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Россия
Голландия
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Rusland
2013

Investing in Russia

An overview of the current investment climate in Russia

April 2013

Contents

Glossary

Bln	Billion
BRIC	Brazil, Russia, India & China
CAGR	Compound Annual Growth Rate
CIS	Commonwealth of Independent States
EUR	Euro (currency)
FIAC	Foreign Investment Advisory Council
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
M	Million
MNE	Multinational Enterprise
NL	The Netherlands
NYSE	New York Stock Exchange
PE	Permanent Establishment
PPP	Public Private Partnership
RO	Representative Office
RUB	Ruble (currency)
SEZ	Special Economic Zone
TMT	Technology, Media & Telecom
UN	United Nations
US	United States
USD	United States Dollar (currency)
UK	United Kingdom
VAT	Value Added Tax
WTO	World Trade Organisation

Introduction

Dear readers,

Ever since Dutch merchants first sailed to Russia to trade wood, iron and wheat in the late 16th century, the Netherlands and Russia have experienced a long-standing and solid economic relationship. Ties between the two countries have intensified over the centuries, covering areas ranging from culture to sport. Today, these relations are as strong as ever, with the Netherlands positioned as one of the biggest investors and trading partners of the Russian Federation.

Based on an idea that arose during the opening of the Hermitage in 2009 in Amsterdam by Queen Beatrix and the current Russian Prime Minister, Dmitry Medvedev, 2013 has been declared a Dutch-Russian bilateral year. As part of this special year, KPMG, together with ING and the Dutch Ministry of Foreign Affairs, has the honour of organising the Netherlands-Russia Business Meet. This event aims to enhance and intensify bilateral economic relations between Russia and the Netherlands, and brings together business people, entrepreneurs, public sector representatives and investors from both countries.

From an investor perspective, the consensus view on Russia remains positive. It is a country that offers a high potential return, as long as the appropriate contingency planning is applied and expectations are realistic.

Nevertheless, we notice that organisations remain hesitant to invest in Russia, due to several potential pitfalls, such as a complex regulatory and fiscal environment, and a distinct business culture.

To reduce some of this uncertainty, this publication provides a brief background of the Russian economy, its main characteristics and key growth drivers. Also, it explores the most important inhibitors for setting up shop, as recognised by market participants, and summarises their tips and tricks for success in Russia.

In summary, the aim of this paper is to highlight the opportunities for foreign companies in Russia, while simultaneously discussing the contingencies that come with potential investments. From this position, we would like to thank Nutreco and Unilever for their kind cooperation, valuable insights and willingness to share their views with us.

We trust that 'Investing in Russia' will prove to be a helpful source of background information and a constructive tool in making your investment decisions. If you have any questions, remarks or suggestions, please feel free to contact us or the respective KPMG specialists listed at the end of this booklet.

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KPMG cutting through complexity

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01 The Russian economy at a glance

Introduction

Key facts[1]

Full name: Russian Federation

Area: 17m km^2

Population (July 2012): 142.5m

Number of regions: 83

Cities with >1m inhabitants (2013): 15

Major language: Russian

President: Vladimir Putin

Prime-minister: Dmitry Medvedev

Climate: Humid continental climate, in all parts of the country except for the tundra and the extreme southeast

Currency: Ruble (RUB)

Inflation (2012): 5.3%

Nominal GDP (2012): USD 2,016 trillion

GDP per capita (USD at PPP): USD 17,618

Real GDP growth (2012): + 3.4%

GDP per sector (2012): Agriculture: 4.4% / Industry: 37.6% / Services: 58.0%

Main exports: Oil and gas, wood and wood products, metals, chemicals, weapons and military equipment

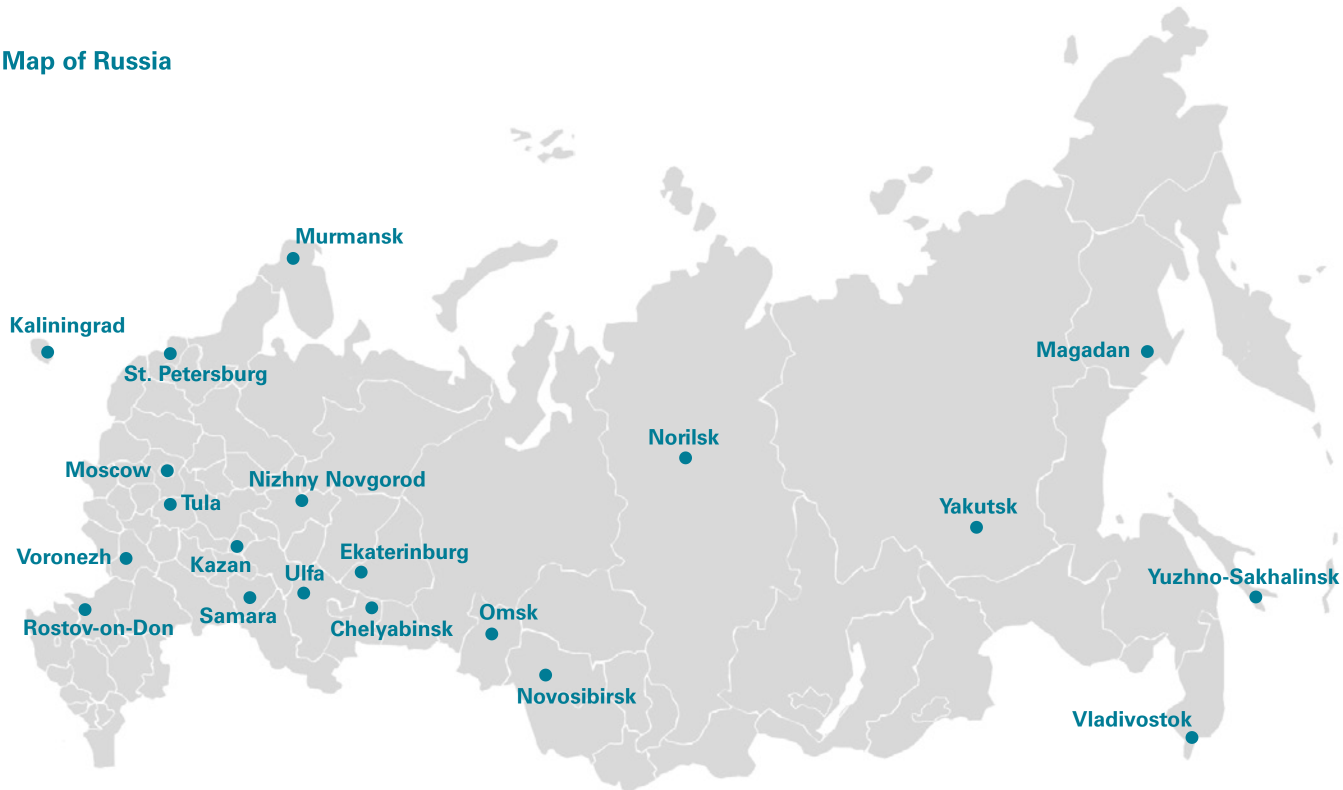
Main export partners (2011): Netherlands 12.2%, China 6.4%, Italy 5.6%, Germany 4.6%, Poland 4.2%

Main imports: Machinery, vehicles, pharmaceutical products, plastic, semi-finished metal products, meat, fruits and nuts, optical and medical instruments, iron, steel

Main import partners (2011): China 15.5%, Germany 10.0%, Ukraine 6.6%, Italy 4.3%

Source: (1) EIU; CIA Factbook; Federal State Statistics Service.

Map of Russia



Key points

- Russia is currently the world's 9th largest economy in terms of nominal GDP.
- The Russian economy is recovering from the financial crisis and has yet to return to pre-crisis levels.

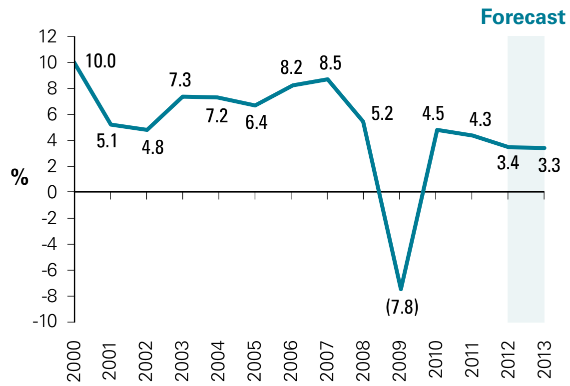
Russia is the world's largest country in terms of territory, spanning nine time zones, with a population of over 142m people, vast natural resources, and a growing middle-class.

Russia has a market economy with enormous natural resources, particularly oil and natural gas, and is perceived as a major emerging market economy. In 2011, it was rated the world's 9th largest economy in terms of nominal value and was the 6th largest judged by purchasing power parity.[1] Russia's per capita GDP (USD 17,618) was the highest among BRIC countries.[2] Historically a political heavy weight, Russia is a member of the G8, G20 and of the UN Security Council.

Following a period of strong GDP growth in the early 2000s the Russian economy experienced a severe decline in 2009. Russia's GDP contracted by 7.8% in that year, and was the biggest GDP decrease of the G20 countries. The drastic drop in growth was primarily related to a sharp decrease in oil prices in 2009, heavily affecting the Russian economy, which is highly dependent on oil and gas exports. On top of this, the ruble came under selling pressure and the availability of bank loans declined.

In 2010, GDP growth partially recovered mainly due to favourable oil prices. However, the economy has not recovered as quickly as other emerging markets, with growth for 2013 expected to slightly decrease to approximately 3.3%.[3] According to the World Bank, there are five reasons behind the expected slowdown. Firstly, the forecast price of oil has been lowered to USD 102.0 from USD 105.8 a barrel this year. Secondly, the foreign economic environment is not as favorable as expected. Thirdly, economic activity in Russia itself has declined. Fourthly, inflation is rising more quickly than originally envisaged. And finally, investment growth is weak.

Real GDP growth, 2000-2013



Source: EIU.

Exhibit 1: Demography[4]

In July 2012, Russia's population was estimated at 142.5m people, amounting to 42m households. That made Russia the 9th most populated country in the world. About 74% of the population lives in urban areas, and some 88m people (62% of the population) were part of the workforce in 2010. According to the 2010 census, 99.5% of the population above 10 years is literate. There are more than 180 different recognised ethnic groups in Russia, but Russians (about 80%) represent the vast majority of the population. Ethnic minorities include the Tatars (3.9%) and the Ukrainians (1.4%).

Exhibit 2: Political system

According to its constitution, the Russian Federation is structured as a multi-party representative democracy. On the 4th of March 2012, Vladimir Putin won the 2012 Russian presidential elections in the first round. He was elected for a six-year term. The President is primarily responsible for domestic and foreign policy. The President is also granted the authority to directly appoint Russia's regional leaders, subject to confirmation by the regional legislature. The Prime Minister, Dmitry Medvedev, oversees the activities of the government. Legislative power is exercised by a bicameral Federal Assembly, which consists of the Federation Council (upper house) and the State Duma (lower house).

Source: (1) World Bank.
(2) EIU.
(3) World bank, reinvigorating the economy 2013.
(4) Russian census, RiaNovosti.

Drivers of Russian growth

Russia has a commodity oriented growth model, which can cause fluctuations in times of low commodity prices. The other main driver of growth is domestic consumption, partly fuelled by strong credit growth. The final key driver is increased spending on fixed assets.

Key points

Russian GDP growth is heavily reliant on:

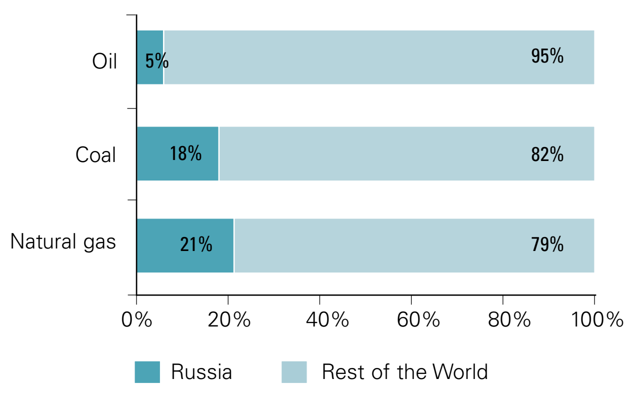
- Natural resource exports, whose value is dependent on global price developments.
- A growing consumer market, which is driven by an increase in disposable income and consumer credits.
- Investments in infrastructure, stimulated by major innovation hubs and sports sites.

