

December 10, 2002

To: CEO, Widget International, Inc.

From: Michel Debolt

RE: Expansion into Russia

Despite many recent positive trends, I recommend against significant direct investment in Russia at this time. As outlined below, the many near term risks outweigh the potential long term benefits. Through a local representative office, we can fulfill many business needs associated with the sale of our products, build our local presence, and better position ourselves for future direct investment when the relative risk and benefits become more certain.

The Good

A number of arguments are commonly put forth in support of current investments in Russia. However, even these positive arguments often have negative aspects

- ***Russia is a huge, open market*** – Russia has a population exceeding 140 million and covers over 17 million square kilometers. In June 2002, both the EU and United States recognized Russia as a “market economy”, thereby augmenting Russia’s position in certain anti-dumping disputes and increasing the possibility of freer trade with Russia’s entry to the WTO.¹ Russia is large and “open”.

However, Russian per capita GDP in 1999 was only USD 2,500, approximately one-ninth of that enjoyed in western Europe.² Even among eastern European countries, Russian per capita GDP rests in the middle of the pack. To reach the prosperity of even

¹ “US calls Russia a free market”, BBC, June 7, 2002 (available at <http://news.bbc.co.uk/1/hi/business/2032498.stm>).

² Appendix 1. Russia estimates that over 30% of its population lives below the level of subsistence in 2002. See Russian Economic Report, The World Bank, October 2002 (available at http://www.worldbank.org/ru/eng/statistics/ereports/10_02/rer4-eng-oct29-10_final.pdf).

the poorest EU members, Russia would need to realize 8% annual growth (compared to 2001's 5% growth) for 15 years.³ Due to deteriorating infrastructure and the spread of citizens across the great Russian expanse, the size of the "reachable market" in Russia is significantly lower than its total population. Finally, hurdles remain to WTO membership, including resistance by some Russians who fear the effects of international competition on inefficient Russian firms.⁴ While Russian citizens may be interested in buying our products, their individual financial capacity is small and our ability to reach them free of trade barriers is currently limited.

- ***an educated, skilled, low wage, abundant work force*** – Russia boasts a literacy rate of 98.5%. The number of Russians pursuing higher education is comparable to the West.⁵ Commentators view the technical capabilities of its workforce as exceeding those of US workers,⁶ while the post-Soviet Russian work ethic is now seen as being comparable to Western standards. Foreign companies realize the benefit of a competent Russian work force despite the fact that average real wages of Russian workers are over 30% below their 1992 levels.⁷ Appreciation for a secure job with a Western company incentivizes Russian workers beyond simple economic compensation.⁸ This enthusiasm translates

³ "Good in Part", Economist, July 19, 2001 (available at http://www.economist.com/displayStory.cfm?story_id=698694).

⁴ Russia gets WTO entry boost, BBC News, December 10, 2001 (available at <http://news.bbc.co.uk/1/hi/business/1702205.stm>).

⁵ Per the United Nations Conference on Trade and Development ("UNCTAD") (available at <http://stats.unctad.org/public/eng/TableView/wdsview/dispviewp.asp>).

⁶ American-Russian Chamber of Commerce, "Managing the Russian Workforce" (available at <http://www.arcci.org/publications/KelloggPapers/ManagingRussianWorkforce.htm>). A McDonald's Russia official noted that "the McDonald's staff is better in Russia than in the West."

⁷ See Appendix 2.

⁸ The high value that Russians place on having a job in a western firm derives from a number of factors, including the quality of benefits, training, a safe working environment (often more secure than their own homes), and promotional opportunities that Russian firms cannot offer.

into an abundance of highly skilled applicants.⁹ It is not uncommon to find individuals with science / engineering degrees performing clerical functions in Western firms.

