

Russia

The second wave

Foreign investment once again pours into Russia, not just into the oil and gas sector

More records for the region (see also page 1). Foreign direct investment (FDI) into Russia is set to reach a record level this year, beating 2003's achievement and promoting the country to the top division of emerging market FDI recipients. It seems that years of FDI underperformance are over. This comes despite the Yukos affair, terrorist attacks and a slide towards authoritarianism, reflecting reform and stability gains in the past four years. Yet a paradox remains; while foreign investors are pouring in, capital flight by wealthy Russians is rising once again.

According to preliminary Russian Central Bank (RCB) data, FDI inflows into Russia reached \$8.1bn in the first nine months of 2004, consistent with the Economist Intelligence Unit's long-standing forecast—initially well above consensus expectations—of FDI inflows of about \$11bn in 2004 as a whole.

After averaging a meagre \$3bn annually between 1998 and 2002, FDI inflows have leapt in the past two years. The 2004 nine-month inflow was slightly down on 2003's \$8.3bn inflow for January-September, but 2004 is nevertheless likely to beat the 2003 post-transition record of \$6.7bn in FDI—net disinvestment in the fourth quarter of that year pulled the twelve-month total down, probably as a result of pre-election uncertainty and some temporary fallout from the onset of the Yukos affair.

The pick-up in FDI inflows is from a low base, and is still far below the country's potential, yet the 2004 figure is also one of the best in any emerging market. Except for China, only Brazil and Mexico are expected to record anything similar this year. The inflows are twice as large as into the next most attractive transition economy, Poland, with \$5bn.

Big international firms from a wide variety of sectors have been making sizeable acquisitions, as reported in *BEE*. Investors include Heineken (Netherlands), tobacco firm Altadis (France-Germany) Alcoa, GE Capital (both US) and UBS (Switzerland) Renault, Michelin (both France) and Scandanavian telecom companies Telenor and Tele2. The list is long. Furthermore, a spate of billion dollar deals in the energy sector, involving ConocoPhillips, ChevronTexaco (both US) and Total (France) among others (*BEE* Sep 20th and Sep 27th 2004) have been announced in recent months, and very little of this will have yet appeared in the RCB's balance-of-payments-based FDI data.

Ironically, the upturn in FDI has coincided with a number of trends that signal a deterioration in Russia's investment climate, which might be expected to deter investment. These include the ongoing official campaign against the Yukos oil

company and consequent negative impact on perceptions of the security of property rights; the increased risk of terrorism; a cooling in political relations with the west; a slowdown in structural reforms; and the intensifying trend towards political and economic authoritarianism.

Time lags

However, there are a number of factors working in Russia's favour. The first is a delayed reaction to the undoubted improvement in the business environment in recent years, the sense of greater political stability after the chaotic Yeltsin years, as well as the robust and ongoing economic recovery. Such delayed reactions are not unusual. Bankers and portfolio investors usually lead the way, with more cautious strategic investors following.

Second is the apparent willingness of the Russian authorities to sanction minority foreign stakes in strategic sectors—a trend accompanied by moves towards increased state control. Indeed, the Kremlin may even prefer to deal with large foreign multinationals rather than the more powerful domestic oligarchs, as the former are seen as less likely to pose a political threat to the state.

Other factors are specific to the energy sector. Yukos-related risks aside, it is not surprising that Russia's oil and gas is attractive for international oil majors. It is one of the few markets in the world that offers large-scale reserves which are not closed to foreigners. Consultancy AT Kearney (US) reports in its October FDI Confidence survey, that oil and gas investors ranked Russia as their second most attractive market in the world, behind Australia.

Perhaps more important, while it has become clear that foreign majors are to be limited to taking minority stakes in Russian oil companies, this has clearly not proved to be a binding constraint. Indeed, the recent ConocoPhillips deal may become a model for foreign involvement in Russian energy against a background of political sensitivity to foreign ownership: the acquisition of a minor stake in a Russian company may establish a launching pad for politically less sensitive investment in new fields through joint ventures that can offer the foreign investor a greater share of production and control. True, there have been recent nerve-racking cases of state meddling, particularly regarding the Sakhalin energy projects over licences and the unwanted participation of Gazprom. But so far none of this has harmed the projects.

Nevertheless, despite the abundance of possible explanations for Russia's FDI upturn, the development

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still appears at odds with the behaviour of domestic investors, namely a renewed increase in capital flight from Russia—a reaction to earlier banking-sector flutters and the Yukos affair (although real fixed domestic capital formation growth has been strong this year, at about 12% year on year).