Natural resources

The key driver to Russia's GDP growth is its vast stock of natural resources. In fact, two-thirds of Russia's stock market is dominated by the extractive industries.[1] The abundance of natural resources continues to be Russia's most globally competitive feature. Russia accounts for some 20% of the world's gas reserves, 18% of the world's coal reserves and 5% of the world's oil reserves. Together with its hydrocarbon deposits, Russia is also home to one of the world's leading mineral industries. From bauxite to iron ore, gold to platinum and a lot of mineral types in between, Russia ranks amongst the world's top 10 in terms of both production and reserves. For example, Russia accounts for nearly 25% of the world's diamond production by value.[2]

Unsurprisingly, the extraction of natural resources is still one of the most popular industries for FDI in Russia. With the gradual depletion of its 'easy' oil and gas, since the 1990s Russia has welcomed investments from technologically advanced foreign firms. A recent example includes the partnership deal between Exxon Mobil and the State-owned oil company Rosneft to develop the rich, untapped oil reserves of the Arctic zone. In many cases, when it comes to hard-to-reach reserves, Russia simply can not develop its locked potential without the support of foreign technologies and increased investments. Yet, despite of this, since Putin's rise to power, the activities of foreign companies in extractive industries have become less dominant. Legal and political barriers limit the participation of foreign MNEs due to the industries' strategic and financial importance.

Proven energy resource reserves split, 2011



Source: BP.

Exhibit 3: Russia & the "Dutch disease"[3]

The Russian economy, like many energy exporters, is vulnerable because of its excessive dependence on oil and gas exports, and the price of these commodities. As a result, Russia is more affected than other countries by fluctuations in the global economy. Russia is often said to suffer from the so-called "Dutch Disease". The "Dutch Disease" is described as the difficulty in achieving effective and successful economic diversification away from oil or other commodities when their prices are high. The term was named after a similar trend noted in the Netherlands after natural gas was discovered in the North Sea.

Source: (1) Sberbank.
(2) http://www.gbreports.com/admin/reports/EMJ-Russia-2012.pdf.
(3) IMF, 'Economic diversification in resource rich countries'.

Consumer market

Another key driver of the Russian economy is the strong domestic demand. From 1998 onwards, the consumer boom in Russia was the result of nearly eight years of economic prosperity and growth in credit facilities. This resulted in a doubling of real disposable incomes and the emergence of a middle-class, with growth averaging over 6.5% a year. This increase is expected to continue in the coming years. According to analysts, the Russian middle-class is expected to more than triple in the next eight years, rising from approximately 20m in 2011 to nearly 70m by 2020. As such, Russia is expected to become the largest consumer market in Europe by 2020, whilst its per capita GDP is expected to triple to USD 35,000.[1]

Driven by the booming consumer market, consumer-related sectors have been responsible for a large share of Russia's economic growth. According to Sberbank, these sectors have driven more than 80% of domestic GDP growth since 2004.[2] Consumer-related sectors include consumer retail & electronics, financial services, automotive, telecom, media and IT, and real estate. To illustrate, the Russian banking sector has been one of the fastest growing of the leading emerging markets over recent years, with a 26% CAGR over 2005-2012.

Domestic fixed investments

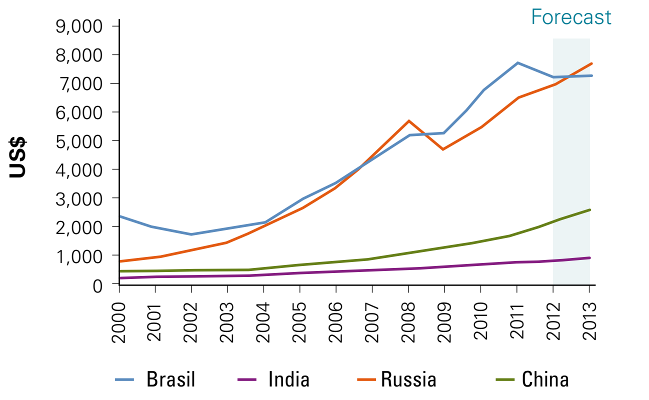
Although domestic fixed investment suffered a decrease in 2011-2012, investments are likely to pick up ahead of the 2014 Winter Olympics in Sochi. As Russia is hosting another major sport event, the 2018 FIFA World Cup, fixed investments are likely to enjoy an additional increase in the near future. Investments will go towards the host cities of the sport events, including Sochi, Rostov-On-Don, Nizhny Novgorod and Kazan. Other projects that may stimulate fixed investment growth include: the Skolkovo Innovation Hub; Russia's aspirations for Moscow to become an international financial centre; and Russia's railways modernisation programme.

Exhibit 4: Russian Silicon Valley[3]

At a planned 400 hectares, Skolkovo will consist of a university and techno park aimed at attracting tech start-ups and foreign investors with government grants. US companies such as Cisco, IBM and Microsoft have already committed to the project. As a special economic zone, foreign companies will get tax-breaks and special treatment when it comes to visas and imports. With construction well under way, the government has pledged USD 4.2bln for the project.

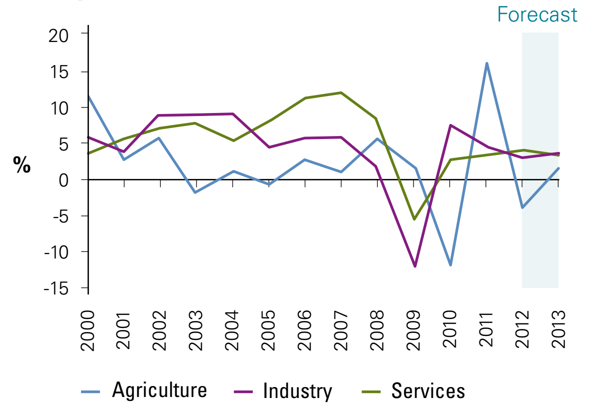
Source: (1) Bank of America, Merrill Lynch, 'Russia 2020: Tripling of Middle Class a Theme Worth Owning'.
(2) Sberbank, Consumer speed kings: team Russia leads the world, 2013; FT.
(3) RiaNovosti.

Evolution of real disposable income, 2000-2013



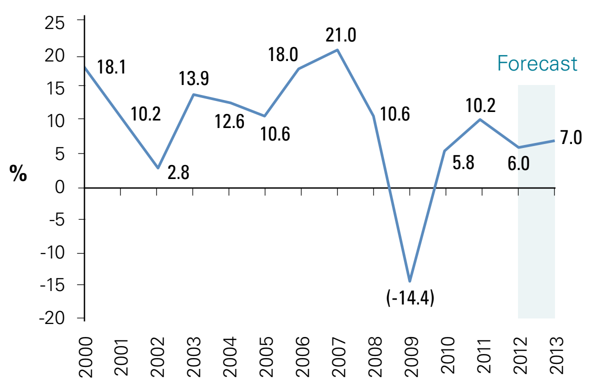
Source: EIU.

Growth per sector, 2000-2013



Source: EIU.

Gross fixed investments growth, 2000-2013



Source: EIU.

Exhibit 5: How sustainable is Russia's growth?

Following Russia's dramatic GDP drop, caused by the financial crisis and subsequent low oil prices, discussions have centred on the sustainability of Russia's economic model. The World Economic Forum identified three critical uncertainties that are highly influential forces in shaping the future of Russia's economic development. Each uncertainty has its own set of challenges.[1]

The evolution of oil & gas prices
In the coming decades, Russia is expected to face a number of challenges caused by a changing energy landscape. First of all, there are likely to be increased supplies of oil from sources ranging from the United States to Iraq, thanks to new drilling techniques and technology. The second challenge for Russia will be turning the threat of unconventional natural resources, such as shale gas, into an opportunity. Finally, Russia will need to accommodate the changing demand landscape. This is likely to shift in terms of the commodity mix and the geographical locations of supply and demand.

The quality of Russia's institutional environment
The quality of the institutions affects the economy, as it can hamper the potential for growth and adversely affect the availability of capital. Russia's institutional environment must be improved in order to act as a stable framework for growth.

The dynamics of domestic social cohesion
Social cohesion relates to the overall welfare within a society, taking into account measures of inequality as well as social polarisation. It also influences the ability of a society to implement reforms. Unless citizens trust that short-term losses will be offset by long-term gains, a government is likely to face popular resistance to change. Trust within Russian society and towards institutions and decision-makers is a key indicator of a society's ability to fully develop its productive potential.

Without predicting the likelihood of each scenario, the World Economic Forum established three scenario's outlining the key uncertainties, risks, challenges and development opportunities for the Russian Federation in the near future:

Scenario 1: Regional Rebalancing
Driver: Gradual decline in energy prices; Leadership for change in some regions; Increased agricultural resource scarcity.
Consequence: Concentration of institutional change at the regional level but stagnation in central institutions; Opportunities created by strong domestic and foreign investments in agricultural and related sectors.

Scenario 2: Precarious Stability
Driver: Sudden and sustained drop in energy prices; Crisis in Russia's economic foundations.
Consequence: No institutional reforms; Threat of popular resistance to cutbacks in entitlements and social spending; Strengthened hold of the Russian state on the economy.

Scenario 3: Beyond Complacency
Driver: Consistently high energy prices; Higher incomes to large parts of Russian society.
Consequence: Complacency about institutional reform. Increasing popular discontent about inefficient public service and state bureaucracy; Split among the elites eventually driving a wave of institutional reforms.

It seems that the first scenario would be optimal, since it would give Russia time to adjust to declining energy revenues and would stimulate change from the regions up towards the central institutions. However, irrespective of the final scenario, the extent of reforms will be dependent on the willingness of the government to accept and implement these changes.

Source: (1) Scenario's for the Russian Federation, World Economic Forum, 2013.

Interview: Unilever

In 2012, Unilever celebrated its 20th anniversary in Russia. Unilever currently operates 4 manufacturing hubs in the country: Food and Ice Cream production facilities in Tula region, Tea and Home & Personal care in St. Petersburg, Personal Care in Ekaterinburg, and Ice Cream in Omsk. Today, Unilever employs 7,000 people in Russia. Total investment of the company in the Russian economy has exceeded EUR 2 bln.

Source: Unilever

Remko Wessels

To discuss Unilever's views on Russia, KPMG caught up with the Vice President Finance of Unilever Russia, Ukraine & Belarus, Remko Wessels. Mr. Wessels joined Unilever in 1996 and has been living in Moscow with his family for the past three years.

Good afternoon Mr. Wessels, thank you for taking the time to speak to us. First of all, congratulations on Unilever's 20th anniversary in Russia. How did you celebrate this remarkable achievement?
Thank you. To mark our anniversary we organised a number of events, celebrating and involving company employees, key opinion formers, representatives of local government, suppliers and, of course, our customers. We also organised a number of public relations initiatives and communicated our anniversary through our brands to our consumers.

Unilever has production facilities in different parts of Russia, how is your company organised?
Our headquarters in Russia is in Moscow, where some 600 employees work. In addition, we have a large Tea and Home & Personal Care production hub in St. Petersburg and a Foods and Ice Cream production cluster in Tula region. In Omsk, Siberia, we have a second Ice Cream production facility and a Shared Services Centre, supporting back office processes for finance, HR and procurement. Finally, with the acquisition of Concern Kalina in 2012, we have also established a manufacturing presence and innovation centre in Ekaterinburg.

We have organised our manufacturing capabilities in hubs, which is basically a cluster of manufacturing facilities in one location. Concentrating these sites creates cost advantages, such as the use of the same production management, technical support and facility services for different plants.