Nevertheless, an archaic 1992 Labor Code makes labor relations inflexible, with courts almost always siding with employees in labor disputes. The efficacy of the Russian education system is currently questioned, due to a lack of change since Soviet times, notorious underpayment of teachers, and academic corruption among students noted throughout higher education.¹⁰ Many of the more highly skilled workers, especially younger ones, have emigrated, resulting in a “brain drain” within Russia.¹¹ The population that has not left is declining in size at an annual rate of over 1 million people per year (since 1993), due to a combination of low birth rates and decreasing life expectancy. Despite the attractiveness of the current workforce, these factors lead some to suggest that the current generation of qualified workers may be Russia’s last, unless it finds a way to rejuvenate its education process and empower its young.

- ***economics*** – Analysts project a budget surplus of between 1.5% and 2.5% of GDP (i.e., at least USD 5.1B) for 2002.¹² Russia has been a net exporter since the mid 1990’s, with the USD value of exports substantially increasing to over 100% of imports in the year 2000.¹³ Inflation has fallen over 80% from a recent high of 84% in 1998.¹⁴ All of these facts constitute positive economic developments.

⁹ For example, when McDonalds opened its first Moscow restaurant in the early 1990’s, it received over 27,000 applications for 600 openings (i.e., even worse odds than applying to most top MBA programs in the US) and still receives 10 applications for every job opening. American-Russian Chamber of Commerce, “Managing the Russian Workforce”.

¹⁰ “Endangered Species”, Economist, July 19, 2001 (available at http://www.economist.com/displayStory.cfm?story_id=698679).

¹¹ Heleniak, Timothy, “Migration Dilemmas Haunt Post Soviet Russia”, Oct. 2002 (available at <http://www.migrationinformation.org/Profiles/display.cfm?id=62>).

¹² An Eye on Russia, November 2002 (available at [http://www.ey.com/global/download.nsf/Russia_E/eye_russia_nov_2002_e/\\$file/eye_russia_nov_2002_e.pdf](http://www.ey.com/global/download.nsf/Russia_E/eye_russia_nov_2002_e/$file/eye_russia_nov_2002_e.pdf)).

¹³ See Appendix 3.

Nevertheless, the Russian economy remains fragile. Over 60% of Russian exports come from commodities, such as oil.¹⁵ Excluding commodities, Russia is a net importer of goods, reflecting the fact that Russians are replacing domestically produced products with imports as their incomes rise.¹⁶ As such, industries that would otherwise diversify Russia's exposure to world commodity prices continue to suffer. The health of Russia's economy remains tied to global macroeconomic factors beyond its control.

- **finance** – Russia's dependence on foreign debt financing has improved substantially since 1999 when total debt outstanding represented over 90% of GDP.¹⁷ By reducing its dependence on foreign debt financing (projected to be under 35% of GDP by 2004), Russia reduces the possibility of default on its debt service obligations if its economy falters in the future.

The Bad

Beyond these positive trends, a number of issues will challenge the future profitability of investors in Russia.

- **lack of bank reform** – In the year 2000, domestic banks supplied less than 3% of the capital invested in Russia.¹⁸ During the Russian debt crisis of 1998, many failed banks failed simply their remaining transferred assets to new companies and refused to pay off existing depositors. As such, Russians inherently distrust Russian banks and simply keep their savings (over USD 40 billion) at home. Current reforms have been under

¹⁴ See Appendix 4. Calculated as $[(84.4\% - 18.6\%) / 84.4\%]$.

¹⁵ See Appendix 5. Note that some sources estimate Russia's dependence on commodity exports exceeds 80% (see CIA Factbook at <http://www.cia.gov/cia/publications/factbook/geos/rs.html#Econ>).

¹⁶ Russian Economic Report, The World Bank, October 2002.

¹⁷ See Appendix 6.

¹⁸ "Commentary: Don't Bank on Russian Bank Reform", Business Week, July 2, 2001 (available at http://www.businessweek.com/magazine/content/01_27/b3739219.htm).

negotiation for eight years.¹⁹ Lack of a viable banking system inhibits economic growth by limiting domestic sources of capital to equity contributions and retained earnings.

Limited domestic growth means fewer customers who can purchase our products and a less capable pool of local suppliers to support our business activities.