State intervention in the economy and the perceived weakening of the property rights regime clearly affects domestic firms more than foreign ones. With respect to the Yukos affair, many expect (and the equity markets seems to have priced in this view) that this will prove to be a one-off political conflict

and that any damage to the investment climate can be weathered and repaired. Foreign direct investors, however, do not even need to make such a risky assessment.

Large foreign investors consider an agreement with the Russian state to be adequate protection against political risk (see box below). For domestic businesses, however, uncertainty will remain a fact of the operating environment, to be offset against the big market opportunities, at least as long as Russia's oil-driven boom lasts.

How to make friends...

The new wave of investors in Russia still need good connections

Foreign investors have long accepted one golden rule of doing business in Russia—don't get on the wrong side of the authorities; better still, get on the right side. The Yukos affair has been a somewhat extreme reminder of that, but in fact even relatively minor foreign ventures need, at the very least, to be on decent terms with the authorities. Investors could do well to invest in a good lobbyist, or find a reliable local fixer who can pull strings.

It's not just a matter of having president Vladimir Putin onside, clearly a vital ingredient in ConocoPhillips' (US) acquisition of a 7.59% stake in LUKoil, following a trip to Moscow by Conoco's CEO (*BEE* Oct 4th 2004). Having the support of the regional governor can also help ward off overzealous tax inspectors. Conversely, myriad tax, safety, public health and other inspectors have been known to descend with remarkable speed when well-connected local interest groups feel threatened by foreign competition.

Setting up communication channels with the authorities is an integral part of starting a new investment, to be undertaken separately from legal due diligence. Law firms may ensure that the letter of the law is applied, but rarely offer much insight into what needs to be done on the ground, notes Peter Ordzhonikidze, chief executive in Russia of Cassidy & Associates CIS, a US lobbying firm. An investment may technically be irreproachable from a legal perspective, but it can still fall at the first hurdle without the tacit support of key officials.

In the absence of any official lobbying channels, it is important to build good rela-

tions with the authorities before an investment gets under way, says Mr Ordzhonikidze. These initial steps may include a public relations campaign to convince decision makers that the venture will benefit the region by generating jobs, taxes and new services, he adds. Alternatively, firms might consider a joint venture, with the local partner doing the necessary lobbying—though this carries other risks, namely the trustworthiness of the partner himself.

The first step, according to Charles Hecker, the Russia manager of UK-based business risk advisory Control Risks Group, is to decide what level of involvement you need from the authorities. Firms may need to lobby at the regional or local level rather than in Moscow. Also, says Mr Hecker, "the assumption is always that you have to go for a high-ranking green light, but that isn't always valid. ... You can waste time and effort unnecessarily, and run the risk of overdoing it and attracting unnecessary attention."

Security first

One way to access local decision-makers is through former security service officials who have set themselves up as private "consultants", according to one expat who has worked on various construction management projects outside Moscow. Many of these retired officials, who maintain their old network of contacts with various authorities, specialise in making introductions between foreign and local businesses.

In one case the expat's company took a former security official on full-time to liaise with the local authorities. "Without these guys you don't go anywhere", he says. "You

need to have one or two guys with friends in high places. We hire them, they go into town and get to know people, and can pull some strings as they keep in touch with their former network." However, Mr Hecker cautions, middlemen need to be thoroughly checked out, especially when they start talking of cutting corners. "You run the risk of beginning to cede control over how the business develops", he warns.

The expat project manager says that his firm has also successfully employed family members of local high-ups to win trust and influence. But this too can easily backfire; the person can turn out to be incompetent, and relations can sour. "It can be the thin end of the wedge if people take advantage. So the decision is not as automatic as people think", says Mr Hecker.

Another common issue is bribery, say lobbyists, but Mr Ordzhonikidze notes that this is not always so, and regional officials may genuinely want to make sound economic decisions. Although bribery may be the only way at lower levels, this can be less effective when the sums paid begin to rise. In fact, investors could be better off establishing trust simply by inviting officials to a corporate entertainment event or inviting them on a bonding trip to the banya.

Douglas Prentice, the representative of the UN Real Estate Advisory Group, advises investors foremost "to be very, very clear about what you want". He suggests making a presentation with a maximum of three key points, asking for a clear commitment, and following up immediately with an e-mail summarising those points and requesting confirmation. "If you don't hear from them with two days resend it and phone them. If you don't get a response from this, forget them."

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