreiter, *Osteuropa Recht* 2008, 157, 158 f. (in German language).

⁸ The broad applicability of the Law is proved by news published by RBK Daily on 29 January, 2010, according

¹⁰ which the FAS may not allow German publisher Axel Springer to acquire the Russian operations of Gruner + Jahr. Citing a high ranked FAS official, FAS has indefinitely suspended considering the deal between the two publishers; see <http://www.rbcdaily.ru/2010/01/29/media/455470>.

⁹ The Russian Federation comprises 83 constituent territories, cf. article 65 of the Russian Constitution.

¹⁰ Hence, thanks to the special intervention of the Ministry of Telecommunication, Internet providers and businesses engaged in telecommunication are not related to strategic sectors, despite the original plan for them to be so; cf. *Moscow Times* dated 07.03.2008.

¹¹ Federal Law No. 160 dated 09.07.1999 “On Foreign Investments in the Russian Federation”, published in “Sobranie Zakonodatel'stva”, 1999, No. 28, Position 3493.

greater, even in non-strategic sectors, is subject to the procedure applicable for strategic sectors.

For all other foreign (private) investors, control arises in the event of a purchase of more than 50% participation. For the purposes of defining a foreign investor, clause 2 of article 3 of the Law refers to article 2 of the Law "On Foreign Investments in the Russian Federation". These are legal entities and legal groups of entities (partnerships) incorporated abroad¹².

Nevertheless, the Law stipulates that in certain circumstances control is also present even if there is an inconsequential participation share, see clause 1 – 2 of article 5. The Law, for example, names cases where the investor has the right to appoint an executive body of the company or can carry out actual control over the company on the basis of other contractual structures.

Special rules apply for organizations which develop subsoil resources and have federal significance¹³. Here, the presence of control is assumed if the foreign private investor purchases 10% or more of shares (and if foreign state investors purchase more than 5%). These restrictions do only not apply if the Russian Federation itself already owns more than 50% of shares in such enterprise and (or) if the Russian Federation can directly or indirectly control more than 50% of the total votes.

Unfortunately, until the introduction of further regulation, the concept of control remains rather unclear, which remains one of the most critical points when analyzing the Law. It is undeniably clear that in the case of more than 50% participation control is achieved. It remains unclear, however, when participation below this threshold should also be considered as control. During the legislative process, representatives of the AEB Legal Committee proposed a borderline of 10-20% below which control is not present, in order to remove clean portfolio investments from the applicable sphere of the Law. Control shall also be considered as not present in cases where another participant owns a larger participation share. Both of these suggestions were discussed, although lamentably they did not survive in the final edition of the Law. This must be deduced as a sign that the Russian government wishes to reserve the right to intervene in cases where participation is at a much lower level than 50%, which questions the claimed aim of providing clear guidelines for foreign investors.

¹² Also included are natural persons who hold foreign citizenship.

¹³ See also Federal Law "On subsoil" N 27-FZ from 03.03.1995, published in "Sobranie Zakonodatel'stva" No. 10, dated 06.03.1995, Position 823.

All transactions resulting in the purchase of control over a strategic company are subject to the Law, even if they are concluded outside Russia (see clause 5 of article 2 of the Law).

Proceeding from the text of the Law, it remains unclear whether prior approval is required for the creation of a subsidiary company in a strategic sector. That said, it is highly likely that, in the framework of the procedure of issuing licenses to carry out activity in a strategic sector, such a license will not be issued to a company under foreign control. At the present time, it has also not been decisively resolved whether an asset deal is subject to the Law¹⁴

Agreement procedure

A foreign investor must receive the prior consent of a Government Commission if purchase of control over a strategic enterprise is intended. Article 8 of the Law establishes a complex procedure¹⁵.

- As a first step, the foreign investor must provide extensive documents to the authorized agency, the Federal Antimonopoly Service (FAS)¹⁶; see clause 1–2 of article 8 of the Law on Strategic Sectors.
- The FAS registers the application and examines the documents. If it comes to the conclusion that the investment is prohibited in accordance with clause 2 of article 2 of the Law, the documents are returned to the applicant, see clause 4 of article 9. If the FAS concludes that the Law is not applicable due to the lack of establishing control by the foreign investor, it returns the documents to the applicant; see clause 3 of article 9. In this case the investment can be made without prior consent.
- In all other cases, the FAS sends the documents to the Federal Security Service (FSB), and if necessary to the Inter-Agency Commission for Protecting State Secrets, and requests their separate conclusion.
- After receiving that conclusion, the FAS sends the documents and a draft decision to the Govern-

¹⁴ Elizarov, in "State Regulation on Engaging Foreign Investment in Strategic Sectors of the Economy of the Russian Federation", *Korporativnyi Jurist* 2008 / 10, p.7 states that asset deals are not regulated by the Law.

¹⁵ The procedure is also regulated in other subordinate acts, and particularly in the Government Resolution No. 795 dated 27.10.2008, published in "Sobranie Zakonodatel'stva", No. 44, dated 3.11.2008, Pos. 5097.

¹⁶ The competences comply with Resolution of the Government of the Russian Federation No. 510 dated 06.07.2008 "On the Government Commission on controlling Foreign Investments in the Russian Federation", published in "Sobranie Zakonodatel'stva" No. 28 dated 14.7.2008, Position 3382 (hereinafter "Resolution No. 510").

ment Commission¹⁷, which takes the final decision on the application. During this process it can, in accordance with clause 1 of article 12 of the Law, other than rejecting outright or approving the request, decide that the application can be approved under certain conditions (for instance, preservation of employment positions or certain production sectors in the country, defining regulations on occupying executive positions etc.). The Government Commission makes its decision at meetings, which, as a rule, are held once every quarter¹⁸.

- The decision of the Government Commission is then officially registered by the FAS and transferred to the applicant.

According to clause 4 of article 11 of the Law, the duration of the consideration procedure must not exceed 3 months from the provision of the full set of necessary documentation¹⁹. In exceptional cases, the term may be increased by another 3 months.

The decisions of the Government Commission can be appealed in the Higher Arbitration Court of the Russian Federation²⁰.

If there are any doubts in relation to the possibility of receiving consent, in accordance with clause 6 of article 8 of the Law on Strategic Sectors, it is possible to approach the FAS with a preliminary inquiry. The FAS shall within 30 days check whether the agreement procedure is required in the case in question. That said, it is unclear to what extent a reply to such a preliminary inquiry will be admissible in court.

If a foreign investor purchases participation which does not give it rights of control, it is possible to avoid undergoing the agreement procedure. However, pursuant to article 14 of the Law, an investor must notify the FAS on each instance of a 5% or more purchase of a participation share in an organization within a strategic sector.

Sanctions

Article 15 of the Law on Strategic Sectors stipulates stern sanctions for transactions violating the Law. Hence, rights connected with participation shares

which were purchased in violation of the requirements of the Law can be blocked, and an adopted decision declared invalid.

The wrong law at the wrong time? – An evaluation

Despite the requests of foreign investors, in accordance with article 17 the Law was introduced into full force without a transitional phase.

As a result, a number of necessary subordinate regulatory acts were lacking when the Law became effective. They were published in partial form only significantly later²¹ and for a period of a few months foreign investments in strategic sectors were effectively barred.

Investors, as is well-known, are a highly sensitive breed. Therefore, the mere adoption of the Law caused ripples of disquiet among major investors, and naturally they have been reluctant to be the first to test the water. Even members of the government assumed that investment volumes would decrease²². At the same time as Russian officials explicitly lauded the final creation of legal security for investors through this Law, foreign investors and business associations criticized the generally restrictive direction of the Law, as well as the multitude of imprecise and bureaucratic rules.

At the same time, it is necessary to note that the Russian legislation does not operate as a unique mechanism, and is susceptible to the legislative trends of other countries, which have also published or plan to adopt measures to safeguard themselves from undesirable foreign investment. This trend is causing uneasiness among proponents of free market economics.

Thus, the evaluation is mixed. The Law is certainly a welcomed introduction, if the aim of creating clear legal guidelines will be taken seriously. However, practice up to now has not hidden the fact that concepts and criteria have not been precisely formulated.

Therefore, the issue of making amendments to the Law on Strategic Sectors is already being discussed for a while²³. As a result of acknowledging the

¹⁷ See Resolution No. 510; besides the prime minister another 16 members have joined the commission, including several ministers and heads of state authorities. See also the Order of the Government No. 975-r from 06.07.2008 on the composition of the commission, published in "Sobranie Zakonodatel'stva" No. 28 dated 14.7.2008, Position 3408.

¹⁸ The fifth and latest meeting of the commission took place on 21 December 2009.

¹⁹ Initial practice has shown that there are differing interpretations of what is to be considered as a "full set of documentation" since the FAS often requests further documentation related to the deal, which is not explicitly mentioned in the Law.

²⁰ Until now, not one decision on this issue has been adopted.

²¹ The latest Government Resolution No. 838, regulating according to clause 6 of article 11 of the Law the procedures for preliminary approval of the transactions, approval of establishing control and the procedures for processing the petitions that are not regulated by the Federal Law was finally adopted on 17 October 2009.

²² Thus, for instance, the Minister of Finance, Mr. Kudrin, expected an outflow of foreign investment in connection with the Law; cf. Moscow Times dated 07.06.2008.

²³ cf. Vedomosti, dated 28.05.2009.

fact that Russia continues to rely on foreign investments in order to develop an efficient infrastructure and modernize its production facilities, earlier last year it was announced by the FAS that barriers for foreigners would be eased²⁴. Finally, FAS and other government agencies elaborated amendments to the Law and it was announced that prior then submitting the draft to the government for further legislation, FAS intends to hold a series of consultations with foreign and Russian investors in order to hear their proposals²⁵.

Upon completion of this article, the draft amendments were not published yet, but it is already clear that proposed changes so far are admittedly quite minor and not substantial. However, the AEB will continue its active dialogue²⁶ with the FAS and gladly welcomes the opportunity being further involved in the ongoing developments, providing particularly through its member companies and its Legal Committee, members of which are working with foreign companies and dealing with this Law on a daily basis, important input for a further improvement of the investment climate in Russia.

²⁴ cf. RBK Daily of 01 October, 2009, <http://www.rbcdaily.ru/2009/10/01/focus/433990>.

²⁵ See FAS press release of 27 January, 2010 http://fas.gov.ru/news/n_28784.shtml.

²⁶ A recent meeting between the FAS and representatives of the AEB took place on 02 December, 2009, see also FAS press release http://fas.gov.ru/news/n_27988.shtml.

