



# HOW TO INVEST IN RUSSIA AEB



**The AEB guide to theory and practical advice for making an investment in Russia in 2011**

## REGIONAL ASPECTS OF INVESTING IN RUSSIA

### The post-crisis development of Southern Russia

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Dr. Vasily Vysokov (PhD) is the founder, President and Chairman of the Board of Directors of Center-Invest Bank (Rostov-on-Don). With international shareholders and a strong business model, Center-Invest Bank is southern Russia's

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Dr. Vysokov is also the current Vice-President of the Rostov Region Chamber of Industry and Commerce, and Deputy Head of the South Regional Committee of the Association of European Businesses in the Russian Federation.

As President of the Endowment Fund for Education and Science in the Southern Federal District, Dr. Vysokov has helped support talented lecturers and students in southern Russia. He is the author of over 200 books and articles on the challenges of the transition economy, privatization, the post-privatization development of small business in Russia, and the post-crisis development of southern Russia (Investment Appeal of the South of Russia (2006),

[http://www.centriinvest.ru/pdf/CI\\_invest\\_privlek\\_English.pdf](http://www.centriinvest.ru/pdf/CI_invest_privlek_English.pdf); Southern Russia Versus the Global Crisis (2009) [http://www.centriinvest.ru/pdf/vysokov2009\\_allbook.pdf](http://www.centriinvest.ru/pdf/vysokov2009_allbook.pdf).

Dr. Vysokov has won awards in many local and international competitions, including a runners-up award in the "2007 FT Sustainable Banking Awards" held by the Financial Times and the International Finance Corporation.

Once the critical phase of the global crisis had passed, many companies began producing post-crisis development strategies and are now actively looking for new markets, new sectors, and new regions in which to sell their goods and services. Companies working in Russia should always include a regional dimension in their strategies; an awareness of the specific characteristics of a region not only reduces risks, but quite often, also generates additional revenue.

In terms of its size, southern Russia (since the end of 2009, the Southern and North Caucasus Federal Districts) is comparable with the markets of

many European countries: it occupies an area of 0.5 million square kilometres, and 23 million people live and work in the region, equivalent to 16% of the total population of Russia. Southern Russia accounts for 8% of the country's gross regional product, more than 6% of its total industrial output, almost one quarter of its agricultural output, 16% of new housing in Russia, 12% of all Russian investment, and more than 13% of Russian retail sales.

### Climate and Location

Southern Russia's annual average temperature is 5°C higher than that of Moscow, and this is crucial to the region's ability to produce many agricultural crops: sunflowers, high-quality wheat, fruit, and vegetables. The unique combination of natural and climatic factors creates an inimitably diverse landscape: semi-deserts, expanses of steppe, alpine meadows, snow-covered mountain tops, and Black Sea subtropics. Foreign visitors acquainted with these sights wholeheartedly agree that, "The south is not the centre of Russia, it is its pearl!"

Southern Russia is located in the triangle of land between Russia's largest rivers, the Volga and the Don, and the Caucasus Mountains and it borders the Caspian Sea, the Black Sea and the Sea of Azov. Long before our time, the trade routes of various peoples passed through this territory and the region contained what we now call "free trade zones". These days, southern Russia is an intersection for water, air, road, rail, and pipeline transport routes between the Caucasus and central Russia and the Urals and Europe. The region's transport infrastructure is well developed: road and rail density is 3 to 5 times higher than the Russian average, and in recent years extensive work has been carried out on upgrading roads, airports, stations, and river and sea ports.

