



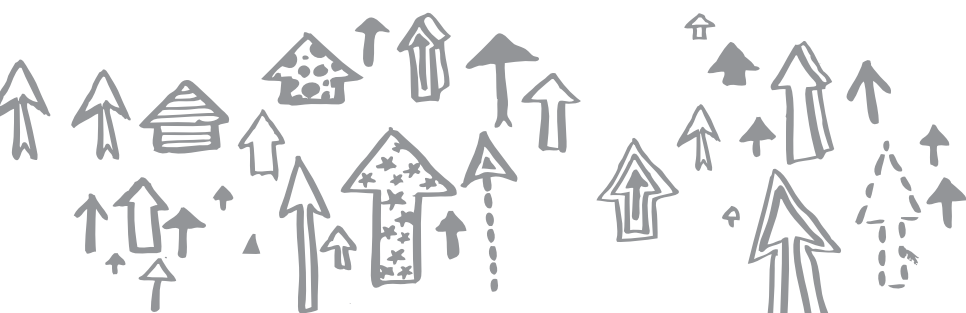
Growing opportunities Russia FDI report

2011



Contents

Foreword	2
Competing in a converging world	
Emerging markets growth	3
The world is converging	3
Russia's true FDI value	
FDI growth returns to Europe	4
Russia ranks fourth in the European league table	4
Moscow is a top 10 European destination for FDI	4
FDI projects in Russia grow steadily	5
The industrial nature of Russia's attractiveness	5
Opportunities and challenges	6
Investors' expectations	
Talent, infrastructure and reform	7
Methodology	
Ernst & Young in Russia	8
Contacts	9



Foreword

The *Russia Foreign Direct Investment (FDI) report* is produced by Ernst & Young. It is based on *Ernst & Young's 2011 European attractiveness survey* results, Ernst & Young's 2011 proprietary European Investment Monitor database and market research.

It provides preliminary insights and analysis that will be further developed in the *Ernst & Young's 2011 Russia attractiveness survey* to be released in the fourth quarter of 2011.

Key findings on Russia's FDI attractiveness

1. The world is becoming more competitive. In 2005, the most attractive region scored 63% and the least attractive scored 6%. In 2011, the spread was between 38% and 11%.
2. From 2005 on, Russia's investment appeal steadily grew, reaching its highest level (doubling) by the start of the world crisis. The subsequent negative trends can be overcome by the course Russia has taken toward modernization and innovative development of the economy.
3. Russia is the fourth largest FDI destination in Europe.
4. The number of FDI projects in Russia grew by 18% in 2010, reaching a total of over 200 announcements.
5. Moscow is ranked 7th in the top 10 cities for FDI in Europe.
6. FDI in R&D is still developing in Russia and accounts for 2% of total FDI projects in 2010, compared with 8% in Europe.
7. 33% of investors are planning to expand or establish new operations in Europe.
8. Investors expect Russia to develop its attractiveness by investing in talent, infrastructure and technology.

Competing in a converging world

Emerging markets growth

Europe's share of actual FDI inflows (in US\$b) was 26% (first place) in 2010,¹ which is equal to its share of world GDP. However, its recovery remains mixed and tentative.

In 2010, emerging markets collectively represented more than half of FDI globally.² The growth in the value of FDI in China was sustained because investors there are benefiting from stable returns on investment. From 2005 on, Russia's investment appeal steadily grew, reaching its highest level (doubling) by the start of the world crisis. The subsequent negative trends can be overcome by the course Russia has taken toward modernization and innovative development of the economy.

When deciding where to invest in 2011, global investors considered the critical factors to be: transport and infrastructure (63%), telecommunications infrastructure (62%) and the transparency of the political, legal and regulatory environments (62%).

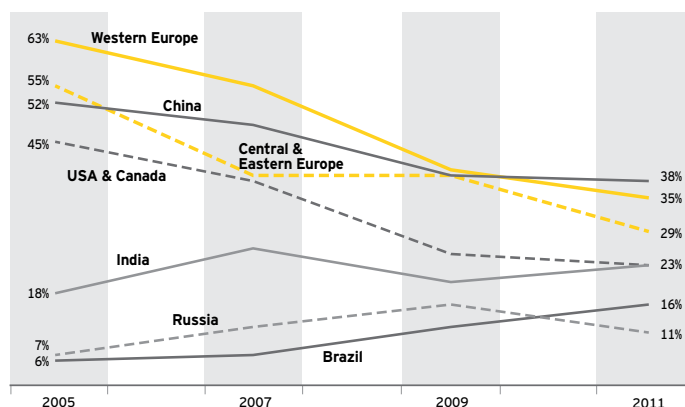
After the global economic crisis, the gap between growth rates in emerging and developed economies widened, as rapid growth in key developing markets has driven the global recovery. In 2010, GDP in China grew by 10.3%, in India by 10.4%, in Brazil by 7.5% and in Russia by 4%. The European Union grew by 1.8%.³ The divergent rates of investment growth between emerging and developed markets reflect a shift in the global economy. The emerging markets are an increasingly important source of growth, as they offer a growing number of accessible consumers to investors. This rebalancing offers more investment opportunities and favors large emerging economies.