REGIONAL ASPECTS OF INVESTING IN RUSSIA

The Russian regions: Moscow is not everything (Thorsten Nestmann, Vice President, Deutsche Bank Research)



Thorsten Nestmann

Thorsten Nestmann is a Vice President at Deutsche Bank Research in the Global Risk Analysis Team and has been with the bank since 2005. He provides internal sovereign ratings and macroeconomic research for Russia and the

CIS and acts as a centre of competence for DB's credit risk management, as well as DB's management board. He has carried out several topical research projects, e.g. on Russia's regions and financial system. Thorsten also spent one month at John Hopkins University in Washington DC doing research on US-Russia economic relations. Prior to joining Deutsche Bank, Thorsten worked for the German Central Bank in the department of banking supervision, focussing on German banks' foreign lending activities. At the same time, he worked as a Research and Teaching Associate at the University of Mainz where he obtained a PhD in Economics in 2006.

Introduction

The Russian Federation, the world's largest country by surface area, comprises 83 heterogeneous regions. The city of Moscow¹ is without doubt the political, economic and financial centre of Russia. Still, there is more to Russia than Moscow. While Moscow accounted for over 50% of the country's credit institutions and foreign direct investment in 2007, its shares in gross regional product and population were below 25% and 8%, respectively. There are numerous investment opportunities available in Russia's regions outside of Moscow. However, finding attractive investment locations in a country as large and diverse as Russia is a challenge.

This article focuses on 9 regions which have an above-average investment climate. There are two reasons to focus on regions with a particularly good investment climate: first, because the investment climate is obviously a key determinant when a firm

decides to allocate capital to a particular region. Investment is still low in Russia as a percentage of GDP, constraining its medium-term growth prospects. Second, a favourable investment climate is conducive to innovation. This is an important factor if Russia wants to reduce its dependence on natural resources. The investment climate rating we use reflects both the investment potential and the investment risk of each particular region. It turns out that Moscow's investment climate ranks highest, followed by that of St. Petersburg and of Moscow Region.

We start by outlining the institutional set-up of Russia's regions, focussing on the relationship between individual regions and the federal centre. We then present our ratings for the regional investment climate. Subsequently, we analyse the selected regions in detail with regard to their population, economic size and structure, FDI and banking sector activities.

Regions' institutional set-up

The Russian Federation consists of 83 federal subjects or regions (субъект). While the English terms are used interchangeably, these administrative units are of several different types: 46 regions proper (область), 21 republics (республика), 9 territories (край), 4 autonomous areas (автономный округ), 2 federal cities (Moscow and St. Petersburg) and 1 autonomous region (автономная область).

According to the constitution, all the regions are equal subjects of the Russian Federation.² The distribution of power between the federal centre and the regions is defined in the Russian constitution. For instance, defence, customs and foreign policy are exclusively assigned to the central authorities.

Other areas, like ownership and use of land, mineral resources, water, and other natural resources as well as public health and taxation are defined as joint competences of the federal and regional authorities.³ In principle, regions are allowed to decide upon revenues and expenditures subject to the national tax law.⁴ The regions' revenues often fall short of their expenditure needs, making

¹ We refer to Moscow city proper as Moscow.

² See Article 5 of the constitution.

³ See OECD (2005, p. 110).

⁴ See Fitch (2008b, p. 3) for an overview.

many regions dependent on transfers from the federal centre.⁵ Regions are authorised to issue public debt and 49 regions had a credit rating issued by an international rating agency as of January 2009.⁶ Finally, powers not exclusively assigned to the federal centre or not perceived as joint competence between centre and regions are to be exercised solely by the regions.⁷ With regard to the joint competences, there is little guidance in the constitution as to how the power is distributed between the federal centre and the regions.⁸

What are the best regions to invest in?

In what follows, we focus on the regions with the best investment climate.⁹ The investment climate classification reflects both the investment potential as well as the investment risk in a region. There are 12 investment climate categories which range from “maximum potential with minimum risk” (1 A) to “low potential with extreme risk” (3 D).

- The *investment risk indicator* focuses on the probability of an investment loss based on factors related to legislation, finance, economics, ecology, administration, crime and the social framework. The regions are ranked relative to the average Russian risk level (Russia = 1).
- The *investment potential indicator* focuses on characteristics such as production factor endow-

ment and regional commercial sales opportunities. The investment potential is measured via indicators related to the labour market, consumption, production, finance, innovation, infrastructure, institutions, environmental resources and tourism. In contrast to investment risk, regions are in this case not ranked according to an index but on the basis of their share in the investment potential of all regions taken together.

To derive a ranking of the best regions in which to invest, we first looked at the investment climate ratings from 1995 to 2007.¹⁰

As there is considerable variation in both the investment potential and investment risk ratings from year to year, we created a proxy for long-term investment climate by selecting regions with above-average investment potential and at the same time below-average investment risk over the period 1995–2007. We were thus left with 11 regions satisfying this criterion.¹¹

In addition, we took the latest (2008) investment potential and risk ratings for our selected regions into account. Compared with the period 1995–2007, eight regions maintained or improved their investment climate rating in 2008, and therefore were selected for the “top regions” ranking. The three remaining regions, namely Moscow, Belgorod Region and Saratov Region, had a worse investment climate rating in 2008 than in 1995–2007. Still, we decided

Table 1: The top 9 regions with above-average investment potential and below-average investment risk 1995–2007 (2008)

	Investment potential	Investment risk	Investment climate
Moscow	16.1 (17.6)	0.77 (1.02)	1A (1B)
St. Petersburg	5.5 (6.5)	0.82 (0.93)	1B (1B)
Moscow R.	4.1 (4.8)	0.87 (0.91)	1B (1B)
Samara R.	2.2 (2.0)	0.98 (1.07)	2B (2B)
Krasnodar T.	2.1 (2.6)	0.90 (0.73)	2B (2A)
Nizhni Novgorod R.	2.1 (2.0)	0.87 (0.87)	2B (2B)
Rep. of Tatarstan	2.0 (2.1)	0.82 (0.82)	2B (2B)
Rostov R.	1.9 (2.0)	0.93 (0.79)	2B (2A)
Rep. of Bashkortostan	1.9 (1.8)	0.91 (0.91)	2B (2B)

Note: The investment potential score reflects a region’s share in the overall investment potential of Russia and ranges from 0% to 100%. The investment risk score reflects a regions’ relative position in relation to an average Russian risk level of 1. Figures in brackets refer to the latest rating from autumn 2008.

Sources: *Expert RA, DB Research*

⁵ See Hanson (2005, p. 314).

⁶ See CBR (2009, p. 34). Fitch (2008b, p. 4) notes that there is a ban on the regions issuing external debt which will be lifted (with some constraints remaining) from January 2011 due to amendments to the budget code in January 2008.

⁷ See Articles 71 to 73 of the Russian constitution.

⁸ See e.g. Territories of the Russian Regions (2002, p. 6).

⁹ The ratings are provided by Expert RA, a leading Russian rating agency.

to include one of them, Moscow, in our list, since it had a fairly good rating (1B) in 2008. Table 1 shows our final rating.

¹⁰ See the special analysis included in the 2007 edition of the investment climate rating.

¹¹ Neither the regions accounting for a large fraction of current oil and gas extraction nor the regions with large future potential in this regard satisfy this criterion.

Regions' population and area

The Russian Federation has a population of 142 million. More than 80% of its inhabitants live in the European part of Russia (Central, North-West, South, Privolzhsky (Volga) and Urals federal districts) and 73% are urban dwellers. Two regions, Moscow and St. Petersburg, together account for 10% of the Russian population (see chart 6) and have a share of 22% of Russia's investment potential. The other 7 regions make up 22% of the Russian population and 16% of the investment potential.

Seven of the 11 Russian cities with a population of more than 1 million are situated in the top 9 regions. Most of these cities, except Omsk and Novosibirsk, are located in the European part of Russia. The Privolzhsky Federal District alone contains four of these cities (Nizhni Novgorod, Samara, Kazan and Ufa).

Russia's land area is 1.7 times larger than that of the USA and 47 times larger than that of Germany. The top 9 regions account for only 4.1% of the total area of Russia.

Russia's population density is, at 8.4 people per sq. km, among the lowest worldwide. For comparison, the United States has a population density of 31 and Germany of 232 people per sq. km. Within the 9 regions, population density varies. There are 9,000 people per sq. km in Moscow, 3,000 in St. Petersburg, 145 in Moscow Region and below 100 in the other 6 regions. A low population density may obstruct economic development as it is, for instance, very costly in per capita terms to provide necessary transport and communication infrastructure.

Regions' economy

The regions' economic size, measured in terms of Russia's gross regional products (GRPs), shows a large variation. The city of Moscow is the unchallenged economic centre of Russia with a GRP of USD 274 bn in 2007, accounting for 24% of Russian GDP. Second to Moscow comes resource-rich Tyumen Region (not among the top 9) with USD 114 bn, followed by Moscow Region (USD 53 bn) and St. Petersburg (USD 45 bn). The top 9 regions together accounted for 45% of Russian GRP in 2007.

GRP growth rates have been strong in all of the top 9 regions, ranging between 5.8% and 10.3% in the period 2000-2007. From 2000 to 2007, Rostov Region had the highest growth rate among the top 9. At first sight, this would point to convergence given that Rostov had the lowest GRP per capita among the top 9 in 2000. However, there is no consistent

evidence of GRP convergence in the top 9 regions. This observation is in line with studies showing that income convergence appeared to take place only for some regions or during specific periods.

GRP per capita also exhibits huge disparities. Russia's gross regional product per capita averaged USD 6,300 in 2007, with a large standard deviation of USD 5,000. Russia's wealthiest region by far was the resource-rich but scarcely populated Tyumen Region (3.3 m inhabitants) with a per capita GRP of USD 34,000 in 2007.¹² Within the top 9 regions, GRP per capita ranged from USD 26,225 in Moscow to USD 4,300 in Rostov Region.

In the top 9 regions, seven economic sectors accounted for about 83% of gross value added in 2007. Manufacturing was of particular importance in the Republic of Bashkortostan and Samara Region, wholesale and retail trade in Moscow, Moscow Region, St. Petersburg and Rostov Region; transport and communication in Krasnodar; real estate, leasing and services in Moscow, St. Petersburg and Nizhni Novgorod; agriculture in Krasnodar Territory and extraction and processing of commodities in the Republic of Tatarstan.

Regarding the share in Russia's output per sector in 2007, the top 9 regions accounted for 45% of manufacturing, 64% of wholesale and retail trade, 44% of transport and communication, 62% of real estate, leasing and services, 39% of construction, 25% of agriculture and 12% of extraction and processing of commodities. The top 9 regions do not hold a dominant position with respect to fishing and extraction of commodities.¹³ Within Russia, the two main regions for oil and gas extraction are the Khanty-Mansiysk and Yamalo-Nenets Autonomous Areas. The Khanty-Mansiysk Autonomous Area accounted for 57% of oil and 4.5% of gas production and the Yamalo-Nenets Autonomous Area for 9% of oil and 86% of gas production in 2007.

