Increasing FDI in the Russian regions

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Committee on International Cooperation

International Council for Cooperation and Investments under the RSPP

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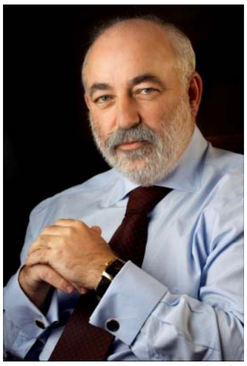


A message from RSPP President Alexander N. Shokhin, Chairman of RSPP Committee on International Cooperation Viktor F. Vekselberg, and KPMG in Russia and the CIS Senior Partner Andrew Cranston

Dear colleagues!

The study you now hold in your hands presents the result of a study of the investment climate of the Russian regions from the viewpoint of foreign investors.

The Russian economy is focused on modernisation and innovation, but it cannot develop outside of the global context, without intensifying the relations between Russian and foreign companies. Thus it is all the more important to ensure that investment conditions are the most favourable possible.

It is not enough, however, to pass good laws at the federal level. Russia is a country of many and varied regions, and this means that the regional authorities are the main interface through which investors interact with the state at all levels of project implementation. The degree to which the investment environment in a particular region is appealing, the level of openness of the local authorities, and their readiness to work with investors can be the determining factor in an investor's decision to embark on an investment, not only in the specific region but in Russia as a whole.

In 2010, the RSPP International Cooperation Committee, the International Council on Cooperation and Investment of the RSPP, and KPMG launched a study to analyse regional investment climates from the point of view of foreign investors. This challenging task was accomplished thanks to the successful combination of the organisational abilities, expertise and intellectual resources of the RSPP and KPMG.

We did not simply take a cross-section of the regional investment climate using 12 constituent entities of the Russian Federation as examples: a principal goal of the work was to assess the effectiveness of the measures taken at the regional level to stimulate foreign direct investment and create a welcoming environment for the investor.

In aiming to reflect the situation objectively and to obtain a representative sample for the study, we focused on regions with experience of attracting investment in a whole range of industries. We set ourselves the task of assessing the effectiveness of the measures taken on a regional level to encourage foreign direct investment and create a favorable investment environment.

Between April and September 2010, RSPP and KPMG teams held meetings with leading foreign investors operating in one or more of the Russian regions covered by the study. We also held a series of consultative meetings with regional administrations and the heads of regions, analysed the laws and regulations that define the regions' investment policies, and looked at how these policies were implemented in practice.

Based on the findings of this work and the opinions expressed by foreign investors, we formulated specific recommendations and suggestions aimed at improving regional investment policies as a whole.

This study is but the first step in promoting a more active approach by private investors to entering regional markets. For our part, both RSPP and KPMG will continue to work together to expand investment and foreign-trade activity at the regional level, and to see that the investment potential of the Russian regions is realised to its fullest extent. We would like to invite all interested regions, companies, and experts to join us in this endeavor.

V.F. Vekselberg

Chairman of the RSPP International Cooperation Committee

A.N. Shokhin

President of the RSPP; Chairman of the RSPP International Council for Cooperation and Investment (ICCI)

A. Cranston

Senior Partner of KPMG in Russia and the CIS

3 December 2010

Contents

The views and opinions expressed herein are those of the survey respondents and do not necessarily represent the views and opinions of KPMG Limited and Russian Union of Industrialists and Entrepreneurs (RSPP).

1. FDI in the Russian regions: relevance and importance

1.1. Executive summary (1/2)

Improving FDI in the regions is to become highly relevant and important in 2011:

- Since the beginning of the 21st century Russia has followed a long-term development plan which was clearly laid out for the international and national business community.
- The global crisis was a major disruption for Russia's development strategy, its ultimate aim of decreased dependency on natural resources and the development of an "added-value" economy.
- After returning to stable growth in 2010 the next wave of Russia's development plan is now becoming a day-to-day challenge: injecting investments in order to accelerate diversification and ensure long-term GDP growth.
- Although growth is already back and the budget deficit is likely to turn into a surplus in 2011, the starting point is clear: Russia needs foreign capital to boost the economy – intellectual and financial capital.
- Regions will play an increasingly important role in attracting FDI as they own the majority of currently under-explored capabilities and capacity.
- More regions understanding and marketing their capabilities and advantages will lead to a much more competitive Russian economy.

Despite all good intentions: so far the regions do not realise their potential, as fundamental gaps between investor expectations and regional reality remain:

- FDI into Russia is highly concentrated: on the one hand Moscow, St. Petersburg, Sakhalin and Arkhangelsk attract significant funds; on the other hand there are 37 regions that attracted less than 100 USDmn over the last 4 years.
- There are of course limitations in terms of hard factors[a] such as infrastructure, that partly explain the high concentration. However, investors indicate that hard and soft factors[a] are at least equally material.
- Even more importantly: investors expressed very clearly that a disadvantage on hard factors can easily be compensated by strong performance on soft factors (obviously, this does not apply to natural resources industries).
- In terms of hard factors, investors highlight the low level of commitment of the regions in terms of improving the quality and quantity of the workforce and in quickly improving infrastructure.
- In terms of soft factors, the picture is broader and much more within the short-term control of the regions:
  - One goal: investors sometimes question the belief of the regions in their own regional strategies. Although there should be an alignment between the interests of the investor and the region, investors feel that regions mistrust them and become too involved in determining the economic base of the investor (determining salary levels, employment numbers, etc.).
  - Consistency: investors often feel treated well on the top-level (where strategy drives action), but do not experience support or even face hostility during implementation (when form dominates substance). There seems to be a clear lack of alignment among different government agencies.
  - Financial and tax: although in place in almost every region, investors believe the that the majority of incentives are not applicable or that the requirements/processes to gain the benefits are complicated or outweigh the benefit.
  - Involvement: investors feels that regions do not learn fast enough from milestone investments and do not establish platforms to facilitate exchange between investors.

(a) Definitions of hard and soft factors used in this report are given on the p.16

1.1. Executive summary (2/2)

Practical recommendations from looking at the strong and weak performers: focus on the needs of your partner, try what is possible now – not what is impossible tomorrow

- Assessing the attractiveness of 12 regions in Russia, we find very different levels of attractiveness for international investors.
- Acknowledging that each region is different, we see clear recommendations that are relevant for all regions. For 8 out of the 12 regions included in the research we found clear potential to improve.
- For all stakeholders involved in attracting FDI we recommend:
  - Shifting intention and focus: from focusing on internal aspects (e.g. organisation, existing programmes) to focusing on customers (i.e. investors and employees).
  - Don't blame the lack of infrastructure: currently you are in control – soft factors are more important than hard factors (but be aware that this will change over time).
  - Stop trying to build the perfect administration: first of all, it will probably never exist. Secondly, it will take too long to build it.
- The federal level can achieve a lot by setting-up a federal institution that advises regions on how to facilitate change and by ensuring distribution of lessons learned in different regions. The federal level should see its role as a 'coach' rather than a player.
- Regions themselves have plenty of room to increase their attractiveness:
  - Focus on specific sectors, milestone investors and a second wave of SMEs.
  - Establish regular meetings between representatives of the government and businesses, try to mix different layers of seniority.
  - Build and communicate a clear and transparent investment process that can deal with 90% of applications but allow exceptions; establish a task force on he governor level to decide on the exceptional cases.
  - Develop trust in the mutual benefits of investments into your region: do not over-regulate early investors in investment contracts.
  - Change your marketing: involve investors in your marketing, be less description about your region.
- Given the high importance of soft factors at this stage, individual behaviour will be a key driver of change:
  - Senior officials should remain involved throughout the entire process (prior to, during and after the investment).
  - You need to ensure that all layers of your administration understand the strategy and the "substance over form" idea.
  - Ensure that your administration treats senior/junior and Russian/international staff of potential investors equally.
- International investors also play a role in making FDI investments in Russian regions more successful:
  - Manage expectations of HQs: being less developed is the reason for high growth outlooks. So one needs to accept the downside of less efficient processes.
  - Be clear to regions upfront: for sure nothing is perfect; indicate where can you be flexible, where not.
  - Communicate any dissatisfaction early: do not wait for a quality process to pick-up the issues.

1. FDI in the Russian regions: relevance and importance

1.2. Aim and approach of the study (1/2)

Our study is aimed at providing insight in relation to current actions to attract FDI in the regions, on the one hand, and how this is perceived by foreign investors and what their requirements are, on the other hand. The initial findings show that there is a gap between foreign investors' expectations and measures undertaken by regional governments.

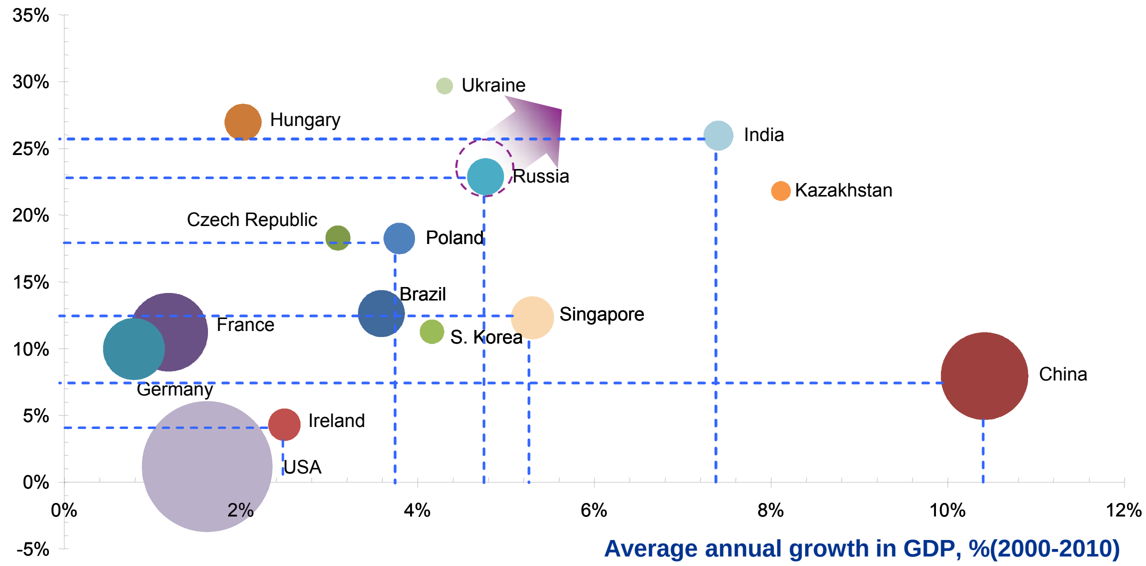
Providing regional leaders with support that enables them to actively increase FDI in their regions.

- Russian regions play a major role in the future economic development of Russia.
- We strongly believe that each region has potential to actively attract more FDI and, therefore, jointly increase the total FDI flowing into Russia.
- Although there is plenty of research on the macroeconomic situation of Russia and its key regions, there is little practical support for regional leaders.
- The lack of support is particularly significant in terms of practical responses to investor expectations, the experience gained by other regions in Russia, and the perception of regions by international investors.
- Our work provides insight in relation to this gap and individual support to 12 regional leaders and a general summary to the public.

Helping investors to prioritise expectations.

- When entering the Russian market, foreign investors invariably choose the region into which their investment is directed.
- The majority of the bigger international investors in Russia already have experience of investing in other emerging markets and recognise the need for a different approach in comparison with other BRIC countries and the rest of the world.
- We believe that taking into account the specifics of doing business in Russia and adjusting expectations, coupled with familiarising oneself with the local culture, will help to streamline the investment process and to achieve a predictable outcome in a set timeframe.
- To ensure successful cooperation with foreign investors it is important to understand that all foreign investors report to their head quarters and there is an underlying investment process.

Average annual growth in accrued FDI, % (2000-2010)



Average annual growth in GDP, %(2000-2010)

Note: (a) The size of the ball reflects the relative size of accrued FDI for 2009.
(b) Total accrued FDI in Russia is shown without investments from Cyprus and BVI.
Sources: (1) World Bank.
(2) UNCTAD.
(3) The Economist Intelligence Unit.

1. FDI in the Russian regions: relevance and importance

1.2. Aim and approach of the study (2/2)

Focusing on specific expectations, specific regions, specific actions.