The world is converging

In 2011, no region was a significant leader in terms of perceived attractiveness. This is illustrated by the difference in the spread of scores in 2005 compared with 2011. In 2005, the most attractive region scored 63% and the least attractive scored 6%. In 2011, the spread was between 38% and 11%, reflecting a converging world in which emerging markets have become increasingly attractive FDI destinations.

Investors see China as the world's most attractive investment region in 2011, with a score of 38%, and Europe ranks a close second, with a score of 35%.

What are the most attractive places in which to establish operations?



Respondents gave three responses (this graph shows responses since 2005)
Total respondents: 812
Source: *European Attractiveness survey 2011*

The graph above reveals that the attractiveness of world regions is converging. Yesterday's leading regions – Western Europe, Central and Eastern Europe and North America – are now only contenders, while rapid growth economies are increasingly dominant. Although Russia is now participating in this new economy, it lacks visibility for investors.

But the outlook for the Russian economy is positive; whereas Western Europe, a former FDI leader, has lost 28 percentage points in its attractiveness score, Russia's attractiveness has doubled since 2005. Although investors remain cautious, given the global economic crisis, investment projects have begun to flow again. Russia's economic fundamentals stabilized in 2010 and its economy grew by 4%.⁴ Furthermore, in 2010, the value of FDI into Russia remained level, at US\$37 b. This is compared with a steep decline in 2009.⁵

1. "Global and Regional FDI Trends in 2010," Global Investment Trends Monitor, UNCTAD, 17 January 2011.
2. "Global and Regional FDI Trends in 2010," Global Investment Trends Monitor, UNCTAD, 17 January 2011.
3. *IMF World Economic Outlook (WEO)*, April 2011.
4. *IMF World Economic Outlook (WEO)*, April 2011.
5. *Doing Business in Russia*, Ernst & Young, February 2011.

Russia's true FDI value

FDI growth returns to Europe

In 2010, the number of FDI projects rose by 14% across the 44 countries in Europe (including Russia), up 10% from 2009, marking a recovery in European investment activities.

The greatest share of FDI projects in Europe came from the automotive, business services and software sectors, as well as innovation activities (R&D).

The UK and France remain FDI leaders in Europe, but they are losing market share to more competitive countries such as Germany, Poland and Russia.

The US, Germany and the UK remain the leading source countries for FDI projects in Europe, while China and India provide 6% of all FDI projects in the region.

Russia ranks fourth in the European league table

In 2010, Russia was the fourth largest recipient of FDI in Europe with over 200 FDI projects, an increase of 18% on 2009. Despite Russia's clear potential in the European FDI market, its market share of projects stagnated at 5% between 2009 and 2010.

FDI in Europe by country

Rank	Country	FDI projects 2010	Growth 2009-10	Market share	Jobs created
1	United Kingdom	728	7%	19%	21,209
2	France	562	6%	15%	14,922
3	Germany	560	34%	15%	12,044
4	Russia	201	18%	5%	8,058
5	Spain	169	-2%	4%	7,723
6	Belgium	159	9%	4%	4,010
7	Poland	143	40%	4%	12,366
8	Netherlands	115	6%	3%	958
9	Ireland	114	36%	3%	5,785
10	Italy	103	3%	3%	627
	Other	903	N/A	24%	49,635
	Total	3,757	14%	100%	137,337

Source: Ernst & Young European Investment Monitor, 2011.

Moscow is a top 10 European destination for FDI

Moscow ranks 7th out of the top 10 cities* for FDI projects. Investors see Moscow as a major destination for FDI in Europe and viable competition for European FDI hubs. It is moving closer in rank to the European leaders, London and Paris, which have cultivated their attractiveness to foreign investors over many decades.