Does a production plant in Siberia make sense when your consumer base is concentrated in the West of the country?
The starting point for our presence in Omsk was our acquisition of Inmarko in 2008, the market leader in Ice Cream. Prior to 2008, we did not have a production facility in the east. By acquiring Inmarko, we expanded our logistical footprint and gained better access to the consumer base in Central and Eastern Russia. People tend to forget that there is a relatively large consumer base east of the Urals. I estimate that about 15% of our consumers live in the region. The area contains a number of cities with more than a million inhabitants such as Omsk, Novosibirsk and Ekaterinburg. Considering the huge distances between the different consumer bases, the poor state of Russia's road infrastructure and the costs associated with transportation, it makes a lot of sense to have a production facility in the east. Furthermore, wages of local labour are considerably lower than those in the Moscow and St. Petersburg regions.

How did the acquisition of a Russian entity differ to that of a West-European company?
The deal process itself was very similar. For due-diligence and transaction services we work with the local offices of global advisors with a strong reputation, such as your firm. The main difference is in the post-deal phase. Many Russian companies are still operated according to top-down, hierarchical management philosophies and company cultures. Integrating these businesses into your existing operations requires careful planning and a step-by-step approach with a high focus on cultural elements.

We have all read about the incredible growth of Russia's middle-class. Russia must be a very attractive market for Unilever at the moment?
Indeed Russia is a very interesting market for our products. Not only is Russia's consumer base substantial in absolute

numbers, it also has an interesting composition. Russia has a population of 143m people of which 75% live in cities or towns, making them easy to reach with our products. What's more, the average Russian's disposable income is growing fast and is higher than inhabitants of other BRIC countries. So, increasing shares of the Russian population are able to afford our products and are willing to pay more for high quality, premium products.

What is your view on the future of the Russian economy?
I am positive about the Russian economy. GDP growth has been stable at around 3,5%-4,0% during the past few years and I expect similar levels for the next few years. Even though the Russian economy is still very dependent on oil and gas exports, the general health of the economy is good compared to many other countries. The country is not burdened by debt, it has substantial reserves thanks to the oil and gas windfall profits in the past and it has no budget deficit. The Ruble has been relatively stable over the past 18 months and the central bank is maintaining a consistent and robust policy.

What will prevent Russia from regaining pre-crisis GDP growth of 7-8% on the short-term?
Russia is dependent on the global economy. The export of oil and other natural resources is an important contributor to GDP growth. As long as the economic malaise continues globally, I have no reason to believe that there will be a sudden increase in growth.

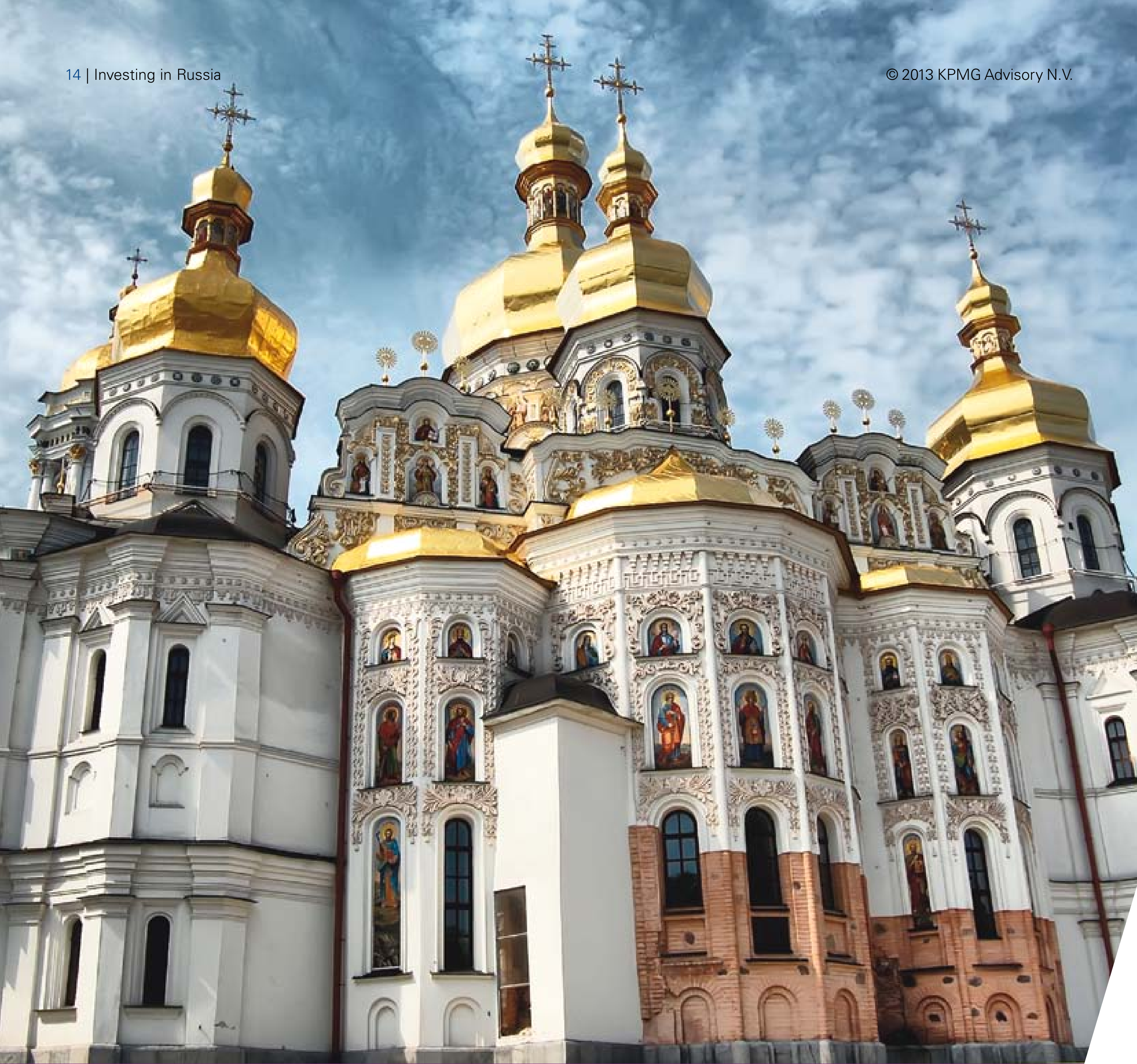
What will the impact be of Russia's accession to the WTO?
I am very pleased that Russia has taken this step. By joining the WTO, Russia will improve its reputation abroad. On the short-term, this will ensure that companies are less hesitant about investing in Russia and it will also improve Russia's trade relations. On the long-term, I hope that accession will contribute to improving Russia's current legal and tax regime. Both tend to be form-driven instead of substance-driven.

A comma in the wrong place on a form can lead to delays – something which would be unheard of in the Netherlands. Hopefully, bureaucracy and complexity will be reduced for investors in the country.

What are the best opportunities for Dutch companies in Russia at the moment?
In my view, when it comes to doing business abroad the Dutch have an advantage, thanks to their ability to adapt and build cross-cultural relationships, their entrepreneurship and their hands-on mentality. This gives them a competitive edge on the Russian market. As far as sectors are concerned, I would say that the best possibilities are in infrastructure, logistics and agriculture. These are traditionally the sectors where Dutch companies have strong expertise and compete well.

Finally, which three tips would you give to Dutch entrepreneurs?
First, when you do business in Russia, you need to have a long-term commitment. That means that you need to have a clear business plan and vision on where you as a company want to be in ten years. It also means that you have to be well prepared for short-term volatility (e.g. liquidity, currency crisis), which is inherent to doing business in Russia. Second, you need to pro-actively manage external relations. By this I mean that from the onset you need to build relations with - and be clear and transparent towards all stakeholders in how you will do business and what your operating principles are. Third, it's very important and challenging to attract the right Russian talent and capabilities. In the Moscow region, for example, there is a lot of competition for highly qualified personnel. As a result, you need to spend a considerable amount of time on attracting, training and retaining Russian talent.

About Unilever
Unilever is one of the world's leading suppliers of Food, Home and Personal Care products with sales in over 190 countries. Unilever's products are present in 7 out of 10 homes globally and are used by over 2 billion people on a daily basis. Unilever employs 171,000 people around the world. Over half of the company's footprint is in the faster growing developing and emerging markets (56% in 2011). The portfolio includes some of the world's best known brands such as Knorr, Persil / Omo, Dove, Sunsilk, Hellmann's, Lipton, Rexona / Sure, Wall's, Lux, Rama, Ponds and Axe. Unilever's ambition is to double the size of its business, whilst reducing its overall environmental footprint (including sourcing, consumer use and disposal) and increasing its positive social impact. The company is committed to helping more than a billion people take action to improve their health and well-being, sourcing all its agricultural raw materials sustainably by 2020, and decoupling its growth from its environmental impact.



02 FDI in Russia

Introduction

Following the collapse of the Soviet Union, Russia opened its doors to FDI. After initial flat growth in the 1990s, FDI peaked in the mid-2000s following the liberalisation of certain sectors of the economy.

Under President Yeltsin, Russia lifted its restrictions on capital inflows. However, during the 1990s the amount of FDI flowing into Russia remained fairly flat due to poorly orchestrated privatisations and the lack of secure property rights.

After 2005, FDI inflows grew exponentially, due to investments in newly liberalised sectors such as the power generative industries, the automotive and real estate sectors. After reaching record heights in 2008, the financial crisis led to a collapse in FDI, as the global economy entered into a recession.

Since the severe drop in 2009, FDI has recovered partially, reaching USD 45bln in 2012, the fourth highest level ever recorded in Russia's history. Foreign investors remain motivated by the continued strong growth of the consumer market and affordable labour costs, coupled with productivity gains. They also continue to be attracted by high returns in energy and other natural-resource related projects.

BRIC

After a period of strong growth, all BRIC countries were severely affected by the financial crisis in 2009 with Russia affected the most. The drop in international confidence had an immediate and sharp effect on capital flows to emerging markets, as investors reassessed risks and capital flows into the BRIC countries collapsed.

FDI picked up briefly in 2011, but all BRIC nations suffered a decline in 2012. This was mainly due to the Eurozone debt crisis and concerns of slowing growth in major economies.

Exhibit 6: Why invest in Russia?[1]

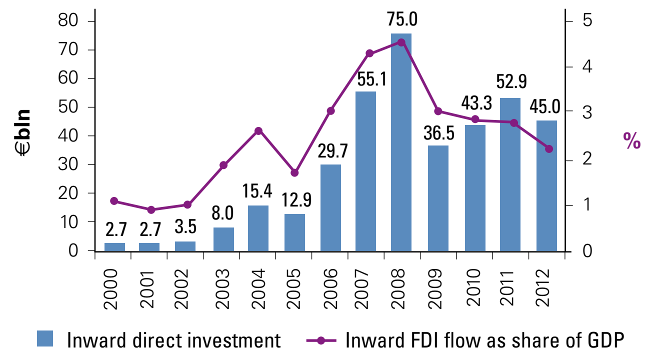
- Consumer market.
- Relatively well educated labour force.
- Vast natural resources.
- Unique geographic position.
- Technologically advanced economy.
- Balanced labour costs and skills.
- Innovation hubs.

Source: (1) http://www.ved.gov.ru/eng/investing/investing-climat/

Key points

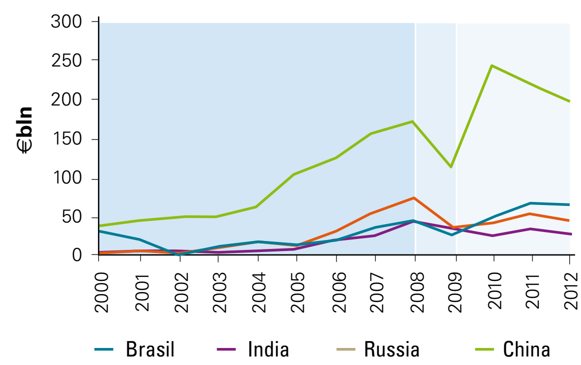
- FDI inflows to Russia have increased substantially in the past decade.
- FDI remains concentrated in resource rich regions and in cities that provide access to the consumer market.
- KPMG investor interviews suggest that a focus on soft factors to facilitate investments can improve regional FDI attractiveness.

FDI inflows Russia and FDI as share of GDP, 2000-2012



Source: EIU.

FDI inflows BRIC, 2000-2012



CAGR (%)	2001-2008	2008-2009	2009-2012
Brazil	4%	(42)%	35%
India	37%	(18)%	(8)%
Russia	51%	(51)%	7%
China	21%	(33)%	20%

Source: EIU.

