



**Investment climate
in Russia –
Foreign investor
perception**



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Introduction

After a period of moderate growth, Russia's economy slowed in 2013, though the overall macroeconomic situation continued to remain favorable. Developments that took place in 2014 have greatly affected the investment climate in Russia, along with sentiments of foreign investors operating in the country. The biggest blow was dealt by the introduction of sanctions against Russia and a plunge in oil prices that significantly worsened the country's macroeconomic environment, spurred inflation, weakened the national currency, limited access to debt financing, hiked interest rates, led to foreign trade restrictions and complicated life for a number of industries.

Strained international relations and weaker macroeconomic fundamentals have visibly undermined investor confidence: In 2014, the inflow of foreign direct investment to Russia dwindled by 70% to USD 21 billion, a record low since 2006. In the latter half of 2014, the Bank of Russia reported a net outflow of foreign direct investment from the country for the first time since 2005. Experts familiar with foreign investment inflows point to a drop in investment projects initiated and pursued by foreign investors in Russia in 2014 and 2015.

The crisis has uncovered the major challenges that foreign investors face in Russia. The traditional concerns that include unstable regulation and red tape have been aggravated by the unfavorable economic developments, reduced attractiveness of the Russian market, the too complicated business environment and uncertainty over the sustainability of economic measures taken by the government.

Our survey suggests that foreign companies with investments in Russia's real economy are not planning to reduce presence in the country despite the current situation which they describe as unfavorable. Noting also positive developments in Russia's investment climate, including the progress made on National Business Initiative road maps, investors are confident in Russia's economic potential and ready to step up investment in the coming few years.

This report summarizes the main findings from our survey conducted among foreign companies that are members of the Foreign Investment Advisory Council in Russia (FIAC).

Key findings

Foreign companies want policy stability in Russia



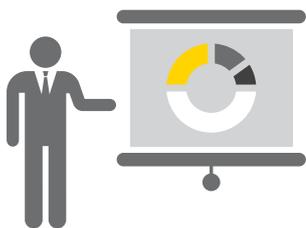
Frequent legislative changes are causing a serious concern among foreign investors. 77% of respondents cite the unstable regulatory environment as a major hurdle for investment. Foreign investors are increasingly calling for a moratorium on the development and enactment of new legislative initiatives which can have a substantial destabilizing impact on the business climate.

Investors are still confident in Russia's economic potential



Around 90% of respondents with operations in Russia describe the country's current economic situation as challenging, expecting the market to lose part of its appeal to foreign investors in the near future. However, 50% of respondents plan to expand their business in Russia as they are optimistic about the future growth prospects for their industry.

The regulatory framework is patchy, but overall falls short of investors' expectations



Tax policies and practices attract little criticism from foreign investors. There have also been significant improvements in customs regulations. However, complicated administrative procedures and technical regulations, combined with the inefficient state apparatus and court system, cause many difficulties for business.

Access to federal government has eased



Many foreign investors complained about the executive authorities' unwillingness to cooperate, slow decision-making and excessive documentation requirements. However, newly introduced mechanisms to drive legislative improvements, enhance government performance and best practices have at least facilitated a dialog between government and business.

Russian partners are willing to learn and deliver a better quality in line with foreign investors' expectations



While mutual trust is still at low levels which is evidenced by an insignificant number of joint projects, foreign partners note positive shifts in prevailing business styles in Russia, which they say are bringing their business relations closer to globally recognized standards.

The local investment climate across regions has greatly improved



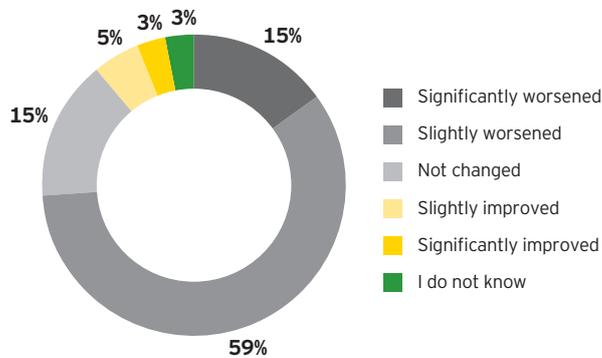
Over 50% of respondents say that regional authorities are directing more efforts to improving the investment climate as compared with a few years ago, and that they are demonstrating a solid commitment to create attractive business conditions for foreign investors.

