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Russia & CIS Express

A look at key issues and trends

Our Russia & CIS Business Group discuss business opportunities, what's happening in some key sectors, and economic and political developments.

Spring 2011

In this issue:

From our Editor

Welcome

Following a challenging past year, when drought and heat-wave slowed down economic activity, Russia's growth trajectory is firmly back on track. And with inflation predicted to recede in the second half of 2011, the climate for investment looks increasingly attractive.

This macro backdrop aligns favourably with government plans to privatise several state-owned enterprises through to 2013. And with a raft of business-friendly reforms scheduled – including the abolition of capital gains tax on long-term investments from 2011 – there are real causes for optimism.

In this issue of PwC's[1] Russia and CIS Express, we showcase some of the opportunities now coming on stream. Russia's surging demand for new infrastructure investment is a case in point. Since President Putin's 2007 announcement that US$1 trillion would be needed to modernise the country's infrastructure over the next 10 years, all levels of government are focusing on fostering the right environment for private investment.

The sheer scale of demand is enormous, with a number of high-profile private investments already improved. These include multiple PPPs and concessions in the St Petersburg and Moscow regions, from the Western High-Speed Diameter, the Orlovsky Tunnel and the Nadex light rail project. The utilities sectors are seeing even more activity and government support for technology and innovation is another high-priority area.

Looking ahead, Russia's host role in two major sporting events – the 2014 Olympic and Paralympic Winter Games and the 2018 World Cup – can only boost demand for foreign investor participation.

As we report in this issue, preparations for the Sochi 2014 Games are already well underway, with a massive programme of development ongoing in Russia's Caucasian Black Sea region. Besides funding a new, state-of-the-art national winter sports centre, the US$9.7 billion investment is set to transform the local and regional infrastructures, turning the surrounding Krasnodar district into a year-round tourism destination supported by new air, road and rail links, alongside upgraded utility projects and 21st century communications.

1. In this document, "PwC" refers to PricewaterhouseCoopers LLP (a limited liability partnership in the United Kingdom), which is a member firm of PricewaterhouseCoopers International Limited, each member firm of which is a separate legal entity.

Crucially too, the Sochi 2014 'journey' will continue long after the Games have concluded. By ensuring compliance with rigorous local, national and international environmental regulation, a core priority is safeguarding the region's ecosystem and setting a new standard for environmentally efficient construction throughout Russia. At a grass-roots level, Sochi's sporting infrastructure should deliver lasting benefits to future generations. To take just one example, the new Russia International Olympic University, being built in Sochi, will produce a new generation of sports managers, satisfying demand in Russia and worldwide for highly-qualified specialists in event management.

The ambition driving progress to Sochi 2014 and the World Cup looks set to redefine the art of the possible in international event management. And with the eyes of the world trained on Russia, there is every incentive to ensure world-class performance at every level. That said, Russia (and the CIS) continue to demand a long-term view from foreign investors, as Sir John Stuttard, co-chair of the Kazakh-British Trade & Industry Council, explains later in this edition.

This is especially true of Russia's financial sector, where more needs to be done to improve the quality of underlying contract law and regulation. That said, investor interest in Russia's banks is definitely on the increase. Although the sector has bounced emphatically since the financial crisis, recording a combined net profit for 2010 of around US$20 billion, multiples remain relatively low and many local banks, particularly in the mid-tier segment, are keen to attract foreign buyers to fund future growth.

Further afield, we report on surging growth in Mongolia's economy – and, specifically, the opportunities that this is creating for rapid expansion in the domestic financial sector. As the country's mining boom gathers pace, some observers believe that it has the natural resources and economic potential to become the 'new Qatar'. Commercial bank assets have doubled in the past three years and, as the country's vast mineral potential is further exploited, huge demand is predicted in both corporate lending and retail business.

The recent strategic partnership announced between the London Stock Exchange and the relatively under-developed Mongolian Stock Exchange should provide a welcome boost to the financial infrastructure, putting in place a firm foundation for IPOs, dual listings and strategic partnerships with international investors. And with ING one of only a few international banking groups on the ground, the potential for significant competitive advantage is there for other early movers, provided they are prepared to put down roots in the country.

Of course, the song remains the same in some ways. Financial sector reforms are urgently needed to strengthen governance, transparency and capital adequacy. But provided these are forthcoming, there is every indication that this country – long off the map for most foreign investors – will start to be seen as a sustainable engine for future growth across the region.

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Russia and the other BRICs: first among equals

Each quarter, PwC's Macroconsulting team produces an in-depth *Economic View* report focused on the fast-growing BRIC economies (Brazil, Russia, India and China). These reports can be downloaded at www.pwc.co.uk/economy

Here is a summary of some of the highlights from the latest edition, focusing particularly on the analysis on Russia.

BRICs: the current state of play—an overview

Overall, the BRIC economies have managed to navigate the financial crisis and global recession relatively well. Brazil, India and China registered strong growth in 2010, although Russia's growth rate lagged behind as drought and a heat wave slowed down the pace of economic activity and triggered an acceleration in inflation. However, Russia's growth is now catching up strongly with the other BRICs as its economy rebounds (see Chart 1).

On account of economic expansion and rising food prices in the BRIC countries, their headline inflation rates rose above their official central bank targets in 2010. A potential easing in inflationary pressures is expected as policy-makers resort to fiscal and monetary tightening. This could facilitate growth at more sustainable rates in 2012 following the strong recovery in 2010 and slight moderation in 2011.

Russia: domestic demand comes to the fore

Russia's fast-paced economic growth lost steam in Q3 2010 with the economy growing at half the pace seen in Q2. The slowdown of growth in Q3 2010 was widely expected on account of the failed harvest and heat wave.

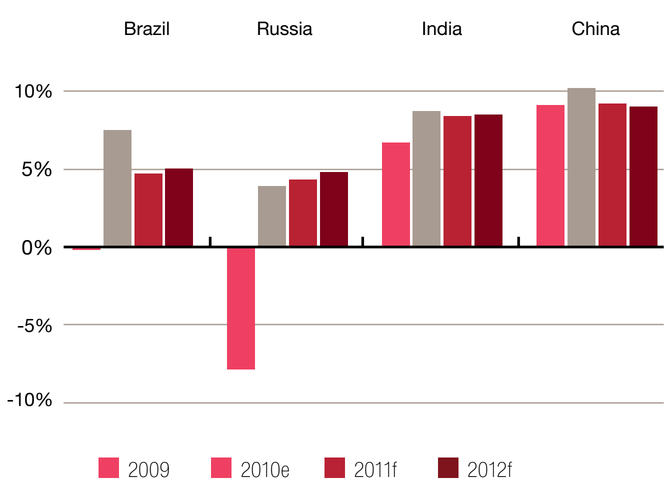
While the breakdown of growth in Q3 2010 is not yet available at the time of writing, the Q2 2010 growth indicates domestic demand has been driving output (see Chart 1). Exports showed very weak growth compared to the spectacular growth recorded in the year to the first quarter. At the same time imports surged, shrinking the current account surplus from US$33.3bn in Q1 to US$18.7bn in Q2 2010.

The Central Bank might hike interest rate further

In response to these economic developments, the Russian Government took measures such as the banning of grain exports in August 2010. However inflation continued to accelerate, rising from 6.1% in August to 8% in November 2010 on account of rising food prices. In December 2010 the central bank took the first step away from the loose monetary policy implemented after the financial crisis, by raising the deposit rates by 25 basis points taking them to 2.75%, but left the benchmark refinancing rate unchanged.

Further rate hikes are expected in the first half of 2011 if inflation continues to remain high. With the

Chart 1: GDP forecasts for BRIC economies



Source: Economic views BRIC, PwC January 2011 likelihood of the export ban on wheat being extended until the end of this year and ongoing monetary tightening, headline inflation should ease off in the second half of next year to average around 6.7% in 2011 and 7.1% in 2012.

Government policies to support investment in 2011-2013

Going forward, we expect the spike in inflation to hurt private consumption, which has been one of the main drivers of growth. We estimate 3.9% growth in 2010, and that monthly year-on-year inflation rose to 8.4% in December. Inflation is expected to start to gradually recede in the second half of this year, resulting in interest rates stabilising and a more favourable climate for investments. This contributes to stronger economic growth expectations over the next two years.