### The population and the economy

The multi-ethnic population that we see today in southern Russia has emerged over the centuries, influenced by the region's location at the intersection of trade routes. This multiethnicity is reflected not only at an official level, but also in everyday life, with the interweaving of different cultures, customs,

**Table 1. Southern Russia as a % of the Russian Federation, 2010**

	Southern Federal District	North Caucasus Federal District
<b>Territory</b>	2.4	1.0
<b>Population</b>	9.7	6.5
<b>Mineral extraction</b>	1.3	0.3
<b>Manufacturing</b>	6.0	1.8
<b>Production and distribution of electric power, gas and water</b>	6.3	2.6
Agricultural output	20.0	9.1
Construction	9.5	3.2
Freight moved by road	9.4	2.2
Communications services*	6.5	3.2
Net financial result**	3.2	0.5
Retail sales	9.1	4.8
Foreign trade*	3.4	0.4
Investment**	11.4	2.4
Foreign investment *	3.5	0.1
Per capita income*	83.3	82.4
Nominal wages**	74.2	60.2
Unemployment	7.7	17.1

\* 3Q2010, \*\* – November 2010.

and traditions imparting a unique character to local literature, music, painting, and even cooking.

Living at the fringes of great empires, the people of southern Russia became bold, freedom-loving, and independent of spirit.

With their long tradition of trade and enterprise, the people of southern Russia have managed to create a market economy that, according to Jean Lemierre, former president of the European Bank for Reconstruction and Development (EBRD), provides a good model for the development of the Russian economy as a whole. The south does produce oil, gas, and coal, but these sectors do not dominate the regional economy. Southern Russia plays an important role in the production of grain, sunflowers, vegetables, meat, milk, and wool. The following sectors have survived and are flourishing in the region: transport, agricultural machine building, ferrous and non-ferrous metallurgy, construction materials production, textile manufacturing, and food production and processing. Southern Russia (the Black Sea Coast and the Caucasus Mineral Waters in particular) continues to be the country's main tourism and recreation destination for the domestic market.

## SMEs

The economy of southern Russia is diversified not only in terms of its sectors, but also in terms of the size of its enterprises: 10% of all Russian SMEs (excluding micro businesses) are based in southern Russia. Although it was these enterprises that “shrank” the most at the start of the crisis, by upgrading their equipment and technology they also began to recover more quickly. It is unsurprising that southern Russia accounts for almost 20% of all investment in Russian SMEs. When visiting areas of southern Russia located far from large towns and cities, foreign partners are pleasantly surprised to see farmers using German technology in their fields, apples being grown using Italian technologies, and companies producing goods that are sold to transnational companies. By using modern equipment and technologies, companies are achieving a three to five-fold increase in production efficiency. SMEs in southern Russia are increasingly being run by young managers who have been educated abroad and who are fluent in European languages.

**Table 2. Indicators characterising the performance of Small and Medium Enterprises (SMEs) – excluding micro businesses, as a % of the Russian Federation**

	Southern Federal District	North Caucasus Federal District
Number of SMEs	8.1	2.6
Number of jobs	9.0	2.7
Investment	17.6	1.6
Sales	7.4	1.9

## Anti-crisis stress test

Not only did the global crisis underline southern Russia's advantages (its climate, geographical location, diversified economy, and entrepreneurial culture), it also demonstrated the sustainability of the region's socioeconomic model in the face of external crises. As personal incomes in the south are lower than the Russian average, the local population could not afford to speculate on the stock market or the property market. Instead, they used savings accumulated before the crisis to purchase goods for which they had longed even before the crisis. With its diversified economy, southern Russia was able to "level out" the slump in production, avoid serious social shocks and unemployment, reduce costs, and adapt production to the new post-crisis environment more quickly. In many sectors in southern Russia the fall in output was less than the average for the same sectors elsewhere in the country. At the same time, by reducing their prices in the early stages of the crisis, southern Russian companies were able to retain their positions in contracting markets and then increase their market shares as these sectors recovered. During the crisis, the general public, the business community, and the authorities in southern Russia all demonstrated a striking level of social responsibility: businesses endeavoured to pay salaries, at the expense of their profits; employees agreed to redundancies and compulsory leave without unnecessary conflict; and the authorities tried to find new jobs for those people made redundant. This crisis was not the first, nor will it be the last; it is just the latest one. The anti-crisis vaccination received by southern Russia and the methods that it mastered during the anti-crisis stress test once again demonstrated the advantages that make it an attractive region.