FDI in Russia's regions

Foreign direct investment is associated with positive spillovers regarding technological and management know-how and is therefore regarded as a contributor to economic growth. In general, empirical analyses on this subject are constrained by the fact that FDI is heavily concentrated in only a few regions in Russia.

¹² Note that Tyumen Region's GRP per capita includes the GRP and population of the Khanty-Mansiysky and Yamalo-Nenetsky Autonomous Areas

¹³ The main fishing regions are Murmansk Region, Primorski Territory and Kamchatka Territory, together accounting for over 50% of total GRP from fishing.

Sakhalin Region, where large oil and gas resources are situated, and Moscow alone accounted for 59% of all FDI inflows in 2000-2007.¹⁴ A further 19% of total inflows went to Moscow Region, Omsk Region, Krasnodar Territory and Tyumen Region. Hence, only six regions accounted for 77% of all FDI inflows.

In per capita terms, the regions exhibit large disparities. The average per capita FDI inflow in Russia was around USD 73 p.a. between 2000 and 2007. While Moscow leads the FDI per capita league among the top 9, the city is dwarfed by the average USD 4,300 per capita inflows which were directed to Sakhalin Region.

The global economic slowdown has reduced FDI inflows to Russia, which were down by 45% yoy in H1 2009, but the potential for further FDI inflows remains large. The energy sector will continue to attract foreign corporates eager to exploit Russia's huge wealth of natural resources. Another example for likely continued foreign interest is the retail sector, where growth is expected to be strong once Russia recovers from the crisis as consumption demand for many products is still unbroken. The regions outside Moscow may be of particular interest given their double-digit retail sales growth in recent years. In the near future, regional FDI inflows may also benefit from investment opportunities in special economic zones as well as in Sochi, where the Olympic Winter Games will take place in 2014. That said, the extent to which Russia's FDI will unleash its full potential will depend on improvements in the country's relatively weak institutional environment.¹⁵

Banking in the regions

Banking in the Russian regions became a hot topic in recent years. Large Moscow-based banks aimed to increase their market share by expanding in the regions. Regional banks, in turn, also expanded to other regions. Foreign banks increasingly looked towards the Russian regions as local banks' price-to-book-values were more attractive than in Moscow.¹⁶ Furthermore, international organisations such as the World Bank and the EBRD have focussed their attention away from the centre towards the regions and regional banks.¹⁷

¹⁴ Note that investments targeted for Russia's regions may be registered in Moscow as companies have headquarters there. See Ledyeva & Linden (2006b, p. 3).

¹⁵ For example, the 2008 "Control of Corruption" indicator of the World Bank's "Governance Indicators" implies that 84% of countries score better than Russia.

¹⁶ See Mellow (2007, p. 54).

¹⁷ Evans (2006, p. 242).

But despite increased interest in the regions, Moscow's position as Russia's financial centre is undisputed. Moscow accounted for 31% of total loans and 50% of total deposits at the end of December 2008. Out of 1,108 credit institutions in Russia, 543 were situated in Moscow (see chart 15). In most regions, apart from Moscow, St. Petersburg and Tatarstan, regional banks only account for a small fraction of total loans.

The other 8 of the top 9 regions (i.e. excluding Moscow) accounted for 25% of loans and 14% of deposits of legal entities, as well as for 26% of loans and 39% of deposits of individuals. Except in Krasnodar, where agricultural loans are important, in all regions loans to the manufacturing sector and retail trade dominate. Construction accounts for between 10% and 20% in several of the top 9 regions. Moscow and St. Petersburg stand out with regard to loans in the real estate sector, which amount to over 10% of total loans.

Banking profits are very unevenly distributed across the regions. Moscow accounts for 85% of total profits by Russian credit institutions in 2008, much higher than its share in loans. This may be due to the fact that many loans in the regions outside Moscow are extended by Moscow-based banks. Another reason may be that some large Moscow-based banks have a more diversified asset structure including fee-based revenues e.g. from M&A activities. Taken together, the top 9 regions account for 93% of all banking sector profits. Profits have declined significantly recently, mainly due to rising provisions against the background of deteriorating asset quality related to the economic downturn.

The global crisis affects Russia's regions

The crisis has put a brake on consumer and investment demand across all regions. Since the regions are so heterogeneous, there is no "one-size-fits-all" economic policy to address these problems. It is also too early to assess the success of the authorities' efforts to deal with the economic crisis at the regional level.

One of the most visible impacts of the global crisis on Russia's regions is the increase in social tensions due to rising wage arrears and unemployment. This rose to 8.3% in June 2009 from 5.3% in September 2008. While support for the political elite is in general still strong, the risk of social unrest has increased. Municipalities and cities relying on one or a few large companies (monocities) in terms of employment and fiscal revenues are particularly hard hit. Against this background, the government

developed a plan to provide help for these monocities. Under this plan, there are about 400 towns and cities eligible for state assistance in 2010.¹⁸

The economic downturn has also put pressure on regional budgets as tax revenues have dropped. Total regional revenues excluding transfers decreased by 14% in H1 2009 compared to H1 2008 while expenditures increased by 20% over this period. Another reflection of increased centre-regional tensions is the resignation of five regional governors since the beginning of 2009.¹⁹ In the coming months, the term in office of 14 regional governors will expire.²⁰ Whether the President will propose that the incumbents remain in office will not least depend upon their ability to promote economic and political stability in their region.

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¹⁸ See Bush (2009a).

¹⁹ See IHS Global Insight (2009a, 2009b). The resignation of the governors of Pskov, Orel and Voronezh Regions and Nenets Autonomous Area was announced by President Medvedev on February 15 while the resignation of the governor of Murmansk was announced on March 21.

²⁰ For details see Schneider (2009, p.5).

POST ACQUISITION ASPECTS OF INVESTING IN RUSSIA

Accounting and internal control systems

(Ilya Kotlov, Partner, Risk & Compliance, KPMG in Russia and the CIS)



Ilya Kotlov

Ilya Kotlov is responsible for delivering internal audit services. He has over nine years of consulting experience in the area of business process controls, risk management and corporate governance. Ilya currently heads work on issues in relation to internal controls, internal audit and implementation of the requirements of Sarbanes-Oxley at KPMG in Russia and the CIS. Ilya has extensive experience in providing advisory services on corporate governance, internal audit and risk management. He graduated from the Plekhanov Russian Economic Academy, specialising in economics. Ilya is a Certified Information Systems Auditor (CISA) and a Certified Internal Auditor (CIA).

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An increasing number of large and medium sized Russian companies publish corporate results in accordance with both Russian Accounting Principles and either IFRS or US GAAP. The latter two sets of standards have largely been adopted to comply with listing requirements of international stock exchanges, to receive financing from banks or to attract investment.

A growing number of Russian companies are listed on the US, UK and other stock exchanges and need to comply, respectively, with Section 404 of the Sarbanes-Oxley Act or the Combined Code on Corporate Governance. Certain Russian companies considering an IPO as a means of attracting investment are also seeking to comply with these regulations in advance of their listing.

However, the vast majority of small and medium sized businesses in Russia prepare only statutory financial statements based on Russian Accounting Principles and have not implemented a modern internal control system.

The purpose of this article is to provide the reader with a perspective on Russian accounting and internal control, to identify some key features and to examine areas of change in Russia where convergence with internationally accepted practice is taking place.

Russian Accounting Principles

The term 'Russian Accounting Principles' (RAP), or sometimes 'Russian Accounting Standards' (RAS) is used informally to describe the body of laws, decrees and ministerial orders governing, directly and indirectly, accounting and reporting in Russia.

Actual reform of the accounting and financial reporting system started with the adoption of the Federal Law on Accounting in 1996 and the revision of the Accounting and Financial Reporting Regulation in 1998. This continued with the introduction of the new Chart of Accounts in 2000 and a series of accounting regulations (so-called PBUs). Many of the fundamental concepts of IFRS have been introduced into the Russian environment. However, significant differences remain between IFRS and RAP.

Financial accounting is now to a large extent separate from tax accounting. However, in practice, as the policing of tax reporting is far more apparent than the policing of financial reporting, the tax rules will usually prevail where there is perceived conflict.

Current Russian accounting practice is characterised by the following:

- Regulations are rule rather than principle based.
- Although accounting principles often appear very similar to IFRS, in many cases they are applied differently in practice.
- While the main function of accounting under the law is to provide the users of financial statements with complete and reliable information on an entity's performance and financial position, accounting is still seen as a tool to ensure that entities comply with legislation and use material, labour and financial resources within set limits.
- The law emphasises supporting every transaction with formal source documents, that represent the basis of the accounting records (e.g. an invoice for a sales transaction, and an internal administrative note with supporting calculations for a provision).
- Prudence plays an important role in accounting. However, although prudence is defined formally as a "higher preparedness to recognise expenses and liabilities rather than possible income and assets", in practice it is interpreted to mean a need for appropriate source documents. For example, often entities do not record accruals at the end of

the year on the grounds that no supporting documents were available at that time.

- While substance over form is stated as a principle, in practice form often takes priority over substance.
- Consolidation requirements are limited and sometimes unclear due to the absence of ‘true’ acquisitions in the past in Russia.

Although differences remain, it is the Russian government’s stated policy to align RAS with IFRS as far as is practical. Progress has been made, although the pace has slowed somewhat over recent years.

Internal control systems

The concept of a control system is closely linked to accounting in Russian business. It may be argued that control in the Russian context has a narrower definition than control as defined and understood from an international perspective.

At the international level, there have been a number of legal regulatory developments in relation to corporate governance which firmly place responsibility on the Board of Directors to ensure that an installed risk and control environment exists within the business to identify, quantify and manage business risk.

The legacy control systems of Russian companies have evolved in a different manner and along a narrower definition of control as relating to accounting and financial reporting, and with limited involvement and oversight by the directors.

The chief accountant plays an important role in Russian companies. Chief accountants are responsible for maintaining books of accounts in compliance with Russian laws and can minimise issues arising from tax and accounting inspections. They have a large amount of personal responsibility for the correct application of the rules.

There is a function usually called the Control and Revision Group (KRU) in many Russian companies. Historically the role of the KRU was to observe and check transactions and ensure compliance with procedures, instructions, laws and regulations. Testing was undertaken at the transaction level on historical financial data in the form of manual and detective type controls.

The KRU is usually focused on past events and is used as part of the management control function. Reporting lines are typically to a financial executive and, as such, KRUs are not truly independent in terms of determining the scope of work of the

function, performing work and communicating the results of work.