At the same time, recent-announced government plans to partly privatise several state owned enterprises during 2011 and 2013 are likely to strengthen investment growth and could attract more foreign investment. This aligns well with the other business-friendly reforms announced earlier, such as the abolition of capital gains tax on long term investments from 2011 and the reduction of foreign investment restrictions. Fuelled by strong domestic demand, we expect Russia to grow at 4.3% in 2011 and 4.8% in 2012.

Risks to growth

Although we expect the Russian economy to grow strongly this year there are certain risks around our forecast. If inflation continues to accelerate, Russia might face a longer than expected period of monetary tightening this year.

Another factor that might slow down economic growth is the slowing of export growth accompanied by rising import growth. According to latest balance of payments data, the current account surplus has been shrinking through last year, reaching US$8.7bn in Q3 2010, down from US$33.3bn in Q1 2010. If this trend continues, the contribution of net exports to the overall growth could turn negative this year.

Chart 2: Russian year-on-year growth rates

Source: Economic views BRIC, PwC January 2011

Spotlight: Russia to host 2018 World Cup

The BRIC countries have recently hosted or are set to host a number of major sporting events — a trend that partly symbolises their increasingly established position and role in the global economy. Russia won the rights to host the 2018 World Cup and is already in an advanced state of preparations for the Sochi Winter Olympics in 2014 (read our article about this on page 15).

In combination, the hosting of these two events will provide a huge investment boost over the next eight years. For Russia, FIFA's decision may speed infrastructure development as the government prepares to spend around US$9.6bn on stadiums and expand both airports and roads. Russia's bid for the World Cup includes construction of 13 stadiums and renovation of three more stadiums. These huge infrastructure plans could cause government borrowing to surge to 15% of GDP from 11% over the next three to four years.

However, the programme will also encourage public-private partnerships and attract more foreign direct investment, which could help limit government borrowing. Companies in the construction business, steelmakers, and transportation companies are likely to gain from an expected rise in infrastructure spending. Russia's airline and media companies could also see a boost.

Growth soars in Mongolia's banking sector

Mongolia's banking sector is undergoing exponential growth as the country's mining boom gathers pace. Yet, this rapid rate of growth in the sector presents inherent challenges and risks. How are the country's banking leaders looking to balance the challenges and opportunities?

Mongolia is at a watershed as its huge mineral resources are opened up to development by international firms. Simon Morris, CEO of Khan Bank, Mongolia's second largest bank by assets, describes this as a 'time of transformation' for the country and its banking sector. John Finigan, Chief Executive of Golomt Bank, the country's largest bank, believes that Mongolia has the natural resources and economic potential to become the 'new Qatar'.

Two years ago, Mongolia was in recession as it grappled with a combination of the global financial crisis, an exceptionally harsh winter and the collapse in the prices of coal and copper, its main exports. Since then, the country has staged what the IMF has described as a 'dramatic turnaround' and is set to grow by an estimated 7% in 2011. By 2015, the IMF believes that growth will reach 13%, outstripping its neighbour and main trading partner, China[1].

Landmark deal

Mongolia has always been a significant exporter of raw materials, benefiting from its strategic position between Russia and China. However, Mongolia's vast mineral potential has remained relatively under-exploited. The signing of the Oyu Tolgoi mining agreement in 2009 and the surge in investment from international mining groups it heralds have therefore opened up a new chapter in Mongolia's economic development.

The Oyu Tolgoi site contains what is believed to be the world's largest untapped copper deposit, along with abundant supplies of gold and silver[2]. The project is a joint venture between Ivanhoe Mines, Rio Tinto and the Mongolian government and is due to begin commercial production in 2013. Once the mine reaches full capacity in 2018, it will provide around 3% of global copper supplies and account for nearly a third of Mongolia's GDP[3]. With Mongolia already supplying around 40% of China's coal imports, the planned multi-billion dollar investment in the giant Tavan Tolgoi coal mine will provide a further boost for economic growth[4].

Banking growth

The expansion of Mongolia's banking sector mirrors the growth in the economy as a whole. Banking penetration is still low in what remains a predominantly cash economy, though expansion in the sector is gathering pace. Commercial bank assets have doubled in the past three years. Loan volumes increased by 19% in 2010[5].

Recent discussions with senior executives from a number of Mongolian banks have revealed renewed optimism within the sector. 'The sector has recovered well from the downturn of 2009. Our own bank had a record year of profitability in 2010,' said Simon Morris of Khan Bank. As personal incomes increase, Mr Morris is looking ahead to rapid growth in Khan Bank's retail business. Corporate business is also expanding. 'SME business is growing. The anticipated increase in IPO activity also offers significant opportunities. While we don't yet have the balance sheet size to transact the large ticket mining deals on our own, we could be in a position to carry out such deals in the next few years as our scale and capabilities increase,' said Mr Morris. 'While there are huge opportunities in this market, we're conscious of the need to concentrate on our core strategy and grow at a sustainable rate, rather than running the risk of spreading ourselves too thinly.'

'One per cent of GDP growth translates into 6% growth in banking sector assets,' said John Finigan of Golomt Bank. 'With growth in the economy accelerating, the potential for our bank and the sector as a whole is clear.' Golomt Bank's assets grew by more than 40% in 2009 and 2010. Mr Finigan sees considerable further potential in both corporate lending and retail business, including debit and credit cards. Golomt Bank has also recently set up a specialist investment banking division.

'Our assets have grown nearly eight-fold in the past five years. We anticipate at least that rate of growth over the next five years,' said Bold Magvan, Chief Executive of XacBank, Mongolia's fourth largest bank. SME lending and housing loans are now growing faster than XacBank's traditional microfinance business. As XacBank looks to bring its services to some of the more

1. IMF Mongolia Update, 13.09.10 and IMF World Economic Outlook, October 2010
2. Ivanhoe Mines Oyu Tolgoi Overview, 10.03.11
3. Wall Street Journal, 08.06.11
4. Coal Investing News, 13.11.10
5. Bank of Mongolia

Mongolian banking at a glance

- Assets of just under $5 billion
- 14 commercial banks
- Upper end of market is highly concentrated, with top four banks accounting for more than 75% of deposits and lending
- Deposits of $3.6 billion
- Loan volumes of $2.6 billion
- Non-performing loans as a proportion of total loans of 12%

(Figures 31.12.10)
Source: Bank of Mongolia

Zaisan Tolgoi Monument for Soviet Military in Ulaanbaatar

remote regions of the country, it has launched a new mobile phone banking service, which is delivered in partnership with local operators and agents.

Randolph Koppa, President of the Trade & Development Bank (TDB), Mongolia's third largest bank, is equally upbeat about his bank's prospects. TDB's assets grew by nearly 70% in 2010. 'As growth in mining accelerates, we're seeing significant expansion in demand for lending to industry suppliers including equipment and haulage firms. We're also seeing strong growth in demand for trade finance including remittances and letters of credit,' he said. 'The potential for further growth is evident. At less than 40%, the loan to GDP ratio is still quite low by emerging market standards. The ratio will need to grow by 40-50% a year to meet increasing demand,' he continued.

Risks and challenges

As with any rapidly growing and increasingly resource-based economy, there are risks. These include vulnerability to commodity price movements and any dip in Mongolia's main export markets, China and Russia. The government is mindful of these risks. This includes strengthening ties with Western countries as part of a 'third neighbour' policy, which seeks to avoid over-reliance on China and Russia.

Mining expansion may also drown out growth in other parts of the economy. 'It is easier to get investment to dig the coal than fund the infrastructure improvements needed to ship it more efficiently and support development in the wider economy,' said Randolph Koppa of the TDB. Chile, another leading copper exporter, has been cited by the government as a possible model for how mineral revenues could be used to develop and diversify the economy.

Rapid growth also presents governance and risk management challenges for the banking sector. These were highlighted in 2008 and 2009 when two of Mongolia's banks collapsed. Bad debts also rose in the sector as a whole, reaching a high of 17% of total loans in September 2009, though they had fallen back to 12% by the end of 2010[6].