- ***law and justice*** – The Russian legal system fails to address many issues important to investors in a capitalist economy. The law itself provides inadequate protection of intellectual property rights. For example, when Ukraine recently enacted legislation to augment the protection of intellectual property rights, many CD piracy operations simply moved to Russia.²⁰ Judges often lack independence from the cases they hear, especially in the regions outside of Moscow. Most have spent their careers deferring to the judgment of other civil servants,²¹ such as the tax inspectors who will contest our own tax declarations, often depending for their livelihood on these civil servants.

A properly functioning legal system is critical to ensuring certainty in our business dealings. Disputes (tax, commercial, employment, investor rights, etc.) will arise, even if we zealously comply with the law. The lack of a developed legal system for protecting investor rights adds to our cost of doing business in Russia.

- ***bureaucracy and “corruption”*** – Payment to a government official for “facilitating” a transaction would be seen as a bribe in the United States. In Russia, such payments are endemic, often even necessary.²² While the cost of paying off organized crimes has been estimated at 5% of profits, some argue that the cost of dealing with the Russian

¹⁹ “Russian Banks: Safer than Mattresses?”, *Economist*, Nov. 28, 2002 (available at http://www.economist.com/displayStory.cfm?story_id=1469543).

²⁰ “Time to Trade”, *Economist*, June 13, 2002 (available at http://www.economist.com/displayStory.cfm?Story_ID=1182451).

²¹ “States within the State”, *Economist*, July 19, 2001 (available at http://www.economist.com/displayStory.cfm?story_id=698722).

²² See Appendix ???. Wages for many Russian civil servants are so low that such forms of compensation are often necessary to reach subsistence levels of income.

bureaucracy is even higher.²³ Russia's own Ministry for Economic Reform estimates that bad regulations cost Russia \$5.7 billion per year.²⁴ Bureaucracy and corruption will increase our costs (while reducing our profit) of doing business in Russia.

- **Infrastructure** - official estimates indicate that over 60% of Russia's public capital assets, including those associated with potable water, are simply worn out.²⁵ While private industry fares better due to foreign direct investment, the products produced privately must inevitably travel over / through public roads, bridges, and buildings currently in service beyond their original design life. Poor infrastructure will increase the cost of moving our products to customers within Russia.
- **national security** – Russia continues to deal with separatist elements in Chechnya. This situation at best constitutes a distraction to business in Russia and at worst represents a significant risk to employee life when separatists bring their cause to Moscow, such as occurred this past October, 2002.

Significant reform is occurring in other areas. However, such areas are either less significant to the profitability of our anticipated Russian operations (e.g., land reform) or have received significant attention in the past and generally are more investor friendly than those issues discussed above (e.g., tax reform and currency control).

²³ American Russian Chamber of Commerce, "Managing the Russian Workforce".

²⁴ "Good in Part", *Economist*, July 19, 2001 (available at http://www.economist.com/displayStory.cfm?Story_ID=1182451).

²⁵ "Waiting for the Crunch", *Economist*, July 19, 2001 (available at http://www.economist.com/displayStory.cfm?story_id=698742).

Recommendation

This memo identifies risks associated with doing business in Russia. It does not purport to argue for or against doing business in Russia. Rather, I simply recommend a cautious approach to expanding our operations into Russia due to significant uncertainties that currently exist. Recent positive trends suggest that Russia is moving in the right direction economically. What remains unclear is how long it will remain in a transitional state and the degree of variability of returns during this transition.