In many modern Russian companies the KRU exists alongside Internal Audit (IA), which functions as the instrument used by the Board of Directors to independently assess how management is performing functions delegated to them by the Board. Specifically, the IA independently assesses whether management effectively performs the function of ‘risk management’ and ‘business process controls’.

The Russian securities market regulator, the Federal Service for Financial Markets (FSFR) encourages companies to invest in internal control and audit systems, and promotes the Code of Corporate Governance. It specifically requires (for A and B level listed companies) that “...the Board of Directors of the issuer should approve a document that determines internal control procedures over financial reporting and business operations. Control over compliance with the internal control procedures should be performed by a separate department that reports to the Audit Committee or equivalent of the issuer”.

Russian companies, especially those that strive to be leaders in their sectors, are learning well from the lessons of North America and Europe. Whilst investment in internal control systems is difficult, especially now that there is increasing demand for greater efficiency and empowerment, management and owners are becoming aware that this is a priority.

There is often a gap between the internal control systems currently in place and frameworks such as COSO, or those required by individual jurisdictions for listing purposes. Russian organisations are therefore investing significant resources in upgrading both their accounting and internal control systems.

Outlook

In recent years Russia has made significant progress in reforming its accounting and corporate governance systems. This is an ongoing process and the forecast is that further evolution of accounting and internal control systems towards IFRS and corporate governance frameworks will continue.

Allocating services provided by the head office (Rainer Stawinoga, Partner in Accounting, Tax and Payroll Outsourcing Companies in the CIS, Russia Consulting)



Rainer Stawinoga

Rainer Stawinoga is Partner in one of the leading accounting, tax and payroll outsourcing companies in the CIS. He is certified in IFRS and has extensive knowledge in IT for accountancy. In more than 14 years of experience in the region, from Georgia

through Moldavia to Russia, he has deep experience not only in accountancy and taxes, but also in due diligence and all kind of organizational and managerial questions. Working previously as a Partner of PwC in Paris he brings multicultural experience as well as the knowledge of small and big organizations. He knows the industrial and distribution sector, as well as financial activities, telecom and energy.

In nearly all groups, or even just between the head office and the local structure (subsidiary or branch, hereinafter referred to as an “office”), services are exchanged. These services can be operational, administrative overheads or financial. In this article we will consider this situation from the perspective of the local structure and not from that of the head office.

In line with the general international understanding, these services must be invoiced from one office to the other (with some generally accepted exceptions, for example interests to a branch). Invoicing Services is subject to different rules, first of all the general local tax rules, but also double taxation treaties and principles of transfer pricing.

Russia has, like most other countries, rules for this, and tax inspectorates control these operations, first of all based on their own practice and their perspective in relation to Russian tax law.

There are three different aspects in relation to such operations: profit tax, VAT and regulations related to the persons performing these services, i.e. personal income tax, social contributions and work permit/visa.

Basic tax rules

According to Russian tax legislation (article 252 of the Russian Tax Code) a taxpayer has the right to deduct such expenses for profit tax purpose under the following conditions:

Expenses must be economically justified and confirmed by appropriate documentation, issued in accordance with Russian Law. Additionally special articles of the tax code for transfer pricing apply.

Article 270 of the Russian Tax Code provides a list of “expenses not deductible for profit tax purposes” and as this list does not include intercompany expenses or expenses related to services rendered by a foreign entity, they are basically deductible.

Transfer pricing

Article 40 of the Russian Tax Code establishes the principles of the determination of the price of goods, work or services:

- the concept of market price, for identical goods
- the methods of determination of the market price (the method of the follow-up sale and cost method) in cases when we do not have information about the market price or there are no identical goods.

There is no specific article or rule about documentation, as for example in Europe the specific Directive. A new law on transfer pricing has been prepared and will bring legislation closer to the recommendations of the OECD.

Under the general tax rules in Russia (as in many other countries), the office must be able to show that:

- the service was actually rendered
- the expense is economically justified and in the interest of the office
- the price of the service is “normal”

Proof that the service has been rendered

When the result of a service is a final product, such as a study, a report or an immaterial right, it seems quite easy to prove that the service has actually been rendered.

However, if the service only consists of participation in a project by providing working hours, this could be subject to discussion, especially if the persons involved did not come to Moscow. Indeed, even if the service provider can submit timesheets, the tax inspectorate could still argue that this is not really proof and that the number of hours in the timesheets could easily be changed depending on a decision of the general management. But in practice tax inspectors accept timesheets if they are presented in an understandable way.

This is also a question of volume: a smaller percentage of realized work in comparison to local staff is more easily accepted by the tax authorities. But this is not a legal argument, it might only be the way of thinking of the tax inspector. Very good documentation is a key factor.

The expense is economically justified

This means that the service must be in the interest of the office.

This kind of question often arises in relation to general management fees, as the tax inspectorate might argue that the local office did not use services like legal or tax services from the head office, IT support or general management services, because in the period under review there was no need for these services.

The price of the service is “normal”

Russian tax law is not very developed in this area, and refers to a comparison with an uncontrolled price. In the case of services, Russian tax inspectorates have many problems forming an opinion on the market price for a certain service. In most cases they have a global approach and want to make sure that due to these invoiced services the local office did not generate losses. But the company should be able to show that the price is the same as they use for other, independent clients, or show a calculation based on the direct salary cost, plus indirect cost plus profit margin. However, Russian tax inspectors have problems accepting hourly rates such as 500 Euro for highly qualified consultants, as they compare this to their own remuneration.

Travelling costs and other direct expenses for clients

Employees will incur expenses, i.e. when they come to Russia in order to work for clients, and these expenses will be invoiced first by the employer (head office) to the Russian office, and then by the Russian office to the final client.

There are several difficult questions in relation to these expenses. For example, if an expense is deductible under foreign tax law but would not be deductible under Russian, can it be deducted anyway? Such expenses can be booked only to the balance sheet and never go to expenses, if the office can show by the contract with the client that they act for this like an agent. Another very frequently observed problem is that the local office may pay hotel and

travel expenses for employees of the head office. As tax inspectorates consider that a taxpayer cannot deduct expenses for employees from other entities, such expenses will in general not be deductible. However, generally it can be said also here that good documentation is a key factor for the tax authorities.

Documentation

Proper documentation is very important in Russia. The following points cannot give you a guarantee that the expenses would be accepted as deductible, but would help in discussions with the tax authorities

- A written contract should be concluded for each project for which services are provided. If the company works on a regular basis with some offices/countries, there could be a framework contract, and later only (small) specific-contracts for each project;
- There should be an invoice with details, and if possible a separate invoice for each client assignment;
- For every invoice (not for demands for advance payment) there must be an act of acceptance.

How to Invoice

Operational Services

Operational Services can be agreed and invoiced as a fixed amount, or on a timesheet basis.

If the basis of the invoiced amount is timesheets, they should be available or already attached to the invoice (paper and details always make a better impression on the tax inspector). These invoices should be prepared either every month, or at the end of the project.

Hourly rates in the timesheets should be economically justified and explained in the very beginning. Both direct and indirect costs (overheads) can be included.

If the local office is a branch, the tax inspectorate may consider that only cost (without a margin) can be transferred (or invoiced). If the local office is a subsidiary, the hourly rate can be a selling rate including a profit margin.

Not only details of the time spent should be available, but also a description of the task or responsibility of each person, and documents, letters, emails or working papers issued by each person if possible.

If it is agreed that the service to be rendered by the head office is a complete part of work, like a subcontractor, the service fee can and would be in

general a fixed amount. In this case no timesheets must be submitted. However, it would be necessary to provide the result of this service, for example a written study, report, design, etc. The tax inspectorate will often check that the Russian office did not incur losses due to a large invoice from the head office. This is not in accordance with international rules, fixed by the OECD, because the Russian tax authorities do not make a functional analysis, or check if the financial responsibility for the project is at the local office or at the head office.

Overheads

If overheads are invoiced, a detailed calculation must first of all be presented. Then the general rules apply: documentation and economic justification. The last point will be the most difficult as Russian tax inspectorates are generally quite reluctant to recognize the economic justification of expenses.

VAT

In most cases the service will be taxable in Russia. If the foreign company has no branch in Russia, but a subsidiary, the invoice will be issued without Russian VAT, but the subsidiary has to act like a tax agent and pay the related amount to the tax authorities. This payment has to be made on the same day as the payment to the parent company; it is not possible to wait until the end of the quarter.

Personal income tax and work permit

The situation and rules regarding working for a Russian subsidiary (OOO) will not be further developed here. But we would like to highlight certain special points in relation to branches.

The general rule under the majority of double taxation treaties, is that when an employee from the head office is on a business trip to another country he does not need to pay income taxes in this country if he stays there for less than 183 days. But if he performs work for a branch in this country, he must pay personal income tax from the first day of work.

In this case all staff working on Russian projects (projects invoiced to the final client by a branch) require a work visa obtained based on a Russian work permit. If their stay in Russia is limited to a period not exceeding 30 days, for practical reasons the approach can be taken that such individuals are on a business trip rather than working in Russia. In such a case they may enter the country on the basis of a business visa. Currently the time that may be spent

in Russia under a multi-entry business visa is limited to 90 days in each 180-day period.

Then, technically for these first 30 days, no income tax and UST should apply, as the individuals are not working in Russia. If, however, an individual is on a Russian assignment then the company's branch in Russia should withhold personal income tax (Russian UST is not any more applicable to foreigners). Individual withholding tax (30%) would apply only if the individuals are paid from a local corporate bank account of the Russian branch. Otherwise, individuals should file Russian tax returns with the tax authorities by April 30 of the following year, declaring income subject to tax in Russia and not subject to withholding

If head office staff work on a Russia-based project without being assigned to the Russian branch (physically working abroad), this should be charged to the branch by a proforma invoice.

This brings many practical complications, i.e. when the personnel involved changes frequently and they come for a limited time, such as 6 weeks for example.

Conclusion

Even if basically all these kind of expense are deductible, in practice there are many details to be respected and difficulties in application. As different rules apply to this issue, i.e. in relation to profit tax, VAT, personal income tax, working permits and visa regulations, civil contract law, foreign exchange regulation and accounting aspects, a regular check up of all of these aspects by a specialized outsourcing firm is highly recommended.

Leading in turbulent times: Priorities for your Board (Alexander Ikonnikov, Head of Board Practice at Board Solutions)



Alexander Ikonnikov

Alexander Ikonnikov is Head of Board practice at Board Solutions and works on Board and top executive searches. He is one of the leading Russian experts in corporate governance and instituted the Independent Directors Association (IDA) in

Russia. As Chairman of the IDA Supervisory Board he is an active participant and guides the transition programs of Russian companies to international standards of corporate governance. At different periods in his managerial career he has led the Department of External Economic Affairs and Investments at the Ministry of Fuel and Energy of the Russian Federation.