The Mongolian government responded with a bank restructuring programme, which seeks to strengthen governance, transparency and capital adequacy[7]. The government has also enacted a deposit guarantee scheme, which helped to boost deposit levels by more than 50% in 2010[8].

The banking leaders we spoke to all underlined the importance of strong governance, disciplined reporting and introducing international audit

6. Bank of Mongolia/Business Monitor International November 2010
7. Mongolia Monthly Economic Update, March 2010
8. Bank of Mongolia

and lending procedures in strengthening client trust and sustaining the stability of their sector. In 2009, the Mongolian Bankers Association established a Credit Information Bureau (CIB), of which Bold Magvan of XacBank is the Chairman. In September 2010, the CIB agreed to set up a joint venture with Dun & Bradstreet to provide consumer and commercial credit information services in the Mongolian market[9].

PwC Mongolia formed in 2010, and as such is the first professional services firm to have partners and staff at all levels permanently in Mongolia. PwC Mongolia now has a team of over 30 people in the country bringing audit, accounting, tax, process improvement and capital markets expertise. In a further boost to the financial infrastructure, the London Stock Exchange (LSE) has just entered into a strategic partnership to help support the expansion and modernisation of the small and relatively under-developed Mongolian Stock Exchange (MSE)[10].

Further challenges include raising sufficient capital to support growth in the sector. This is likely to open the way for possible IPOs, dual listing on international exchanges and strategic partnerships with international investors. IPOs are the main topic for any gathering of Mongolian business leaders following the successful listing of the Mongolian Mining Company in October 2010 and the potential listing of the Tavan Tolgoi mine in the course of the next year. The question no longer seems to be 'if' but rather 'when and where'. Until recently, Hong Kong was the preferred location. However, the LSE deal with the MSE may well have changed the game, creating opportunities to develop the domestic capital market and bringing with it the potential option of a dual listing in London and Ulaanbaatar.

Mongolia's banks also face the challenge of competing with the mining sector for talent. 'We need to be able to offer young graduates a long-term vision for our future and their career development prospects within this,' said Bold Magvan of XacBank.

International banking groups have limited presence on the ground in Mongolia – ING is one of only a few to have set up a representative office – though this is likely to change as growth in the economy continues to accelerate. The capital required to establish an operation is relatively modest (circa $6 million). However, as groups seek to develop and strengthen their presence, being able to demonstrate a long-term commitment to the country and a readiness to provide opportunities for local people will be vital in attracting business, talent and government backing.

Preparing for lift-off

Mongolia is on the verge of economic transformation, which will in turn lead to a huge increase in demand for lending and banking services. As the country's banking leaders recognise, strengthening governance, transparency and risk management will be crucial in creating a sustainable platform for long-term growth.

Mongolia's banking sector offers significant and still largely untapped opportunities for international groups. Early movers will gain a significant advantage, though groups will need to be prepared to put down roots in the country to realise the full potential.

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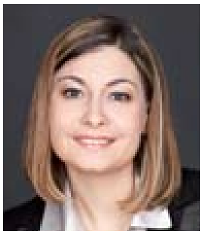
Sebastian Merriman leads the Tax team in PwC Mongolia. He is currently on secondment to the region from PwC UK office, and worked in Kazakhstan for a year and a half before relocating to Mongolia to set up the new office in Ulaanbaatar in summer 2010. Sebastian advises a range of international mining and engineering companies as well as funds and banks wishing to structure their investments into Mongolia.



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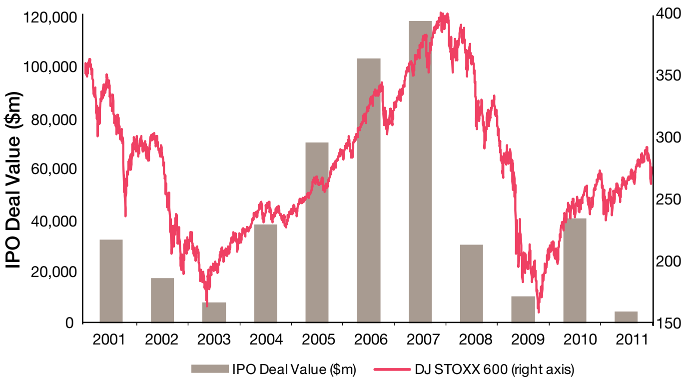
Jelena is a Senior Manager in PwC Mongolia's Assurance team and has almost eight years' experience in providing audit services to banks and other financial institutions. She relocated from PwC Kazakhstan to PwC Mongolia in September 2010 and was active in establishing the office in Ulaanbaatar, which opened that month. Jelena is a certified accountant in Mongolia and is currently in the process of applying for a Mongolian audit license.

9. Dun & Bradstreet media release, 21.09.10
10. London Stock Exchange media release, 18.01.11

When is a Door Not a Door?

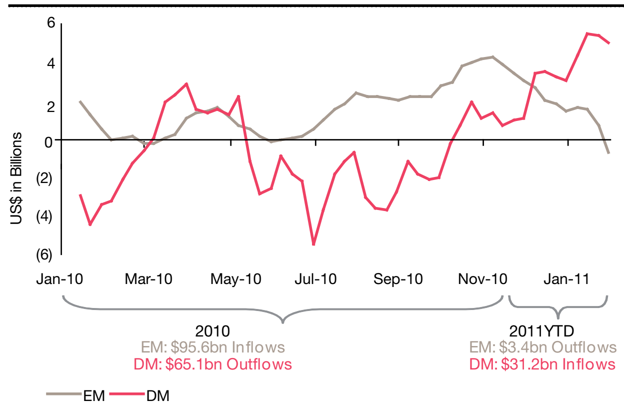
The answer to this English school riddle is, of course, 'when it's a jar'. In a similar way, ten years of drama in the capital markets taught us to think of them, like doors, as existing in either an "open" or "shut" state, but very rarely did we think of them as "ajar". Citi's capital markets execution team takes a closer look at the capital markets.

EMEA, IPO and Market Activiting 2001 to 2011 YTD



Source: Dealogic

Inflows into Emerging Markets in 2010; into Developed Markets 2011 YTD



Source: CIRA, Bloomberg

Open to Optimism

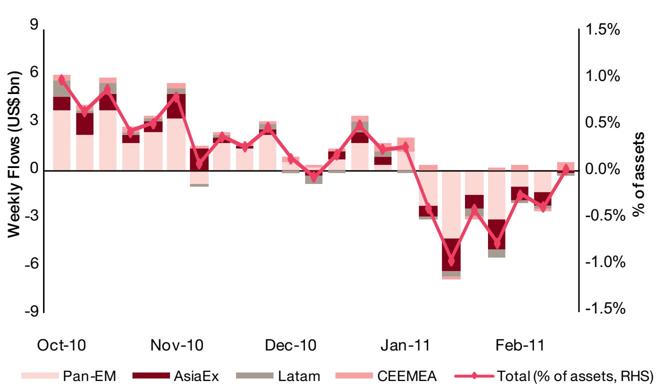
And so when towards the end of 2010, after two very "shut" years, the tide of economic news seemed to have turned it was only natural to enter 2011 brimming with optimism. We had, after all, weathered the worst fallout of a generation and there was hope that the capital markets would respond to the new state of affairs and, conveniently and obligingly, throw themselves "open".

Markets in 2011 have, however, been more measured. The early part of the year has been characterised by equity money flowing out of the emerging markets, ever the high risk high reward part of the market equation, and into the perceived "safe haven" of developed markets. This trend was initially led by improvements in US fundamentals, but gained momentum in response to the political events in North Africa and, most recently, the natural catastrophe in Japan. Pockets of secondary market resilience existed, especially in Russia, partially insulated by rising oil prices and relative political stability and Poland, with its captive domestic investor base, but investor sentiment remained fragile and, against this backdrop, it has not been a straightforward matter to execute an IPO.