Economic outlook

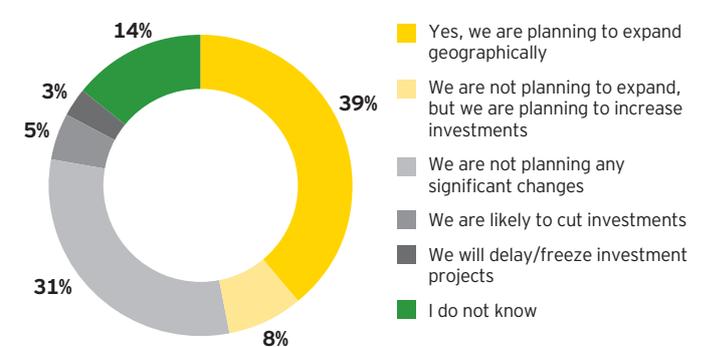
Foreign investors share the opinion that the current economic situation in Russia is unfavorable (92% of respondents). Around 90% of respondents believe that the economic situation has deteriorated over the last year, while only 5% note some positive changes. 59% of respondents consider the effects of the worsening economic situation on the business climate minor and 15% describe them as grave.

Almost a half of respondents (42%) expect the Russian market to lose its appeal to existing and potential foreign investors in the next two years, and only 17% say that the country will become more attractive. However, a significant number of investors plan to geographically expand their presence in the country (39%), or at least maintain it at the current level in the coming two-year period (31%).

? How do you think the business conditions for your company have changed in Russia's new macroeconomic environment?



? Is your company planning to increase its presence in Russia and/or increase investments in the next two years?



Investment plans mostly focus on shifting production to Russia or working closely with local supply chains. When asked about using Russian components and resources, 58% of respondents say that they are considering increasing local content in manufacturing.

With regard to the investment prospects for the Russian market, foreign investors are wary about the ongoing debate over the government's import substitution policy. While ready to continue localizing production in the country, investors are concerned that policy measures will stifle competition and restrict access to the internal market for products made by companies with foreign capital.

Looking forward, investors appear to be largely optimistic: 53% of respondents expect to see significant or moderate growth in their industry. On the other hand, a fourth predict a downturn. The top three industries expected to be most attractive in the next two years include the power industry (44%), pharmaceuticals (39%), and telecommunications (28%).

Perception of Russia's regulatory environment



The regulatory environment remains a key factor that determines the investment attractiveness of Russia.

Respondents point to a number of regulatory improvements that have taken place over the last few years. Among the most important initiatives are the gradual shift toward market economy, the harmonization of legislation within the Customs Union, the introduction of the Federal Contract System, and the simplification of administrative procedures for developers. While the progression of some reforms such as the movement toward market economy principles may be seen as insufficient, respondents remain exceptionally buoyant about the ongoing changes.

Overview of positive and negative regulatory changes

Positive changes	Negative changes
<ul style="list-style-type: none">▶ The adoption of the Customs Union's Customs Code and technical regulations▶ The introduction of electronic documentation systems across operations▶ Clarifications on customs law enforcement▶ The Federal Contract System▶ The Law on Rapid-growth Regions▶ The promotion of long-term contracts▶ Newly introduced property tax incentives for investors▶ Improvements in migration procedures for highly skilled workers▶ The use of financial incentives to support investors	<ul style="list-style-type: none">▶ The Personal Data Protection Law▶ The Law on Foreign Capital Controls in the Media▶ The Law on Undesirable Organizations▶ The Law on the Temporary Agency Work Ban▶ Tighter alcohol sales controls▶ Sharp fluctuations in the refinancing rate▶ Proposed amendments to the commerce law▶ The ban on food imports▶ Restrictions on the participation of foreign companies in government procurement processes