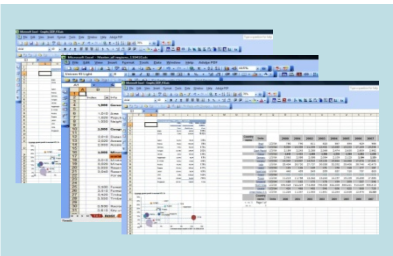
- To identify key factors for a foreign investor that affect the adoption of decisions on investments in a specific region.
- To identify the barriers that foreign investors encounter when starting up a business in the Russian regions, and that prevent the Russian regions from fulfilling their investment potential.
- To highlight the priority areas for improvements in a region's investment policies from the perspective of foreign investors.

The aim of this study requires a hands on approach in order to gain a deep understanding of discrepancies in expectations and perceptions.

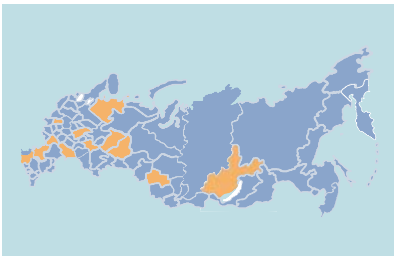
- This study is not macroeconomic research and is not aimed at making general conclusions that could otherwise be drawn from desk top research alone.
- This study uses a unique approach which was made possible through the joint efforts of the RSPP and KPMG in opening communication channels with regional governments and investors alike.

1

Desk research



Selected 12 regions



KPMG interview program

Over 70 Interviews with international investors

2

Hypothesis of the study

Interactions

3

Foreign investors

Regional authority representatives

Gap analysis / Making recommendations

4

Outside-in approach for the benefit of the regions

High level conclusions

5

Conclusions for each of the twelve regions

Based on the opinions of foreign investors, investment potential and existing barriers for investors were evaluated for each of the twelve regions. As a result specific recommendations and suggestions aimed at improving the investment policy in a region were formulated .

High level conclusions

Based on the analysis of the investment climate in the twelve Russian regions studied, the effectiveness of measures taken by regions to encourage FDI and create a comfortable environment for investors was evaluated .General recommendations for improving the investment climate applicable to the majority of Russian regions were made.

1. FDI in the Russian regions: relevance and importance

1.3. Russia's need for FDI (1/2)

Strategically reliable: Russia's roadmap implemented.

- Russia's strategy for economic development well planned since the beginning of the 21st century.
- Exploration of natural resources and restructuring of domestic industrial structures was the strategic paradigm of the government and has served the country well.
- The downside of this strategy – being a "high beta economy" – was probably a price worth paying but is now becoming an area of concern.
- The crisis was – as across the world – a disruption to the long-term plan – but only a disruption.
- We are convinced that Russia has left the crisis behind and has reached a phase of stable positive development again.
- The current budget is not sufficient to make all investments needed in the country. Russia's growth will rely on debt financing, PPP, privatisation and FDI.

The next strategic wave focuses on moving the economy to a new quality level.

- The Russian government is leading its economic strategy into a new cycle: decreasing dependency on natural resources as well as on food and pharmaceuticals imports, opening up for international investments and competition.
- The announced privatisations are an indicator that the strategy has moved into implementation: expected income of 30 USDbn during 2011 to 2013 and more than 50 USDbn over the next five years.
- The focus areas of investments over the coming years are likely to drive diversification and domestic markets: infrastructure, agriculture, food processing and pharmaceuticals are likely to lead.
- The character of investment industries and the purpose of the investments suggest wider coverage of Russia's territory outside of Moscow, St. Petersburg and the natural-resource-rich regions.
- Therefore, regional governments are increasingly playing a crucial role in creating a chance for their region to attract FDI.

Increasing FDI is a key requirement to take the next step of Russia's long-term development plan.

- Russia has suffered from a long period of underinvestment and is currently experiencing acute pressure in most aspects of social and business spheres:
  - Companies in the Russian regions often under-invest in business development due to the lack of competition.
  - Underfinancing of infrastructure (roads, electricity, etc.) by the government and the private sector has led to a high level of depreciation. The current condition of infrastructure is critical and the government is not able to improve the situation on a stand-alone basis.
  - Underinvestment in R&D by the government and the private sector has resulted in a human capital flight problem in the regions (where the most qualified and educated people move from the regions to Moscow or St. Petersburg) and for Russia as a whole (where people move abroad in order to "employ their talents").
- Russia's deficit in 2010 is likely to be significantly lower than expected and to turn into a surplus in 2011 – although this will be used for milestone investments it is not sufficient for large-scale change.
- Improving the quality/diversification of the Russian economy requires an inflow of both capital and knowledge.
- "Russia the investment case" appears solid to us: asset prices are discounted without significant fundamental justification, the economy is recovering.
- There remains a significant lack of FDI: we conclude that the key reasons behind the low FDI are soft factors such as behaviour and perception. These soft factors can be changed but this requires recognition from top officials and clear action for change.

1.3. Russia's need for FDI (2/2)

Still, in the global context, Russia's need for FDI is strong but its competitiveness for investment funding needs improvement.

- The productivity problem in Russia needs fixing: productivity of labour in Russia remains an issue for investors and can often serve to undermine Russia's competitiveness in the global market.
- In the global context, Russia can still do more to improve its perception among investors, which currently limits the pool of available investors into Russia and the Russian regions.
- Although there is generally a high level of competition between the countries for investment funding, "Russia the investment case" appears to have strong future potential: some important steps have already been taken.
- However, there is still a way to go: Russia's key strategic priorities, i.e. diversification and modernisation or the Russian economy, reinforce the need for FDI as a key instrument, which is, outside of oil and gas, is currently very low.

2. Gap analysis: investor expectations vs. regional observations

2.1. Current status of FDI in the regions

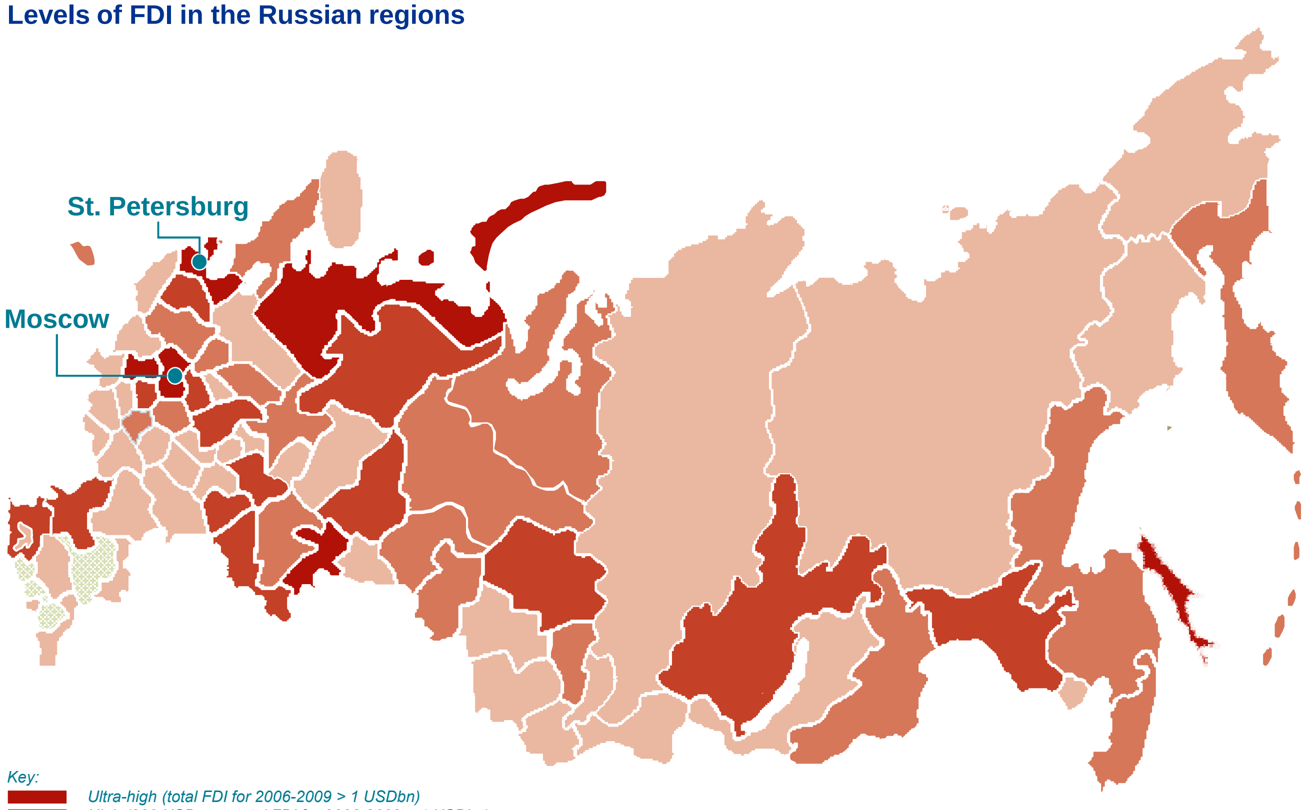
2.2. Investor expectations

2.3. Regional response

2.1. Current status of FDI in the regions

FDI is very unevenly distributed among the Russian regions: while some attract FDI on a world-class level, others are virtually on their own.

Levels of FDI in the Russian regions



Key:

- *Ultra-high (total FDI for 2006-2009 > 1 USDbn)*
- *High (300 USDmn < total FDI for 2006-2009 < 1 USDbn)*
- *Medium (100 USDmn < total FDI for 2006-2009 < 300 USDmn)*
- *Low (total FDI for 2006-2009 < 100 USDmn)*

Note: *(a) Level of FDI was estimated as total inward FDI in a region (excluding FDI from Cyprus and BVI) for 2006-2009*

Source: *Rosstat, 2010, KPMG analysis*

There are only a few regions in Russia that have an ultra-high level of FDI.

- Moscow, St. Petersburg and the surrounding regions are attractive for FDI due to the high concentration of business activities and the size of local markets.
- Sakhalin and Arkhangelsk regions showed high performance on attracting FDI, which was directed into the oil & gas sector.
- There was a large FDI inflow in the Chelyabinsk region in 2008 from the Netherlands in the sector of thermal power generation, which was most likely related with the sale by RAO EES of its share in Chelyabenergosbyt.
- The only example of the creation of a favourable business environment for foreign investors was Kaluga region, which attracted 1.3 USDbn between 2006 and 2009.

The majority of Russian regions demonstrated much weaker performance in terms of attracting FDI.

- 37 regions attracted less than 100 USDmn of FDI during the last 4 years.

2. Gap analysis: investor expectations vs. regional observations

2.2. Investor expectations (1/11)

Doing business in Russia is different to in other countries including, BRIC and the rest of the world, therefore for companies entering Russia often face gaps in expectations.

- Although foreign investors provide open and honest feedback that is supported by cross-references to other sources, their business issues often do not receive appropriate hearing and response.
- However, the current wave of foreign investors by and large recognises the specifics of doing business in Russia and have adjusted their expectations to that effect.
  - most investors already perceive Russia as different from BRIC economies.
  - most investors recognise Russian business culture and have integrated into the Russian business society.

The majority of feedback of foreign investors reflected the different factors that they experienced when investing in the Russian regions, which as a result can be perceived as their selection criteria.

- All the factors considered by a foreign investor in a certain region can be indicatively divided into 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, resources) and the ability to influence them is very limited.
  - Soft factors are those relating to creating or managing perceptions, process efficiency, internal capabilities of the people who form the relevant government agencies, legislation, etc.

The investment attractiveness of a region is therefore perceived as a complex measure of hard and soft factors.

- Hard factors form the investment potential of the region that can be quantified for comparison purposes, but each of the hard factors would receive different importance depending on the investor and the type of business.
- Soft factors are more difficult to quantify; however, it is possibly to qualify soft factors as barriers to entry.
- Investment attractiveness therefore means the overall assessment of investment potential (i.e. hard factors) in light of barriers to entry (i.e. soft factors).

The reason why the hard/soft distinction is important is because it helps to explain the relative importance of each group of factors, depending on the strength of institutional development and the degree of convergence of expectations of key stakeholders in the investment process.

- In cases where the level of institutional development is poor and there is a significant gap between expectations of key stakeholders in the investment process, soft factors become relatively more important and explain the drivers of choice of a particular region over another one.
- On the other hand, when the level of institutional development is able to guarantee the outcome from the investment process, then hard factors become significantly more important.