Nonetheless, Citi's equity strategy research team remains upbeat on the prospects for CIS and the broader emerging markets. A good foundation exists for equities as an asset class: economic fundamentals are robust, the global economic recovery is intact, corporate earnings remain resilient, fund flows are positive and returns on non-risk assets are anaemic. Absent another unexpected negative development we expect there to be a rebalancing of equity money flows back into the emerging markets as investors regain confidence and seek opportunities for enhanced growth. There are already early signs of this starting to materialise. (See Figure 1)

It should not really come as a surprise that while an economic shock can have an almost immediate impact on markets, causing them to snap shut, the act of re-opening them takes somewhat longer. Rather like reputation, investor confidence tends to be lost in yards but only regained in inches. In the short term therefore we expect investors will be more selective and more price sensitive than they are in more stable markets. And despite the sticker shock of the delay of transactions such as ISS, the successful completion of a number of IPOs in recent weeks underlines that demand remains for high quality issuers at the right price. As further testament to this, a number of IPOs, including Etalon Group, Euroset, Nomos and Rusagro in Russia, continue to launch despite the heightened execution risk that has seen a number of high profile transactions postpone. (see Table 1)

Figure 1: Recent EM Fund Flows



Source: EPFR

Likeability, Liquidity and Leadership

So a critical question for prospective issuers becomes the assessment of what kind of transaction is likely to meet with success and how, given the volatility in market conditions, they should prepare.

Russia remains the centre of a huge volume of planned and potential activity. While there is an established bedrock of interest in CIS and Russian opportunities, there are several themes to which prospective issuers need to be alert. One is the ability of an issuer to differentiate itself. In a market which has tended to be dominated by issuance from specific sectors,

Table 1: EMEA IPOs >USD 100m in 2011 YTD

Pricing Date	Issuer	Country	Sector	Size (USDm)
IPOs				
23/03/2011	Open Finance SA	Poland	Finance	156
21/02/2011	Aker Drilling	Norway	Oil & Gas	635
14/02/2011	Justice Holdings	UK	Finance	1,440
08/02/2011	Hydraulic Machines & Systems	Russia	Machinery	360
03/02/2011	Derby Cycle	Germany	Transportation	105
31/01/2011	Bizim Toptan	Turkey	Retail	248
27/01/2011	InterXion	Netherlands	Telecoms	305
24/01/2011	Italy 1 Investment SA	Italy	Finance	204

Source: Dealogic

Moscow International Business Centre, Moscow, Russia

such as natural resources, there is clear upside potential for companies offering exposure to less accessible sectors. Cases such as mail.ru have demonstrated that where a story stands out, money will follow. Issuers and their advisors will need to work harder than ever to make sure that their equity story is robust and presents a compelling or 'must own' investment proposition.

Liquidity remains a key topic. Investor concerns on this point during the early months of this year, combined with high volatility, meant that it was easier to find buyers for billion dollar opportunities than 500 million dollar opportunities. Investors want reassurance that, if markets become fragile, they are able to trade their positions. This 'liquidity argument' can also impact upon valuation expectations as investors seek to build in a buffer to their valuations if they are concerned about their ability to trade. Prospective issuers should enter any IPO process alert to these tensions and be prepared to test the market appetite before launching marketing formally to maximise chances of success.

Corporate governance is another 'hot topic' for investors, and one often particularly relevant to Russian issuers. Adherence to international best practice on corporate governance and minority protection is a great way to help investors build confidence in a story, especially where there is a majority or dominant shareholder. Companies better able to convince investors of the strength of this commitment are likely to be at a significant marketing advantage come the launch of their IPO.

The Importance of Being Prepared in Earnest

There is no escaping the fact that an IPO is a process intensive project. Preparation takes months and involves subjecting the company to extensive investigation by accountants, bankers and lawyers. But in an environment where market windows can be brief, there is no alternative to being ready. More than ever, the ability to execute at speed when the door swings open can be the difference between success and failure. So serious prospective issuers should invest the time to prepare well in advance because the fact remains that while an IPO can always be postponed or delayed, it is nigh on impossible to accelerate.

Navigating these challenges requires advisors who are involved in the daily flows of capital through the markets and who maintain constant dialogue with investors to be able to understand and help issuers react to their concerns.

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The land of opportunity – Russia's surging demand for new infrastructure investment

Russia's infrastructure sector has been sorely underfunded since the fall of the Soviet Union in the early 1990s. To put this into perspective, while China has invested 8-10% of its GDP in infrastructure in the last two decades and India has invested 6.4% of GDP, infrastructure investment in Russia stands at just 1-2% of GDP over the same period.

The scale of investment needed in Russia is enormous by any standards. In 2007, President Putin estimated that US$ 1 trillion was needed to modernise Russia's infrastructure over the next 10 years, with the federal authorities planning for the bulk of this amount (up to 80%) to come from the private sector. Precisely how this should be achieved continues to receive active consideration at all levels of government – with a high-level focus on fostering the right environment for various forms of private investment (spanning direct private investments, PPPs, concession structures etc).

The 2008/9 financial crisis was a difficult period for the infrastructure sector, paralysing most of the large projects that had been signed up to that point. Now, as markets continue their recovery, we are seeing a revival of interest in the sector, with many investors once again ready to consider Russia risk and long-term investments.

acting as a financial advisor to Ural Industrial-Ural Polar with several projects already actively seeking financing

- The water utilities sector has been active, and concessions are being finalised with private (including foreign) players including Remondis, Veolia Voda SA and Alfa Group
- Various sport facilities are being constructed with support from large Russian companies including Gazprom, Russian Railways, Inteross, Lukoil and VTB.

The drivers of change...

This broad-based surge in demand for new infrastructure is being driven by various factors. These include the rapid development of Russia's oil and gas sector – and the need for an accompanying infrastructure capable of supporting its onward growth (eg ESPO, Nord Steram and Southern European pipelines).

Russia's host role for the 2018 World Cup, Formula 1 and the 2014 Sochi Olympics will require substantial infrastructure development, not just in terms of stadia and facilities, but also across the transport, communications and hospitality sectors. The Russian government is actively encouraging private investors to take part and a number of non-PPP projects associated with these events are being sponsored by state-owned and private corporates (airports, high-speed rail, stadia, power plants and investments in power distribution, for example).

A world-class infrastructure in prospect

Against this backdrop, Russia has announced one of the world's largest infrastructure programmes. However, these are early days and while there have been some successful examples of large projects achieving financial close (for example, the Moscow-St Petersburg toll road, which has capital costs estimated at around € 1.5 billion), it is clear that a lot of work remains to be done before such landmark developments become a mainstream and accepted way forward.

The following selected examples show the sheer scale of opportunity, in terms of the private investments in infrastructure projects that have already been approved:

- Multiple PPPs and concessions in the St Petersburg and Moscow regions, such as the Western High-Speed Diameter ('WHSD'), the Orlovsky Tunnel, the Odintsovo Bypass (Moscow-Minsk), sections of the Moscow-St Petersburg Highway, the Nadex light rail (St Petersburg) and the Pulkovo Airport expansion projects; these range in size from USD 600 million (Moscow-Minsk road detour) to US$ 7 billion (WHSD)
- JSC Ural Industrial-Ural Polar (set up and owned by the regional governments of the Urals) has developed a programme to invest in the infrastructure of Russia's Ural region with around USD 30 bn of projects under consideration; PwC Russia is

Russia's host role for the 2018 World Cup, Formula 1 and the 2014 Sochi Olympics will require substantial infrastructure development

More fundamentally, following its partial privatisation a few years ago, Russia's ageing electricity generation industry is expected to require very substantial investment across the nuclear, coal and hydropower sectors. Healthcare is another basic requirement, and with per capita spending in this area still low compared to other developed countries, a number of targeted regional and federal programmes have already been launched.

Government support of technology and innovation is driving the creation of infrastructure related to scientific clusters and industrial parks (Skolkovo is just one example of this trend). And the facilitation of trade links is another important factor, with the planned Pan-Asian freight corridor and the commercialisation of the Northern Sea Route (NSR) standing out as very significant initiatives (the latter means good prospects for port construction along the Northern Russian coast, offering new routes in and out of Russia and between Europe and Japan).

The Russian government has committed to support private investors that decide to invest in the country's transport infrastructure, with significant progress already having been made in developing an institutional and legal framework and special tax regimes for such investments. Regional legislation has also been introduced to give investors more flexibility in non-PPP projects. For example, the Nadex light rail and Pulkovo Airport have been conceived as the first PPPs based on regional St Petersburg legislation.