I recommend that we establish a local representative office (“rep office”) initially. While rep offices in many countries may not engage in commercial activities, Russia treats such entities as a commercial subdivision (i.e., a “permanent establishment”) of a foreign entity. A rep office has the following benefits over using locally established Russian legal entity or partnership:²⁶

- ***fewer administrative, tax, and accounting obligations*** – Russian entities must prepare and submit records in accordance with Russian statutory accounting principles that differ from GAAP and International Accounting Standards. A rep office is subject only to the accounting standards imposed by its foreign head office. Additionally, rep offices are subject to a condensed version of the tax compliance procedures applicable to Russian entities.
- ***more favorable currency control treatment*** - A Russian legal entity must settle payments with Russian customers in Roubles. A foreign legal entity may settle transactions deemed to occur outside of Russia in foreign currency. With recent (relative) stability of the Rouble, this has had less impact because even Russian legal entities may maintain foreign currency accounts (and can move their Rouble receipts into those

²⁶ Ernst & Young’s Guide to Doing Business in Russia (available at [http://www.ey.com/global/download.nsf/Russia_E/Doing_Business_in_Russia/\\$file/Doing_Business_RussiaE02.pdf](http://www.ey.com/global/download.nsf/Russia_E/Doing_Business_in_Russia/$file/Doing_Business_RussiaE02.pdf)).

accounts). Therefore, the real benefit of settling transactions in foreign currency are twofold: (i) we avoid the administrative burden of having to convert Rouble receipts to foreign currency (a small benefit) and (ii) should the Rouble devalue significantly, as it did in August / September 1998, we mitigate our exposure to currency risk (a potentially large benefit).

- ***benefits from applicable double tax treaties*** – Activities of our rep office can be divided between those that are commercial within Russia, such as negotiating and signing contracts, and those that merely support our commercial activities outside of Russia (e.g., collecting information on the Russian market). Income from the former is subject to Russian profits taxation, while income from the latter may receive tax relief under a double tax treaty.

Developing our initial Russian presence through a rep office, allows us to scale up our operations once we gain familiarity with the risks outlined above. Additionally, there are few activities, such as certain businesses that require licensing (e.g., insurance and some leasing activities), that a rep office cannot engage in.

Appendix 1 – Population, Area, GDP²⁷

Russia vs Selected Western Economies

UNIT	Value							
YEAR	1995				1999			
COUNTRY/GROUP	United States	France	United Kingdom	Russian Federation	United States	France	United Kingdom	Russian Federation
INDICATOR								
Population (thousands)	267,020	58,020	58,308	148,097	276,218	58,886	58,744	147,196
Area (square kilometers)	9,363,520	551,500	244,100	17,075,400	9,363,520	551,500	244,100	17,075,400
Density (inhabitants per sq km)	29	105	239	9	29	107	241	9
GDP (millions of dollars)	7,038,400	1,535,090	1,107,040	337,903	9,299,200	1,410,260	1,439,793	375,345
GDP per capita (dollars)	26,359	26,458	18,986	2,282	33,666	23,949	24,510	2,550

Russia vs Eastern European Countries

UNIT	Value													
YEAR	1999													
COUNTRY/GROUP	Albania	Belarus	Bulgaria	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Moldova, Republic of	Poland	Romania	Russian Federation	Slovakia	Ukraine
INDICATOR														
Population (thousands)	3,113	10,274	8,279	10,262	1,412	10,076	2,389	3,682	4,380	38,740	22,402	147,196	5,382	50,658
Area (square kilometers)	28,750	207,600	110,910	78,860	45,100	93,030	64,500	65,200	33,700	323,250	238,390	17,075,400	49,010	603,700
Density (inhabitants per sq km)	108	49	75	130	31	108	37	56	130	120	94	9	110	84
GDP (millions of dollars)	3,736	10,795	12,102	53,120	5,101	48,355	6,259	10,454	1,092	154,146	34,027	375,345	19,307	31,661
GDP per capita (dollars)	1,200	1,051	1,462	5,176	3,612	4,799	2,619	2,839	249	3,979	1,519	2,550	3,588	625