In terms of the number of projects, the largest investors in Russia are the US and European countries. Increased Russian consumer spending is driving FDI growth in consumer sectors, such as the automotive and food markets.

Between 2007-2011, the US was a leading investor in Russia with 122 projects, corresponding to 16% of total projects.[1] Leading US companies, such as Boeing, Cisco, ExxonMobil, were active in sectors including automotive, IT, food, and oil and gas. The second largest investor was Germany, with 99 projects in a range of sectors including oil and gas, banking and consumer goods.

Foreign investment projects were concentrated in the automotive, food sector and the industrial sector, attracting 90, 86 and 62 projects respectively. The Russian automotive sector is the largest market in Europe, and employs 600,000 people or 1% of the Russian total workforce. The combination of a surge in consumer spending, readily available car loans and a Russian taste for foreign brands helped stimulate foreign investments in the sector. Some 11 foreign brands are currently active in Russia, with Volkswagen recently announcing that they will be investing close to EUR 1bln by 2018.

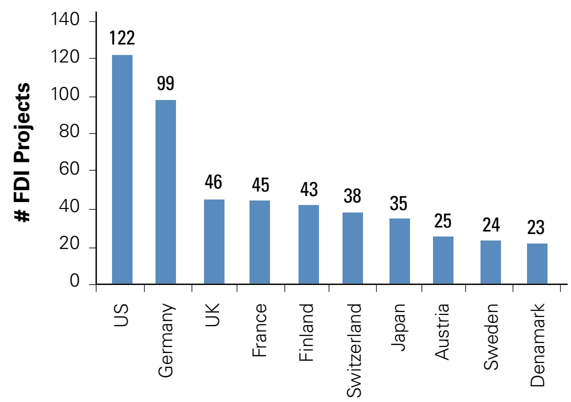
The food sector was the second largest sector with 86 new projects. Rising levels of disposable income as well as the construction of modern infrastructure (shopping malls, cinemas) and drive-through establishments have stimulated investments in the food sector. Major companies active in Russia include Danone, McDonald's, Nestlé and Coca-Cola.

Source: (1) Positioned for growth: E&Y's 2012 Russian attractiveness survey.

Dutch consumer goods companies include Heineken, Unilever and Friesland Campina.

The sector with the third highest amount of FDI projects was the machinery and equipment sector. Rising demand for new machinery was fuelled by infrastructure modernisation, power sector construction and the growth of industrial sectors.

FDI projects in Russia per country of origin, 2007-2011

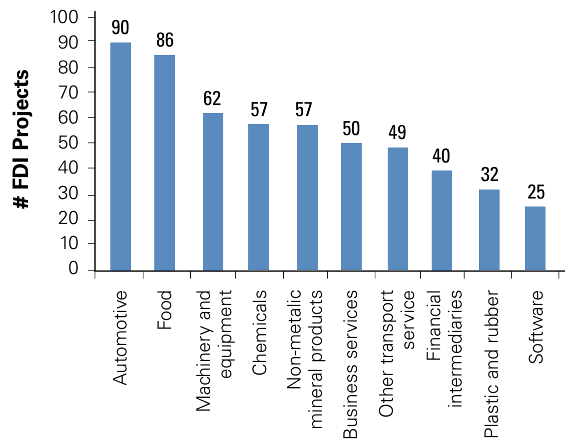


Source: Positioned for growth: E&Y's 2012 Russian attractiveness survey.

Exhibit 7: Skewed numbers

In terms of the value of FDI flows, Cyprus, the British Virgin Islands and the Netherlands are typically the largest investors in Russia. These figures tend to be misleading though, as these are primarily financial flows and are not necessarily related to physical investments. Intermediate holding companies in these countries are used to achieve tax savings and other objectives.

FDI projects in Russia per sector, 2007-2011



Source: Positioned for growth: E&Y's 2012 Russian attractiveness survey.

Regional disparities

The majority of FDI is geographically confined to a handful of regions that are attractive through their market size and the wealth of their natural resources. Companies have noticed a gradual improvement in the regional investment climate – though this differs per region.

Regional FDI concentration

The distribution of FDI across the Russian regions is typically driven by their market size and wealth of their natural resources. Other determinants include the proximity to European markets, infrastructure and the regulatory environment. To illustrate, in 2010-2011 78% of total FDI in Russia was destined for the top-10 regions. Of that 78%, nearly 50% was absorbed by Moscow (region and federal city) and St. Petersburg. However, during 2006-2007 the share of the top-10 regions was 87%, indicating a gradual shift of FDI to regions outside of the traditional strongholds of major metropolis and energy-rich regions. Most notable was Voronezh, that attracted foreign investment from a number of companies in the agrifood sector, including Dutch company Nutreco.

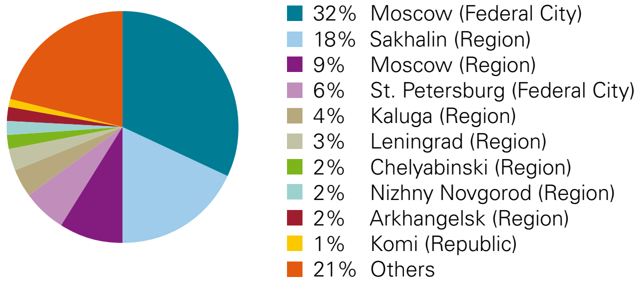
The leading position of the Sakhalin region and the Arkhangelsk region was due to major oil and gas projects, whilst the Kaluga region and the Vladimir region were remarkably effective in creating favourable conditions for investors in manufacturing projects. The Kaluga oblast, for example, established a special regional development agency more than five years ago to accommodate investor needs. Six "industrial parks" have since been established in the region. Volvo, Volkswagen, Peugeot Citroen and Mitsubishi Motors, all initiated car and truck assembly projects in these "industrial parks".

Investment climate

According to a KPMG Russia survey[1], 61% of respondents affirmed that the regional investment climate is improving. This is a positive development and reflects the efforts of the Regions to improve their attractiveness to investors. However, at the same time, respondents acknowledged that improvements are not yet happening at the right pace.

Note: (1) Study based on interviews with respondents detailing over 200 investment experiences.

Cumulative Russian FDI stock per region, 2006-2010

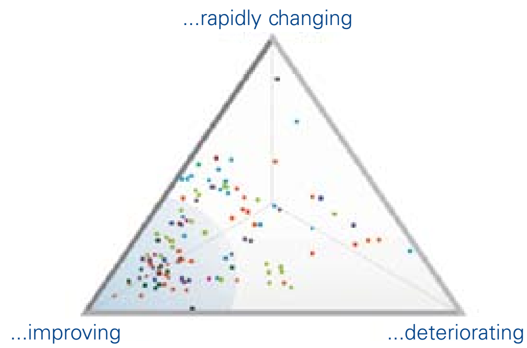


Source: KPMG analysis.

Exhibit 8: The regions

The Russian Federation consists of 83 constituent entities (46 oblasts (regions), 21 republics, nine krais (territories), four autonomous districts, one autonomous oblast and two federal cities (Moscow and St. Petersburg)). Formally, all of them have equal status. Regions (oblasts) and territories (krais) are areas in which the ethnic Russian population is the majority. Republics are ethnically based and have a slightly higher status, which, for example, allows them to have their own constitutions. Autonomous districts and the autonomous oblasts are also theoretically ethnically based, but in reality the ethnic Russian population is the majority there.

Degree of change in regional investment climate

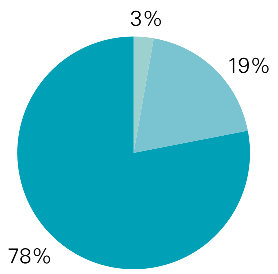


Key: Each dot represents an investor experience. Different colors denote different industries.

Source: KPMG analysis

FDI in Russia per region, 2007-2011

FDI split per region type, 2010-2011



Key:
- Top-10 regions
- Average attracting = > USD 25m FDI
- Low attracting = < USD 25m FDI

Note: FDI in Russia excludes investment origination from Cyprus and British Virgin Islands

Source: Rosstat; KPMG analysis

1	Moscow	21	Omsk region	41	Tver region	61	Tambov region
2	Sakhalin region	22	Rostov region	42	Saratov region	62	Vologda region
3	Moscow region	23	Sverdlovsk region	43	Perm Kray	63	Ivanovo region
4	Kaluga region	24	Voronezh region	44	Yaroslavl region	64	Bryansk region
5	Saint-Petersburg	25	Zabaykalsky Kray	45	Penza ergion	65	Kursk region
6	Nizhny Novgorod region	26	Tomsk region	46	Jewish Autonomous region	66	Republic of Yakutia
7	Arkhangelsk region	27	Pskov region	47	Kirov region	67	Smolensk region
8	Tyumen region	28	Khabarovsk region	47	Republic of Udmurtiya	68	Astrakhan region
9	Leningrad region	29	Primorskiy Kray	49	Tyva Republic	69	Kostroma region
10	Vladimir region	30	Stavropol Kray	50	Murmansk region	70	Republic Mariy El
11	Orenburg region	31	Belgorod region	51	Krasnoyarsk Kray	71	Republic of Buryatia
12	Komi Republic	32	Irkutsk region	52	Republic of Chuvashia	72	Dagestan Republic
13	Krasnodar region	33	Samara region	53	Kamchatsky Kray	73	North Ossetia-Alaniya Republic
14	Tula region	34	Bashkortostan Republic	54	Altayskiy Kray	74	Chukotka Autonomous region
15	Lipetsk region	35	Republic of Karelia	55	Chelyabinsk region	75	Republic of Kalmikiya
16	Khakasia Republic	36	Orlovsky region	56	Kemerovo region	76	Republic of Altay
17	Amurskiy region	37	Republic of Adigeya	57	Ryazan region	77	Chechen Republic
18	Tatarstan Republic	38	Novosibirsk region	58	Magadan region	78	Ingushetiya Republic
19	Novgorod region	39	Volgograd region	59	Kurgan region	79	Cabardin-Balkarskiy Republic
20	Kaliningrad region	40	Ulyanovsk region	60	Republic of Mordovia	80	Karachaevo-Cherkes Republic

Despite improvements, Russia and its regions need to step up their efforts to attract FDI. This will serve to attract capital and knowledge required to modernise. One way of achieving this is by improving 'soft factors'.

KPMG's research indicated that so-called 'hard and soft' indicators (see exhibit 9) are at least equally important when it comes to investor decisions. This is of course not the case for industries exclusively focussed on natural resources. Even so, investors indicated that a disadvantage on hard factors can easily be compensated by a strong performance on soft factors. Kaluga (see exhibit 10) is a notable example of a region deprived of strong hard factors but that is still able to attract substantial FDI through its soft factors.

Building on the conclusions of its study, KPMG established a set of recommendations in order to increase the attractiveness of FDI for specific regions.

1. Have a governor who clearly makes attracting FDI the unquestioned priority of his/her tenure.
2. Have a senior team that recognises when rules are abused and is willing to end such abuse.
3. Make 'business-orientation' the key element of recruitment and promotion policies for all staff.
4. Develop a 'hand-in-hand' approach with investors to overcome deficiencies in the business environment and focus on delivering results.
5. Willingly engage in pan-regional projects that improve labour productivity.
6. Learn how to differentiate one-self in a level playing field.

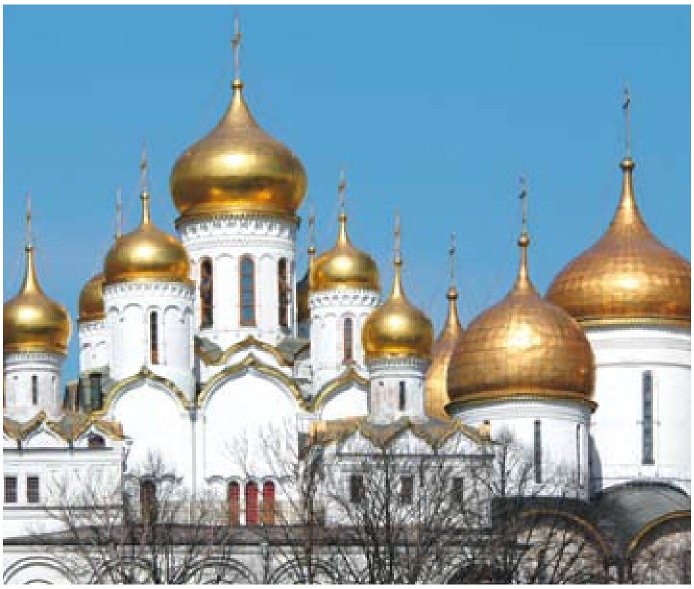


Exhibit 9: The influence of hard and soft factors on FDI

KPMG Russia developed a framework, establishing the attractiveness of a region as a combination of hard and soft factors.