The environment for private sector investors is rapidly gaining in sophistication – and in stability. For example, the establishment of institutions such as the Investment Fund of the Russian Federation and the rapid development of state-owned Vnesheconombank have enabled Russia to channel state funds as a co-investor on market terms alongside private interests. Specific features include:

- Vnesheconombank (VEB) has made infrastructure one of its top priorities, and is now offering investors ruble-denominated loans at favorable fixed rates
- State support is available through the Investment Fund, including co-financing under investment agreements with provision of ownership rights in Russia, allocation of funds to the share capital of legal entities and state guarantees of investment projects.

... but some barriers remain

Notwithstanding the enormous progress that has already been made, much remains to be done. Successful projects are predominantly clustered around St Petersburg and Moscow, and there have still been very few successful initiatives at the regional level. Meanwhile, on a bureaucratic level, although Russia recently introduced a new regulatory framework to provide comfort for investors looking to finance future infrastructure projects, some discrepancies regarding concession, security, and tax and budget legislation still need to be overcome in order to bring creditors' protection in line with international best practice.

It is important to remember that Russia has its own technical, construction, sanitary and other standards – and that these can often be rather different to those that apply in comparable situations in the West (although sometimes for good reason). This can limit companies' ability to apply best practice in project design and can result in less than optimal solutions. In extreme cases this may result in projects that are bankable in the West failing to meet minimum financial return requirements in Russia.

Given the potential for volatility, there are concerns over hedging currency and pricing risks. While instruments are available to manage these issues, their application can mean that project economics are adversely affected – sometimes to an unacceptable degree.

Last but not least, there is still a limited track record of successful projects – although there is a sincere hope that the few PPPs and other initiatives brought to market in recent years will serve to reassure by highlighting the successful outcomes that can be achieved.

Looking ahead

Despite the recent economic crisis and some legislative, administrative and fiscal barriers, Russia has a manifest strong demand for new infrastructure and offers a wide range of opportunities for investors, developers and construction companies.

The country's vast size and varied geography mean that many projects are much larger than their equivalents elsewhere – meaning that the opportunities for involvement are exciting and broad-based. Supported by a high oil price and a willingness for state institutions to co-invest, we are optimistic that the prospects for infrastructure investment in Russia are exceptionally strong. The main challenge, looking ahead, will lie in matching international best practice with local execution – an area where the relevant authorities continue to work closely alongside specialist international advisers such as PwC.

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The view from the hustings

On the back of a broadly stable political backdrop, and an improving macroeconomic situation, the outlook for the Russian investment environment in coming months is cautiously positive. Any broad-based effort to tackle the underlying structural challenges to the investment environment, though, will be relegated to the back burner until after the end of election cycle in 2012.

Russia is entering an election season, with parliamentary polls set for December 2011, and the presidential ballot in March 2012. At this point the risk of political instability in the run-up to elections is very low. The country remains firmly under the control of Prime Minister Vladimir Putin, President Dmitry Medvedev, and the ruling United Russia party. Nevertheless, some dislocations are possible as jockeying among political and economic elites will intensify in coming months, as the country's leadership moves towards a decision on whether Putin will return to the Kremlin in 2012. At this point it appears on balance likely that Putin will stand for president again; given his perennially high approval ratings and the dearth of real opposition, there is a high probability that the prime minister would be voted back into the presidency. There is a smaller, though real, possibility that President Dmitry Medvedev will stand for a second term. Regardless of Putin's precise role, however, there is almost no question that he will remain a key decision-maker in the Russian political structure.

On another front, Russia's post-economic crisis macroeconomic rebound appears to be accelerating. Fourth quarter GDP growth of 5% pushed full-year growth to 4% for 2010. Following an extended period of underperformance during most of the second half of 2010, the ruble has rallied, moving up sharply against the dollar since its autumn lows. The budget deficit for 2010 clocked in at 4%, significantly lower than anticipated earlier in the year. Commodities prices – and the oil price in particular – remain the single most critical factor in Russia's macroeconomic outlook, so recent price strength suggests that consensus forecasts for growth, the ruble and the deficit will be upgraded in coming weeks, particularly as the Finance Ministry's $75/barrel oil price assumption appears increasingly conservative.

Inflation and rising fiscal expenditures stand out as the most prominent macroeconomic risks in the near term. Inflation has risen sharply in recent months, from 5.5% year-on-year to 9.7% year-on-year as of the end of February, primarily on the back of global commodity and food price growth. Encouragingly, the Central Bank of Russia in late February raised interest rates and widened the ruble foreign exchange corridor, to allow for greater appreciation – and appears to be adopting a more proactive stance to counter rising prices. On another front, in coming months there will be substantial pressure to boost populist spending – particularly on pensions, social security, and other social programmes – in the run-up to elections. But Russia's highly respected finance minister, Alexei Kudrin, is expected to hold the line on excessive spending growth, and has indicated that tax hikes may be implemented to help compensate for higher spending.

Russia's fairly stable political backdrop and improving macroeconomic situation notwithstanding, the country's investment environment remains challenged by the endemic issues of corruption, rule of law, and personalised politics. The ongoing so-called modernisation campaign, focused on the diversification of the Russian economy beyond the extractive industries, is unlikely to yield material results in the medium term. Whether after elections the Russian government will launch a comprehensive reform program to address the underlying structural weaknesses of the economy remains to be seen, although indications at this point are somewhat encouraging.

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Artist's rendering of the Sochi 2014 Coastal Cluster

Sochi 2014 when the world is watching

As the host city for Russia's first ever Winter Olympics – the XXII Olympic Winter Games and XI Paralympic Winter Games – Sochi is now preparing to be a focus for international attention in 2014.

Since 2007, when the International Olympic Committee finalised its decision in favour of Sochi's bid, a massive programme of development has been underway in Russia's Black Sea region. Besides funding a new, state-of-the-art national winter sports centre, the US$9.7 billion investment is set to transform the local and regional infrastructures, turning the surrounding Krasnodar district into a year-round tourism destination supported by new air, road and rail links, alongside upgraded utility projects, 21st century communications and new resort facilities. To put the scope of development into perspective, according to the IOC, this is the first time an Olympics project has been attempted on this scale.

Progress is well on target, with approximately 70 percent of construction now completed. Some Olympic venues have already been tested in international sports competitions. Most recently, in February 2011, this saw the mountain slopes at Rosa Khutor hosting the European Cup stage in downhill and super giant slalom. Just one of a series of 25 test events scheduled to take place over the next 30 months, this assurance exercise allows venues to be put through their paces well in advance of 2014.

As well as marking a defining moment in the development of Sochi and the Krasnodar district, the 2014 Winter Olympics is a project of national importance for Russia. From the outset, the Sochi 2014 Organising Committee has been focused not just on ensuring that the Games are staged in harmony with the IOC's requirements, but also on shaping an Olympic legacy that adds value to Russia and to the Olympic/Paralympic movement.

Central to the Sochi 2014 vision is its strong socio-cultural legacy of regional development, volunteering and Paralympic awareness in Russia. As well as establishing Sochi as a diversified, world-class hub of sporting activity, this sees the Paralympic Games driving a change in public attitudes to disability nationwide.

The Sochi 2014 'journey' will continue long after the Games have concluded. All Games preparations comply with rigorous local, national and international environmental regulation, safeguarding the region's ecosystem and setting a new standard for environmentally-efficient construction throughout Russia. At a grass-roots level, Sochi's sporting infrastructure will deliver lasting benefits to future generations. Some of the venues, including the ice-hockey stadium, will be deconstructed and relocated after the event. And the new Russia International Olympic University, being built in Sochi, will produce a new generation of sports managers, satisfying demand in Russia and worldwide for highly-qualified specialists in event management, governance and sport diplomacy.

In its exclusive role as Official Professional Services Provider and Partner of the XXII Olympic and Paralympic Winter Games, PwC Russia is now working with the Sochi 2014 Organising Committee on over 70 projects spanning the planning, preparation and staging of the Games. Focused on ensuring the Organising Committee gets to the 7 February 2014 starting-line in peak condition, our activities span multiple competencies, including taxation, human resources, risk management and sustainability, marketing, financial planning and budgeting.