Alexander has experience serving boards in telecommunication, consumer, private equity and infrastructure companies.

Alexander earned his diploma from the Russian State Oil and Gas Institute specializing in the development of oil and gas fields. He also earned his PhD in economics.

Corporate governance in Russia

Russia is a country with a highly concentrated ownership, where the combination of ownership and management is common practice. In most instances companies are governed by a dominant shareholder of the “first generation”. In turbulent times, this structure tends to increase the latent conflict between the company and its “founding shareholder”, particularly in distressed situations when the dominant shareholder will want to support his other businesses which have also been heavily hit by the crisis.

A Forbes Magazine poll in 2008 demonstrated that the average age of the richest people in Russia, the “Golden 100”, is 46, and that 50% of them are between 40 and 50 years old. The Standard&Poor’s report, “Transparency & Disclosure by Russian Companies 2007”, states that the average share of controlling stakes in the aggregate market capitalisation was 49%. The trend is still relevant.

The lack of domestic capital led Russian companies to look for international financing, forcing the adoption of corporate governance (the value of corporate governance and independent directors is not

always appreciated and is often seen as merely “window dressing”). Corporate governance listing rules on the Russian stock exchanges are much “softer” than Sarbanes-Oxley (SOX) or UK Combined Code requirements. Out of 150 listed companies only the top 15 A1 listed companies fully comply with the Russian Corporate Governance Code.

The lack of legislation or comprehensive codes of practice, together with a misunderstanding of the importance of contributions from independent directors, limits Board effectiveness. Under Russian legislation, shareholders owning at least 2% of the shares can nominate candidates for the Board. The Board nominates candidates when shareholders do not submit nominations. Having a nominations committee is not a common practice. As a result, Russian Board members are still largely selected by the main shareholders. Therefore Boards consist almost exclusively of representatives of the group that nominated them. This means that non-executive directors often see themselves representing different shareholder blocks rather than acting solely in the best interests of the company. A Board constructed in this way misses out on the wider challenge of good independent directors.

Although much is yet to be done, during the last 15 years Russian business has demonstrated significant progress in developing corporate governance.

Survey: impact of the financial crisis on Russian boards

In spring 2009 Board Solutions decided to conduct a survey to review the impact that the financial crisis was having on the role, performance and perceived value of Boards of Directors in Russia, and to compare it with international experience. The Survey “Leading in Turbulent Times – Priorities for your Board” was performed in partnership with the international law firm Allen & Overy and the Russian Independent Directors Association.

The Survey was conducted in the form of personal interviews with Chairmen, CEOs and independent directors of 64 major Russian companies with established Boards of Directors. The Survey’s conclusions have been drawn from the opinions of the participants and through roundtable discussions with a select group of non-executive directors and CEOs.

A key issue was to establish whether improving corporate governance was perceived as adding value to companies in a period of crisis or whether it

was seen as an expensive and bureaucratic luxury of little relevance.

International view on board dynamics

In times of economic turbulence, the general response is often to avoid all expenditure and cut out all processes that will not immediately contribute to the bottom line. As a result, R&D is often cut, staff training and development are put on hold, and Boards focus on the short term crisis. In particular, there are companies that see governance as a chore that takes too much time and adds little value. In looking at examples around the world of how companies and Boards are reacting to the financial crisis, it was found that different models of governance made it difficult to find clear and simple answers to our queries. However, several themes and indicators of best practice have emerged, as follows:

- Boards' agendas are re-shaped in difficult times to focus much more on managing cash and managing the risks in the business;
- Boards' agendas are re-ordered to deal with the important items of strategy or big decisions first and more routine business has less time allocated;
- Reports to the Board are prepared in a more timely manner and are quicker to provide information on critical variables and give a more comprehensive view of the business than in the normal situation;
- Boards tend to spend more time in special meetings where they are required to deal with critical issues;
- Boards with the right balance of skills and experience, from not only the company's own industry but also from other industries, are able to deal more effectively with their priorities than those with limited diversity;
- Balance on the Board is a key prerequisite for good decision-making and good governance.

(Source: *Institute of Directors UK*).

These indicators are definitely relevant. However, we wanted to see first hand from discussions with top business leaders what the situation is in Russia.

Perception of corporate governance in Russia

The view that corporate governance does not create value during a crisis did not receive strong support. 73% of the participants believe that corporate governance is important and half of them consider it to be even more important in a crisis, while 27% think that it is an unnecessary cost when valuations crash and capital markets are closed.

As far as our feedback was concerned, some doubts were expressed as to whether in a crisis a typical Russian Board has sufficiently well-qualified professionals that can exercise independent judgment and make decisions in the best interests of all shareholders. On the other hand, practice shows that many Boards are able to cope with the challenges and to focus on practical value creation rather than box-ticking. In our discussions, we heard a clear view that those companies whose Boards are focusing on the substance rather than the form of good governance will more likely emerge from the crisis as winners.

Key market challenges

The majority of respondents believes that business is facing an unprecedented situation, where companies are mainly focusing on immediate survival measures and efficiency. Only a few participants admitted that they were able to address the crisis with their companies in good shape thanks to the former cautious investment and M&A policy. The chairman of a consumer company said: "We were able to avoid many of the problems because the business has been very cash generative and, as a result of not paying dividends, has very low debt". The main challenges for business are high leverage costs and shortage of capital, a crash in asset values, and market uncertainty, including supplier and customer risk. Other challenges included the lack of crisis management skills, altering the business model, and downsizing the business.

Board structure

The results of the Survey indicate a general view that the key to a successful and productive Board is a good balance among its constituents. There should be a mix of independent directors and executive directors and, more importantly, a proper mix of talent and a variety of skills and experience.

When asked whether the CEO and other executives should be Board members during a crisis, participants were divided into two opposing camps: 45% of the participants believe that the CEO should not be on the Board, but should participate in meetings, and 55% believe that at least the CEO should be on the Board. UK/USA directors tend to prefer a unitary Board while continentals favour a supervisory Board concept.

The first camp believes that the CEO should not be a Board member in order to separate responsibilities between the Board and the executives. A con-

cern that was expressed is that it creates conflicts of interests when the Board considers management performance, remuneration and other issues. It also means that the non-executive directors do not get access to executives in the organisation that would help the Board have a more balanced view of the whole executive team.

The second camp asserts that the participation of the CEO and other key executives is important as it makes them feel more responsible for decisions; increases interaction, collaboration and involvement between directors and executives; and is a platform for executives' further development and an element of succession planning.

An alternative view was expressed. The formal membership of the CEO is less relevant than a good spirit of co-operation and teamwork between the Board and the CEO. Some CEOs said that they do not want to be a Board member when there is tension between the main groups of shareholders.

Independence

The majority of the respondents consider that Boards should have two to three independent directors. State-owned companies should have a majority of independent directors to ensure a balance between the interests of the government and other stakeholders.

One way to ensure Board efficiency and independence from the different groups of shareholders is to have an independent Chairman. Such a Chairman can develop a proper agenda; ensure the Board receives complete information and that each individual director is involved in discussions and decision-making. He/she also takes a leading role in determining the right composition of the Board and acts as a mentor to the CEO, providing input on key processes such as strategy, management development and succession planning

Diversity

What skills and experience should a director have to be able to add more value to a company's Board in a crisis? Most respondents agreed that "relevant industry experience" together with "financial expertise" are required. Part of the reason lies in a desire to have candidates with specialised knowledge of relevant businesses and industries and the business environment in which the company functions, who can provide insight regarding strategy and risk.

16% of respondents felt that there was a lack of crisis management expertise in most Boards. This

credit crisis has demonstrated the real value of having independent directors with experience in similar conditions capable of providing a balanced and informed view, using their experience and a cool head. Clearly, if a company hopes to respond to market uncertainty, its Board must be equipped with directors who know how to anticipate and react to a crisis. Government expertise was noted by 8% of respondents as another important qualification. In the current business environment and credit crisis, the government and state-owned banks are perceived as the only source which can provide capital.

Boardroom practice

The common view is that there is no need to schedule more frequent and longer meetings in person. Circumstances may require more telephone meetings for urgent situations. Companies should use management resources wisely and eliminate processes which are not currently important. Most respondents believe that there are two valuable committees: strategy and audit, and Boards should have both of these.

Some participants believe that the audit committee now has an even more important role than normal, as transparency and probity have never been more important. There must be more frequent meetings and more time for the audit committee. The topics which were raised by directors include:

Audit committee practice

Review and monitor risk regularly. In today's continuously changing business environment, factors affecting the likelihood and consequences of a risk are very likely to change. Today's minor issue could be tomorrow's major concern. This is why monitoring and reviewing risks is an important part of the risk management process. The best Boards have reviewed their risk assessment and control process to see that it is effective and that the Board is clear about the high level risks affecting their company. Risk assessment is not an annual exercise that can be completed and set aside. It is continuously evolving and must be supported by the Board and embedded in the decision-making of the business.

Alertness and an early warning system are crucial. It was noted that mapping early warning indicators and conducting early warning exercises are vitally important in order to ensure preparedness and timely responses to the effects of a financial crisis.

The risk oversight function of the Board was seen as being even more critical today to ensuring

that risk management is in line with the company's strategy and is functioning properly.

Recommendations

There are a few simple things that the Board can do to add real value to the business:

In a time of crisis, the Board should review areas for improvement and optimisation in order to become a real strategic asset for the company and to create a competitive advantage. The Board internal evaluation exercise (that includes assessment of key processes and Board member performance) is an essential tool for examining how it is currently operating and to find ways to improve performance. This need not be a costly or time-consuming task.

Numerous key processes need to receive the proper inputs from appropriately skilled directors. Risk assessment, control and management development and succession planning are key areas which, along with the strategy review and planning, are cornerstones of the Board.

The companies that responded more effectively to the credit crisis were those which were able to ensure that their Board's agenda was altered to allow sufficient time for reviewing and discussing major strategic decisions, rather than spending Board time on administrative exercises. Boards should review their agenda on an ongoing basis, especially in times of turbulent changes. Further, it is of tantamount importance to establish a clear separation between management meetings and Board agendas.

Directors must carefully examine the information that they receive in terms of appropriateness and timeliness. In times of crisis, there is a need for more timely information, more focused on the short term and to the current needs of the business. Cash control and clarity of current and forward projections of borrowings against covenants are key weekly indicators.

The composition and structure of the Board must guarantee a broad variety of views and ensure diversity of skills and experience. There is a strong case for Russian Boards having a critical look at their composition and re-thinking the way directors are appointed by making active use of a nomination committee. This approach will ensure a wide range of candidates meeting the expected qualification and experience requirements, and that recommendations to the Board are the result of a rigorous selection process. This process will increase the quality of Board members, shareholder confidence and the Board's competitive advantage.