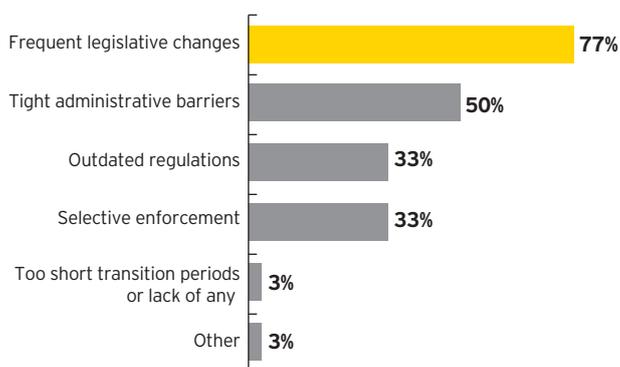


While noting the positive changes, foreign investors are worried about a great number of regulatory issues that they say inhibit Russia's potential to attract foreign direct investment.

They point to systemic problems that should be addressed in order to improve the regulatory climate. These include a lack of coordination between federal-level authorities in the development and the promotion of legislative proposals, both of which place roadblocks on decision-making and hinder the market. The regulatory issues are further exacerbated by the lack of clarifying documents for newly introduced laws and regulations, giving rise to ambiguity and multiple interpretations.

According to the most respondents (77%), the unstable and inconsistent regulatory framework poses the most serious threat to Russia's investment attractiveness. This risk is placed higher on the agenda than tight administrative barriers, including a corruption risk (50% of respondents), selective enforcement (33%), or outdated rules (33%).

Major regulatory hindrances affect Russia's investment climate, including the following:



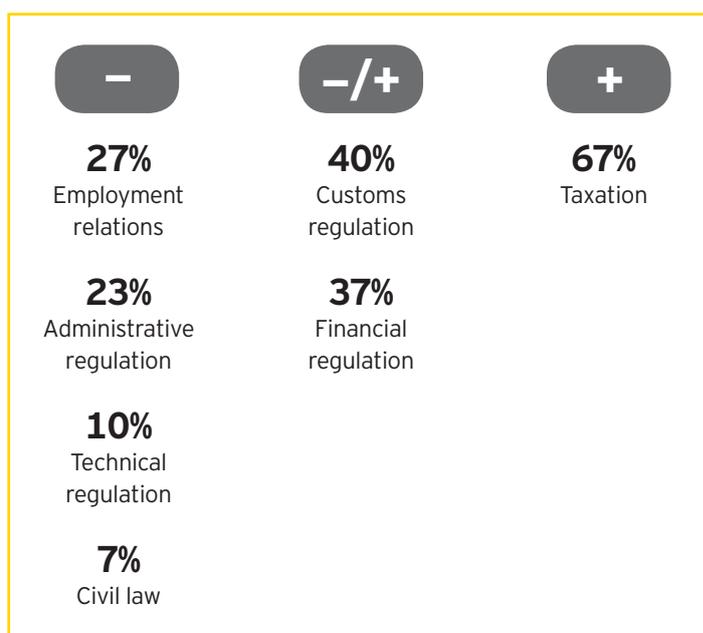
In many cases, legislative initiatives have an adverse impact on business. Respondents say that the authorities are tightening controls instead of clarifying ambiguous provisions or improving the regulation of irregular violations. The changes not only create difficulties for companies, but also drive costs. Investors are calling for consistent and sustainable improvements to make the regulatory framework transparent and easy to understand.

The greatest legal progress made by Russia over the last few years has been in areas such as tax, customs, and finance.

The majority of respondents (67%) describe tax legislation as the most effective and stable regulatory regime. They say that this framework is being brought closer to international standards as Russian companies are increasingly using intentional financial reporting standards. Among negative trends are the introduction of new taxes and quasi taxes that downplay measures designed to ease the tax burden. Many investors express satisfaction with the existing financial and customs regulations (40% and 37%, respectively), stating that the regulations are in line with their expectations.

Technical regulations, labor legislation, and administrative law present the most serious challenges on the regulatory front facing investors.