2.2. Investor expectations (2/11)

Key factors in investment decision

Key factors in consideration of foreign investors

		Ability to change	Speed of impact
Hard factors	**Hard factors currently have limited importance and poor performance can often be compensated by soft factors.** ■ There is no doubt that for some Russian regions, for example those rich in mineral resources, hard factors are a key determinant of investor choice. ■ However, in average Russian regions, like in the 12 chosen by the study, hard factors play a significantly less important role with a low ability to change.	◔	◔
Soft factors	**Poor performance on soft factors represents a significant barrier for entry and cannot be covered by hard factors.** ■ Although soft factors are often perceived as secondary, investors mention that strong performance on soft factors helps to negate poor performance on hard factors. ■ On the other hand, poor performance on soft factors may often divert investment from the region even when performance on hard factors is strong.	◕	◕

Soft factors have a strong upside for a material impact in the short term, while performance on hard factors has limited ability to change and the speed of impact is substantially slower.

- Soft factors currently appear to be a stronger driver of investment decisions, since institutional weakness cannot deliver synergy for hard factors.
- When Russian regions reach the institutional maturity phase soft factors will become less relevant and the importance of hard factors will increase.

Key: ○ *– weak/ slow*
● *– strong/ fast*

2.2. Investor expectations (3/11)

Given the current level of institutional development and the significant gap in expectations, soft factors are often the key driver of investment decisions.

- Although hard factors allow the economic effect from location in a particular region to be quantified, the role of hard factors in Russia is often overrated and decisions taken by foreign investors appear in some cases to present an opportunity cost.
  - The investment potential of the regions as a measure of hard factors varies significantly, however natural sources of competitive advantages (geography, infrastructure, regional market, etc.) often receive a lower priority in decision making and are therefore not fully utilised.
  - Hard factors are of higher importance for Brownfield projects:
    - The choice of Brownfield projects in the regions primarily consists of the leftovers of Soviet infrastructure and, as such, represents little value for foreign investors due to, in most cases, significant issues with soil contamination and other ecological burdens, amongst other factors.
  - As a consequence some of the regions with high investment potential are not in fact the most sought after locations.
  - On the other hand, regions that have lower investment potential, or do not have natural resources (like Kaluga) and are already operating at their full capacity in relation to infrastructure and human resources, are still a more preferred option for investors.
- Investment decisions are an interplay between the investor's assessment of hard factors and soft factors, i.e. economic effectiveness vs. unpredictability of result, in any particular moment in time, and can change over time with institutional development and changes in expectations.
  - It is possible that soft factors can compensate for shortfalls in hard factors; however, hard factors can only in exceptional cases compensate for a shortfall in hard factors.

2.2. Investor expectations (4/11)

Assessment of hard factors

2.2. Investor expectations (5/11)

Factor	Assessment of performance on foreign investor expectations
Geographical location	**Geographical location is a given factor and cannot be changed; however, a region can gain an investor over other regions with similar characteristics of location.** ■ The relative weight of this factor (calculated for each region as the relative importance of the factor for the investor, normalised to 100%) varies from 10% to 20% for different types of investors: the variation indicates that this factor is more or less important for every investor. ■ Geographical location is very important and in some cases a crucial factor for those investors who have a raw material base in a certain region, have their main or only customer in this region, or in other cases leaving no alternatives. ■ But in the majority of cases investors consider different regions with approximately equal components of location, therefore a favourable administrative environment may win investors over to their side. – *"We were considering a few neighbouring regions in the Central and Volga parts of Russia – all of them had the required factors. But in all of them except one we met an absence of support for our project from the regional administration – even at the pre-investment stage. Therefore we've chosen the region where we were supported",* – foreign investor.
Natural resources	**The availability of natural resources is a competitive advantage of every region, but according to investor feedback regions should not overestimate the importance of this factor.** ■ The relative weight of this factor varies from 5% to 30% for different types of investors: the significant variation indicates that this factor is important only for those companies with a business based on natural resources (mineral, water, recreational, soil and forest resources). ■ Russian regions are rich with natural resources and almost every region can have a competitive proposition for investors. ■ According to investor feedback, currently mineral and forest resources are more attractive for investing than recreational resources due to the shorter payback period and the lower resulting risks, and are more attractive than soil resources due to higher margins. ■ As in the majority of cases natural resources are not unique, regions compete with each other to attract investors. Therefore investors expect a more favourable attitude of the regional government: – *"Many regions in Russia have mineral resources that we need. We've found a good mine in one region but our presence there was not supported by the local government – too small a project and of minor priority for them. Therefore we gave up our intention to invest in this region",* – foreign investor.

2.2. Investor expectations (6/11)

Factor	Assessment of performance on foreign investor expectations
Workforce	**In international investors' opinion the workforce in Russia is one of its competitive advantages, especially in relation to technical staff.** ■ The relative weight of this factor varies from 10% to 20% for different types of investors depending on the investors' needs in staff, quality of the staff and the level of mechanisation of the production process. ■ The quality of the labour force, especially technical specialists, was assessed by all investors as very high, which is related to the high quality of the education system. – Often courses taught need to be adjusted to the modern technologies. Therefore investors often need to cooperate with educational organisations to conduct specialised training. ■ Another issue that investors face in regions which are close to Moscow and in economically weak regions is the significant ouflow of qualified labour force, to Moscow or other economically stronger regions. This results in an increasing shortage of labour force in these regions and rapidly growing salaries. – As the majority of foreign investors are looking for long-term perspectives of their investments in Russia, they expect certain measures to be undertaken by the government in order to decrease migration of qualified labour force and implement long-term programs for skill conversion.
R&D base	**Many Russian regions historically have a developed R&D base; however, it is of secondary priority for many foreign investors as they bring own technologies.** ■ The relative weight of this factor varies from 5% to 15% for different investors. ■ In the majority of cases local business is interested in the transfer of foreign technologies, rather than vice-versa: – "*We do not need a local R&D base as we use only our technologies",* – foreign investor. – *"We only need a qualified staff with a good education who will be capable of working on our facilities",* – foreign investor. ■ R&D specialists have great value for foreign investors if they intend to localise their R&D centres: – *"We localised our R&D centre in one of the Russian regions with a very strong R&D base – in this region we are close to R&D professionals with whom we can interact during development and realisation of our projects",* – foreign investor.

2.2. Investor expectations (7/11)

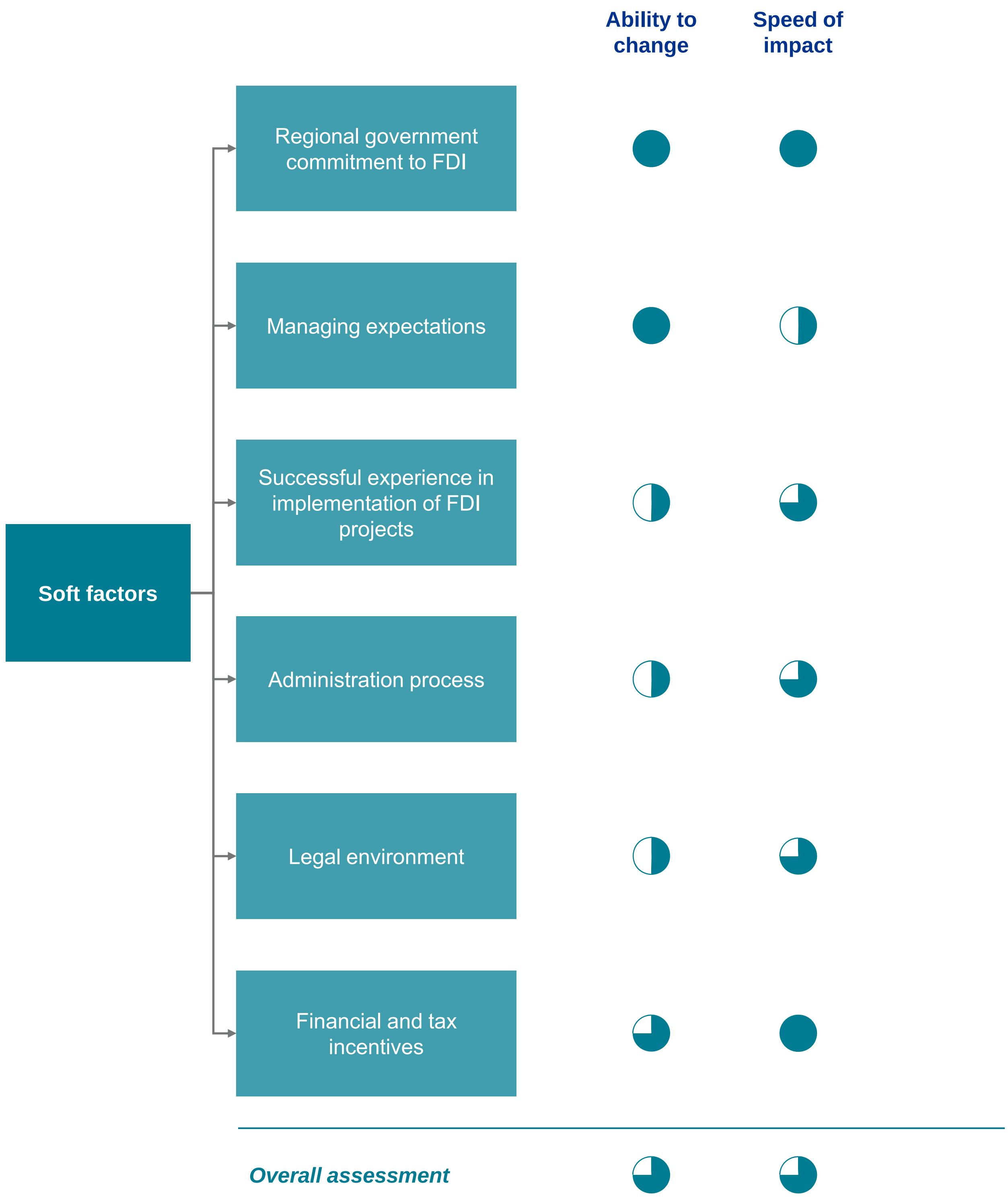
<table>
<tr><th>Factor</th><th>Assessment of performance on foreign investor expectations</th></tr>
<tr><td>Size of the accessible B2C market</td><td>Regional B2C markets are compared by foreign investors in terms of size and purchasing power.
■ The relative weight of this factor varies from 5% to 20% for different investors: in a lager scale it is important for producers of consumer goods and retailers and in smaller scale – for industrial goods manufacturers.
■ Foreign investors consider not only the internal regional B2C market, but also neighbouring regions as potential markets for their products which, if highly attractive in terms of size and purchasing power, may outweigh other important factors.
■ Foreign investors take into account the influence of seasonal migration flows, where this is significant, on the B2C market size and customer behaviour, as it may significantly adjust the assessment of market attractiveness based on pure official statistics on the resident population.
– “When we looked at the official statistics of a region which we considered for investing, we found that retail turnover in the region was greater than the personal incomes in the region”, – foreign investor.</td></tr>
<tr><td>Size of the accessible B2B market</td><td>Foreign investors assess B2B market attractiveness from the perspective of existing industry clusters and their development.
■ The relative weight of this factor varies from 5% to 20% for different investors, depending on the extent to which the producers of the value chain are geographically concentrated throughout the country in a given industry.
■ In some high-added-value industries there are a number of mutually dependent productions which preferably if allocated within one region, and even better – within one industrial park.
– Thus, some foreign investors consider an existing industry cluster in a region and/or developing industrial parks as an attractive destination for production localisation in the region.
■ “Technoparks and similar industry clusters are attractive for us also because they provide a channel of sale for our products to companies in the parks”, – foreign investor.
■ At the same time there are investors which are not so sensitive to B2B market proximity and may have different types of customers which do not have to be connected.</td></tr>
</table>

2.2. Investor expectations (8/11)

Factor	Assessment of performance on foreign investor expectations
Infrastructure	**Investors are often not satisfied with the available infrastructure and service which regions offer, even though the majority of investors perceive their requirements not as excessive, but the minimum required for doing business.** ■ The relative weight of this factor varies from 10% to 20% for different types of investors: the low variation indicates that this factor is approximately equally important for different types of investors. ■ The existence in a region of an international airport with an extensive network of international flights is a preferable but not always required factor: it becomes less important when there are significant “bottlenecks” in local infrastructure, such as roads, energy infrastructure, etc. ■ Roads and waterways are important for logistics purposes: limited road and traffic capacities often become a barrier for doing business and restrict investors initiatives. – When production requirements include special transportation (large-size platforms, special approach ways, etc.) investors consider their availability or the cost of their creation as a criteria for choosing the region for investing. ■ Investors need sufficient energy resources to performing their business: the capacity of electricity and gas systems and infrastructure are perceived as critical factors for opening a new business in a certain region. – “*Availability of electricity was a key point in choosing location. In the chosen town capacity utilisation was currently 40%”,* – foreign investor. ■ Because international investors bring part of their staff from their foreign offices, providing social infrastructure for them is also important, although some investors have to accept the current insufficient level if the most appropriate set of other key factors are available in the specific region they choose to invest in. – *“There is only one hotel in the town where we established our production. As a result our company faces difficulties every time employees from other offices arrive, not mentioning the lack of schools, kindergartens and hospitals for foreign staff who located here on a long-term basis”,* – foreign investor. ■ Building industrial parks attracts investors as an opportunity for relatively fast access to specially prepared land plots with engineering and transport infrastructure and, if the industrial park is created on a cluster basis, further access to the local B2B market. ■ Investors tend to choose regions where they can establish production within industrial parks. ■ *“Industrial parks are very important for us, since they offer a wide range of advantages such as predictable cost of connection to utilities, predictable timeframes for connection to utilities, certainty of receipt of permits for a land plot and a construction permit”,* – foreign investor.