The full version of the Survey is available on the Board Solutions, Allen & Overy and IDA websites:
www.boardsolutions.com,
www.allenoverly.com,
www.nand.ru.

Reorganising through staff outsourcing

(Lyudmila Kazimirova, Regional Manager of SGS Recruitment and Staff Outsourcing Services for Russia and Eastern Europe)



Lyudmila Kazimirova

Lyudmila Kazimirova is the Regional Manager of SGS Recruitment and Staff Outsourcing Services for Russia and Eastern Europe, a role she has filled since 2009. Lyudmila has been with SGS since 2005 starting as a Manager for the

Russian region. Previously she worked in staff outsourcing and recruitment consultancy for a Moscow-based recruiting agency. At SGS, Lyudmila is responsible for the development and operations of the staffing services business line in Russia and Eastern Europe, including executive search, mid-level and mass recruitment, staff leasing and project staffing, focusing on industrial sectors of the Russian economy. Her field of competence covers oil and gas, chemical, engineering, construction and other industries.

employees hired by private employment agencies with the objective of providing their labour to third parties". The authors of the law propose implementing a licensing system for agencies engaged in staff outsourcing in order to eliminate "grey" (that is not always following the law) and non-reliable providers from the market. There are also clauses determining the division of responsibilities between an employer and a staff provider, for example in relation to HSE, financial responsibility and so on. However, as long as this law is not enforced all stakeholders are subject to the existing labour and civil law systems of the Russian Federation, which do not take into account the particularities of staff leasing.

Therefore, when taking a decision on whether to use outsourcing in Russia, so far the investor should rely on his own and his partner's ability and experience to judge the best scheme for his specific situation and make relevant provision in the agreement between the two parties for every potential handicap.

Introduction

2009 brought a lot of changes. The year was different for different companies, but most of them were undergoing changes, whether restructuring or even opening a new office, which took place with some companies this year however strange it may seem. One of the ways to reduce risks arising as a result of such activities is to use staff outsourcing. Below we shall focus on the pitfalls and recommendations with regard to staff outsourcing in Russia.

Escaping paperwork?

Staff outsourcing provides an opportunity to concentrate on an organisation's core business without being distracted by diverse and time-consuming paperwork and administrative issues in relation to personnel management. Indeed, you get rid of prikazy (orders), zayavleniya (applications), payroll and other documentation necessary for the Russian kadrovoye deloproizvodstvo (HR-related paperwork). The advantages are obvious when expatriates are concerned, since staff outsourcing releases the organization from the need to go through the registration and work permit procedure for foreign staff employed in Russia.

Lack of legal framework

The key characteristic of the current market situation is the absence of any law regulating the relations between the staff provider and the company physically employing the person and the employee.

There have been a lot of disputes about the draft of such a law, which has the following preliminary title: "On protection of rights of

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At the same time you should be prepared for organizing documentary logistics and communication concerning any changes in the employee's activities within your company. In the contract between the provider and the employer it is advisable to clearly define responsibilities and specify timeframes. For example, if an employee goes on a business trip (*komandirovka*), the employer should send notice to his provider a few days prior to the trip so that the latter is able to issue a *komandirovochnoe udostovereniye* (document authorising a business trip) to the employee and transfer an *avans* (advance payment) to the person sent on the trip. It is also necessary for the employer and the staff provider to come to an agreement with regard to how soon a provider should issue documents required by employees following their personal requests. Quite often employees need to obtain *spravki* (references) or copies of *trudovyye knizhki* (labour books) for provision to banks or other organizations and they might need to get these papers urgently. Ideally, the service provider should be able to cope with this.

Information needs protection

One should also pay attention to the security of the information passed to the agency on all HR matters related to the outsourced personnel, especially concerning remuneration figures etc. Unless you stipulate a confidentiality clause in your contract with the staff provider information security could be at risk.

Social risks

When opting for staff outsourcing, the social climate in the organisation should not be neglected. In Russia, many people still have no scruples about sharing labour contract terms with colleagues, which creates serious barriers for practising unequal conditions of work. If office personnel is partly outsourced and partly kept on your payroll, large discrepancies between their salary levels and fringe benefits could be critical for staff productivity and loyalty.

What kind of personnel to outsource?

One of the key issues when considering an outsourcing scheme is to decide upon the right category of personnel to outsource. There are basically no problems for white-collar workers, but there can be difficulties when outsourcing blue-collar workers. The Russian social insurance system includes mandatory social insurance against accidents at work and occupational illnesses with rates varying from 0.2% to 8.5%

of the total labour remuneration, depending on the organisation's occupational risks. A traditional recruitment agency would normally have a 0.2% tariff, whereas a manufacturing facility would be obliged to pay more. The legal solution for such a case could be partnering with a staff provider classified as an industrial facility itself and consequently paying the appropriate rate of the obligatory tax for the accident otherwise the outsourcing scheme could be considered illegal. The same ambiguity relates to pensions, which an industrial worker is entitled to receive earlier than other employees. If he is not on the payroll of the plant, what is he supposed to be classified as by the pension fund – an office employee?

The need for cooperation

When outsourcing staff, an investor considerably reduces his legal risks due to the fact that according to the relevant documentation his workforce is employed by another company (the staff provider). Indeed, it is the provider who deals with hiring, dismissal, etc. However, if something happens in relation to discipline or HSE there should be cooperation between the two organisations to solve the problem, including in cases involving court examination.

Apart from having everything stipulated in the contract and hopefully in the law in the near future, the Russian business environment still depends a lot on relations. The key to success in outsourcing, like in other activities involving more than one party, is to have a clear understanding of what each side expects from the partnership, implementation of an effective interaction scheme and a trustworthy relationship.

WHAT TO EXPECT IN THE FUTURE IN RUSSIA

Outline of the declared future tax policy of the Russian Federation – 2010 to 2012 (Richard Wellmann, Lawyer/Tax Advisor, BDO DWT, Frankfurt/Germany)



Richard Wellmann

Richard Wellmann is a German lawyer and certified tax adviser in both Germany and Russia with BDO Deutsche Warentreuhand Aktiengesellschaft Wirtschaftsprüfungsgesellschaft, Frankfurt, Germany, Manager in BDO Germany's

International Tax Center of Excellence. Head of BDO Germany's Russia Desk.

After passing the German bar exam Richard started at BDO Germany's Essen office tax department in late 2000, advising clients on German profit, income, VAT and inheritance tax matters.

From 2004 to 2006 he was part of BDO Germany's Transaction Tax Center of Excellence in Hamburg and became German tax advisor early in 2006.

In 2007 and 2008 Richard worked for almost two years in BDO Russia's Moscow tax office and advised German and other international clients on tax and related matters in relation to their investments into Russia.

In late 2008 Richard joined BDO Germany's International Tax Center of Excellence. His daily work includes tax advice on in- and outbound investments and primarily relates to profit tax and transfer pricing.

A critical element of a pre-investment evaluation in any circumstances is an assessment of the likely tax environment faced. In the case of Russia, this process should carry a higher priority as the fiscal reform process and subsequent refinements are ongoing. A realistic estimate of tomorrow's tax burden on the business's core activities, the general direction of legislation and any possible industry specific items are vital to the success of any undertaking. Tax laws in Russia, as elsewhere, are subject to the interests of various different parties, so constant changes are par for the course and any outlook is likely to be sufficiently accurate only for a short to medium period of time. In Russia, not only in light of the ongoing financial crisis, interest in courting additional investment is high and in order to address this, a medium term tax strategy has been published.

On May 25, 2009 the Government of the Russian Federation adopted the Russian Ministry of Finance's ideas on the evolution of Russian tax policy for the period 2010 to 2012 ("Основные направления налоговой политики в Российской Федерации на 2010 год и на плановый период 2011 и 2012 годов", hereinafter "the Guidelines")¹. The Guidelines continue 2008's declared tax policy for the period 2009 to 2011² and commit to nurturing and developing the existing tax system in the medium term. The announced goals include the exclusion of an increase in the nominal tax burden – provided that revenue received by the tax authorities does not decrease significantly – unification of tax rates, improvement of the effectiveness of tax administration, and integration of the Russian tax system into the international tax system. This year's Guidelines, however, give special consideration to the ongoing economic crisis affecting the Russian economy.³ Balancing a higher tax yield against anti-crisis tax measures, the Government announced its intention to pursue the direction taken at the end of 2008⁴, i.e. a continuation of the anti-crisis tax policy by taking countermeasures and by introducing stimuli to accelerate economic growth.

The fact that in some areas changes proposed in previous years' Guidelines have already been put into effect, e.g. regarding taxation of dividends⁵, depreciation⁶, VAT exemptions⁷ and social allo-

¹ The document can be downloaded from http://www1.minfin.ru/ru/tax_relations/policy/

² "Основные направления налоговой политики в Российской Федерации на 2009–2011 гг.", see last year's edition of the AEB's "How to invest in Russia" publication, pg. 81–84

³ See also pg. 4 and 5 of the Russian Ministry of Finance's "Report on results and general guidance for 2010–2012" (draft) of August 2009, available on the Ministry's website (see footnote 1)

⁴ Federal Law № 224-ФЗ of November 26, 2008 introduced, amongst others, a reduction in the corporation profit tax rate from the previous 24% to 20%, increased interest limits on loans for standard tax deduction, increased depreciation premiums and new regulations in relation to deferred payment of taxes

⁵ Federal Law № 76-ФЗ of May 17, 2007, taking effect from January 1, 2008, lowered tax rates on dividends

⁶ Federal Law № 158-ФЗ of July 22, 2008 taking effect from January 1, 2009, introduced certain new rules regarding straight-line and declining depreciation

⁷ Federal Law №. 195-ФЗ of July 19, 2007, taking effect from January 1, 2008 re. innovative companies, Federal Law №. 240-ФЗ of October 30, 2007 re. special economic harbor zones (but the zones themselves have not yet been implemented)

wances⁸, may be cited as evidence as to the level of reliance that can be placed on the future implementation of proposals made in the Guidelines. What follows is a short overview of the intended changes that are most likely to significantly affect foreign investments in the Russian Federation.