According to foreign companies, Russia's most advanced regulatory systems include:



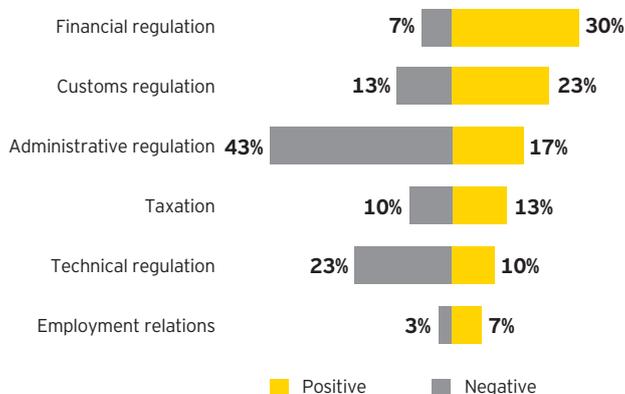
Respondents say that financial and customs regulations have recently seen the most significant improvements in Russia. With regard to the financial framework progress that have a positive impact on business, respondents cite the adoption of regulation in the special evaluation study of working conditions and travel authorization annulment.

Investors also value the adoption of the Customs Union's Customs Code, the introduction of electronic documentation systems across operations, and what they describe as more consistent customs law enforcement.

Administrative law and technical regulations attract the most criticism from investors. With regard to recent changes to administrative law, they mention initiatives such as the personal data protection law, the federal law on water supply and disposal, tighter penalties for a number of civil offenses (including environmental breaches), the media law, and the law on undesirable organizations.

As far as technical regulation is concerned, changes that adversely affect business operations included restricted access of foreign companies to government procurement, enactment of the law on mandatory licensing of waste disposal operation, adoption of the law on vegetation quarantine without any supporting by-laws, and excessively rigid rules for water supply and disposal.

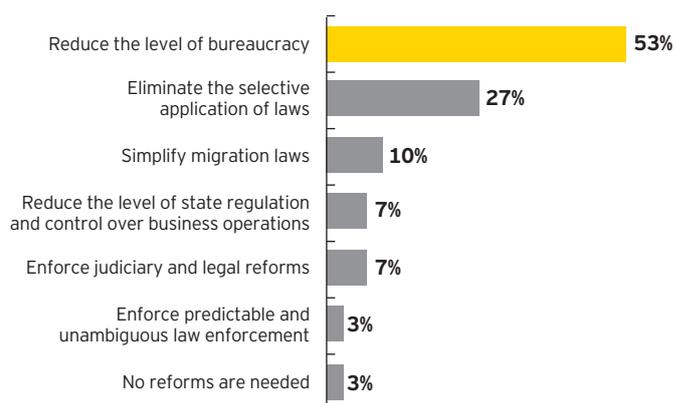
? Indicate the area of legislative regulation where the most significant positive/negative changes are taking place



The representatives of foreign businesses believe that for a tangible improvement of Russia's investment climate to occur, it is important to improve the regulatory environment in the following areas:

- ▶ Increase efforts to reduce the administrative burden by cutting down on bureaucratic procedures. The respondents acknowledge that the Government of the Russian Federation realizes the importance of these tasks and is implementing certain initiatives to improve the situation (such as requiring fewer documents needed to bring a new product to the market). However, these measures are limited in nature and the level of bureaucracy remains high. The procedures for bringing new products to the market should be altered to reduce time wasted during communications between businesses and the government, and to ensure no detriment to quality of the product.
- ▶ Take steps to enhance the transparency and efficiency of laws by removing the selective application of the legal framework and setting up predictable rules for all market players. Legal hurdles and uncertainties allow for multiple interpretations of the same provisions of the law to arise, which may be used for creating artificial barriers. To make the investment process more transparent, hidden demands to investors must be ruled out.
- ▶ Liberalize the migration legislation that helps engage high-skilled expat professionals with global expertise in order to use the knowledge and technologies required to simplify project management in the Russian Federation.
- ▶ Reduce the level of state control over the business of investors: remove obsolete industrial safety regulations, eliminate excessive requirements to raw materials and products, and harmonize national and international standards of raw materials and products.

? Which reforms do you believe the Russian Government needs to pursue in order to improve the legislative environment?