2.2. Investor expectations (9/11)

Assessment of soft factors



Key: ○ – *weak/ slow*
● – *strong/ fast*

2.2. Investor expectations (10/11)

Factor	Assessment of performance on foreign investor expectations
Regional government commitment to FDI	**Foreign investors' experiences in communication with regional governments varies throughout the regions, but most of them appreciate an open dialogue and cooperation.** ■ A regional marketing programme establishing clear principles of cooperation with foreign investors which bring mutual benefits for the region and the foreign investors, ensures the stability required for successful long-term investments. – *"The regional marketing programme should show local government's motivation to attract foreign investors, which we can see in region A",* – foreign investor.
Managing expectations	**Foreign investors consider that there is insufficient consistency between regional governments' policies and their actual implementation, while this is vital for effective cooperation on a long-term basis.** ■ According to the experience of foreign investors throughout different regions there are few examples of good coordination between governments' declarations of the principles of cooperation with foreign investors and the actual actions of executives; however, hard work on getting actions to be consistent with the implementation of the declared principles is necessary in most regions. – *"The combination of open and motivated government and the same executives, which we met in region B, is always important",* – foreign investor.
Successful experience in implementation of FDI projects	**Foreign investors perceive a region's successful experience in the implementation of FDI projects as evidence of the achievability of success for their own projects if they invest into the region.** ■ Foreign investors tend to choose regions which have successful experience in realisation of investments projects with FDI. ■ Negative experience in FDI projects initiatives and implementation, as a rule, is widely shared within the investment community and has a long-term negative effect on the regional investment climate, as foreign investors reasonably prefer to avoid such regions.
Administration process	**Foreign investors assess the administration process as complicated and non-transparent, because it requires them to deal with many government institutions which are not directly interested in foreign investors and the requirements are often not clearly communicated.** ■ *"There is a lack of organisation among government federal and regional authorities: there are many different institutions we have to deal with (Fire Emergency, Emergencies Ministry, Russian Technical Supervisory Authority, Tax Administration, etc.) and a lack of coordination in the policies of different government institutions, inconsistence in requirements, time-consuming consideration and decision making processes,* – foreign investor.

2.2. Investor expectations (11/11)

Factor	Assessment of performance on foreign investor expectations
Administration process (cont.)	**Regional government has limited ability to facilitate administration processes for foreign investors.** ■ Although in many regions foreign investors are provided with personal account managers and in some of them special government investment agencies have been created, these measures cannot provide the performance of administration processes in accordance with the one-stop shop principle expected by investors.
Legal environment	**Foreign investors consider federal legislation in Russia as unclear and frequently changing.** ■ Current federal legislative practice creates significant risk for investors if they do business in Russia, due to the scope for multiple interpretation and frequent changes, especially regarding the issue of establishing and protecting property rights.
	The dependency of regional legislation and legal practice on changes in leadership generally increase risks for investors, although there are cases when new regional governors change the regional policy in favour of foreign investors. ■ Investment initiatives based on favourable conditions within cooperation with regional governments may be terminated if the new government changes the priorities of regional policy and reconsiders granted incentives.
Financial and tax incentives	**Most regional laws provide tax incentives for new investors; however, foreign investors not always consider them as attractive.** ■ There are examples of effective tax incentives in some regions which foreign investors consider favourable (property tax). – *“We use tax privileges which the regional government provide and consider them as a positive stimulus”,* – foreign investor. ■ However, other regions offer tax incentives for investors which require compliance with unreasonable criteria for investors, such as providing economic, social and budget guarantees, establishing a headquarters in the region, etc. Thus, compared to the corresponding risks and inconvenience for foreign investors, benefits from tax incentives appear unattractive. ■ Additional administration procedures and reporting requirements also may decrease the attractiveness of tax incentives. **Foreign investors perceive financial incentives as “nice to have” but not a critical decision making factor.** ■ Different kinds of financial incentives which imply co-financing of investment projects, including direct debt/equity investments by the regional government and subsidisation of interest rates of banks, are usually are not perceived as critical by foreign investors.

2. Gap analysis: investor expectations vs. regional observations

2.3. Regional response (1/7)

Russian regions can do a lot to perform better in the eyes of investors, and better performing regions will raise the attractiveness of Russia as a country.

Russian regions can contribute significantly to the improvement of Russia's FDI balance.

- On their own each region has limited influence on the inflow of FDI into Russia; however, through their policies and actions, regions can try to increase their share of Russia's inflow of foreign investment.
- A change in the mindset of regional governments towards more investor-focused behaviour will result in raising the standards in the Russian regions and improving the competitiveness of Russia on the global stage.
- Therefore, competition for investment between the regions calls for raising the bar in terms of efficiency of the investment process for all stakeholders which include regional governments, municipal governments and regional branches of federal government.
- Additionally, it is critical for regions to realise that they have to change, as regions often believe they do the right things.

International and domestic best practice demonstrates the availability of a variety of instruments that, if used correctly, can have a significant impact on increasing the region's attractiveness.

- Best practice for all stakeholders in the investment process is to understand the expectations of other parties and adjust own expectations and actions in order to arrive at a positive outcome.
- Best practice is directed at enhancing the value proposition and positioning of the region, while also creating internal capabilities or covering shortfalls in operational performance.

Russian regions have access to a variety of measures that are aimed at improving their attractiveness for FDI, and a lot of these measures have already found strong application in the majority of the regions.

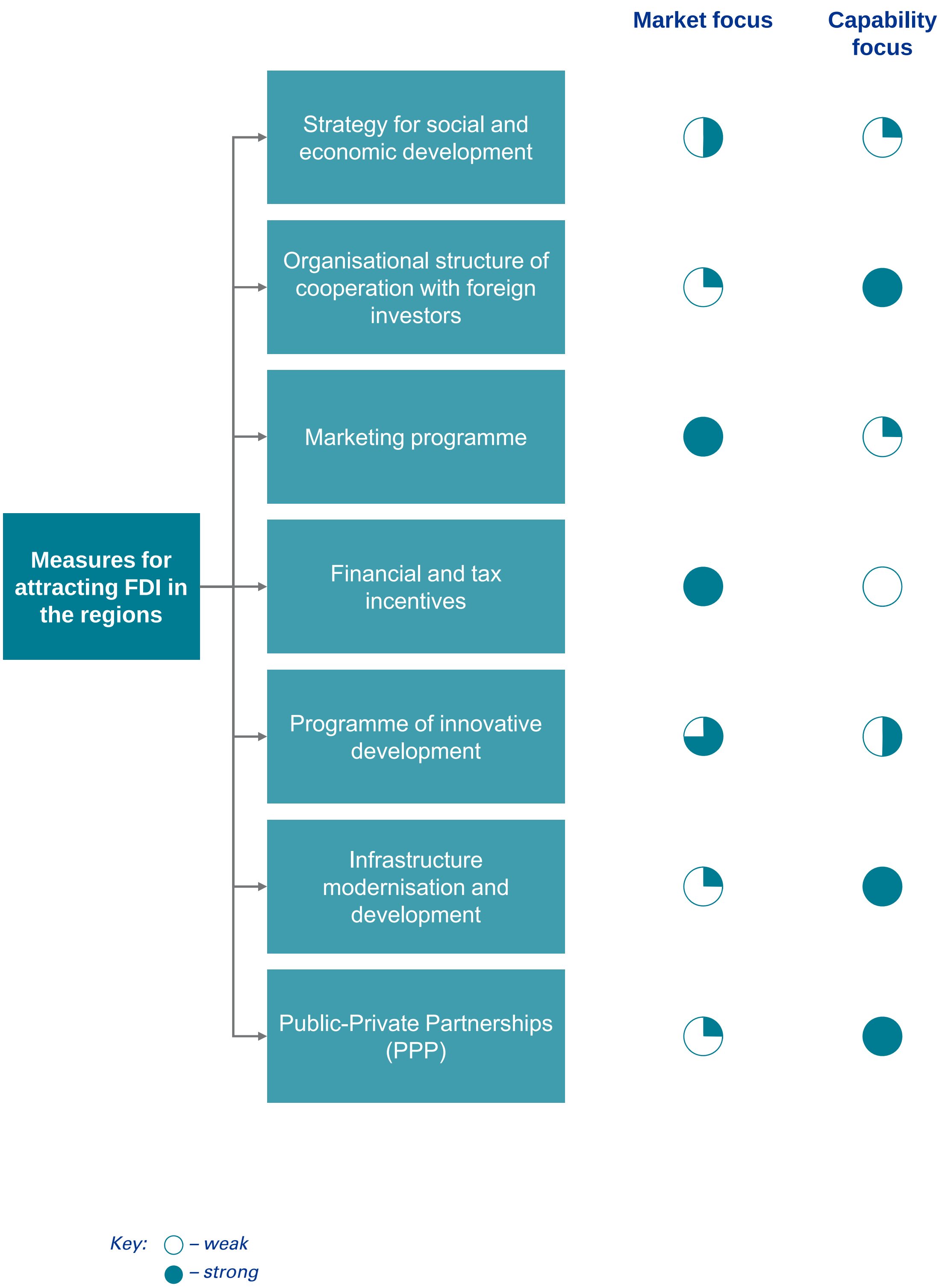
- Strategy for social and economic development.
- Organisational structure of cooperation with foreign investors.
- Marketing programme.
- Financial and tax incentives.
- Programme of innovative development.
- Infrastructure modernisation and development.
- Public-Private Partnerships (PPP).

Measures are generally focused on enhancing the market positioning of the region (market-focused) or on developing certain internal capabilities (capabilities-focused).

- Market-focused measures are those with the primary purpose of increasing inward FDI flow through enhancing the image and positioning of the region among potential investors (strategy for social and economic development, marketing programme, financial and tax incentives, programme of innovative development).
- Capabilities-focused measures are those which first of all are dedicated to process improvement (organisational structure of cooperation with foreign investors, infrastructure modernisation and development, PPP).