Much of our work is breaking new ground in the field of event planning at this level. In particular, PwC Russia has been collaborating closely with the Sochi 2014 Organising Committee , bringing its global experience and local commitment to bear to pioneer a new integrated, client-oriented approach to Games preparation. By incorporating Project Oriented Organisation into its planning, the Organising Committee will manage the seamless transition from its current 300 members to the more than 3,000 members needed to stage the Games, keeping firmly on track for a successful event without losing sight of core longer-term legacy objectives.

Recognising PwC Russia's contribution to 'National Project #1', Dmitry Chernyshenko, President and CEO of Sochi 2014 Organising Committee, says: "When holding such large-scale events as the Olympic and Paralympic Games, it is critical to have business partners you can rely on. PwC has been active in Russia for more than 20 years and has made significant contributions to Russia's economic development. The firm has always been distinguished by the fresh approach and original thinking of its people in meeting new challenges, which is exactly why we have chosen them."

The 'Sochi model' that we have created to coordinate and manage this complex, multi-project engagement assumes that all related work for Sochi 2014 is a set of interlinked programmes and projects. While pursuing their own objectives, each of these projects is subordinate to the overall Games strategy. To give some idea of the scale of planning involved, the operational work plan accounts for over 2,600 events and control points. This model provides a mobile 'template' that can be applied elsewhere in Russia and in emerging economies worldwide, adding a layer of control and experience to the staging of large-scale events.

Another major project undertaken by PwC Russia has been the development of a Performance Management System. Incorporating a sum of strategic and operational key indicators, scaled to apply to Sochi 2014 overall and to each team member individually, this ensures cohesion between the Sochi 2014 Organising Committee high-level strategic objectives and the day-to-day work of each individual employee in the run-up to the Games.

PwC Russia is committed to helping the Organising Committee realise its larger vision. As such, legacy planning is key to our involvement in this project. Through our Corporate Responsibility programme, as well as direct sharing and collaboration between PwC Russia and Sochi 2014 people beyond the framework of strict project delivery, we hope to contribute to the vital long-term legacy objectives. Robert Gruman, Partner and Advisory Lead at PwC Russia, continues: "As well as infusing PwC's global sustainability know-how into the overall planning process, we are also able to share international experience acquired by the firm in carrying out projects for Olympic and Paralympic Games in other countries. One of the main benefits for PwC is that our firm and our people in Russia have been given a unique opportunity to develop personally and professionally through Sochi 2014."

These Games are set to have a major, lasting impact on the future of investment and innovation in Russia. As the countdown to 2014 continues, the first phase of investment (focused on new build in the Olympic region) is gathering pace. Once that is concluded, the second wave will drive far-reaching transformation throughout the surrounding region. Just as Barcelona's regeneration did not end in 1992, so the lasting impact of Sochi's unique journey will be felt for years to come.

We look forward to bringing you further updates on Sochi 2014 in future issues of this publication.

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Profile: Sir John Stuttard

Co-Chair of the Kazakh-British Trade & Industry Council, and Chairman, PwC Kazakhstan Advisory Board

Taking the long-term view

Sir John Stuttard's horizons have always extended far beyond his native UK. "When I joined PwC in its former guise in the mid-1960s, one of my objectives was the opportunity to travel and deal with other countries," he recalls.

His career to date reflects this global view. Much of it has been devoted to advising global businesses—whether helping companies from the Nordics list on the London Stock Exchange in the 1980s, building up PwC's fledgling operations in China in the 1990s, or forging strong business relationships in Kazakhstan and Russia as he does today.

Sir John's current focus on Russia and the CIS began between 2005 and 2007 during his tenures as Sheriff of the City of London and then Lord Mayor of London. His main role as Lord Mayor was representing and promoting the financial, maritime and business services industries that underpin London's position as the world's leading international financial centre.

In the course of these duties, Sir John visited Russia and met many leading figures in Russian politics and finance. He also hosted a delegation to London led by President Nazarbayev of Kazakhstan in 2006, and led a pioneering business delegation to Kazakhstan in 2007. He was so impressed by the country's potential that he became Chairman of the PwC Kazakhstan Advisory Board in 2008 and Co-Chair of the Kazakh-British Trade & Industry Council in 2009.

Looking at the current change under way in Russia and the surrounding region, Sir John draws some interesting parallels with the opening-up of China in the 1990s. "Initially there was something of a gold-rush into China 1993-95, when everyone wanted to invest there," he explains. " Then around 1997 people became more aware of the risks—especially regulatory and legal risks, and the lack of certainty around contract." In Sir John's view, similar challenges face Russia's potential to become a global centre for financial services.

"In natural resources, Russia is of course hugely important, because of its enormous reserves of gas and other resources," he comments. "But in terms of the development of its financial institutions and its emergence as a global financial centre, Russia is being held back by the lack of certainty around contract law and the regulatory environment. Russia would become much more successful if these weaknesses were dealt with, and the legal and regulatory regimes were made more reliable and transparent."

So, is the will there to achieve this change? "Yes, I think the will is there—the question is whether it actually happens," he replies. "That's a question for the future."

Whatever the immediate uncertainties in Russia and the CIS, Sir John is excited and energised by the longer-term opportunities for PwC and other businesses, and for London's role in the region. "From PwC's point of view, I think it's very important that we should be engaged in these markets because of the tremendous opportunities they offer," he says. "And it's vital that we build up expertise and knowledge about these countries in London and other centres—which is exactly what we have been doing."

"If Russia and the CIS are open for business, then people are very ready to go there. And I am pleased that PwC is well established there."

Russia's banks back on the investment radar

Bank lending and deposit levels in Russia are seeing a strong resurgence as the sector emerges from the financial crisis. With multiples still below their pre-crisis levels, could this be the time to take a fresh look at investing in Russia's banks?

Having rebounded from the Russian financial crisis of 1998, the country's banking sector was growing at around 50% a year leading up to the global financial crisis (see Figure 1). This phenomenal expansion attracted a number of international banking groups, with acquisitions by Italy's UniCredit (International Moscow Bank in 2007[1]) and Austria's Raiffeisenbank (Impexbank in 2006[2]) propelling them into the list of Russia's top ten banks by assets (see Figure 2).

Although the impact of the global financial crisis came late to Russia, it hit particularly hard. In addition to the pressure on liquidity created by global instability, Russia's banking sector was affected by a number of local factors including currency volatility, a comparatively low level of retail deposits and an increasing reliance on international capital markets for funding. The breakneck speed of growth had also not been matched by developments in underwriting and credit analysis, which exacerbated the levels of non-performing loans (NPLs) created by the downturn in the economy.

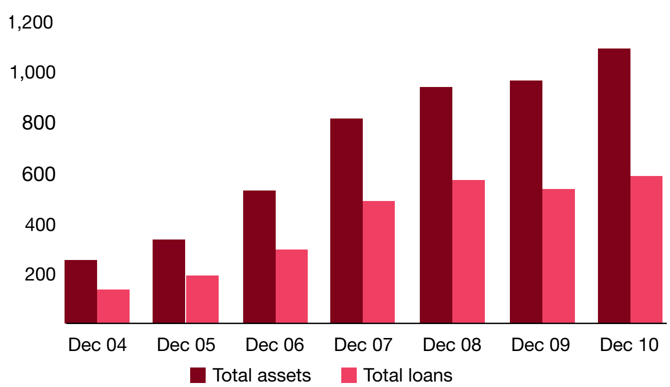
The Russian government spent some $125 billion in support of its banks in 2008 and 2009. It also increased retail deposit protection to $23,000 and has carefully managed the sector's approach to provisioning on overdue loans for Russian Statutory reporting purposes. Official provisioning rates doubled in 2009 to more than $30 billion at the beginning of 2010 (5% of outstanding loans); how NPL provisioning is managed by the Central Bank of Russia (CBR) going forward is of fundamental importance to the sector. Certainly there is currently limited incentivisation for banks to sell NPLs (like in other markets, their true value is often significantly below book value), raise additional capital or to participate in consolidation of the sector.