## The post-crisis development of southern Russia: new challenges and new opportunities

Situational analysis has shown that whatever the developments on global markets, southern Russia adapts quickly. Under all scenarios, southern Russia's sustainable development will continue along its current trajectory:

- a) Economic recovery in developed countries will allow these countries to invest more in modern equipment (fixed assets) and additional demand will be created for the Russian regions that produce energy resources and food products;
- b) Accelerated growth in developing countries will increase demand in these countries for food products;

- c) Fluctuations in market prices for raw materials will only affect the rate of growth in some industries in southern Russia.

At the same time, southern Russia itself will become more attractive for participants in global markets: the region's problems once again highlight its potential for economic growth.

The fact that personal income in southern Russia is 25% less than the average in the Russian Federation indicates potential for improved standards of living and changes in the structure of consumption, the quality of goods and services, and lifestyles. In terms of labour productivity, the efficiency of production, including energy efficiency, and the time taken to implement projects, southern Russia lags three to five times behind European countries. This disparity creates a basis for the formation of a "new industrial space" between European countries and southern Russia.

There are the following opportunities to overcome these disparities:

- a) The post-crisis recovery of the Russian economy by 2013;
- b) The faster pace of economic development in southern Russia, connected with the decision to hold the 2014 Winter Olympics in Sochi (USD10-30bn) and the implementation of projects to develop resorts and recreational facilities in the North Caucasus (USD20bn). As a result, the growth rate of investment in the region will be 15-20% higher than the average rate in Russia, the region will have new infrastructure, and personal incomes will rise;
- c) The unsatisfied demand among the population of southern Russia that became apparent as a result of pre-crisis growth; the emergence of new needs, and the opportunity to satisfy this new demand using earnings from entrepreneurial activities;
- d) The drive demonstrated by southern Russia's entrepreneurs, their recognition of the benefits of new technologies, and their understanding of how to access sources of finance for small projects. The ambitions of the region's politicians and the independence of its entrepreneurs create scope for constructive dialogue between the authorities and the business community, as well as a competitive environment for the introduction of modern equipment and the production of competitive goods on a new technological basis;
- e) There are also additional opportunities to achieve accelerated development in southern Russia by expanding the forms and the spheres of application of the public-private partnership mechanism, drawing on European experience of arrangements such as long-term tariff agree-

ments, purchase guarantees, project co-financing, and equity shares.

### Business and the authorities

The regional political leaders in southern Russia display a healthy level of ambition, as do all southern Russians. There is an unspoken competition among these politicians to achieve the best results for a range of indicators, including: the amount of construction work, investment, the harvest, and repairs to housing and roads. From a roughly equal starting point, each of the Federation members in southern Russia is trying to attract investors by offering more favourable conditions for doing business. Almost every Federation member has created an Investment Promotion Agency, which provides support for large projects involving foreign investors, and these agencies are operating with a fair amount of success. Participants in large projects can obtain tax concessions from the local authorities, and even co-financing for the infrastructure components of projects. A number of the Federation members in southern Russia have designated zones for intensive development, and investment projects in these zones benefit from simplified pro-

cedures for land allocation and the building of infrastructure.

For small projects it is best to find a local partner who knows how to overcome the barriers presented by Russian legislation and its application at the local level. With a local partner, a simple explanation of the content of the project and a public signing of a memorandum of intent is usually sufficient. Although it is not mandatory, the inclusion in agreements of social obligations to support sport, education, and culture is welcomed.