2.3. Regional response (2/7)

Assessment of regional governments’ measures for attracting FDI



2.3. Regional response (3/7)

Factor	Assessment of regional response
Strategy for social and economic development	**The majority of regions have a strategy for social and economic development, but only some of them contain measures on FDI attraction.** ■ Generally in the regions there is an understanding of the importance of a social and economic development strategy for attracting investments. – *"Investors need to understand how the region wants to develop. It helps them to assess the prospects for their own development", – regional administration.* – *"We positively assess the existence of a development strategy in the region since it makes clear the direction it is going", – foreign investor.* ■ Only few regions seek and take into account foreign investors' opinions in their development strategies, while foreign investors' involvement is necessary to ensure their interests are met and to increase inward FDI. – *"We received a call from the regional government asking us to participate in consultations regarding the development of the regional strategy", – foreign investor.*
Organisational structure of cooperation with foreign investors	**Regions generally respond to investor demands by establishing processes, rolling out programmes, creating complex organisational structures** ■ Some regions have established special agencies responsible for FDI policies and cooperation with foreign investors, while in the majority of regions there remain overlaps in relation to responsibilities and a lack of coordination between the policies and actions of different government institutions involved in the investment process. ■ Most regions understand the importance of the "one-stop-shop" approach as a means to facilitate the investment process; however, there are some obstacles to overcome before the one-stop shop can really deliver value to investors and efficiency to the regions. ■ There are often requirements to attend personally at one or another government agency in the region and compile another set of documents; this prevents the concept of a one-stop shop from successfully operating in the eyes of the investor. ■ The lack of synchronisation of activities, which also means that information is not shared between the relevant government agencies, drives each individual agency or ministry to set up their own "one-stop shop", which eventually leads to a number of one-stop shops in the regions and undermines the whole concept of a single point of contact and responsibility. ■ Many regions seek to overcome the shortcomings of coordination between the different ministries by introducing account managers from the investment agency or other government institutions which are assigned to support foreign investors. ■ Although this is perceived as micro management of issues faced by investors, the account managers advise foreign investors on documentation requirements and accompany them on their visits to the government agencies, ministries and their regional branches, in order to maintain control of the process and achieve a greater likelihood of the expected result. ■ In foreign investors' opinion regional governments often do not clearly communicate the requirements and administration procedures during the investment process, on such major issues as the investment contract, allocation and registration of ownership of land plots and other facilities, requirements in relation to financial and tax incentives.

2.3. Regional response (4/7)

<table>
<tr><th>Factor</th><th>Assessment of regional response</th></tr>
<tr><td>Marketing programme</td><td>Regions provide general information for investors via internet resources; however, the advantages of investing in a specific region are not always clearly communicated.
■ Every region has an investment passport with brief information on key investment opportunities and the business environment in the region.
■ The majority of regions maintain a register of investment projects and place information for investors on a special investment portal and other government internet resources; however, they do not always provide sufficient information and an understanding of the region’s position compared to others.
– “We consider that the region’s activity in self-positioning and marketing is not sufficient”, – foreign investor.
In several regions governors drive the direct marketing policy for attracting foreign investors; however, these measures are limited by the capacity of the governors and special investment agencies where they are organised.
■ Governors and specially created government investment agencies, where they exist, target and attract foreign investors by offering value propositions through direct contact with foreign investors.
– “We understood the advantages of production localisation in the region after meeting with the government investment agency”, – foreign investor.
– “For instance, one international company did not even consider our region as a place for building their plant, because there were no confirmed reserves of resources they needed. We identified a potential minefield and convinced the company to conduct prospecting work – finally it was decided to build the plant in our region”, – regional government investment agency.
The majority of regions promote themselves at investment conferences and forums where foreign investors participate, while only some of them provide information on successful cases of implementation of FDI projects.</td></tr>
<tr><td>Financial and tax incentives</td><td>Regional legislation provides a wide range of tax and financial incentives for investors.
■ Most regions provide tax privileges in relation to income and property tax for foreign investors if they invest in the industries which have priority for the region’s development; however, some incentives are linked with specific requirements, such as the requirement to establish a headquarters in the region.
■ Specific requirements such as the number of people employed and the average levels of salaries are often perceived as government intrusion into the running of the investor’s business and make investors believe they are not trusted by the government to deliver a positive economic impact in the region.
■ More progressive regions derive synergies from working with foreign investors that come in the form of job creation, transfer of technologies, etc. rather than from setting stringent rules as far as running business is concerned; therefore, in many cases investors will chose to opt out of all or some financial and tax incentives in order to avoid perceived government interference in their affairs.</td></tr>
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2.3. Regional response (5/7)

Factor	Assessment of regional response
Financial and tax incentives **(cont.)**	■ Some forms of financial and tax support, such as corporate income tax, appear generally less interesting than other forms from the perspective of the investors. – *"If we launch a new project, it takes some years to reach break-even level after completion of construction. For us incentives on land tax would be much more attractive",* – foreign investor. ■ Foreign investors in the industrial sectors are more interested in government financing of infrastructure facilities than in tax incentives. – *"It would be much more effective to allocate budget resources not for tax incentives, but for further financing of infrastructure facilities",* – foreign investor.
Programme of innovative development	**Current regional policies are deliberately oriented towards innovative development, in compliance with the priorities defined on the federal level, and include measures on creating innovative infrastructure and support of the most perspective R&D sectors.** ■ Depending on the current level of development of their R&D sectors, regional governments are focused either on creating an R&D cluster in the region or on using their existing R&D base to attract FDI in R&D centres. Most regions have worked out a strategy for innovative development. ■ Most recently created and planned science and techno parks are primarily focused on the support of domestic R&D entities; however, they may become a base for further cooperation with foreign investors. ■ There are some examples of successful R&D centre localisation by leading international innovative companies in regions. ■ Some regions develop educational programmes designed in cooperation with foreign companies and educational institutions to meet new production requirements.
Infrastructure modernisation and development	**Regional governments' long-term commitment to infrastructure development often coincides with the long-term perspective of foreign companies.** ■ Regional governments implement regional programmes of transport and energy infrastructure development and support programmes of federal significance. ■ The transport and energy infrastructure in many regions requires modernisation, thus regional governments have to focus significant resources on short-term issues to eliminate the most significant limitations and "bottlenecks". ■ Some regions organise industrial parks – regional or within federal special economic zones (SEZ) – where most infrastructure facilities are provided for investors. These measures strongly drive foreign investors' choice of region; however, there is often an insufficient number of existing brownfield and greenfield sites in an appropriate condition in other locations the industrial parks.

2.3. Regional response (6/7)

Factor	Assessment of regional response
Public-Private Partnerships (PPP)	**A PPP mechanism is often used in the creation of industrial parks: the government usually provides financing infrastructure, while foreign companies invest in production facilities.** ■ *"In creating the park we use the PPP mechanism. The government allocated funds for building roads, ports and other infrastructure facilities, and investors finance the construction of production sites",* – regional government. **Some regional governments attract foreign investors to co-finance the construction of industrial parks and some other infrastructure facilities; however, this practice has not yet found common usage.** ■ *"We used a PPP mechanism in the implementation of an investment project on the construction of an industrial park",* – foreign investor.

2.3. Regional response (7/7)

However, certain issues remain outside of regional control: infrastructure, Russia's reputation and some other factors need to be solved on the federal level.

Through its policies and actions the federal government directly influences the image of the entire Russian economy in the world investment arena.

- A consistent and reasonable policy of federal government should reassure foreign investors and attract more FDI inflow into Russia.
- Adjusting federal laws in accordance with leading international practices – including in relation to property rights of foreign investors – will drive the improvement of the legal environment in Russia throughout all regions.

A simpler organisational structure and better synchronisation among federal government ministries and their regional representatives can drive the improvement of the environment for FDI.

- Establishing a clear organisational structure of cooperation with the regional authorities would streamline the investment process by ensuring the minimum necessary administration procedures and requirements for investors.
  – *"We literally have to take our investors by the hand and take them to some of the federal government agencies; we can always escalate the problem to the vice-governor or another key figure, therefore, our approach receives stronger support compared with the investor doing it on their own",* - regional government.
- Synchronisation in relation to the actions and requirements of different government ministries would help to decrease bureaucracy and red tape and make the outcome of the process more predictable for foreign investors.

Regions often perceive the federal government as a regulator rather than a "facilitator" or a "coach" in increasing FDI in the regions and need to re-establish connections with the key ministries

- There are legal obstacles preventing the regional government from becoming a real one-stop shop for investors – this can only be resolved on the federal level.
- Both regional governments and investors state that if the issues between regional government and branches of the federal government agencies could be resolved, this would mean a leaner investment process, fewer windows and a more predictable outcome.

To support FDI, the federal government has to take into account regional requirements in relation to infrastructure modernisation and development from the perspective of foreign investors' expectations.

- Clear prioritisation of infrastructure projects (transport routes, energy facilities, etc.), properly communicated to the investors, creates a strong image of coherence in the government structure.
- Open dialogue and cooperation with investors, including understanding their infrastructure needs, helps to build stronger ties with the investor and derive synergies.
- The ability to manage investors' expectations, and to support government infrastructure development plans through real action, is the key requirement for any successful investment project in the Russian regions.

3. Closing the gap: measures to increase FDI in the regions

3.1. Key conclusions (1/4)

There are signs of change in the mindset of all stakeholders in the investment process (federal government, regional government, investors) that helps regions and, by extension, helps Russia to become a more attractive investment proposition for FDI.

There are signs of recognition that investor-focused behaviour and cooperation between the regions is a prerequisite for improvement of investment attractiveness of the regions.

- Historically there was limited sense of competition between the regions, and best practices were not shared.
- There are clear signs of a change in mindset among all stakeholders in the investment process, directed at deriving more synergies from the process.
- However, the map of Russian regions is currently very varied in terms of levels of success in attracting FDI, making some regions clear leaders.

Understanding and capitalising on each region's value proposition for foreign investors gives a strong impetus to the process of diversification.

- Strong commercial thinking is already present in some of the regions to help them to clearly position themselves on the competitive landscape for foreign investment on the country level.
- Most regions however are still highly unaware of their neighbours and the reasons behind foreign investors' choice of region are often ignored.
- Best practices in dealing with foreign investors and knowledge of success stories, when shared between the stakeholders, can help on the one hand to identify institutional synergies and on the other to improve the competitiveness of individual regions.

Competition on the regional level sends strong impulse to the federal government and drives change.

- Convergence of expectations is the key theme in the change in mindset and there is a sense that some regions are spearheading the drive for change on the federal level.
- There are strong examples where regional branches of federal agencies cause barriers for foreign direct investment in the regions, therefore fuelling the need for change.
- The limited capacity of federal government agencies and focusing on controlling rather than assisting is said to frequently cause significant delays in the process, diminish the efforts of the regional government and increase tensions.

3.1. Key conclusions (2/4)

The institutional response to the issues arising in the attraction of FDI often fails to resolve the expectation gap and, despite attempts by the regions, has so far made an immaterial difference for foreign investment.

Although regions make significant attempts to attract foreign investment, the outcomes of some initiatives do not appear to have material impact.

- Some regions make significant efforts to attract FDI and, out of the remainder, most recognise the importance of FDI and also make attempts to draw foreign investors.
- However, there are strong cases of mismatches between government measures and initiatives, and investor expectations, which reduces the effectiveness of such measures in making a material impact on FDI figures.

Governors of the regions are the key driver of increasing attractiveness of their region; however, execution often suffers and can undermine efforts at the executive levels.

- Governors of most regions appear highly committed to increasing FDI and demonstrate a proactive and supportive approach in cooperating with foreign investors.
- However, at the executive level support for FDI noticeably fades, and without micro-management from the top can undermine prior efforts.
- As a consequence of shortcomings at the level of execution, even top tier politicians cannot guarantee a successful outcome of the investment process.

A change is necessary to reduce the gap in the understanding of foreign investors' expectations among all stakeholders.

- Most foreign investors take into consideration Russian business culture and the existing process of setting up in business in Russia and, by adjusting their expectations, make the first step towards closing the expectation gap.
- However, the lack of alignment between government agencies and the supremacy of form over substance at executive levels, among other soft factors, call for change in order to reduce the gap.
- There is no denial that transparency is a means of managing perceptions and expectations, and is key to success in attracting foreign investment to the regions.
- Importantly, it is not always the individual government agencies, but the lack of synchronisation in their activities in relation to the investment process that creates inconsistencies in the process and reduces transparency.
- Therefore, changes are necessary in order to make the process more transparent for all stakeholders, both on the side of investors and on the side of government agencies.

Initiatives such as tax incentives, according to investors, have a limited impact and are unlikely to benefit investors due to the complexities in administration.

- Some tax incentives provided by regional governments appear inapplicable to foreign investors or imply onerous or infeasible requirements for foreign investors.
- For example, maintaining the priority investor status necessary for tax benefits to apply, often entails additional administration procedures and reporting, at times including regular disclosure of confidential business information.
- Therefore, foreign investors often consider that the cost of compliance in relation to many of the tax incentives on offer outweighs the actual tax benefits.

The concept of a 'one-stop shop' is definitely a vision of the future according to all stakeholders, but there are currently significant disparities between the views of investors and regional governments: governments seek to set up a one-stop shop at every ministry, therefore undermining the whole concept.