Corporate income tax

Transfer pricing – The existing regulations on transfer pricing (art. 20 and 40 of the Tax Code of the Russian Federation; hereinafter, “**NK-RF**”) are problematic in terms of practical application due to their ambiguity. 2008’s Guidelines criticized in particular the list of controlled transactions⁹, the current definition of “related party” (“взаимозависимое лицо”), the existence of a rigid 20% price range that – if observed – avoids tax drawbacks, the lack of detailed regulations for determining the arm’s length price and the absence of sources of information for such prices. Furthermore, while currently the burden of identifying irregularities is placed on the Russian tax authorities, the Ministry of Finance aims to require that taxpayers maintain documentation on transfer pricing in the future. In this context the introduction of mutual agreement procedures between the tax authorities and taxpayers is also intended. Determination of arm’s length prices is to be referenced to standard OECD terms and recommendations. The above deficiencies were intended to be remedied by 2009-2010. Not only in light of the ongoing financial crisis, the implementation of these rules should make sense from a state-budget perspective. Rumor had it that in 2009 the first reading was supposed to take place in the State Duma.¹⁰ In fact, only in January 2010, was a bill finally introduced. This bill tries to remedy the deficiencies mentioned in the Guidelines and is scheduled to take effect from 2011 onwards.

Tax groups – Together with new transfer pricing regulations, the Ministry of Finance still plans to introduce group taxation rules regarding corporate income tax (“консолидированная налоговая отчетность”). The latest available draft bill was published in April 2008.¹¹ Subject to certain precondi-

tions, not only the distribution of dividends but also the implications of transactions within the group are planned to be disregarded for corporate income tax purposes. It is intended that losses of group companies may be set off against profits of other group companies.

Depreciation – Although changes to depreciation rules were introduced from the 2009 tax year¹², the Guidelines announce that the transition is not yet complete, as the arrangement of depreciation groups should be scrutinized and it should be checked whether the useful lives established by the relevant government decree are still up to date.

Limiting tax minimization – From 2010 onwards the Guidelines propose the introduction of loss offset restrictions regarding group reorganizations or the acquisition of legal entities carrying forward losses. Furthermore, provisions on the deduction of interest expenditure are to be revised to (i) extend transfer pricing rules to financial operations and (ii) modify thin capitalization rules in relation to “dependent parties” or limit tax deductible expenditure to a fixed proportion of taxable income (not exceeding actually incurred interest payments).

Taxation of operations with commercial papers – Regulations on the tax implications of securities lending and certain REPO¹³ operations involving non-tax residents shall be introduced. Amongst others, tax withholding at source is to be improved, REPO rules are to be extended to foreign commercial papers that comply with the preconditions set forth in sec. 2 of the Federal Law of April 22, 1996 No. 39 “On the commercial paper market” and the rules for determination of the market price of commercial papers are to be clarified. Furthermore, the RUR 500 million requirement for Russian ‘strategic’ shareholders in order for dividends to be taxed at a zero rate is to be dropped and, last but not least, the LIFO method, which has already been abandoned in Russian Accounting Principles, is also to be abolished for tax purposes. In the meantime, extensive new regulations on REPO operations have been introduced to the NK-RF¹⁴ and from 2011 the aforementioned threshold on dividends will be dropped¹⁵.

Tax deductible expenditure – Increased limits for interest payments mentioned in the Guidelines have already been implemented¹⁶, meanwhile tem-

⁸ Federal Law № 121-ФЗ of July 22, 2008, taking effect from January 1, 2009, raises tax deductible allowances and thresholds

⁹ E.g., loans are not within the scope of transfer pricing rules (letter of the RF Ministry of Finance of March 14, 2007 N 03-02-07/2-44)

¹⁰ See <http://www.glavbukh.ru/news/9878>

¹¹ The document entitled «Законопроект о внесении изменений в Налоговый кодекс Российской Федерации. Пояснительная записка (21.04.2008)» can be downloaded from

http://www1.minfin.ru/ru/tax_relations/policy/use_regulation/

¹² Federal Law № 158-ФЗ of July 22, 2008 introduced the pool account method for certain depreciation groups

¹³ The term “REPO” is derived from the English “repurchase operations”

¹⁴ See Federal Law № 281-ФЗ of November 25, 2009

¹⁵ See Federal Law № 368-ФЗ of December 27, 2009

¹⁶ Federal Law № 202-ФЗ of July 17, 2009

porarily extended¹⁷ and stay in effect until the end of June 2009. For losses incurred in connection with the storage and sale or transport of products to be treated as tax deductible expenditure, the Ministry of Finance proposes introducing (i) a general ceiling and (ii) special ceilings for retail trade depending on different commodity groups. Companies engaged in the exploration of natural resource deposits are to have an expanded list of deductible exploration expenditure and simplified deduction rules from 2010 onwards.

Changes discussed in 2008's Guidelines regarding the creation of permanent establishments by foreign companies without having a definite location in the Russian Federation, the possibility for the tax and calendar year to differ, simplified prepayment calculations and a modified concept of tax residency are not mentioned in 2009's Guidelines.¹⁸

Taxation of the extraction of mineral resources

Natural resources that are extracted under the jurisdiction of the Russian Federation are subject to taxation in accordance with legislation ("налог на добычу полезных ископаемых"). Due to the enormous quantity of oil, gas and other commodities that are extracted on the territory of the Russian Federation, the tax on the extraction of mineral resources contributes a major part to Russian federal tax revenue (according to the information of the Federal Tax Service of the Russian Federation, the natural resources and commodities sector contributed about 20% to the budget in 2008).

In order to encourage the development of new oil deposits, the Guidelines propose new tax incentives, e.g. the introduction of zero tax rates in relation to the Black Sea and the Sea of Okhotsk, or lowered coefficients for small deposits. The introduction in the NK-RF in 2010–2011 of new mechanisms for providing incentives for the exploitation of complex deposits

is discussed, at first limited to the Yamal-Nenetskiy autonomous region. As domestic gas prices have more than doubled since January 2006, the Guidelines propose that starting from 2010 the tax rates on the extraction of gas are to be indexed and adjusted annually.

Last but not least, the introduction from 2011–2012 of a surplus profit tax («налог на дополнительный доход») on the exploitation of oil deposits is proposed. Unlike the existing mineral extraction tax, the new tax is intended to be of a progressive nature, its base being computed as the difference between the revenue from extracted and sold hydrocarbons on the one hand and on the other hand production and sales expenses (excluding depreciation), capital expenditure and non-adjusted expenses of preceding tax periods. In this context, from 2010 onwards tax rates on the production of coal are proposed to be diversified and fixed annually with reference to market prices, e.g. the rate for the production of one ton is planned to be fixed for anthracite coal at RUR55, charcoal at RUR70, lignite at RUR10 and other coal at RUR34. From 2011 onwards, these rates shall automatically be fixed to reflect the market prices of the preceding year. The

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¹⁷ Federal Law № 202-ФЗ of July 17, 2009

¹⁸ For more details please refer to the article on the Guidelines in last year's edition of "How to Invest in Russia" (at the end of section 1)

Guidelines also propose that if production is carried out at a higher risk, the computed mineral extraction tax may be reduced by up to 30% in relation to expenditure on operational safety.

Value added tax

Value added tax (VAT) is ascribed great importance in Russia as it contributes a substantial percentage to the Federal Budget (in 2008, 12% according to statistics published by the Federal Tax Service of the Russian Federation). In addition to the standard VAT rate of 18% and the reduced rate of 10%, there is a zero rate that applies in particular to the export of goods from the Russian Federation. The application of the zero rate remains subject to an audit of the relevant declaration and supporting documentation by the tax authorities. 2009's Guidelines also repeat most of 2008's suggestions: the Guidelines propose that changes in relation to accelerating the application of the zero rate be considered. Furthermore, the Guidelines propose introducing credit-invoices ("кредит-счетов"), determining insignificant inaccuracies in invoices that can be tolerated for input VAT deduction and commenting on the newly introduced rules on the VAT treatment of prepayments made/received. The Guidelines also mention that the results of a pilot project regarding electronic invoices will be gathered in the third quarter of 2009 and utilized when the relevant legislation is introduced into the NK-RF.

Despite public discussions in relation to these issues, 2009's Guidelines do not mention the unification of standard and reduced VAT rates as compensation for delays in the reimbursement process for input VAT or the coming increase in social security contributions for employers. 2009's Guidelines also do not elaborate on the introduction of separate VAT-ID numbers.

Unified social tax

As was proposed in 2008's Guidelines, from January 1, 2010 onwards, the unified social tax system has for the meantime been replaced with a social contribution system.¹⁹ The Guidelines did not provide details on the upcoming regulations; perhaps due to the fact that tax authorities are no longer the competent organs. Apart from the fact that the relevant competency was transferred to various funds, the main difference under the new social contribution system is that the current regressive rate of 26%

to 2% (including two breaks) will be replaced from 2010 onwards by a fixed rate of 26% and – from 2011 onwards – of 34%, for an annual salary base of up to RUR 415,000. Above this ceiling no additional mandatory social contributions will be due. The new regulations also stipulate that remuneration received by foreigners that stay in Russia on a temporary basis is not subject to social contributions.

Excise taxes

The Guidelines propose abolishing, with effect from January 2010, the generally extended payment due date for excise taxes²⁰ that applies, amongst others, to oil products, which would result in the creation of a one time double excise tax burden. Furthermore, the prevention of the use of abusive schemes in the production of alcoholic beverage is to be tackled, exemption and return of overpaid excise duties for exporters shall be clarified and excise rates are to be indexed, and petrol and diesel fuel for vehicles are to be differentiated according to their ecological class. The majority of these issues have in the meantime been addressed, with effect as of January 2010.²¹ In addition, excise taxes on "unhealthy" products such as alcoholic beverages and tobacco were significantly increased.

¹⁹ Federal Laws № 212-ФЗ and 213-ФЗ, both of July 24, 2009

²⁰ Cp. the current version of sec. 204 Tax Code of the Russian Federation

²¹ Federal Law № 282-ФЗ of November 28, 2009



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Toward a new paradigm of International Financial Regulation (Art Franczek, president, AIBEC)



Art Franczek

Art is currently the president of The American Institute of Business and Economics in Moscow (an English language MBA program that was founded in 1989). He holds degrees in History and Political Science in addition to an MBA, CPA

and a Masters of Taxation. In addition to managing AIBEC he teaches courses in IFRS, Taxation and Cost Management. He has served as a consultant for the Russian Central Bank (IAS 39), the World Bank (on implementing IFRS in Russia), the Bank of Albania (implementing IFRS and IAS 39) and has written many articles on IFRS, Customs and Taxation issues in addition to a book on IFRS.

Prior to joining AIBEC, Art served as a business consultant in Togliatti after working for many years as a Corporate Tax Manager for a Fortune 1000 company.

The world has been engulfed in a financial crisis encompassing almost every aspect of our lives for the past two years. The causes of this crisis are many and it took many years until they reached this stage. While it is generally agreed that the crisis began in the United States and spread to the rest of the world, I think it is valuable to understand the root causes of the crisis if we want to comprehend some of the inevitable corrective measures we will experience in the coming years. Ten years ago in the US, Glass-Steagall, the law that prohibited commercial banks from operating as investment banks, was repealed. In addition, the US Congress made the decision to forbid regulations on credit derivatives such as Credit Default Swaps, which at the time were about one trillion dollars and have since ballooned to 33 trillion dollars. In 2004 the SEC raised the leverage ratio for financial institutions from 10 to 1 to 30 to 1. This non-regulatory environment set the stage for many of the financial innovations that drove the boom and the bust that would follow.