- Hard factors are those which are part of the existing environment and cannot be changed in the short/ medium term (assets, geographical location, resources) and the ability to influence them is very limited.
- Soft factors are those which a regional government has considerable ability to positively influence in a reasonable period of time (business support, regulator environment, tax incentives).

Exhibit 10: Kaluga case-study

Kaluga stands out from other regions. It features among the top-3 destinations for FDI in per-capita terms despite the fact that it lacks natural resources and has shortcomings in energy infrastructure and availability of labour. In other words, Kaluga has a relatively poor performance on hard factors but a strong focus on soft factors.

Kaluga is successful in attracting foreign investors thanks to a proactive cluster strategy (automobile, transport and logistics and pharmaceuticals and biotechnology). Where many regions promote their existing industrial capabilities, infrastructure (e.g. the number of universities) or natural resources as their competitive advantages, Kaluga took a different approach. The region decided to focus on building and leveraging the following competitive advantages:

1. Having a client-oriented approach.
2. Establishing clear guidelines for working with investors.
3. A continuous focus on developing the region's infrastructure.
4. A beneficial geographical location near the Moscow region.

Results

Kaluga has become one of the centres of the Russian automotive industry, with a number of foreign companies opening assembly plants in the area. Companies include Volkswagen, Volvo and Continental.

Dutch FDI

Key points

- The Netherlands is accountable for a substantial share of FDI to Russia (USD 6.5bn in 2011) – though much is in the form of capital relocation.
- Dutch companies are active, amongst others, in technology, media & telecom, healthcare, infrastructure & logistics, agriculture & food and natural resources.
- Most Dutch companies are located either in St. Petersburg or Moscow.

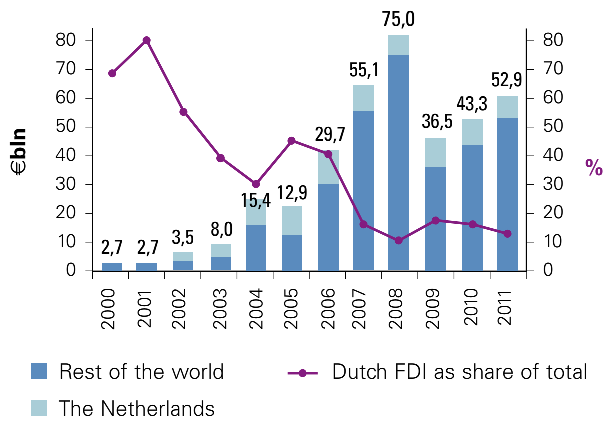
"We have a special relationship with the Netherlands, which is one of our top three trade and investment partners."

Dmitry Medvedev, 2011[1]

Exhibit 11: Netherlands and Russia - a history of cooperation[2]

Beyond these trade and investment flows, Russia and the Netherlands have strong historical ties. Peter the Great lived, worked and studied in the Netherlands and returned to Russia with new ideas ranging from the colours of the Russian flag to the concept of a city of canals on a river delta, which he saw in Amsterdam and copied in St. Petersburg.
Today Russia has several reconstruction projects, such as an early 18th-century Dutch garden in Yaroslavl, the Summer Garden in St.Petersburg, which was of Dutch origin, the ship with which the Dutchman Willem Barentsz sailed the Arctic Ocean in the 16th century and buildings in Kemerovo designed by a Dutch architect in the constructivist style in 1925.

FDI in Russia split, 2000-2011



CAGR (%)	2000-2005	2005-2011
Rest of the World	25%	2%
The Netherlands	54%	36%
Total	37%	27%

Source: EIU; Nederlandse Bank.

Ties between Russia and the Netherlands date back to the 16th century. Nowadays, the Netherlands has substantial direct investments in Russia – though somewhat inflated through fiscal flows - with a large number of top tier companies positioned in Russia through sales offices or production sites.

In 2011, investments from the Netherlands accounted for 12% of total FDI in Russia. A substantial share of these investments were financial flows and not necessarily related to physical investments. Intermediate holding companies in the Netherlands are used to achieve tax and other objectives. A big part of the remaining share of FDI represents physical investments in a number of sectors in which Dutch companies are traditionally well positioned:

1. Technology, Media & Telecom (TMT)

Dutch media investors have been active in this sector since the early 1990s. Dutch media tycoon Derk Sauer, who was one of the founders of Independent Media, launched Russia's first independent daily newspaper in English, The Moscow Times in 1992.

Source: (1) http://eng.special.kremlin.ru/news/2953.
(2) Agentschap NL.

2. **Healthcare**
   With an ageing population, healthcare spending in Russia is likely to increase substantially in the coming decades. Eleven Dutch companies, including Philips, Simed International and DSM, have recently joined forces to establish joint ventures and PPP ventures with Russian companies and government agencies in the health sector.[1]

3. **Infrastructure and logistics**
   Due to its size, ageing infrastructure and need for investment,the Russian infrastructure market is interesting for Dutch companies. A cluster of Dutch companies is currently actively pursuing Russian airport redevelopment contracts.[2]

4. **Agriculture & food**
   The agrifood market in Russia, except for dairy products, lags substantially behind the EU level in terms of per capita consumption and thus has potential for further growth. Responding to this need, the Dutch agricultural and food processing sector is leveraging its highly innovative technology, and is focused on creating opportunities for technological cooperation in Russia.

5. **Natural resources**
   Since the 1990s, Dutch companies have been active in the natural resources industry. Recently Gazprom formed a strategic partnership with a cluster of Dutch companies, the 'Delta Group', with the purpose of promoting longterm cooperation between Russia and the Netherlands to secure sustainable production, transportation and delivery of energy carriers.[3]

Source: (1) EGM architecten website.
(2) DHV website.
(3) Delta Group website.

Selection of Dutch companies active in Russia, 2012

Ekaterinburg	Heineken	meyn Poultry Processing Solutions	TNT	VAT logistics	
Moscow	ahrend	BOON EDAM	D·E	Heineken	ING
	meyn Poultry Processing Solutions	nutreco	PHILIPS	Shell	TNT
	Van Oord	VAT logistics	Unilever		
St. Petersburg	AkzoNobel	Boskalis	Heineken	PHILIPS	TNT
	Van Oord	Unilever			

Note: Selection of companies is not-exhaustive.

Source: Moscow Times; Locations of companies supplied by Dutch Embassy in the Federation of Russia.

Beyond some notable exceptions, the majority of Dutch companies seem to be concentrated in the large Russian cities or in natural resource rich regions.

There are 800 Russian-Dutch joint ventures in Russia and some 300 Dutch companies have office or production locations in Russia. St Petersburg and Moscow are home to the vast majority of Dutch companies active in the country. These locations are attractive due to their access to the Russian consumer market.

Dutch companies in the energy sector are present in oil and gas rich regions. Shell's involvement in Sakhalin-2 is an example of such an investment.

A number of companies, such as Heineken and Unilever, have production facilities in regions where relatively little FDI is present. The location of such production facilities is often due to acquisitions and/or part of a regional coverage strategy.

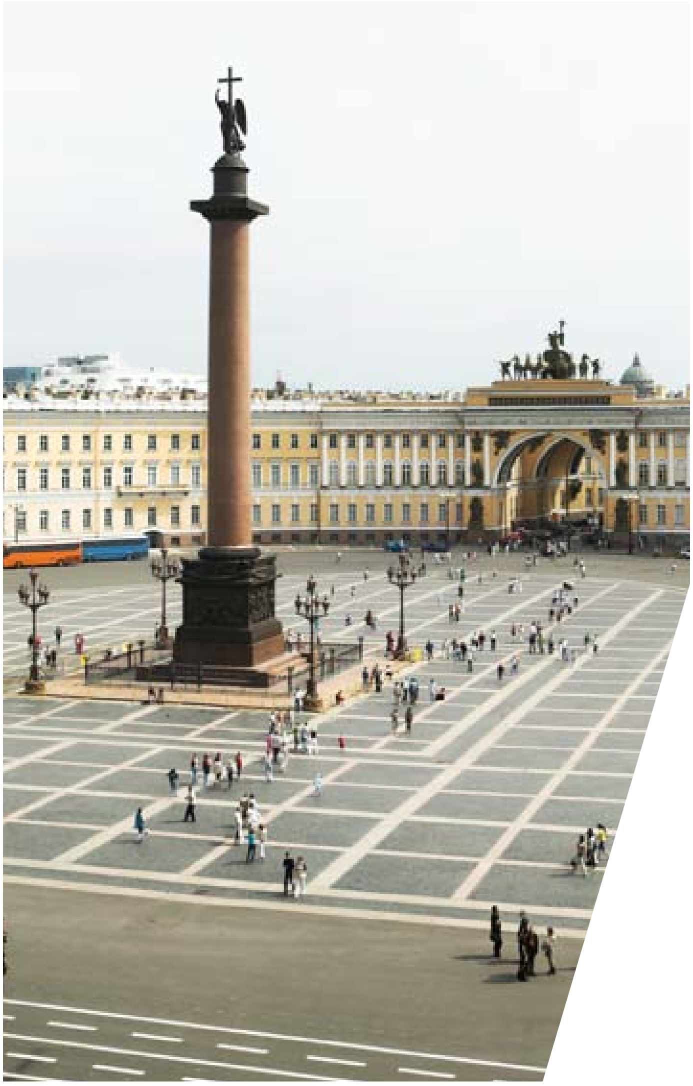
Exhibit 12: Do's and don'ts when doing business in Russia[1]

Be prepared
- Leave your preconceptions at home.
- Partner up with a Russian company/partner, that can provide insights on doing business in Russia.
- Be ready to start your business relations in the Russian language or through an interpreter.

Understand Russian business etiquette
- Take the time to meet and speak with people - in Russia people prefer to do business with people who they know personally; building a positive relationship will be crucial. In addition, decisions are often taken during personal meetings.
- Planning appointments is typically done just a few days ahead of the meeting. Always confirm the appointment on the actual day of meeting.
- Appointments are often followed by food and drink. It is custom to eat what is served and to stay and socialise.
- Small gifts for business partners are generally accepted but must in no case be excessive. A bouquet with even flowers is considered inappropriate.
- A handshake is always appropriate (but not obligatory) when greeting or leaving, regardless of the relationship. Remove your gloves before shaking hands. Don't shake hands above a door threshold.
- Age and function is an important symbol of hierarchy in doing business in Russia. An older interlocutor will be preferred to a younger one.

Be prudent when doing business
- Always document agreements. Be sure to obtain good-quality, independent legal and professional advice.
- If your product is in danger of being copied or counterfeited, seek specialist legal advice on how best to protect your intellectual property rights.
- Be patient - bureaucratic issues can take much longer than you might expect.

Source: (1) Interviews; UK Trade and Investment website.



Interview: Nutreco

Press release Amersfoort, 31 January 2011

Nutreco invests EUR 20 million in new premix and feed specialties plant in Russia

Nutreco is investing approximately EUR 20 million in a new factory in the Voronezh agricultural region in Russia. The plant will produce young animal feed, concentrates and premixes for ruminants, pigs and poultry. The plant is scheduled to become operational in the first half of 2012 and will employ 50 people. The investment will strengthen Nutreco's market position in Russia. Nutreco currently has a sales organisation in Russia with 140 employees. Sales are primarily based on imports.

Nutreco is one of the largest importers of young animal feed, concentrates and premixes in Russia. The investment is a logical next step and offers Nutreco a good opportunity for sustainable growth in one of the most important agricultural countries in the world. The development has been welcomed and supported by the local government.