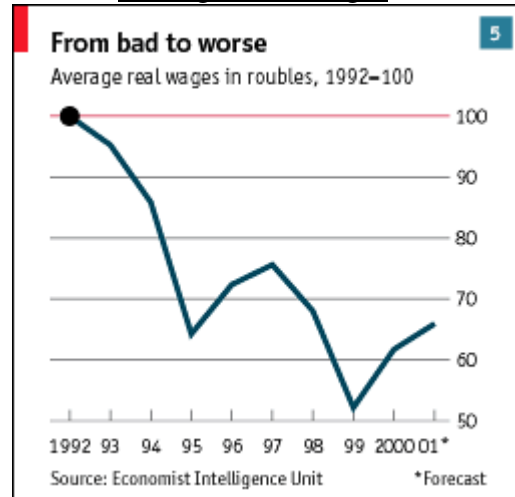
²⁷ UNCTAD (available at <http://stats.unctad.org/public/eng/TableViewer/wdsview/dispviewwp.asp>).

Appendix 2 – Social Indicators

Population & Age Demographics ²⁸




Average Real Wages ²⁹



²⁸ “Endangered Species”, Economist, July 19, 2001 (available at http://www.economist.com/displayStory.cfm?story_id=698679).

²⁹ “Waiting for the Crunch”, Economist, July 19, 2001 (available at http://www.economist.com/displayStory.cfm?story_id=698742).

Appendix 3 – Value and Share of Exports vs Imports³⁰

YEAR		1990		1995		1996		1997		1998		1999		2000	
FLOW 		Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports
COUNTRY/GROUP	UNIT														
World	Millions of dollars	3,485,598	3,602,839	5,127,780	5,191,367	5,343,636	5,446,410	5,543,651	5,631,996	5,456,263	5,550,918	5,646,733	5,788,312	6,326,525	6,505,276
	World %	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00
Developed countries	Millions of dollars	2,489,625	2,610,792	3,517,073	3,487,314	3,614,462	3,615,473	3,697,168	3,696,060	3,720,325	3,783,293	3,792,188	3,980,513	4,041,970	4,379,185
	World %	71.43	72.46	68.59	67.18	67.64	66.38	66.69	65.63	68.18	68.16	67.16	68.77	63.89	67.32
Developing countries	Millions of dollars	834,249	815,396	1,425,915	1,508,364	1,530,077	1,606,374	1,638,043	1,697,326	1,531,958	1,532,181	1,651,980	1,601,114	2,032,086	1,893,967
	Percentage	23.93	22.63	27.81	29.06	28.63	29.49	29.55	30.14	28.08	27.60	29.26	27.66	32.12	29.11
Countries in Eastern Europe	Millions of dollars	161,724	176,650	184,793	195,689	199,097	224,564	208,440	238,610	203,981	235,445	202,565	206,685	252,468	232,124
	World %	4.64	4.90	3.60	3.77	3.73	4.12	3.76	4.24	3.74	4.24	3.59	3.57	3.99	3.57
Russian Federation	Millions of dollars	...	...	81,096	68,863	88,599	74,879	88,288	79,076	74,888	63,817	74,663	43,588	104,836	49,125
	World %	...	...	1.58	1.33	1.66	1.37	1.59	1.40	1.37	1.15	1.32	0.75	1.66	0.76
	Exports as % of Imports	...	...	118%		118%		112%		117%		171%		213%	
European Union	Millions of dollars	1,496,691	1,549,627	2,061,164	1,965,151	2,124,446	2,014,905	2,119,168	2,004,110	2,201,101	2,103,763	2,187,852	2,133,945	2,231,864	2,232,350
	World %	42.94	43.01	40.20	37.85	39.76	37.00	38.23	35.58	40.34	37.90	38.75	36.87	35.28	34.32

Missing Values:
... Not applicable

³⁰ Per UNCTAD (available at <http://stats.unctad.org/public/eng/TableViewer/wdsview/dispviewp.asp>).