Subprime mortgages became a major tool for predatory mortgage lenders, who aggressively recruited marginally qualified borrowers to take the mortgages. The lender sold the mortgages to investment banks, who then sold them to the public in the form of bonds (MBS mortgage backed securities).

The bond holders purchased Credit Default Swaps (a form of insurance contract) to protect themselves in the event their MBSs defaulted. Between 2000 and 2007 trillions of dollars of securitized subprime mortgages and Credit Default Swaps were initiated. As long as the prices for residential homes in the US kept increasing, all of the participants in these structures were earning lots of money. In 2007 the price of US houses declined and the default rate on subprime mortgage loans greatly increased. These events set off a chain reaction, the value of MBSs declined, the CDS insurance contracts were triggered and by the end of 2008 such illustrious banking houses as Bear Sterns and Lehman Brothers had disappeared. What also happened in late 2007 was the implementation of an obscure GAAP rule called Mark to Market (FAS 157) that as we shall see not only further exasperated the crisis but also contributed to its recovery.

FAS 157 is an accounting standard that was issued in September 2006 with the objective of defining fair value, establishing a framework for measuring fair value and expanding disclosures about fair value measurements. FAS 157 was intended to achieve greater consistency and comparability in fair value measurements and to provide better information, i.e., more transparency, about the extent to which fair value is used to measure assets and liabilities, the inputs used to development the measurements, and the effect of certain measurements on earnings for the period. FAS defines "fair value" as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. In short, the standard requires that assets and liabilities must be valued at a price in a hypothetical market transaction based upon the assumptions of a current participant who is independent, knowledgeable, and willing and able to transact. To help achieve consistency and comparability in fair value measurements, FAS 157 establishes a hierarchy (Level 1, Level 2 and Level 3) prioritizing those assumptions ("inputs") that a market participant would use in pricing an asset or liability. Generally, Level 1 inputs are current quoted market prices for an identical asset or liability in an active market. Level 2 inputs are quoted current market prices for similar assets or liabilities in markets that are not active; other observable inputs for the asset or liability in question such as interest rates, yield curves, volatilities, prepayment speeds, loss severities and credit risks. Level 3 inputs are un-

observable, meaning they are the reporting entity's own assumptions that market participants would use in pricing an asset or liability "based on the best information available in the circumstances".

When the housing prices declined and the default rates increased in late 2007, investment banks had to write down a vast amount of mortgage backed securities and credit default swaps they were holding in order to comply with FAS 157. For institutions holding on to bank loans – assets for which there is an active secondary market – marking to market was relatively simple. If markets priced bank debt of companies with a particular credit rating at 85 cents on the dollar, banks had to write down 15 cents of the value of each dollar of the loan. This process helped drive the massive write downs seen at banks like UBS and Citigroup in late 2007. Mark to Market accounting (FAS157) greatly amplified the financial crisis, because when prices are on the way down, particularly when buyers are thin on the ground and sellers are distressed, the downward price movements can themselves trigger the need to unwind investments, further depressing prices, and they soon become self-reinforcing. In 2007–2008 there was no market for toxic assets such as mortgage backed securities backed by subprime mortgages. If there is no market FAS 157 says a bank must mark the investment's value down, possibly all the way to zero. As I have tried to demonstrate, the Mark to Market (FAS157) rule was most controversial and helped to create huge losses for many banks and contributed greatly toward the bankruptcy of Lehman Brothers on September 15, 2008, which was the catastrophic event of the crisis

For most of 2008, Congress, major banks and the US Chamber of Commerce lobbied the FASB (US GAAP rule making organ) to change FAS 157 so it would not have such an adverse effect on the financial statements of banks. Finally on April 3, 2009 (right before the stress tests for banks were due to the Federal Reserve) the FASB announced some major changes. The FASB changed FAS157 so that a bank was no longer required to write off a distressed asset that had no active market if the bank stated that it intended to keep the asset. Thus, under the April 3rd rules banks no longer had to write off most distressed assets. Some analysts estimate that the new rule increased the earnings of banks by 20%.

The FASB came under much criticism for its decision to soften FAS 157 and it was accused of succumbing to "outside pressures". The fair value issue is of extreme importance because the way in which fair value is determined can have a significant im-

act on a bank's capital adequacy ratios and thus its ability to lend. In July the FASB together with the IASB issued a joint exposure draft on mark to market accounting in which they try to simplify the rules and classify assets into two categories and simple debt securities. The emphasis of these new rules as they apply to impaired assets will be on the expected cash flows of the asset. Perhaps this new exposure draft will end what the Economist magazine calls a religious war between those who want financial assets shown at fair value and those who want those assets shown at cost.

Until September 2008 Russia thought it was a safe haven in the world and that it was immune to the effects of the global financial crisis. After the collapse of Lehman and the almost simultaneous drop in the price of oil, Russia's banking system suffered from a severe liquidity crisis. Since 2008 non-performing loans have increased dramatically and are now a controversial issue. Western rating agencies and other authoritative sources have little faith in the non-performing loan figures. The Central Bank recently estimated NPLs at 10% and leading rating agencies estimate NPLs in the range of 35–50%. The Central Bank and IFRS have different definitions of non-performing loans. In Russia, when a debtor misses a repayment, banks are required to report as delinquent only the amount missed, while IFRS defines a NPL as more than 90 days overdue or individually impaired. Western analysts also have problems in reviewing the financial statements of Russian banks because most banks do not prepare IFRS consolidated financial statements. At this point the Central Bank is reluctant to require consolidated financials due to concerns that they could be manipulated. Which NPL numbers are better, is hard to say.

Since the 1998 crisis the Central Bank has been very risk adverse in its Instruction No. 110 establishes prudential ratios that are more conservative than Basel recommendations. A finding by the Supreme Arbitration Court held that derivatives constituted a form of a wager and thus could not be held to the norms of the Civil Code. The Central Bank's strict liquidity requirements have also made it impossible for companies to have a loan agreement of more than one year, which is why banks may allow a credit line for 3 years but 3 one year loan agreements. Many Russian banking experts I have talked to believe the NPL situation in Russian banks is manageable and that a second wave of the banking crisis is unlikely. I guess I will have more faith in the financials of Russian banks when Russia fully adopts IFRS and it becomes possible to do a reliable analysis of the financial health of Russian banks.

In responding to the global financial crisis, the G20 has taken the lead. Since November 2008, the G20 has coordinated a global recovery strategy and the world avoided a worldwide depression. The G20 implements financial reforms through the Financial Stability Board. There are many reforms that this group is trying to implement. For example, the FSB is currently working on issues that are considered to have caused the crisis, such as abuses with Credit Default Swaps and securitizations, and issues pertaining to credit rating agencies. The FSB is also working with Basel to establish a new minimum global liquidity standard. A major issue that the FSB is addressing is the need to strengthen accounting standards. It recommends that a global set of accounting standards (IFRS) be adopted by member countries by 2012. It also specifically supports the efforts by the IASB and FASB to adopt a new accounting standard on impaired assets (replacing FAS157 and IAS39) using expected cash flows as the basis for writing off non-performing loans (NPLs). This issue, as we have seen, is of great significance in both Russia and internationally because it can affect how a bank makes loans to business. The implementation of IFRS, along with establish-

ment of consistent rules on loan provisioning, will greatly enhance the transparency of financial statements and will increase capital flows between countries, while reducing the probability of fraud.

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ABOUT THE ASSOCIATION OF EUROPEAN BUSINESSES (AEB)

The AEB was established in 1995 on the initiative of several European companies registered in the Russian Federation, Ambassadors of EU member states and the Head of the Delegation of the European Commission to the Russian Federation. The AEB is an independent non-commercial association with a membership of about 600 companies

AEB membership is made up of enterprises and entrepreneurs from the member states of the European Union (EU) and the European Free Trade Association (EFTA), which have business activities with and in the Russian Federation. These members form the AEB General Assembly (GA), which determines the overall strategy and policies of the association.

The mission of the AEB is to represent and promote the interests of its members by supporting them in doing business with and in Russia through quality lobbying, information support, and through activities aimed at improving the Russian trade and business environment in conformity with internationally accepted business principles and promoting integration and partnership between the European Union and Russia.

The AEB conducts lobbying activities through its committees and working groups, which cover a wide spectrum of industries and sectors, including Finance and Investment, Visa Task Force, Energy, Customs & Transport, Machine Building and Engineering, Safety, Health, Environment and Security and, Finance and Investments – to name but a few.

The committees work closely with the Russian and European authorities, for instance by holding public and closed meetings with government representatives and submitting comments and amendments to draft laws.

The AEB also offers informational support to the European business community via its website and publications, press campaigns, surveys and legislative and business alerts.

The Association works hard to support its members wherever they are located in Russia by hosting regional presentations, business missions and maintaining regional representations, such as Krasnodar Steering Committee and a local presence in Yekaterinburg.

ABOUT THE FINANCE & INVESTMENT COMMITTEE OF THE ASSOCIATION OF EUROPEAN BUSINESSES

Since 1995, the AEB, (formerly the European Business Club), has evolved from an informal business organisation into an influential group that improves the business and trade environment of European business in the Russian Federation.

The three main functions of the AEB are effective lobbying, quality information, and valuable networking. The AEB is a forum for dialogue between international businesses and the Russian Government. The AEB participates in lobbying in the Duma and in the Federation Council.

Over the last ten years, the AEB's lobbying initiatives have included a wide range of issues of importance to its members including: small- and medium-size business issues; transport and customs; alcoholic beverages import; visa issues; taxation; corporate governance issues; and anti-monopoly issues, making it a significant voice in policymaking in the Russian Federation.

Furthermore, the AEB participates in dialogue with administrative bodies to promote AEB member interests. These organisations include: the European Union; Industrialists' Round Table (IRT); Foreign Investment Council (FIAC); EBRD; OSCE; IFC; IMF; and the Federal Anti-monopoly Service.

The mission of the AEB Finance Committee is to improve the investment climate in Russia by integrating the information and discussion related to the critical finance issues that are of prime importance for foreign companies working in Russia. These include accounting, auditing, and financial reporting; capital markets; ratings standards; and investment, corporate finance, and venture capital. To achieve these objectives, the Finance Committee serves as a forum for discussion, lobbying and information network for the exchange of ideas concerning finance issues among finance officers, accountants, auditors and policy makers in the Russia Federation.