- Most regions have already implemented the concept of one-stop shop; however, often it is a one-stop shop at each or a number of government agencies.
- There are also regulatory issues that inhibit this concept by requiring attendance in person at regional branches of federal agencies.

3.1. Key conclusions (3/4)

Mid-size foreign investors have an especially high sensitivity to regional policies, while tier 1 investors have internal capabilities to overcome a range of obstacles that arise.

The regional measures and policies are significantly more important to mid-size companies, which have lower access to such resources as political support to escalate regional issues to the federal government level.

- Mid-size foreign investors often fall outside of regional government priorities and therefore receive a different level of support.
- Unlike tier 1 investors, mid-size investors do not have the clout (including the name recognition) to be able to escalate their issues or receive appropriate hearing from government agencies.
- Mid-size companies rely on institutions and the legal regime to resolve their issues, which is still underdeveloped in some regions, and do not have resources to force a change in attitude at the executive level.

Therefore, mid-size multinationals will invariably suffer a significantly different reception in the regions, making some of them a 'no-go'.

- A number of mid-size foreign investors face a lack of support and cooperation with regional governments, especially if their projects are not considered a priority.
- In many cases the regional government's approval is necessary to start the implementation of an investment project, as otherwise investors are not able to obtain the necessary permits for land, construction, etc.
- As a result, many FDI initiatives of mid-size foreign investors are not realised.

3.1. Key conclusions (4/4)

On the basis of a sample of twelve regions, it is clear that the investment attractiveness of the regions differs significantly, with an almost even split between the winners and the losers in attracting FDI

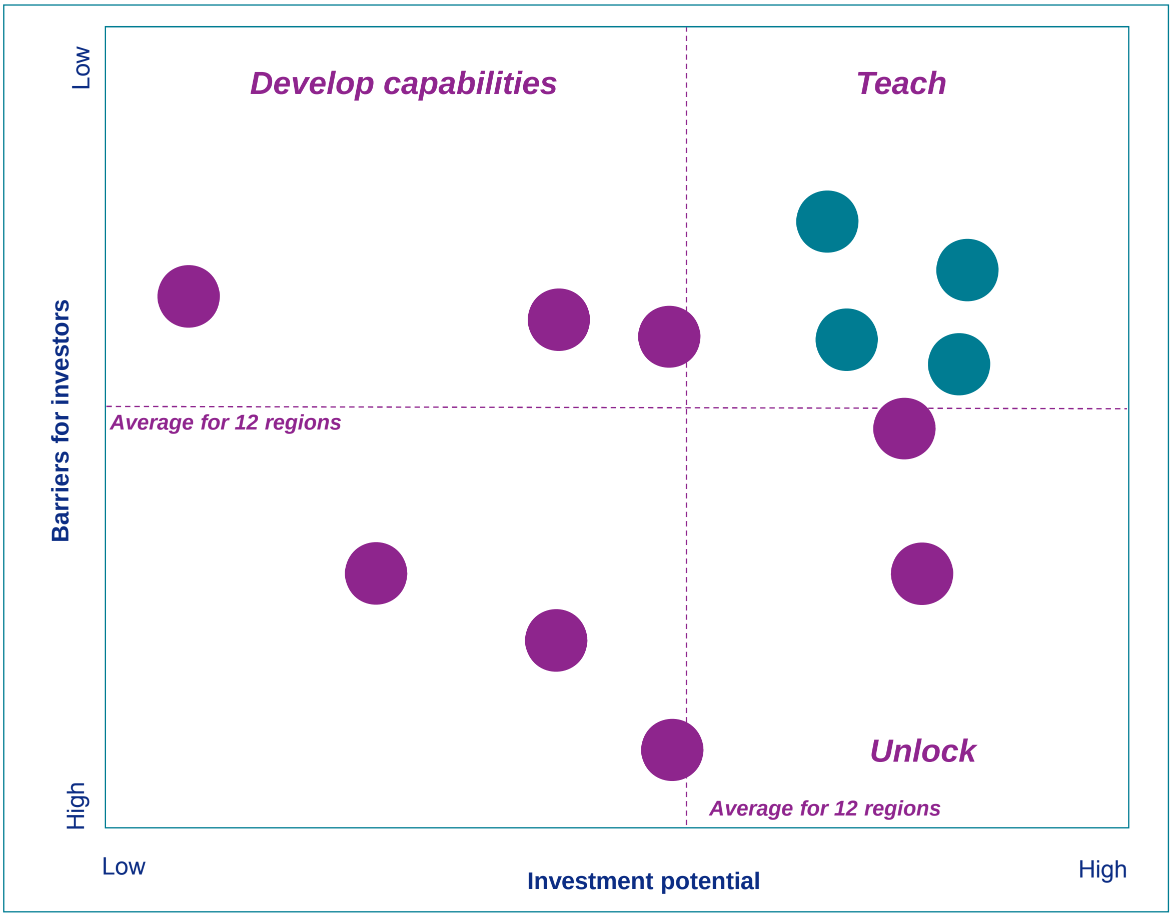
Investment potential in most cases is a reflection of hard factors, and investors do their homework through due diligence.

- Hard factors were only relevant and, therefore, perceived by the investor in the context of a particular investor's industry or business (e.g. southern regions more suitable for agriculture, more central – for logistics etc.).
- Following the investors' logic, there are still chances to unlock investment potential through targeting more relevant industries or companies to match the region's specific hard factors.

"Barriers for investors" were often expressed as perceptions and expectations, i.e. soft factors, and those regions which succeeded in managing perceptions and expectations had lower barriers in the eyes of the investors.

- The metrics applied by investors in relation to barriers were mostly uniform across all regions, which made the regions comparable irrespective of industry.
- Those investors with experience of a number of Russian regions which they can compare, state that there are strong discrepancies between performance on soft factors across the regions.

Analysis of the investment attractiveness of the regions



Sources: (1) KPMG interview programme.
(2) KPMG analysis.

3. Closing the gap: measures to increase FDI in the regions

3.2. High-level recommendations (1/6)

Increasing FDI in the Russian regions requires changes among all stakeholders in the investment process, although the most critical recommendations are addressed at the regional level. We have structured our recommendations to include overall, federal, personal and investor recommendations, but focused clearly on the regional ones.

Overall recommendations

- All stakeholders, including investors, need to adjust their expectations and actions.
- In making the Russian regions more attractive for foreign investors, clearly the next steps need to come from the federal and regional government, since investors have already expressed support for the country's growth and development.
- Therefore, the key overall recommendation is to become more investor oriented, i.e. customer focused as opposed to internally focused.
- Don't blame the lack of infrastructure: in the current environment soft factors are key to attracting FDI.
- Do not try to find a 100% solution, it does not exist; start implementing 80% solutions, leaving 20% to micro management.
- Trust in your own capabilities and importance: you are as important for investors as investors are for you.

At the federal level

- The federal level remains important in relation to solving certain key issues, such as infrastructure, reputation in the outside world etc.; therefore in increasing FDI in the regions the federal government can have a strong role of a "coach" and "facilitator".
- Initiate regular exchange between the regions about lessons learned, help to understand and implement best practices at the regional level.
- Establish institutions that consult the regional governments and distribute case studies, information on solutions and failures.

At the level of individuals

- At the current stage of development, soft factors play a key role in increasing FDI in the regions; therefore, individual behaviour is the key driver of change.
- Senior officials need to demonstrate commitment to increasing FDI in the regions and be involved throughout the entire investment process:
  - This applies at the stage when the region is being considered by the investor, when negotiating an investment contract, when building a factory, when hiring or developing people, when growing the business and developing the supplier base, etc.
- Every layer of regional administration needs to understand the idea that substance prevails over form.
- It is all about execution: the personal impact of individuals at each stage of the investment process creates the credibility of the region and the government as a whole.
- Put yourselves into each others' shoes; understand that you may be coming from completely different starting points, different cultures, different backgrounds.
- Learn from individual experiences and encourage to learn your partners and counterparts.
- Ensure that your administration treats senior/junior and Russian/international staff of potential investors equally.

International investors

- Manage the expectations of your headquarters, make them accept the downside of less efficient processes: being less developed is the reason for the high growth outlook.
- Be clear to the regions upfront, outline the areas where you can be flexible and where you cannot.
- Communicate any dissatisfaction early: do not wait for the new, ideal process to emerge and pick up the issues – it never will.

3.2. High-level recommendations (2/6)

Situation	Complication	Recommendation
Social and economic development strategy:		
Regions need an integrated investment strategy with clear statements of priorities, especially in relation to sector clusters and the role of FDI. **The strategy needs to be sufficiently long-term to cover the standard forecast periods of foreign investors.**	▪ Regions often do not realise the advantages of a cluster approach in developing the regional economy. ▪ It is still not evident for many regions which sectors should be developed; these regions usually do not have a clear social and economic development strategy based on careful diagnosis of existing strengths and weaknesses in the context of nationwide competition between the regions for FDI. ▪ Even if priority sectors are identified, the approach to attracting investors is often unclear.	▪ Prioritise sector activities and develop key sector clusters with a mix of local firms and foreign investors, with foreign investors not discriminated against in local markets. ▪ Priority sectors and companies are expected to be reviewed annually in order to re-focus efforts and identify further opportunities. ▪ Force the development of municipal strategies within the region to ensure a high degree of coordination among municipal and regional authorities in order to attract investors. ▪ Target and attract large anchor investors who will form the foundation for the entire cluster, as well as to develop missing segments in the value chain with the help of local businesses. ▪ Create favourable conditions for companies which invest in priority areas (tax privileges, specialised industrial parks, etc.) which will provide an additional impetus for investing.
Organisational structure of cooperation with foreign investors:		
Regions need to establish a transparent and efficient structure of cooperation with investors that will reduce administrative barriers – the key obstacle for foreign investment in the Russian regions.	▪ There is a significant number of stakeholders (including regional branches of federal agencies) in the investment process, therefore it may be difficult to distinguish responsibilities. ▪ Regions are not aware of best practices in creating a clear organisational structure.	▪ To decrease administrative barriers establish a special investment agency, either private or state-owned, with a focus on the following areas: – Development and implementation of the strategy for attracting foreign investors. – Work on creation of a favourable investment climate. – Provision of input to other government authorities on how to create an attractive business environment. – Operation as a one-stop shop for foreign investors, providing important information and a range of services.

3.2. High-level recommendations (3/6)

Situation	Complication	Recommendation
Organisational structure of cooperation with foreign investors (cont.):		
		■ It is also best practice to introduce simplified procedures throughout the investment process, in order to eliminate unnecessary red tape in the workflow of state authorities (for example submission of official forms online).
Regions need to resolve the lack of synchronisation between different levels of government.	■ While the top tier of regional government (governor, senior ministers, etc.) appear to be the key supporters of initiatives related to attracting foreign investors, at levels below, i.e. at the levels of execution as well as on sub-regional and municipal levels, the support noticeably fades. ■ Many issues under the jurisdiction of federal government require its involvement.	■ Formulate an investment strategy and assign roles at all levels of government, with clear KPIs which will force them to work more efficiently in attracting investors, as well as reflecting better coordination between the authorities. ■ Develop a clear allocation of responsibilities throughout the entire process of cooperation with investors for all involved stakeholders (from the governor to executor). ■ Make an agreement between the branches of federal authorities and regional authorities to reduce the time needed for consideration and approval of the investment projects.
The government needs to be in a position to guarantee the outcome of the process and issue a full scope of requirements in relation to setting up business.	■ There are legal boundaries and ambiguities that allow for different interpretation of the same law, which can be used to create artificial barriers. ■ There are issues of coordination between different government agencies that often complicate the whole process. ■ The concept of a guarantee has a different perception among investors and the authorities; where the latter understand it as merely an "obligation" but not a "guarantee" and hide behind the legal definition.	■ Develop up-to-date legislation to efficiently protect investors' rights and minimise their risks. ■ Reduce the "hidden" requirements in relation to investors in order to increase the transparency of the investment process. ■ Issue and publish a document outlining the steps for an investor to set up business in the region, with a detailed list of steps and milestones.