Source: Nutreco.

Frank van den Brink

In order to gain on-the ground insights on Nutreco's investment experience in Russia, KPMG spoke to the General Manager of Nutreco in Russia, Frank van den Brink. Mr van den Brink has been residing in Moscow for the past five years and was responsible for setting up Nutreco's new factory in Liski in the Voronezh region. The plant will become operational in the coming weeks.

Good afternoon Mr. van den Brink, thank you for taking the time to speak to us. To start off with, why did you decide to set up a factory in the Voronezh region?
There are a couple of reasons for our investment in Voronezh. First, the region is located close to our clients. It is close to the 'Black Earth' region where a lot of grain is produced and where a lot of cattle, pigs and chickens are raised. The second and most critical reason was the commitment of the Regional Government. The current Governor, Alexey Gordeyev, was Minister of Ariculture under Vladimir Putin's presidency and understands how important the agri-food segment is. He welcomed our investment with open arms and made sure we were a 'strategic project', thereby ensuring that we were given enough support by the local government. The third reason is the logistical placement of Liski. Liski is accessible via train and motorway, making it possible for us to reach all our clients. It is very important to have access to the right transport infrastructure. Finally, there is a good agriculture university in the area, which gives us access to qualified employees.

Are other companies active in the region?
A number of German companies active in cattle breeding are also located in the region. One with a future capacity of 250,000 cows. Naturally, some of these cattle breeding companies were attracted to the region through our activities here. Siemens also has a plant in Voronezh, where they produce power transformers.

Did you look at other regions before investing in Voronezh?
We spent two years looking at a variety of possibilities: from greenfield to brownfield. In the end, we decided that a greenfield project was the best choice. Brownfield projects are disadvantageous as you end up having to renew all the permits and licences, An acquisition has the same issue. In addition, since we were looking for a production location, we wanted to ensure that we had a high quality factory. Most available factories are 40-60 years of age and are of dubious quality. A greenfield project has the advantage that all parts of the factory were imported and consistent with our quality objectives.

Which obstacles did you encounter upon investing in Russia?

We didn't encounter any major obstacles. I suppose the biggest obstacle was finding the right location. We hardly had any problems concerning corruption. This was mainly because we have good relations with the local government and could report any such problems. Otherwise, there are two obstacles in Russia. First, bureaucracy can lead to huge delays. The procedure for gaining permits and contracts, such as property paperwork, can take a long time – especially if the papers are not filled in properly. Getting connected to gas, water and electricity can take 6 months, as opposed to a few days in the Netherlands. To make sure that the process is done as quick is possible, make sure you have strong ties with local government. Second, the Russian language can be problematic. This is not a major barrier though, as a lot of Russian stakeholders enjoy speaking English.

In what part of the process did you encounter obstacles?

After the initial investment decision within Nutreco was taken, it took some time to set up an agreement with the Governor to sign a letter of intent. There were some lengthy procedures involved though. Our plant designs were made by a Dutch bureau and they had to be translated and modified to be made compatible with Russian regulations. Moreover, as we imported nearly all factory parts from abroad, it took some time to get the appropriate import permits sorted. Construction itself was fairly quick, besides during the winter. Getting the property contracts after construction was completed also involved a lengthy procedure.

In retrospect, we are very happy with the investment process. We experienced more delays through Dutch counterparts than through Russian ones.

How do you ensure that you have a good relationship with local government?

Make sure that you have relationships at all levels of government - at a regional level with the governor, but also with the deputy and economic departments at a local level. If you encounter obstacles at one level, you can switch to another level. It is also very important to make the regions understand how important your investment is for the region. Relationships with other stakeholders, such as railways and utilities, are equally important. You build these relationships by making frequent visits and communicating openly.

And with your local labour forces?

Good management is key. A strict hierarchy with responsible managers must be in place to ensure sufficient support for local employees. This is vital, as local labour forces must be taught and trained according to Western standards, where the quality is more important than the quantity of output - as was once the case under the Soviet Union.

Has the Russian investment climate improved over the past years?

I have been told that corruption has increased, though fortunately we at Nutreco have not experienced any such increase. The country is stable, and inflation is reasonably under control. Economically speaking Russia is a very interesting country to invest in. High oil and gas prices are driving the purchasing power of the growing middle class up. This is good news for Nutreco. With rising consumer prices for meat, cattle breeders can invest in our products.

In addition, regions seem to be more assertive in attracting investments. The governor of this region visited the Dutch embassy not so long ago in order to attract investments.

Where can Dutch companies find interesting opportunities?

Definitely in the agriculture sector. Russia is the largest country in terms of territory offering a lot of opportunities for agrifood, such as cattle breeding. Another opportunity for Dutch companies is the transfer of knowledge. For example, the Dutch have a lot of expertise in the creative sector, which can be conducive to innovation and economic development in Russia.

Finally, do you have any tips for Dutch entrepreneurs planning to invest in Russia?

Negotiations can be tough. They are not always win-win like in Holland. As mentioned before, invest time in building up relationships. Russians do business with people and not with companies. Finally, make sure that you are decisive when it comes to doing business, and do not renege on your agreements.

Trade missions can be a good opportunity to get a first glimpse of the country, but if you want to have detailed information make sure to get insights from consultants on the ground like KPMG.

About Nutreco

Nutreco is a global leader in animal nutrition and fish feed. Its advanced nutritional solutions are at the origin of food for millions of consumers worldwide. Quality, innovation and sustainability are guiding principles, embedded in the Nutreco culture from research and raw material procurement to products and services for agriculture and aquaculture. Experience across 100 years brings Nutreco a rich heritage of knowledge and experience for building its future. The company employs approximately 10,000 people in 30 countries with sales in over 80 countries. Nutreco is listed on the NYSE Euronext stock exchange in Amsterdam and reported annual revenues of € 5.2 billion in 2012.

03 Areas of improvement

Introduction

Russia's ranking of 112th out of 185 economies in the ease of doing business confirms that there are still areas for improvement for Russia. However, the country's recent accession to the WTO could lead to further amelioration in the near future.

Key points
- Russia still has work to do when it comes to improving the investment climate.
- Corruption remains a key concern, as well as the amount of bureaucratic procedures.
- Transparency and the application of laws is expected to improve due to the accession to the WTO.

Selected World Bank Doing Business rankings 2013[1]

	Russia (+6)	NL (+3)	Brazil (-2)	India (-)	China (-)
Ease of doing business	**112**	31	130	132	91
	Russia (-3)	NL (-6)	Brazil (-3)	India (-3)	China (-2)
Investor protection	**117**	117	82	49	100
Importing	Russia 162 (-1)	NL 12 (+1)	Brazil 123 (-)	India 127 (-2)	China 68 (-8)
Documents to import (number)	**11**	4	8	11	5
Time to import (days)	**36**	6	17	20	24
Cost to import (USD per container)	**2920**	975	2275	1200	615
Starting a business	Russia 101 (+4)	NL 67 (+10)	Brazil 121 (+1)	India 173 (-4)	China 151 (+2)
Procedures (number)	**8**	5	13	12	13
Time (days)	**18**	5	119	27	33
Cost (% of income per capita)	**2**	5.1	4.8	49.8	2.1
Registering property and land	Russia 46 (-1)	NL 49 (-)	Brazil 109 (-4)	India 94 (+3)	China 44 (-3)
Procedures (number)	**5**	5	14	5	4
Time (days)	**44**	7	34	44	29
Cost (% of property value)	**0.2**	6.1	2.6	7.3	3.6
Corruptions Perceptions Index[2]	Russia (+10)	NL (-2)	Brazil (+4)	India (+1)	China (-5)
Rank out of 176 economies	**133**	9	69	94	80

Despite the announcement in 2010 by Dmitry Medvedev of an extensive list of measures for the improvement of the investment climate, results have been difficult to realise. In the World Bank's report Doing Business 2013, Russia's overall ranking was 112th. In addition, investor protection deteriorated (Russia's rank decreased from 114th position in 2011 to 117th in 2012). Also, according to the 2012 Corruption Perceptions Index, Russia was ranked the lowest of the BRIC economies.

In terms of 'importing', 'starting a business' and 'registering property and land' Russia's performance was largely in

Source: (1) World Bank "Doing Business 2012 & 2013" reports.
(2) Transparency international, Corruption Perceptions Index, 2012.

Note: Total index includes 185 countries in 2013 and 183 countries in 2012. Red numbers indicate a decrease in ranking whilst green numbers indicate a rise since 2012.

line with - and often slightly better than - its BRIC peers. For example, compared with its peers, it was relatively easier to start a new business (considering the procedures, time and cost required). However, it is important to note that there were strong variations in these performance indicators across the Russian regions. These regional differences should certainly be taken into consideration when choosing an investment location.

On a positive note, two notable steps were taken by the Russian government: 1.) the liberalisation of the Russian migration regime for foreign high-skilled specialists;
2.) the introduction of mechanisms of state assistance for investors struggling against bureaucracy and corruption, including the designation of special high-ranking officials in the federal and regional governments.

I always say to people that continuity and predictability [concerning the investment climate] is the most important thing. [...] I think that it gives investors a great level of reassurance.

Arjan de Jongste, Philips' CEO Russia, Ukraine, Belarus, Transcaucasia and Central Asia, 2012[1]

Source: (1) Interview with the Voice of Russia.

Investment project cycle

Identifying when and why investors pull out of their investment

According to a KPMG survey, many potential investments failed at early stages of the investment project cycle because the Russian central and local government were unable to gain the confidence of foreign companies. Of particular concern was that a significant amount of foreign investors pulled out of potential deals following preliminary talks with officials. In some cases these talks clearly frightened off investors instead of providing extra reassurance as they should have. Increasing transparency appears to be a simple way of solving this issue.

"There is a general belief that corruption is everywhere in Russia and that this will prevent you being able to do business in a normal way".

B2B Services, Western Europe

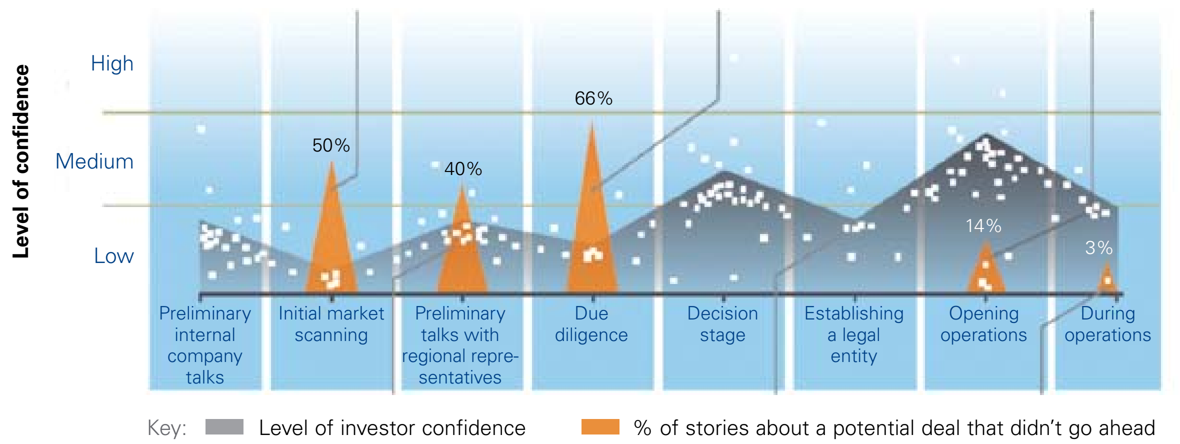
"When you start looking at techno parks in Russia you realise people understand this term differently. We were offered a piece of land and when we asked what the legal rights were some guy told us 'if you agree to come here, I'll work it all out for you'. Not very encouraging".

Investor information not given

"In the final stages of an investment project, after essentially all terms had been agreed the local government suddenly brought up additional requirements for the project creating immense frustration and even more time and money wasted".

Investor from Western Europe

Investment project cycle



Source: Rosstat; KPMG analysis.

"We scheduled meetings with different stakeholders at the regional level. The outcome of these meetings caused a lot of confusion: information was conflicting, incomplete or not up to date".