Appendix 4 – November 2002 Economic Indicators³¹

Russian Economic Indicators

	1997	1998	1999	2000	2001	2002*	04-02	05-02	06-02	07-02	08-02	09-02	10-02
General													
Nominal GDP, RUR trillion**	2.52	2.68	4.77	7.30	9.04	10.83		2.56			3.04*		
Real GDP, year-on-year change**	0.9%	-4.6%	5.4%	9.0%	5.0%	4.0%		4.1%			4.1%*		
Fixed-capital investment, year-on-year change	-5.0%	-6.7%	1.0%	17.7%	8.7%	4.0%	3.7%	3.5%	3.1%	3.3%	1.6%	2.9%	3.0%
Industrial output, year-on-year change	2.2%	-5.2%	8.1%	9.0%	5.0%	3.5%	1.2%	4.4%	6.1%	6.2%	4.9%	3.9%	4.0%
Corporate profits, US\$ billion	30.1	-11.8	29.3	40.2	39.1	27.8	2.30	2.88	1.47	2.33	3.45	2.35	2.53*
Prices													
Change in CPI, year-on-year	12.0%	84.4%	36.5%	20.2%	18.6%	14.5%	16.1%	15.9%	14.7%	14.9%	15.0%	14.8%	14.8%
GDP deflator, change to previous year**	14.4%	14.5%	64.6%	40.5%	17.9%	15.2%		15.8%			15.3%*		
Money													
M2, RUR b	374	448	706	1119	1603	1843	1621	1686	1751	1776	1812	1846*	1864
Gross international reserves eop, US\$ billion	17.8	12.2	12.5	27.9	36.5	40.0	39.2	42.2	43.6	43.3	44.3	45.6*	46.8
Average exchange rate, RUR/US\$	5.8	9.8	24.6	28.1	29.2	31.7	31.1	31.3	31.4	31.5	31.6	31.6	31.7
Real RUR/US\$ exchange rate eop (1997=100)	100.0	187.5	179.6	155.8	140.3	131.6	136.1	134.2	134.2	133.2	133.6	133.2	132.4
Federal Budget													
Revenue, % GDP	12.4	10.2	12.7	15.5	17.1	16.7	18.4	16.9	16.5	19.7	15.6	15.0	16.5
Expenditure, % GDP	19.6	15.2	14.3	14.0	14.3	14.8	14.6	15.1	15.0	14.7	14.8	14.1	12.9
Surplus/(Deficit), % GDP	-7.3	-5.0	-1.6	1.5	2.8	1.9	3.8	1.7	1.6	5.0	0.8	1.0	3.6
Interest payments, % GDP	4.7	4.0	3.4	3.5	3.1	2.6	0.6	2.1	1.9	1.7	3.4	2.3	0.5
Trade													
Exports, US\$ billion	88.2	74.2	74.7	105.5	101.6	102.1	9.0	8.3	8.2	9.1	9.6	9.6*	8.9*
Imports, US\$ billion	73.6	59	40.4	44.9	53.8	59.3	4.9	4.6	4.8	5.5	5.0	5.0*	5.6*
Trade Balance, US\$ billion	14.6	15.2	34.3	60.6	47.84	42.7	4.1	3.7	3.4	3.6	4.5	4.6*	3.3*
Oil price (Urals Med) avg, US\$/bbl	18.3	11.8	17.2	26.6	23.0	23.8	24.0	23.9	22.9	24.7	25.7	27.1	26.2*

* estimate, the precise data is not available

** data is reported every quarter

Source: Goskomstat, Ministry of Finance, Central Bank, Russian European Center for Economic Policy, NICEX, Bloomberg

³¹ An Eye on Russia, November 2002 (available at [http://www.ey.com/global/download.nsf/Russia_E/eye_russia_nov_2002_e/\\$file/eye_russia_nov_2002_e.pdf](http://www.ey.com/global/download.nsf/Russia_E/eye_russia_nov_2002_e/$file/eye_russia_nov_2002_e.pdf)).

Appendix 5 - Imports vs Exports (% by Type) ³²

<u>Industry</u>	<u>Exports</u>	<u>Imports</u>
Minerals	55%	11%
Basic Manufacturing	21	10
Chemicals	6	14
Wood Products	5	3
Non-electric Manufacturing	4	14
Misc. Manufacturing	3	7
Transport Equipment	3	4
Fresh Food	1	14
Processed Food	1	11
Electrical Components	1	4
Textiles	0	2
Other	<u>0.</u>	<u>6.</u>
Total	100%	100%

³² Data compiled from UNCTAD / WTO International Trade Center Data (available at <http://www.intracen.org/menus/countries.htm>).