3.2. High-level recommendations (4/6)

Situation	Complication	Recommendation
Organisational structure of cooperation with foreign investors (cont.):		
Mid-size foreign investors are more sensitive to regional policies than tier 1 companies.	▪ Mid-size multinationals receive a significantly different reception in the regions, as they do not bring significant value in the short term; therefore regions do not provide them with extensive support – organisational or financial. ▪ Apathetic or even negative attitude of a region to mid-size companies makes some of them a “no-go” that may result in a negative image of the region.	▪ Provide mid-size companies with resources (such as administrative support, an account manager) which will help them to overcome a number of critical barriers. ▪ Put the work with investors "on stream" and standardise all procedures and processes to minimise barriers for mid-size companies.
Marketing programme:		
Each region needs strong examples of success stories in attracting foreign investment.	▪ The first example is difficult to generate and requires significant effort at all levels, but especially crucial is the governor's involvement. ▪ Not every first example can be a success story so additional investments are particularly necessarily at the earliest stage. ▪ If successful examples are not used for marketing, promotion or development of reputation, the value of examples has a tendency to diminish over time. ▪ Often, bad examples damage the value generated from a track record of successful examples and therefore high standards need to be maintained.	▪ Invest in your first success story and find an effective way to communicate it in investment circles. ▪ Establish a local community of foreign investors that will be a reference point for other potential investors.
Strategic marketing, coupled with the role of the governor, can increase awareness of a region and have an immediate and protracted effect on attracting FDI.	▪ In many cases information on the investment opportunities provided to investors is not sufficiently comprehensive and clearly structured, and does not fully meet investors’ requirements. ▪ Often, the leaders of a region are not aware of the effect which comes from dedicating their time to meeting with potential investors.	▪ Provide comprehensive and clearly structured information about the region, for example via the internet, which should also include all relevant information in English, internet based services but also make walk-in centres of government agencies available for personal visits. ▪ Ensure the participation of regional leadership in the investment process to demonstrate involvement and strengthen downward alignment across all levels of executive power. ▪ Use Russia’s representative offices in other countries to promote the region “closer” to potential investors.

3.2. High-level recommendations (5/6)

Situation	Complication	Recommendation
Financial and tax incentives:		
A customised package of tax and non-tax incentives or grants is a measure to encourage companies to use the region as a base.	■ A system of benefits will only be effective if it has clearly defined criteria and procedures for obtaining this support. ■ The complexity of administration of tax and non-tax incentives can deter investors and have an opposite effect to that planned.	■ Set clear requirements and procedures for obtaining the privileges, as only providing it the system of incentives will effectively work. ■ Use financial and tax incentives to stimulate technology transfer: – Deduction for R&D expenses. – Tax incentives and grants to improve R&D capabilities. – Venture capital fund incentives.
Programme of innovative development:		
Establishing an appropriate infrastructure for innovative activities and comprehensive people development programmes are key success factors in bringing modern technologies to the economy.	■ Applied science is significantly less developed in the regions than is required by foreign investors. ■ Applied science cannot be changed immediately to meet investors' requirements. ■ Foreign businesses prefer to hire the best scientists to work in their company, leaving educational establishments without their best resources. ■ Often foreign investors do not find appropriate resources for their R&D activities, in particular there is an especially large gap in in terms of people skills and innovative infrastructure.	■ Promote local research activities through a specially established government agency. – The agency should specialise on science, research and technologies and focuse on promoting research in sectors of high priority. ■ Provide infrastructure for innovation (such as science and IT parks, business incubators) that could attract foreign investors in the area of R&D. ■ Introduce people development programmes on a stand-alone basis, as well as in cooperation with investors, focused on closing the gaps in relation to skills required by investors.

3.2. High-level recommendations (6/6)

Situation	Complication	Recommendation
Infrastructure modernisation and development:		
Infrastructure in most of the Russian regions is poor: in many cases the problem can be solved through negotiating with investors.	■ Although foreign investors in general have a longe forecast period for their financial planning regional governments appear to have a short-term view, even in relation to infrastructure. ■ The governments make significant efforts to modernise the existing infrastructure and build new infrastructure; however, this often leaves bottlenecks that if left unresolved, have detrimental impact and can deter investors.	■ Negotiate infrastructure needs with investors (especially with anchor investors) and provide them with the necessary facilities on a case-by-case basis. ■ The provision of land-plots with connected infrastructure may help regions put their limited resources to best use. – Western-type industrial parks with shared common facilities are highly in demand and are likely to be the next focus for development in Russia.
Public-Private Partnership (PPP):		
PPP is an important tool of cooperation with investors in areas where the government cannot realise projects on a stand-alone base.	■ The PPP instrument is not widely used in the regions. ■ The current government understanding and experience of PPP may not be sufficient to build a successful PPP case.	■ Use PPP mechanisms to create industry parks and techno parks that create new business opportunities and add value to existing companies. ■ Use PPP mechanism also for the modernisation of infrastructure facilities like airports, roads, electrical grid, etc. ■ The existence of appropriate effective legislation, with clearly defined forms of PPP and responsibilities for each of the participants in the process, is a prerequisite for the PPP mechanism to be successful.

3. Closing the gap: measures to increase FDI in the regions

3.1. Key conclusions

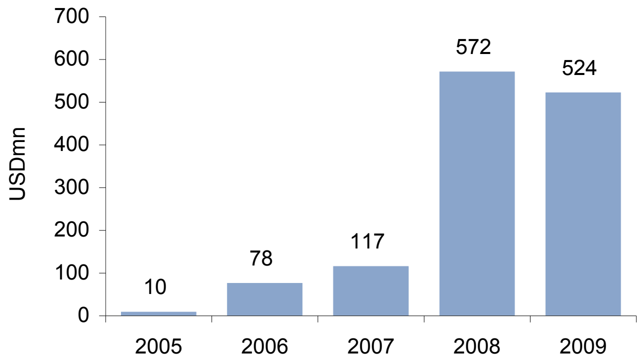
3.2. High-level recommendations

3.3. Case studies

3.3. Case studies (1/3): Kaluga

Kaluga region is a strong example of successfully bringing FDI to a region with relatively poor performance on hard factors but a strong focus on soft factors.

FDI in Kaluga region, 2005-2009



Note: (a) Total FDI excluding Cyprus and BVI.
Sources: Rosstat, 2010, KPMG analysis

As a step towards more competition Kaluga helps to share its experience in attracting foreign investors.

- In the last five years Kaluga region was among the most successful regions in attracting FDI.
  - FDI[(a)] CAGR in Kaluga region amounted to 168% in 2005-2009;
  - The share of the region in total FDI[(a)] into Russia grew from 0.1% in 2005 to 4.5% in 2009.
- Currently Kaluga region is in second place after Sakhalin region among all Russian regions in terms of FDI[(a)] per capita, with a value of 520 USD per capita, despite having low exposure to natural resources.
- Kaluga recognises the advantages of competition among the regions and conducts round tables with the participation of other regions for exchanging experience.
- Understanding Kaluga region's critical success factors will help other regions to compete to attract foreign investments in a more efficient manner.
- Competition focused on internal capabilities and marketing helps Kaluga to resolve its qualified workforce shortage in the mid-to long term period.

Kaluga's case is particularly interesting because the region has relatively poor performance on some hard factors.

- Natural resources in Kaluga region are limited to some raw materials for production of construction materials; this could be of potential interest only to a limited group of investors.
- The existing energy infrastructure in the region is not balanced:
  - The north of the region experiences electricity, while the south has sufficient spare capacities; the energy systems are also characterised by a high level of depreciation of transmission equipment (about 68%), which requires modernisation.
- There is a deficit in workforce which is currently compensated by an inflow of the workforce from other regions.
- The local B2C market is relatively unattractive, with a small population and relatively low income per capita.
- The size of the internal B2B market is still fairly small, but it is growing as new automobile and pharmaceutical production facilities are commissioned.

Note: (a) Total FDI excluding Cyprus and BVI.

3.3. Case studies (2/3): Kaluga

However, despite relatively poor performance on hard factors some foreign investors have decided to locate in Kaluga region even if it was less economically efficient.

- "*Our clients are located in the North-West of Russia and also in Siberia. Therefore, we would prefer to be in the Urals regions, but had to choose Kaluga instead; the region was very proactive, Kaluga's Moscow office had the same level of responsibility as the regional Kaluga government and they even offered us a site for our plant at a very early stage of our negotiations*", – foreign investors.

The regional government appears to make best use of all available resources and tools, which has a significant impact on increasing the region's attractiveness.

- The most efficient measures taken by the government were as follows:
  - Realisation of the cluster strategy in attracting investors.
    - "*We only focus on particular industries and target particular companies. Support is provided to each investor, irregardless of the volume of investments*" – regional government.
  - Establishment of eight industrial parks for large business with ready infrastructure, including one privately owned park.
  - Modernisation of infrastructure using the PPP mechanism – for example, reconstruction of Grabtsevo airport.
  - Tailored financial and tax incentives for priority sectors.
    - "*Tax benefits are one of the instruments for creating conditions for a rapid return on investment projects, so we are ready to provide them*" – regional government.
  - Effective streamlining of the organisational structure of cooperation with investors through clear allocation of responsibilities of all participants in the investment process – both the regional government and specially created public organisations:
    - "*We have three public organisations: the Kaluga region Development Corporation, which supports the development of techno parks in the region, the Regional Development Agency of Kaluga region, which is responsible for cooperation with existing and potential investors and "Industrial Logistics", which is responsible for providing access to logistics infrastructure* "- regional government.
  - Leadership by the governor, driving alignment from the top.
  - The regional government focused on creating strong examples from day one:
    - "*During the first wave the region introduced Volkswagen as a key investor.*
    - *During the second wave, other anchor investors such as Peugeot Citroen-Mitsubishi and Samsung.*
    - *And the third wave brought all other investors to the region*".
    - "*We focused on creating a reputation through every investor, be it 1 USDmn or 1 USDbn. We understand that our reputation can be damaged even if a small investor is dissatisfied. Our reputation took a long time to build*".

However, the lack of synchronisation between different government agencies, and especially between regional branches of federal agencies, requires micro case-by-case management

- The one-stop shop approach appears impossible to realise due to the specific requirements of some agencies, especially regional branches of federal agencies, which require attendance in person.
- In order to cope with this issue the Regional Development Agency of Kaluga region assists investors with filling in the forms submitted to the federal authorities' offices, as well as with making appointments in those offices.
- In addition, the top-tier politicians of the region take personal responsibility for all incoming requests, in order to guarantee that all requests are taken into account and processed.

3.3. Case studies (3/3): Singapore

The international community recognises the experience of Singapore as one of the most successful cases of creating favourable business environment. The success was mainly achieved by creating in 1961 a special government agency (the Agency of Economic Development - AER), responsible for attracting foreign investors to the country and providing them with required support.

SCOPE

- The budget is 410 USDmn (0.3% of GDP) of which 330 USDmn is spent on grants
- Provides input to create a favourable business environment (Top 3 rank in Ease of Doing Business Ranking since 1995). Performs annual strategic reviews of targeted sectors and investors
- 500 employees, approximately 100 persons are located in 19 international offices, which help to establish contacts with potential investors. Headquarter staff manage relationships with foreign and domestic companies within a "cluster"

PROGRAMMES

- Customised assistance is provided throughout the investment process: easy access to visas and permits, step-by-step guides for international companies
- Provision of a list of science park locations to investors. Attractive taxation policy for investors: 17% corporate income tax, capital gains not taxed, good and services tax (GST) is 7%
- Financial incentives range from assistance in manpower development (EDB sponsors trainings for local and overseas employees), technological and equipment upgrading, to R&D and intellectual property

ORGANISATION

- Focused around seven values: Care, Integrity, Team, Imagination, Courage, Excellence and Nation
- Training programmes for EDB employees: financial knowledge, functional and managerial skills development, workshops on creativity, teamwork and risk-taking. The agency recruits people with high potential and offers them scholarships for studying abroad and then returning to work for the EDB
- Fast promotions and large salaries are the main incentives for EDB employees

The divisional organisation structure of the EDB helps to improve the efficiency of the agency's activity

International Advisory Council (senior executives from multinational companies)

EDB Board (mixed group of private and public sector professionals)

EDBI (independent investment branch which funds new strategic industries)

International Operations

- Four executive directors lead division with area responsibility
- 19 international offices with more than 100 EDB employees

Planning and Eco-Enterprising

- Resource development
- Enterprise ecosystem
- Incubation unit
- Intellectual property
- International policies

Corporate Services

- Business Knowledge Group
- Client Services
- Finance, Administration
- HR
- Information Systems
- Legal
- Marketing
- Organisation Excellence