Consumer markets, Western Europe

"In Russia there is no protection of property rights, intellectual rights or any judicial protection. This is why so many companies register in Cyprus because if a business becomes interesting to large Russian companies, they can use their power to seize it".

Investor from Southern Europe

"We are in a JV and our partners, who have strong government connections, use this influence to try and bully us when we do things they disagree with – often using governmental resources, the judiciary, or mass media".

Investor from technology sector

Key areas of improvement

Red tape

In studies by KPMG and the FIAC, foreign companies indicated that they are often burdened by excessive red tape, caused by inconsistent, lengthy and non-transparent bureaucratic procedures. Consumer market firms endured problems with 'time-wasting bureaucracy' whilst industrial firms encountered problems around a lack of transparency during large scale investment projects. The Russian government is aware of these problems and has suggested the creation of an anti-bureaucracy filter for business legislation as part of the country's long-term economic policy objectives.[1]

Corruption

Corruption is still a major issue in Russia, resulting in a lower Transparency International ranking (133rd out of 176) than countries such as Togo and Uganda.[2] KPMG research indicated that corruption occurred in 40% of foreign investors experiences in Russia. In the consumer markets this figure was even higher at 60%. Levels of corruption varied per region, with Moscow and St. Petersburg (the most important regions in terms of FDI) performing relatively badly. KPMG's study also revealed that corruption is more widespread at a federal level (70% of cases) whereas it was far less at a regional level (30% of cases).

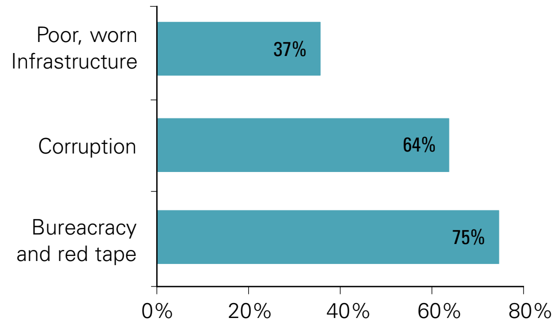
A common problem for foreign businesses in many regions is that government repeatedly expects them to make further direct investments in the region, despite there being no business incentive for the firm to do so. Tax incentives are often tied to compliance with these requests, making many investors suspicious of such incentives. Some companies have even experienced government dictating which investments they have to make.

A perception problem exists at regional levels, where foreign businesses are seen as short-term cash cows that can be used to directly supplement regional budget shortfalls. This view not only drives investors away (to more business-friendly regions or countries) but also fuels corruption. The view widely exists that investors should pay extra for the 'privilege' of doing business in a region.

Source: (1) Positioned for growth: E&Y's 2012 Russian attractiveness survey.
(2) Transparency international.

Negative investment factors

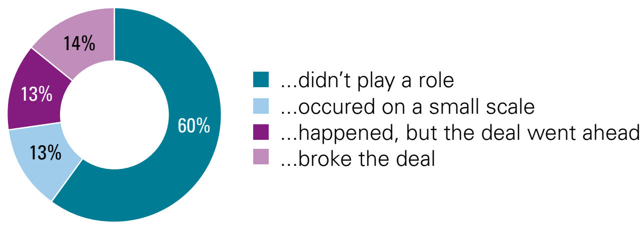
What were the most negative investment factors?

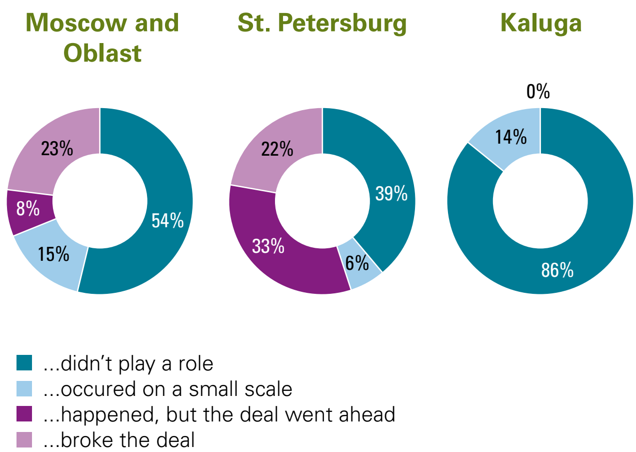


Source: FIAC, 'Russia's investment climate 2012'.

Corruption in investment experiences in Russia

In your experience, corruption...





Source: KPMG analysis.

Infrastructure

In KPMG and FIAC surveys, investors expressed concerns about the availability of physical, social and financial infrastructure. Utilities and the road infrastructure in particular do not always meet business needs. Fortunately, the government has set the maintenance and repair of road and rail infrastructure as a high priority. According to foreign investors, the social infrastructure (including hotels, kindergartens and housing) is not sufficient outside of major cities. Additionally, the absence of a comprehensive financial infrastructure hampers the efficient raising and allocation of capital.

Application of the rule of law

Russia has a body of conflicting, overlapping, and frequently changing laws, decrees and regulations, which complicate the legal environment. This was confirmed in a number of interviews that KPMG conducted. In an attempt to address these challenges, in 2010, the government set the objective of coordinating and overseeing efforts to improve the business and investment climate, including the protection of foreign and domestic investors. In 2011, President Medvedev appointed Investment Ombudsmen in each Federal District to perform similar roles at the regional level. The government also encouraged international business leaders to participate in the discussion of dispute resolution mechanisms, as well as individual commercial disputes, as part of their work in the FIAC. While these steps offer some promise, overall the country's investment dispute mechanisms remain underdeveloped and largely non-transparent compared to western standards.

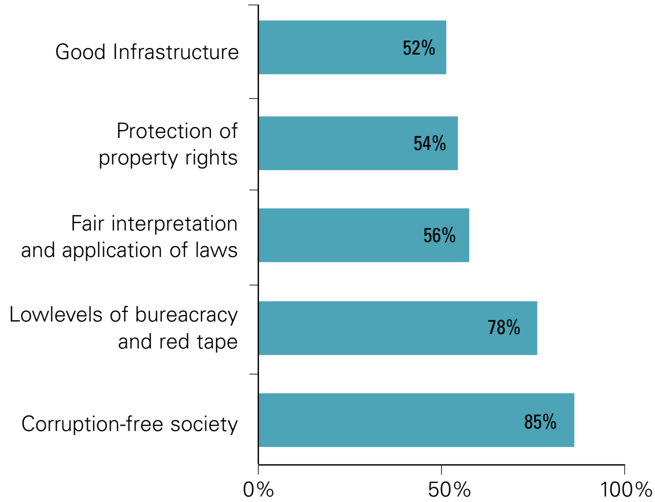
Property rights[1]

The 1991 Investment Code prohibited the nationalisation of foreign investments, except following legislative action deemed to be in the national interest. Such nationalisations may be appealed in the courts of the Russian Federation, and the investor must be adequately and promptly compensated. In reality, compensation has not always been adequate. For example, Russia forced Shell to reduce its share in the Sakhalin field from 55% to 27.5% for USD 7.5bn in 2006, which was considered deeply below market value.[2] At the sub-federal level, expropriation has occasionally been a problem - as has local government interference and a lack of enforcement of court rulings protecting investors.

Source: (1) Doing Business in Russia: 2012 Country Commercial Guide for U.S. Companies.
(2) Oxford Institute for Energy Studies.
(3) Interview with Russia Times in 2011.
(4) FIAC, 'Russia's investment climate 2012'.
(5) Doing Business in Russia: 2012 Country Commercial Guide for U.S. Companies.

Improvement areas

In which areas does Russia lag behind other emerging markets?



Source: FIAC, 'Russia's investment climate 2012'.

"Significant improvements in the business climate lead to the establishment of effective partnerships, including public private initiatives and co-operation between Russian and foreign private companies."

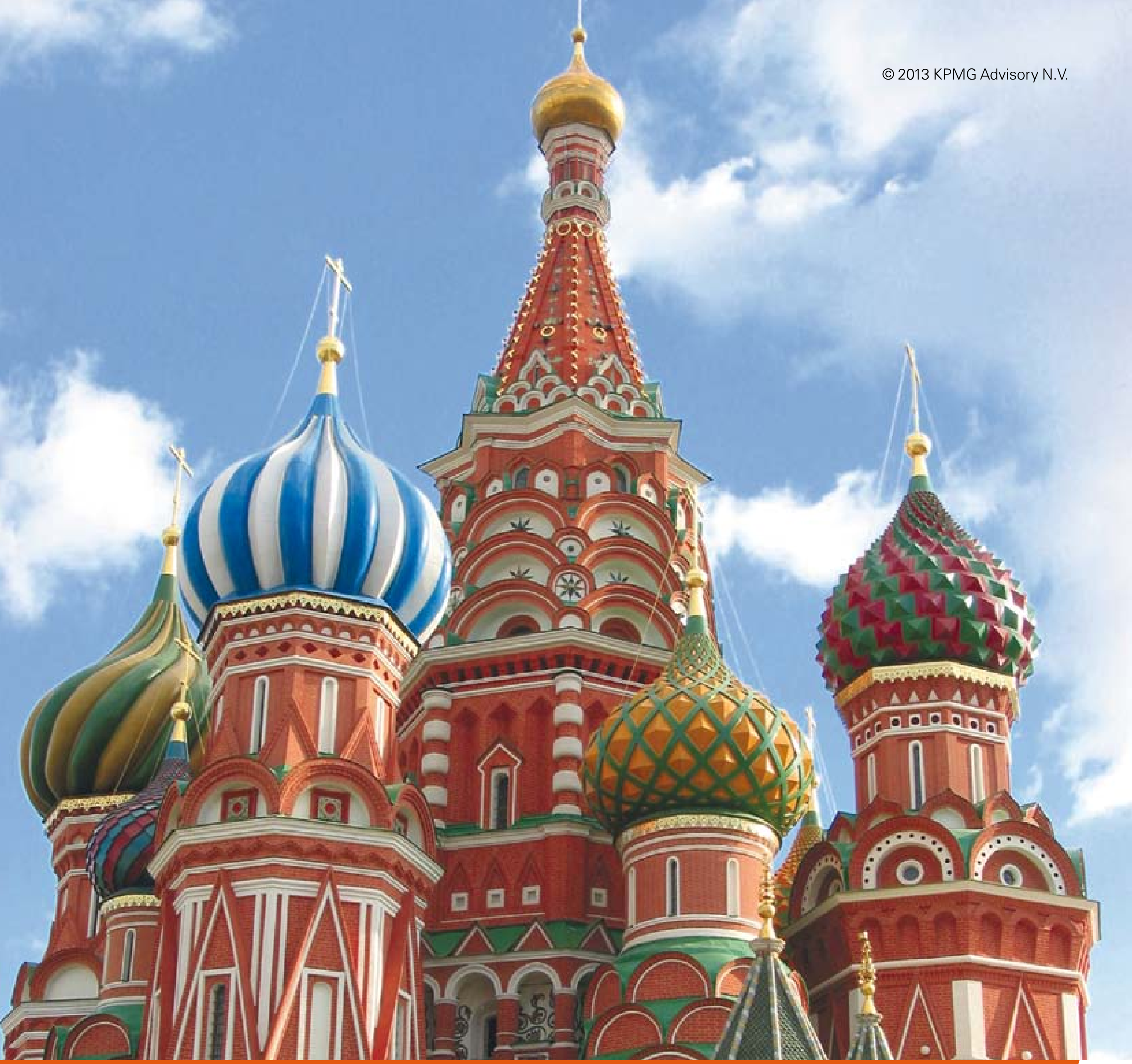
Arjan de Jongste, Philips' CEO Russia, Ukraine, Belarus, Transcaucasia and Central Asia, 2011[3]

Exhibit 13: WTO – a significant step forward

On the 22nd of August 2012, after eighteen years of negotiations (the longest till date), Russia became the 156th WTO member. In joining, opportunities for foreign investments are likely to arise in a number of sectors including banking, insurance, business services, telecommunications and distribution. In fact, in a study by the FIAC, respondents stated that of all measures, Russia's accession to the WTO had the most positive impact on the investment climate.[4] The business climate will improve by making it more competitive.