Moscow's attractiveness to foreign investors is further enhanced by the presence of special economic zones within the region: Zelenograd and Dubna are located in the Moscow area and offer investors an appealing combination of corporate tax incentives, easy access to real estate and lower VAT on imports.⁶

Top cities for FDI in Europe

Rank	City	FDI projects 2010	Growth 2009-10
1	Greater London (London)	289	9%
2	Ile de France (Paris)	162	-5%
3	Rhone Alps (Lyon)	122	51%
4	Dusseldorf (Dusseldorf)	73	0%
5	Autonomous Community of Madrid (Madrid)	71	8%
6	Darmstadt (Frankfurt)	68	31%
7	Moscow (Moscow)	65	20%
8	County of Dublin (Dublin)	62	35%
9	Lombardy (Milan)	55	104%
10	Antwerp Province (Antwerp)	55	8%

Source: Ernst & Young European Investment Monitor, 2011

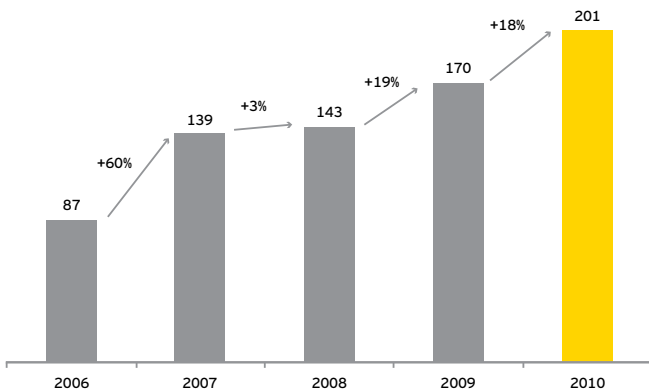
*City includes urban regions, defined by Ernst & Young's analysis of urban regions based on Nuts 2 and Nuts 3 classification

6. Invest in Russia, http://invest.gov.ru/en/government_support/, accessed 28 April 2011.

FDI projects in Russia grow steadily

Although the value of FDI into Russia fluctuated significantly, especially during the global economic crisis of 2008-09, Russia has seen a steady increase in FDI projects since 2006: they have multiplied by 2.3 from 2006 to 2010. In addition, during this period, Europe experienced highly volatile FDI levels, swinging from -11% to +14%, while FDI growth into Russia only slowed and was always positive.

FDI growth in Russia by investment project



Source: Ernst & Young European Investment Monitor, 2011.

The industrial nature of Russia's attractiveness

Investors are attracted by Russia's industrial potential and, as such, they have supported its growth. 54% of the total FDI in Russia in 2010 was used to create projects in the Russian manufacturing sector.⁷ In particular, there was significant growth of FDI in the automotive sector in 2009-10. This can be explained in part by a government policy to facilitate automotive production. Other industrial sectors that attracted significant investment in Russia were the manufacturing of mineral products, and the food industry, the chemicals, logistics and equipment sectors.

FDI in Russia by business sector

Rank	Sector	FDI projects 2010	Growth 2009-10	Market share
1	Automotive	29	107%	14%
2	Non-metallic mineral products	17	13%	8%
3	Food	16	-36%	8%
4	Chemicals	15	0%	7%
5	Machinery and equipment	13	-43%	6%
6	Logistics	12	9%	6%
7	Business services	11	-27%	5%
8	Other transport equipment	11	1000%	5%
9	Electrical	9	800%	4%
10	Plastic and rubber	8	100%	4%
	Other	60	N/A	30%
	Total	201	18%	100%

Source: Ernst & Young European Investment Monitor, 2011.

Russia is a major global energy exporter with a growing industrial sector.

Two-thirds of Russia's export receipts come from oil and gas,⁸ demonstrating the importance of the extractive industries sector in the Russian economy. However, the economic dominance of the natural resources sector has been changing and in 2010, manufacturing provided 60% of aggregate GDP growth in Russia. Russian manufacturing grew by 13.4% in 2010, while Russian extractive industries (natural resources) grew by 4.8%.⁹ Although energy has dominated the Russian economy since the fall of the Soviet Union, industrial production has begun to catch up, providing a more stable and skill-intensive basis for economic growth. These factors combine to create a significant opportunity for Russia to develop a world-leading science-and knowledge-based economy.

7. Ernst & Young European Investment Monitor 2011

8. *Doing Business in Russia*, Ernst & Young, February 2011.

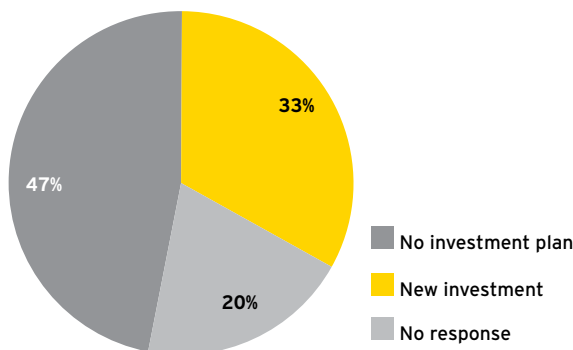
9. *Russian Economic Report*, The World Bank in Russia, March 2011.

Russia's true FDI value

Opportunities and challenges

33% of global leaders say they intend to expand existing operations or establish new operations in the enlarged Europe in 2011.