Communication and coordination of efforts with the Russian government authorities

Communication with federal government authorities

The respondents note that the communication with the government authorities needs to be more efficient. Foreign companies indicate the following difficulties that arise when communicating with the federal executive authorities:

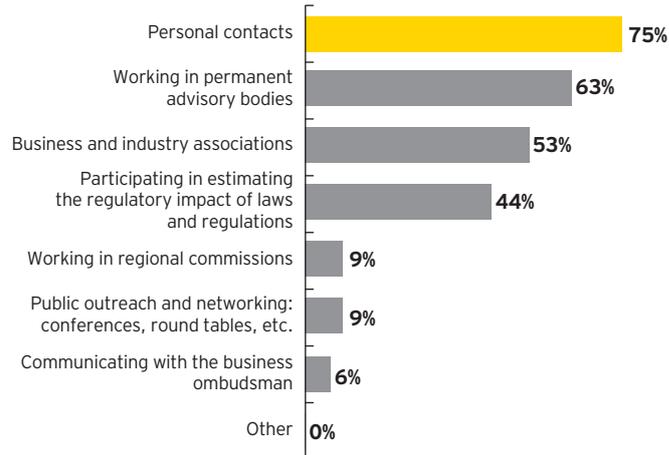
- ▶ Contacts are difficult to establish
- ▶ Lack of public outreach
- ▶ Certain federal executive authorities are reluctant to address issues raised by foreign investors
- ▶ Feedback to requests is insufficient
- ▶ Inconsistent and selective law enforcement
- ▶ Non-transparent decision-making procedures

At the same time, credit is given to existing tools that enable efficient communication with the government authorities with regard to addressing investors' problems. For example, 80% of respondents say that the Foreign Investment Advisory Council meets and exceeds their expectations regarding communication with government authorities, addressing investors' problems, and improving the investment climate.

In addition, foreign companies doubt the necessity of excessive inspections and audits (redundant control and supervisory functions), question whether the inspecting authorities always remain within the limits of their powers, and criticize the excessive amount of bureaucratic requirements. Foreign investors believe that the high level of corruption still requires serious attention.

In order to reduce the adverse effect of these factors, the representatives of foreign companies tend to focus on personal contacts for establishing transparent communication with the government authorities (29%). Other efficient tools are the participation in permanent advisory bodies (24%) and business and industry associations (20%), and the project to estimate the regulatory impact of laws and regulations (17%).

? Which tools of communication between the business and government authorities work best in Russia?





The Regional Investment Standard, along with regional investment attraction ratings introduced by the Agency for Strategic Initiatives, create incentives for improvements and benchmarks for companies considering investing in Russia. According to respondents, the introduction of these practices suggests that the authorities are keen on creating an attractive investment climate and engaging effectively with investors (along with addressing social stability issues).

Excessive centralization of power and the specifics of budget regulation (as far as tax allocation is concerned) impede growing interest in foreign investments in Russian regions.

Investors view Tatarstan as a clear leader among Russian regions in terms of investment attractiveness. The Kaluga and Tula regions are also regarded as attractive regions for investment. As indicated by respondents, the authorities of these regions have put much effort in improving the investment climate, reducing bureaucracy, increasing openness, and creating convenient and attractive infrastructure. Respondents also note that in other regions, the authorities are also ready to change the existing routine. While the command-and-control paradigm still exists in some regions, their authorities are becoming increasingly ready to bend to corporate standards commonly used by Western companies.

The growing interest of regional authorities in attracting foreign investors is seen in how the companies perceive various aspects of business climate. When asked about the level of satisfaction with various elements of the business environment in the region, the factors perceived most positively by the investors are the general attitude of government authorities towards businesses and assistance in overcoming bureaucratic barriers (59% of respondents are fully or to a significant extent satisfied with these aspects).

The equally important critical decision-making factors used to determine whether a region is attractive are size and pattern of development of the consumer market, and the extent to which the region is a business-friendly environment (half of respondents indicated these as key factors).

In response to the question about the problems most frequently encountered while operating in the regions, investors indicated bureaucracy and administrative barriers (34% of respondents indicated that this problem is the most important). Issues such as the quality of transport infrastructure (22%) and availability of sufficiently skilled personnel (16%) still require attention. 16% of respondents provided positive answers. They indicated that no difficulties were encountered during their work at a regional level.





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