### Business infrastructure

Almost all the large banks, insurance companies, legal and consulting firms, and recruitment agencies, including those founded abroad, have offices in southern Russia, and competition among companies offering business services is strong. Modern business centres, with office premises for rent, have been opened in large towns and cities. The commercial and residential property markets are sufficiently transparent and a wide range of properties is available. Many Russian and foreign investors prefer to set up production facilities in small towns that have railway stations, river ports and access

## At the forefront of sustainable banking in southern Russia



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to federal highways. By purchasing existing enterprises in small towns, investors benefit from simpler land allocation procedures and easier connection to the electricity, gas and water supply networks, but, generally, such a step requires the complete reconstruction of buildings and production facilities.

Chambers of Trade and Industry and various industry-specific business associations are active in all the Federation members of southern Russia. The South Regional Committee of the Association of European Business brings together foreign companies already operating in southern Russia. Members of the committee work together with the authorities, promoting best management practice, including corporate conduct, social responsibility, and public-private partnerships. They also provide advice on an informal basis to anyone wanting to set up a business in southern Russia.

### **The investment potential and modernisation of southern Russia**

Despite inadequate funding for research and development, the number of undergraduate and postgraduate students studying in southern Russia is fairly impressive, and a considerable number of patents are registered. However, when it comes to introducing new equipment and technology for production, southern Russia lags six to seven times behind the average European levels for this indicator. Given this specific configuration of southern Russia's potential for innovation, the optimum strategy for the region's modernisation is for its companies to purchase modern equipment and technology on global markets and to become expert in the efficient production of products, goods, and services that are competitive on global markets.

Southern Russia is increasingly becoming a forum for the reference projects of European equipment suppliers and an area in which they can replicate their experience of modernising different economic sectors. For example, bringing agricultural yields and productivity in southern Russia up to European levels will require an eight to ten-fold qualitative and quantitative improvement in the technology and equipment used by the sector. Bringing the provision and standards of housing up to European levels will require a ten-fold increase in residential construction. Road construction needs to increase by the same amount. According to World Bank calculations, approximately seven billion dollars will be required for the implementation of energy efficiency programmes in the Rostov region alone. Ensuring that SMEs in southern Russia can provide the same level of employment as their counterparts in Europe

will require at least a three-fold increase in the current amount of investment in the sector.

Successful cooperation with European companies to modernize southern Russia requires an integrated approach, including technical, financial and social engineering. By using modern equipment and technologies, as well as trade finance, leasing and factoring, and by introducing best management practice and a system for establishing contractual relationships, southern Russia can "multiply" the effects of investment in the region. Southern Russia has a particularly acute need for European rules of the game in the utilities and communal services market; international financial institutions such as the EBRD, International Finance Corporation (IFC) and Kreditanstalt für Wiederaufbau (KfW) are actively supporting pilot projects in this area.

### **Foreign trade**

As a border region, southern Russia plays a modest role in foreign trade. At the same time, the region accounts for 25 to 30% of Russia's food exports, more than 7% of its textile and footwear exports, and more than 10 to 15% of Russia's imports of metal and minerals. Southern Russia already has the necessary infrastructure to develop its foreign trade: large sea ports, rail services, water transport routes, and regular flights by European airlines. Logistics centres are being built at the intersections of major highways. The customs agencies in southern Russia provide the same range and quality of services as their counterparts in the central region. Today, as much as 65% of Russian grain is exported via ports in southern Russia. However, due to the traditional centralization of foreign trade in the Russian Federation, progress in re-directing trade towards southern Russian channels is slow and requires European companies operating in Russia to adjust their business strategies. For example, following the successful modernization of boiler houses in the city of Taganrog, a European boiler supplier opened a new dealership at the local heating company. All the major car manufacturers and suppliers of general-purpose manufacturing equipment have dealerships in southern Russia. Gradually, dealerships are becoming service centres, capable of assembling components. Many companies are introducing energy-efficient technologies and expanding their imports of energy-efficient equipment.

One of the markets that is doing well in southern Russia post-crisis is the real economy. This sector is demonstrating attractive, sustainable growth, driven by increased efficiency resulting from the modernization of equipment and technology.