Key regulatory changes:[5]

- For industrial and consumer goods, Russia's average bound tariff rate will decline from almost 10% to under 8%.
- More liberal treatment for service exports and service providers.
- Rules-based treatment of Agricultural exports.
- Market access under country-specific tariff-rate quotas.
- Improved transparency in trade-related rule-making.
- More effective WTO dispute resolution mechanisms.



04 Tax regime in Russia

An introduction

Introduction

The rate of foreign investment in Russia has grown steadily in recent years. While the Russian taxation system continues to evolve and foreign investors still face various challenges in navigating the system, it has become more stable for foreign investors.

Current legislation does not provide for an advanced ruling system. Although taxpayers may apply directly to the tax authorities for guidance, in practice such guidance is often contradictory, and, in any case, never legally binding which means that the possibility of tax penalties on a challenge by the authorities can never be excluded. The uncertainty of this has in recent times driven taxpayers to seek clarity over certain tax matters by taking proceedings to the courts. The impact of this approach is that the wider tax environment continues to grow significantly. However, since there is no defined concept of legal precedence in Russia, a court's decision on a tax issue often varies depending on the particularities of each case.

Forms of Business Operations in Russia for Foreign Investors

Foreign investors may choose to establish a presence in Russia through participating in a Russian entity, a representative office (RO) or a branch. An RO is authorised to conduct certain "preparatory and auxiliary" activities for the head office. A branch can perform all business activities, including execution of sales contracts.

Types of taxes

Taxes and levies are imposed in Russia at the federal, regional and local levels. Federal taxes and levies include profits tax, personal income tax, value-added tax, excise tax, mineral extraction tax, water tax, levies for natural and biological resources consumption and stamp duty.

Regional taxes include property tax, gambling tax and transport tax. Local taxes include land tax and individual property tax.

Tax registration requirements

There is no separate tax registration for VAT purposes – a taxpayer obtains a single tax ID number for all taxes. Foreign legal entities have to obtain tax registration with the local tax authorities within 30 calendar days from the day activities begin at that location.

Profits tax

The maximum profit tax rate is 20%, of which 2% is paid to the federal budget and 18% to the regional budget. The regional profits tax rate can be reduced to 13.5% at the discretion of the regional authorities.

Foreign entities with a permanent establishment (PE) in Russia are subject to profits tax on profit attributable to the Russian PE. A PE includes a branch, office or other independent unit as well as an independent agent who regularly exercises the right to conclude contracts in the name of the principal. Foreign entities without a PE in Russia are subject to withholding tax on Russian source income.

Dividends received by a Russian company are subject to profits tax at the rate of 9%. However, this rate could be decreased to 0% provided that at the date of dividends distribution the shareholder owns not less than 50% of shares in the respective subsidiary during the period of not less than 365 calendar days.

Withholding taxes

Foreign entities in receipt of Russian source income not attributable to a PE in Russia are subject to withholding income tax. The withholding tax rate on dividends paid by a Russian entity to a foreign investor is 15%.
The withholding rate on most other Russian source income such as interest, royalties and leasing and rental income is 20%. Such withholding rates are subject to reduction under an applicable double taxation treaty.

Russian tax authorities may try to challenge the application of treaty benefits in case the recipient entity does not have enough substance in the jurisdiction of its tax residence.

Disposal of shares in a Russian entity

Proceeds from the disposal of shares in a Russian entity by a foreign entity are subject to withholding income tax of 20% unless reduced by an applicable double taxation treaty.

However, a foreign entity with no PE in Russia is not subject to withholding income tax on the sale of the shares of a Russian entity if immovable property located in Russia owned by the Russian entity accounts for less than 50% of its assets.

Capital gains from disposal of shareholdings in a Russian company could be exempt from Russian profits tax, provided the shareholder owns such shareholdings for no less than 5 years and such shareholdings are acquired after 1 January 2011.

Debt Financing

Debt financing of the business activities of the Russian subsidiary may permit the Russian subsidiary to claim interest deductions in computing profits for profits tax purposes in Russia. The interest expense by the Russian subsidiary on related party debt is restricted by Russian thin capitalisation rules.

Value-added tax

VAT is a key source of tax revenues for Russia. VAT is a tax designed to be borne ultimately by consumers. VAT applies to the sale of goods, provision of services and other activities. The general VAT rate is 18%. A 10% rate is applicable to essential commodities, foods, goods for children, etc. Exports are taxable at 0% rate. There are special place of supply rules. For example, consulting, legal and engineering services are subject to VAT in Russia if the buyer of such services is a Russian company. The same relates to royalties for the usage of intellectual property. However, transfer of rights to use patented technology or know-how is exempt from VAT.

Special Economic Zones

Special economic zones (SEZ) are territories in Russia where certain tax, customs and other concessions are granted to entities operating in these zones. The possible advantages of SEZs include the reduction of profits tax, property tax and land tax. As well, foreign goods placed within a free customs zone regime are not subject to VAT and import customs duties.

Consolidated profits tax reporting

Since the 1st of January 2012, consolidated profit tax reporting is allowed only if the parent company has a 90% or higher share in subsidiaries and the total annual amount of VAT, excise taxes, profits tax and mineral extraction tax is RUB 10bn or more (USD 312.5m). Also, total sales of the group must equal RUB 100bn or more (USD 3.13bn), and total assets must be RUB 300bn or more (USD 9.38bn). Consequently, only a few major Russian companies are able to use consolidated profits tax reporting.

Tax concessions

The gratuitous receipt of assets from a parent company, a subsidiary or an individual does not result in taxable income if:

- The recipient's or transferor's ownership in the other party's share capital amounts to more than 50%;
- The individual owns more than 50% of the recipient company;
- The property received (except for money) is not disposed of within one year from the date of receipt.

Receipt of property, property rights or non-property rights to increase net assets from a shareholder, as well as the forgiveness of debt by a shareholder and reinvestment of dividends payable to (but not received by) a shareholder does not result in taxable income, regardless of the percentage of shares owned by the contributing shareholder. Tax losses can be carried forward for 10 years.

Customs Union

On the 1st of July, 2010, the Customs Union between Russia, Belarus and Kazakhstan came into effect. Russian tax legislation provides for special rules that are applied to transactions between member states of the Customs Union.

Goods exported from one member state of the Customs Union that are destined for another are subject to a 0% VAT rate. The application of a 0% VAT rate should be confirmed by a specific list of documents. Goods imported from one of the member states are subject to the same VAT rates that are applied to domestic transactions within the importing member state.

Transfer pricing

As of 1 January, 2012 new transfer pricing regulations came into force in Russia. The new Transfer Pricing Law essentially changes the approach to market price definition and adds the concept of a market price range, which should be determined in accordance with the new rules defined by the Tax Code for transactions with identical (or homogeneous) goods (works, services) exercised in comparable economic (commercial) conditions by non-related parties.

According to the Russian transfer pricing rules foreign economic transactions between related parties are treated as controlled without limitation of annual turnover. Starting from 2012 the taxpayers should notify the tax authorities about the controlled transactions and prepare documentation that justifies pricing arrangements in respect of the controlled transactions if total amount of such transactions exceeds RUB 80m for 2013 (all transactions from 2014).

KPMG contacts

Russia Practice, KPMG the Netherlands

The KPMG Russia Practice in the Netherlands serves as a bridge between the Netherlands and Russia & CIS. Our country specialists assist Dutch companies in their business and investment decisions in Russia and also provide support for Russian and CIS companies considering various investment opportunities in the Netherlands. The team serves as a central point both for clients and KPMG professionals who specialise in providing financial advisory, tax, transaction and other services both to Dutch and Russian & CIS companies who want to expand and/or manage their cross-border businesses effectively and successfully.

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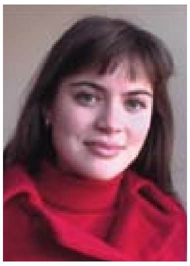

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KPMG Russia

KPMG has been working in Russia since 1990, and currently employs more than 3,800 professionals in 19 offices in seven CIS countries. In 2012 KPMG was rated the No. 1 Audit & Advisory firm in Russia, and the No. 1 Audit Firm in Russia, 2009 – 2011, by the Expert RA Rating Agency, and was named Tax Firm of the Year 2012 in Russia by the International Tax Review magazine. KPMG's clients in Russia include LUKOIL, Rosneft, Gazprom, TNK-BP, RUSAL, Norilsk Nickel, SUEK, Aeroflot, Rostelecom, MTS, Gazprombank, Rosgosstrakh (RGS) and other national economic leaders and major global companies.

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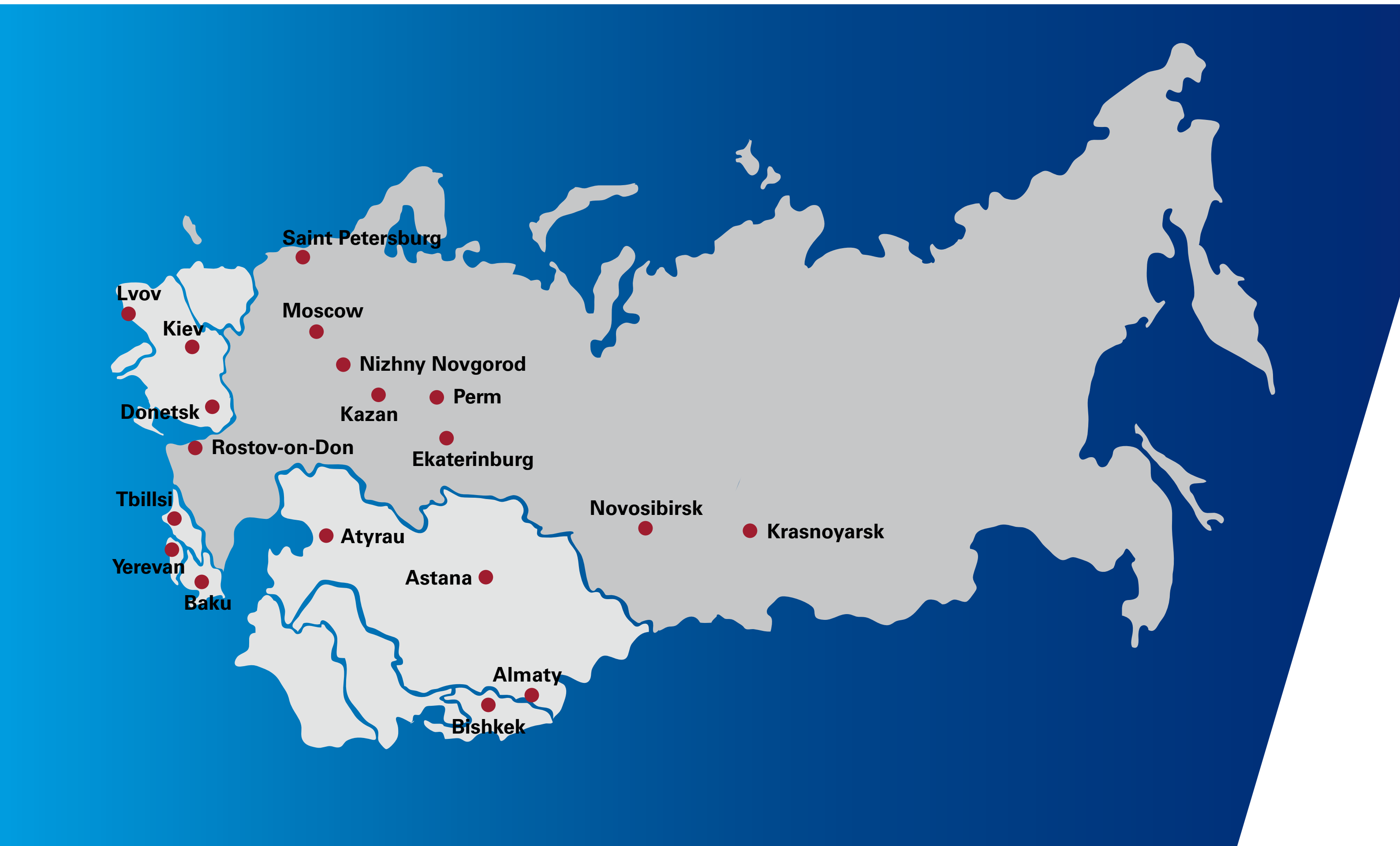

Notes

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