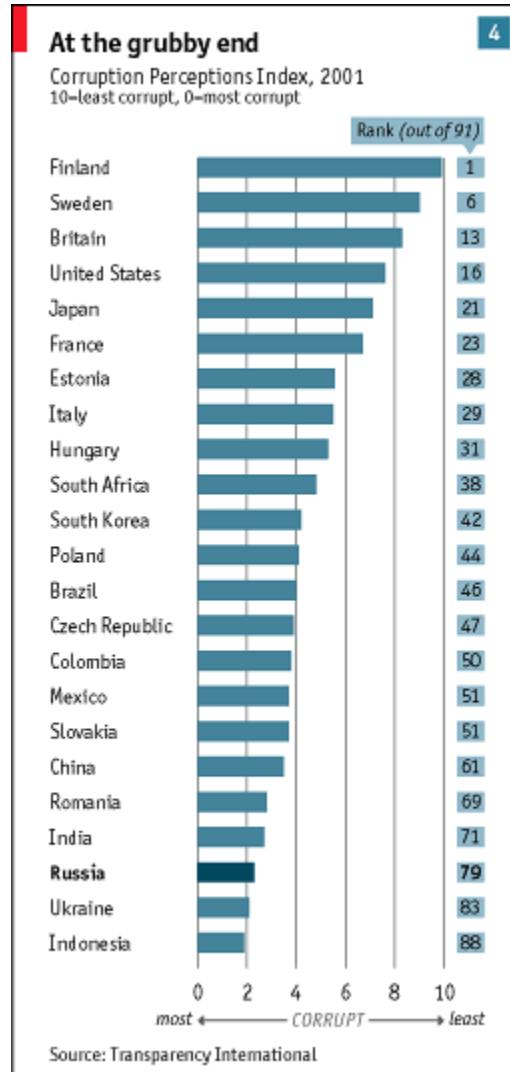
Appendix 6 – External Debt Financing³³

	1999	2000	2001	2002	2003	2004
External debt outstanding and disbursed (TDO) ^a	175,001	162,023	157,727	152,157	145,416	141,424
TDO/GDP (%)	90.4	62.4	50.9	45.3	39.1	34.9
IBRD DOD/Total TDO (%)	3.8	4.2	4.4	4.4	4.6	4.5
Memo: total public debt	207,720	199,017	182,241	177,219	174,833	171,192
of which domestic ^d	32,719	36,991	24,514	25,062	28,917	29,268
Total debt service (TDS) (US\$ m) ^a	9,761	11,512	16,490	18,489	19,367	16,141
TDS/XGS (%) ^b	11.5	9.9	14.4	16.0	16.7	13.5
IBRD DS/public DS (%)	5.9	6.2	6.0	7.1	8.3	8.3
IBRD DS/Preferred creditor DS (%) ^c	9.4	15.7	27.4	24.1	27.8	36.8
Memo: IBRD TDO (US\$ m)	6,707	6,844	6,891	6,708	6,235	5,864

- a. Includes public and publicly guaranteed debt, private non-guaranteed, use of IMF credits and net short-term capital. All debt in this table is to the Russian federation
- b. "XGS" denotes exports of goods and services, including workers' remittances.
- c. Preferred creditors are defined as IBRD, the regional multilateral development banks, the IMF, and the Bank for International Settlements.
- d. Converted at end-year exchange rate

³³ Per the World Bank in Russia (available at <http://www.worldbank.org/ru/eng/group/strategy3/strategy12.htm>).

Appendix 7 – Corruption³⁴



³⁴ “States within the State”, *Economist*, July 19, 2001 (available at http://www.economist.com/displayStory.cfm?story_id=698722).