Emerging from the crisis

Following the government-backed stabilisation, the banking sector is now bouncing back strongly. Russia's banks recorded a net profit of around $20 billion in 2010, with corporate lending rising by 12% and retail loans by 14%. The CBR anticipates that overall lending will increase by 20-25% in 2011[5]. In addition to loan and deposit growth, there has been some recovery in net interest margins towards pre-crisis levels.

A particularly encouraging sign is the increase in retail deposits, which

Figure 1: Total value of banking assets



Source: Central Bank of Russia

1. UniCredit media release, 28.12.06 and www.unicreditbank,ru, 21.02.11
2. Raiffeisen Bank International media release, 01.02.06 and www.raiffeisen.ru, 21.02.11
3. Reuters, 23.11.10
4. Central Bank of Russia statistical update 2010

reached $322 billion in December 2010, having risen by more than 60% since January 2009[6]. The CBR expects deposits to rise by a further 26-28% in 2011[7]. Having been shaken by the bank failures of the 1998 crisis, the rise in deposits reflects a welcome increase in public confidence in the banking system and, if sustained, will boost long-term stability and access to funding.

The deal market declined significantly during the instability of 2009. Now, however, we are seeing renewed market confidence in the sector, which was reflected in VTB Bank's successful placing of $3.3 billion worth of shares in February 2011[8].

Investment potential

This is an interesting juncture for foreign investors. Some international groups have been reviewing their investments in the wake of the crisis; others have continued to perform relatively well and are now seeing a return to growth. Groups looking to establish and strengthen their presence in the Russian market might see this as an opportune time to invest. Figure 3 sets out the price/book values of the country's two largest banks on either side of the global financial crisis. Current transaction values are

Russian banking at a glance

- Assets of just over $1 trillion
- Over 1000 banks
- Upper end of market is highly concentrated, with top 20 banks accounting for 68% of total assets and top 50 for 80% of assets
- State banks still dominate (six out of top ten), with 48% of the sector's total assets

Source: Central Bank of Russia

Figure 2: Top 10 banks by total assets at 31 December 2010

Bank	Total assets USDbn	% of banking assets*	Ownership
Sberbank of Russia	279	25.2	State-controlled via CBR, 60.6%
VTB Bank	91	8.2	State-controlled via Federal Agency for Sate Property Management, 85.5%**
Gazprombank	59	5.3	State-controlled via Gazprom and NPF Gazfond, 91.7%
Rosselkhozbank	34	3.0	State-owned via Federal Agency for Sate Property Management, 100%
Bank of Moscow JSB	30	2.7	State-controlled via Moscow State Property Department and SSG, 63.5%***
VTB 24	29	2.7	State-controlled via VTB, 95%
Alfa Bank	26	2.4	Privately-owned
UniCredit Bank	22	2.0	Foreign-owned
Raiffeisenbank	16	1.4	Foreign-owned
Promsvyazbank	15	1.4	Privately-owned

*- % of total Russian banking sector assets

**- VTB placed 10% during SPO in February 2011, attracting USD 3.3bn

***- VTB purchased 50.48% of Bank of Moscow shares from Moscow State Property Department and Stolichnaya Strakhovaya Group (SSG) in February 2011

Source: Central Bank of Russia

5. Reuters, 07.02.11
6. Central Bank of Russia statistical update 2010
7. Moscow Times, 09.02.11
8. Reuters, 14.02.11

much lower than 2007 and 2008. While multiples have been recovering again, they are unlikely to return to the very high levels seen before the global financial crisis.

With banking penetration and development within Russia still low, especially outside the main urban centres, the long-term growth potential remains strong. The combined assets of Russia's banks are only around 70% of GDP[9]. In Brazil, a fellow 'BRIC', bank assets are around 105% of GDP[10]. By 2050, our analysis suggests that the asset size of the Russian banking sector will be on a par with Italy or Spain[11].

The crisis has in turn increased the appetite for foreign investment and acquisition. Many mid-tier banks (including those in the 10-50 in the size ranking) may be especially keen to attract a foreign buyer as they seek to gain access to the funds and expertise they need to sustain growth and compete with the larger institutions.

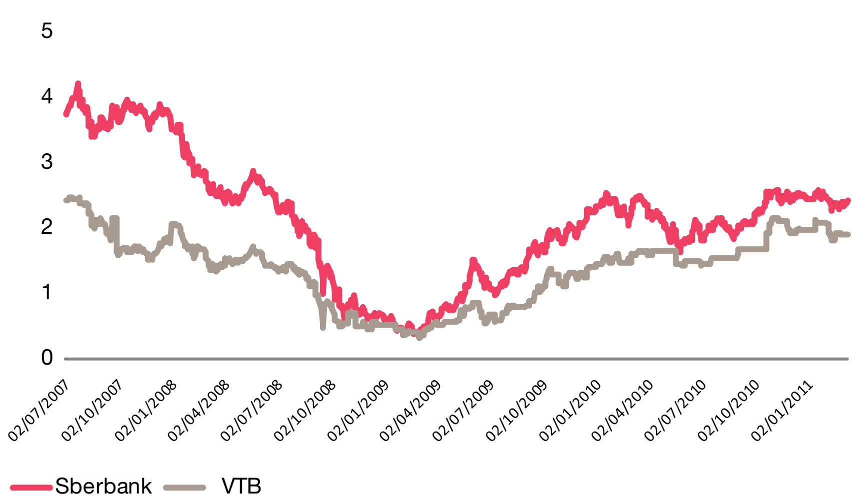
Within a relationship-driven corporate banking market, many of the mid-tier banks rely on around 20 clients for up to 50% of their business. This limited client base is making it difficult to sustain growth. Some institutions will look to foreign investors to develop the scale, differentiation and risk management capabilities they need to accumulate further market share.

Within retail banking, many banks may seek outside assistance to boost innovation and improve the quality and delivery of products and services. Every year, we carry out a customer experience survey of Russian retail banks in association with Senteo, a market research company, which rates the quality of the brand, offering, environment, communications and customer-centric culture. The average rating for Russia's banks lags some way behind their counterparts in the Ukraine, Slovakia and the Czech Republic (see Figure 4). In contrast, foreign banks operating in Russia have consistently scored above the Russian average, providing them with a valuable competitive advantage. A differentiated approach in Russia also may bear fruit – TCS Bank is an example of a fast-growing institution that has established country-wide coverage without branches.

Build or buy?

As Citibank has shown, green field development is a feasible option, though it can be a relatively long haul – Citibank is Russia's 19th largest bank, having been established in 1993. It can take at least a year to secure a licence and foreign institutions must be fully incorporated rather than operating as a branch. Once up and running, entrants face entrenched competition from established players – while there are over a thousand banks in Russia, the six largest institutions, all state-owned, account for 48% of the market by assets.

Figure 3: Price/book values of VTB and Sberbank

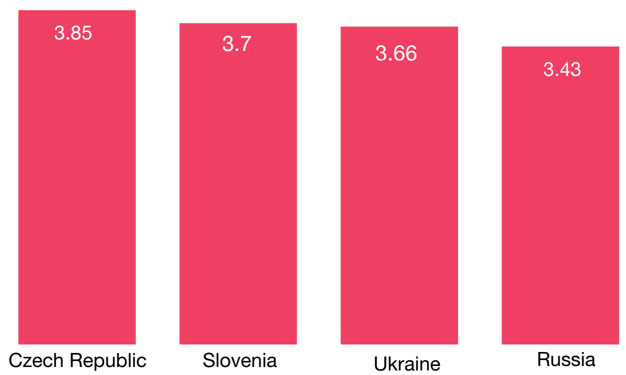


Source: Bloomberg and PwC analysis

9. Central Bank of Russia and CIA World Factbook
10. Central Bank of Brazil and CIA World Factbook
11. 'Banking in 2050: How big will the emerging markets get', published by PwC in 2008

As UniCredit and Raiffeisenbank have shown, acquisition offers a faster way to establish a strong market presence. As reported earlier, a number of mid-market institutions may now be up for sale. However, buyers need to be aware of the challenges in the Russian banking environment and have clear plans to address them before making a deal. These include a general shortage of qualified and experienced bankers in the Russian market, along with issues relating to IT infrastructure. As businesses may not be properly prepared for sale, the deal execution phase can also prove lengthier and more challenging than in more developed markets.