Cluster Development

- Cluster development for local firms and foreign investors

4. Appendix:
Research methodology

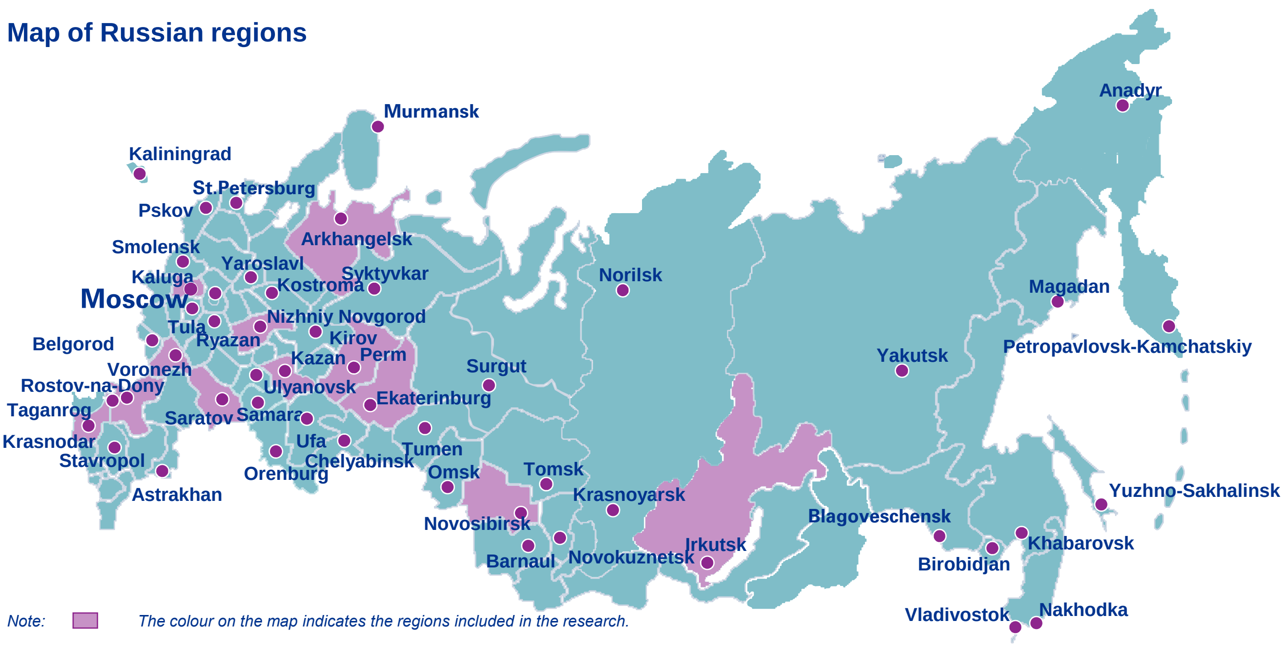
Research methodology (1/5)

12 Russian regions were selected for analysis of the investment climate.

Central federal district	Volga federal district
■ Voronezh oblast ■ Kaluga oblast	■ Republic of Tatarstan ■ Perm krai ■ Nizhny Novgorod oblast ■ Saratov oblast
Northwestern federal district	**Urals federal district**
■ Arkhangelsk oblast	■ Sverdlovsk oblast
Southern federal district	**Siberian federal district**
■ Krasnodar krai ■ Rostov oblast	■ Irkutsk oblast ■ Novosibirsk oblast

- The research was based on 12 Russian regions from six federal districts, which are comparatively neutral to external political factors and independent of business related to the extraction of minerals.
- These 12 regions account for 19% of the aggregate GRP for all constituent subjects of the Russian Federation (according to data for 2008) and 12% of the total FDI into the Russian Federation (with the exception of FDI generated from the Republic of Cyprus and addressed to lines of business related to the extraction of minerals, based on aggregate data for 2008-2009).

Map of Russian regions



Note: The colour on the map indicates the regions included in the research.

Research methodology (2/5)

The current investment climate of the selected regions was analysed based on research into the indicators determining the region's investment attractiveness and a study of the confidence of foreign investors.

- At present the main indicator for the high investment attractiveness of a specific region concerns its focus on a foreign investor. This implies that the state executive authorities at all levels should create favourable terms for the investor and provide services that comply with its main expectations.
- During the research, the whole FDI process was considered from the perspective of a foreign investor.
- In essence, this approach coincides step-by-step with the approach of a foreign investor when taking an investment decision.
- In order to perform a comprehensive analysis within the framework of the research, international experience was also considered – both best and worst practice – for the purpose of identifying key success factors and the reasons for failures.

Stages and results of the research

1

Investment attractiveness

- Rating of the region's investment potential.
- Assessment of barriers to entry.

2

Focus on soft factors

- Identification and analysis of soft factors
- Positive and negative investment experience.

3

Gap analysis

- Identification and analysis of the expectations of foreign investors in each separate region.
- Analysis of the measures adopted by regions aimed at meeting investor requirements.
- Identification of the gaps between investor expectations and the measures adopted.

Conclusions

- The deliverables of the project are recommendations on how to improve the investment climate and raise the investment attractiveness of the regions from the perspective of foreign investors.

Research methodology (3/5)

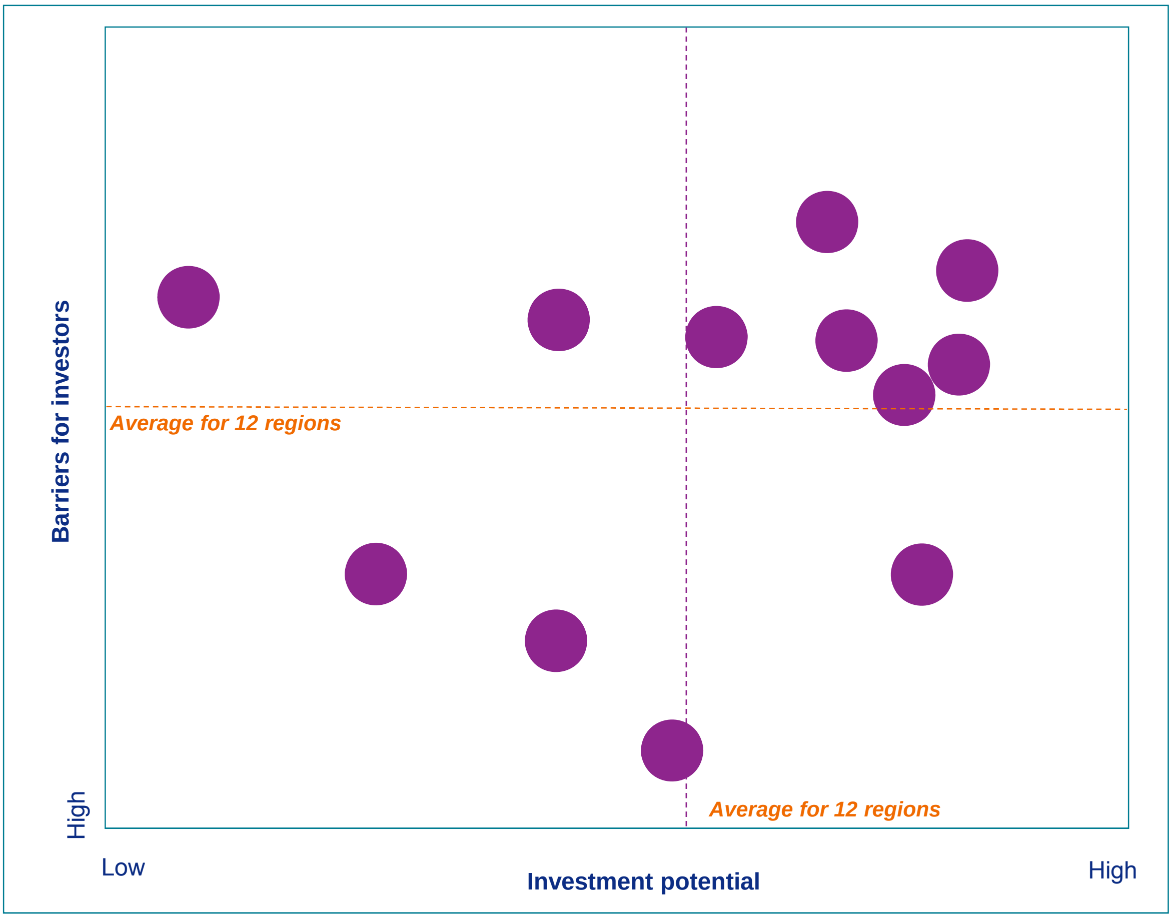
1 Analysis of investment attractiveness: the opinion of foreign investors.

- The investment appeal of a region was analysed based on the balance of investment potential and existing barriers for foreign investors.
- Highly attractive regions have significant investment potential and low barriers for investors compared to other regions.

Investment attractiveness of a region

Investment potential of a region	Barriers for investors
The investment potential of a region was rated by foreign investors based on a number of factors that can be improved by the regional authorities, and other factors that cannot be altered as they are attributable to the physical environment.	The assessment of existing barriers for investors was obtained during a programme of interviews conducted by KPMG.

Analysis of the investment attractiveness of the regions



Sources: (1) KPMG interview programme.
(2) KPMG analysis.

4. Appendix
Research methodology (4/5)

1 Analysis of investment appeal: the opinion of foreign investors.

The comparative rating of investment potential and the barriers for investors for each region was formed based on the results of the interview programme.

As part of its research, KPMG implemented an interview programme from June to September 2010. This involved over 70 interviews with a large number of stakeholders involved in some way with FDI in Russia, including:

- Representatives of the regional authorities participating in the investment process in the region.
- Foreign companies making FDI in the region or considering such a possibility: respondents were selected based on the significance of their contribution to FDI in Russia, and also their participation in different sectors of the economy, existing operations in different Russian regions and their representation in different countries globally.

The results of the KPMG interview programme were summarised for the purposes of comparative analysis, and to identify the regions considered relatively attractive by investors.

Investment potential of the region

Based on the results of the analysis of interviews with foreign investors, the following key factors of the region's investment appeal were identified:

- Geographical location.
- Natural resources.
- Infrastructure.
- Labour resources.
- R&D base.
- Size of the accessible market for consumer goods (B2C market).
- Size of the accessible market for industrial goods (B2B market).

The aggregate indicator of a region's investment potential was obtained as the sum total of investor ratings in relation to a specific region compared to the other regions included in the research, weighed by the specific proportion of this region among all the factors.

- Investors rated the quality of each factor in each of the researched regions on the basis of the current status of these factors, taking into account the impact of anticipated changes, on a scale of one to five, with account taken of the advantages and drawbacks which it has for FDI purposes relative to the corresponding factor in other regions.
- The specific proportion of each of the factors in the overall rating of investment potential by investors represents the share of this rating in the sum total of all the ratings for the different factors in the region.

Barriers for investors

Based on interviews with foreign investors, the following areas have been highlighted as areas where there are barriers to FDI (the specific proportion of each category of barrier is indicated in brackets by degree of importance):

- Administrative and legislative (35%).
- Economic (25%).
- Social and ecological (15%).
- Workforce (25%).

The aggregate level of the barriers for investors was obtained as the sum total of relative ratings of the barriers for each category, compared to other researched regions (on a scale of one to five), weighed by the specific proportion among all categories of barriers.

4. Appendix
Research methodology (5/5)

2 Focus on soft factors.

On the basis of analysis of interviews with foreign investors the key factors which drive their choice of a particular region were identified. Those investment attractiveness factors were indicatively divided into 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, resources) and the ability to influence them is very limited.
- Soft factors are those related to creating or managing perceptions, process efficiency, internal capabilities of the people who form the relevant government agencies, legislation, etc.

Soft factors are more difficult to quantify; however, it is possibly to qualify soft factors as barriers to entry. They lie in the following areas:

- Regional government commitment to FDI;
- Managing expectations;
- Successful experience in implementation of FDI projects;
- Administration process;
- Legal environment;
- Financial and tax incentives.

3 GAP analysis.

- In the interviews foreign investors expressed their expectations. Meeting these expectations could materially enhance the investment attractiveness of a specific region and affect the selection of a region.
- The expectations of investors were benchmarked against current measures being adopted by the regional authorities.
- In areas where there are gaps between the expectations and the results from the measures being implemented based on the results of the research, we provide recommendations on how to eliminate them and attain mutually advantageous cooperation from the perspective of global best practice.