Figure 4: Retail bank customer experience ratings



Source: Customer Experience Index 2010', published by PwC in association with Senteo

Brief window of opportunity

Russia has a rapidly evolving banking sector, which presents both opportunities and challenges for international groups looking to take advantage of its considerable growth potential. With many mid-tier banks looking for buyers and multiples still some way below their pre-crisis peak, this could be a good time to consider an acquisition. However, prospective buyers will need to move fast as prices are climbing back up again and transactions can often take more time to complete than in a more developed market.

It is important to establish a clear and differentiated strategy for growth and be prepared to invest significant sums in developing and supporting the purchased business. Patient and careful due diligence will also be critical, especially as the prevailing provisioning rules may make it difficult to ascertain the true level of bad debts. Nonetheless, with the right price and the right strategy, Russian banking is and will continue to be a highly profitable investment opportunity.

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Belarus – prospects for growth?

Belarus's central European location is generally acknowledged to be one of its principal attractions for foreign investors. Sitting at the crossroads of major transport and communications links between the EU, Russia and Ukraine, the country is well placed for accessing the markets of the Former Soviet Union.

The country's relationship with Russia has shaped its history and its economic development. From the times of the USSR, Belarus has been a major supplier of plant and machinery to its neighbour, to the extent that its economy became synonymous with heavy industry. That continues to be the case today, with almost 90 percent of the tractors used in the Former Soviet Union (FSU) being built in Belarusian factories.

More recently, however, the economy has been mired in difficulties and when the global financial crisis hit, the impact was dramatic. State-owned heavy machinery factories saw their sales to Russia drop by up to 50 percent in 2009. This spurred attempts by the government to develop new markets – specifically in western Europe – with companies across this sector seeking to establish joint production facilities to help win new contracts.

Up to this point, the autocratic president, Alexander Lukashenko, had been reluctant to introduce reforms that might undermine his rule. But the severe economic crisis engulfing Belarus left him little choice. And, if anything, the country's problems have intensified since the elections in December 2010 that saw Mr Lukashenko retaining power – largely because of the wage rises and spending increases that were introduced at that time.

Now, faced with rapidly diminishing foreign currency reserves, rising natural gas prices and a yawning trade deficit, the government has announced further steps to kickstart urgently-needed foreign investment. Reported by the Financial Times newspaper, this includes plans to privatise 244 state-owned companies, machine tool, power generating and construction plants.

To an extent, this greater openness to foreign participation fits with a broader trend for increased liberalisation, designed to stimulate growth and release pressure on the country's fast-growing entrepreneurial segment. Amongst the raft of reforms brought in during 2007-2008, some of the most significant included the introduction of a 12 percent flat-rate income tax, allowing an increase in the foreign ownership of individual banks from 25 percent to 50 percent and terminating the 'golden share' system (which entitled the government to take over previously state-owned businesses where they were considered to be at risk).

However, while the short-term impact of these various reforms

Independence Square, Minsk, Belarus

remains to be seen, the long-term potential for foreign investment may now be more encouraging. The World Bank's 'Doing Business' annual report now ranks the country fourth in the top-ten reformers of business regulation. And in terms of doing business, Belarus now ranks 58th out of the 183 countries under review.

There is, of course, much more to be done. But there is an emerging consensus that, subject to the resolution of immediate political and economic tensions, Belarus does now represent a relatively predictable destination for western investors.

On a par with developed European countries and the US in terms of its literacy levels (source: United Nations) and with the highest density of well-educated people anywhere in the FSU, there is growing interest in the country's potential for high-tech development. Highly-skilled labour is readily available at relatively low wage rates and there is still little competition. Indeed, amongst the countries of the FSU, Belarus continues to have a relatively low average monthly wage – USD 376 in 2008, compared to USD 732 in Russia and USD 836 in Lithuania (source: National Statistical Committee of the Republic of Belarus).

Provided that Belarus continues with its liberalisation programme, rises in living standards are expected to fuel the ongoing boom in real estate and construction (now accounting for 10 percent of GDP). Until now, international contractors have bypassed the fast-growing residential and commercial property sectors, in part because of the overly-complex legislation. But as reforms gather pace, some western European developers will inevitably seek to seize first-mover advantage.

Financial services (and insurance in particular) is another area of potential opportunity. While the banking sector is now partly privatised, insurance continues to function, to a large extent, as a state monopoly; although formally there a number of private insurance companies, they are not permitted to write most of the state-related or compulsory types of insurance. That said, the fast-growing middle class combined with ongoing liberalisation means that this situation is likely to change rapidly, and demand for insurance products can only increase from today's low penetration rates (at around 1 percent). Anticipating this surge in demand, a number of international insurers (including Vienna Insurance Group, ERGO, Generali-PPF, AXA, Rosgosstrakh and Ingosstrakh) have already bought into some of the smaller local companies. Their example will help to build the critical mass needed to accelerate further reform.

Bearing in mind the country's strategic location between the countries of the FSU and western Europe, additional opportunities for foreign investment lie in the chemical and petrochemical industries – significant for producing high-quality potash, nitrogen and phosphate fertilisers which are in great demand abroad (Belaruskali owns 50 percent of the Belarusian Potash Co, a joint venture with Russian miner Uralkali that controls about 30 percent of the world potash market; source: Reuters).

Looking ahead, although ongoing privatisation of state-owned companies remains a challenge and further legislation is required, Belarus represents a relatively untapped prospect for foreign companies attracted by prospects for growth in what remains a relatively high-risk business environment. As Kirill Savrassov, CEO of the British-Belarus Chamber of Commerce, sums up: "For British businesses that are already established in Russia and neighbouring countries, this represents a great opportunity to leverage that experience for repeat success – rapidly and for a small level of investment."

To find out how PwC Belarus can help, please contact Oleg Gvozd, Country Leader, PwC Belarus oleg.gvozd@by.pwc.com

The British Belarus Chamber of Commerce (BBCC) has been in existence for some years and throughout 2011 will focus on expanding its membership of UK-based companies.

This new phase in the Chamber's development compliments some liberalisation steps recently declared by the Belarusian government, and further decentralisation and privatisation processes will be inevitable. As a result, in the short and medium terms, commercial and business opportunities will arise.

Working closely with the British Embassy in Belarus as well as the Belarus Embassy in London, the Chamber focuses on organising activities which will, ultimately, facilitate more business between the two countries. Delegation visits, seminars and networking opportunities will play a key role in this.

The BBCC also offers members access to a database of information on goods and services, as well as lobbying assistance, due diligence services on potential partners in Belarus, visa support and help with business visits to the country.

Further information about the Chamber can be found at www. bbelcc.org.uk

Facts & figures

Belarus means "white Russia"

Capital: Minsk

Population: 9.6 million (UN, 2010)

Major language: Russian, Belarusian (both official)

Monetary unit: Belarusian rouble; 1GBP=4,879.28BYR

Area: 207,595 sq km (80,153 sq miles); Border countries: Latvia 141 km, Lithuania 502 km, Poland 407 km, Russia 959 km, Ukraine 891 km

Climate: Because of the proximity to the Baltic Sea (257 meters at the closest point), the Belarusian climate is moderately continental, and ranges from maritime to continental, with mild and humid winters, warm summers and damp autumns. Average temperatures: January -6°C, July 18°C, with high humidity.

Economy: Most of the Belarusian economy remains state-controlled and has been described as "Soviet-style". Thus, 51.2% of Belarusians are employed by state-controlled companies. As of the 1991 dissolution of the Soviet Union, Belarus was one of the world's most industrially developed states by percentage of gross domestic product (GDP) as well as the richest CIS state. As of 2006, Belarus's largest trading partners are Russia and the EU.

Natural resources: potash, forests, marlstone, peat deposits, small quantities of oil and natural gas, granite, dolomite limestone, chalk, sand, gravel, clay.

Main exports: Machinery (tractors), agricultural products, chemical and petroleum products

GDP: GDP per capita (PPP): $13,400 (2010 est.); GDP real growth rate: 4.8% (2010 est.)

Unemployment rate: 1.1% - (2009 est. official figure)

Sources:
http://en.wikipedia.org/wiki/Belarus#Economy
http://www.noc.by/eng/bsog/htdocs/28/
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