What are your investment plans over the next year in Europe?



Total respondents: 812.

Source: European attractiveness survey 2011

The total number of FDI projects in Russia is expected to grow by 16% in 2011, representing an increase in the value of FDI to US\$ 43 b.¹⁰

FDI opportunities will come from knowledge-intensive sectors such as business services, software and R&D, which account for the bulk of FDI in Europe, but are currently underinvested in Russia.

- ▶ Business services: a mainstay of the European economy, representing 25% of FDI projects; however, they declined by 27% in Russia.
- ▶ Software: creation, development and maintenance activities represent a total of 15% of FDI projects in Europe; however, they do not rank in the top 10 for FDI in Russia.
- ▶ R&D: 8% of FDI projects in Europe, but only 2% of FDI projects in Russia.

Russia needs to harmonize its economy, continuing to maintain its pre-eminence in natural resource extraction and its strength in industrial production, at the same time, developing its capacity as a knowledge-based economy with a strong service sector. The first step toward the development of a service sector is the creation of domestic demand.

Currently, domestic demand in Russia is low and, as a result, Russian companies tend to reduce investment in this area. If the Government were to offer fiscal incentives to Russian companies that modernize their processes and invest more in technology and R&D, this would help to increase internal demand and boost Russia's service sector.¹¹

Russia has the capacity to be a world leader in innovation; it can achieve this by encouraging its highly trained scientists to develop the companies of tomorrow. Building on the potential of high tech clusters such as Skolkovo, Russia could expand the model across the country, drawing inspiration from the innovation development pioneered by other countries.¹²

Russia could develop its economy via increased internal consumption, the use of high tech clusters to develop innovation, as well as encouragement for businesses to modernize, for instance, by adopting the new technology solutions that would be developed in the clusters. Attracting business knowledge and investment to finance these clusters is one possible means of supporting Russia's innovation and service sector development.

10. *Doing Business in Russia*, Ernst & Young, February 2011.

11. *Russia's Modernization and Innovation from the Perspective of Foreign Investors*, FIAC White Paper High Tech & Telecom Working Group, October 2010.

12. *Russia's Modernization and Innovation from the Perspective of Foreign Investors*, FIAC White Paper High Tech & Telecom Working Group, October 2010.

Investors' expectations

Talent, infrastructure and reform

Investors already view Russia as a leader in natural resource production and as a country that offers many industrial opportunities. However, natural resources are a finite and limited source of revenue, and the full economic development of a country cannot rely on industrial production alone. Russia needs to develop new sources of growth and economic attractiveness to increase its share of world FDI. To develop a strong new service sector and knowledge-based economy, Russia needs to foster talent and invest in new infrastructure and reform.

- ▶ **Talent:** Russia retains the legacy of the vast human capital developed during the Soviet era, especially in its world-class science programs. However, these science programs have not focused on the marketability of their research.¹³ Instead, highly skilled students have tended to leave Russia and seek their fortune in world-renowned technology locations such as Silicon Valley in the US. In particular, many computer science graduates leave Russia to pursue economic opportunities elsewhere.¹⁴ Russia needs to nurture its internal creative capital and support its scientists through the effective marketing of their inventions. In this way, Russia can develop a knowledge economy that will help to create economic growth.
- ▶ **Infrastructure:** Investment in infrastructure will help Russia to create innovative products. Specifically, the establishment of more high tech clusters like Skolkovo will develop the critical mass that is necessary to support innovation and retain scientists. Russia needs to demonstrate that it has a credible innovation policy and that it is capable of developing enough technology centers across the country to boost the sector.

- ▶ **Reform:** The Russian Government has a good record of economic reform. However, onerous regulations, administrative barriers and lack of transparency limit Russia's attractiveness and deter many potential investors from investing in its service sector. Larger companies have been willing to invest in working through the Russian bureaucracy; but many smaller, and often highly innovative, companies do not have the resources to deal with the lengthy process of investing in Russia and will simply look elsewhere.¹⁵ Russia needs to continue reforming its economy and simplifying the regulation for new investors who want to enter the market. Greater access to the Russian economy will encourage more companies to benefit from its rich human capital and profit from the emerging consumer marketplace.

13. *Russia's Modernization and Innovation from the Perspective of Foreign Investors*, FIAC White Paper High Tech & Telecom Working Group, October 2010.

14. Charles Clover, *High-tech project raises awareness*, Financial Times, 1 October 2010.

15. *Russia's Modernization and Innovation from the Perspective of Foreign Investors*, FIAC White Paper High Tech & Telecom Working Group, October 2010.

Methodology

Ernst & Young's 2011 European attractiveness survey is based on a twofold, original methodology that reflects:

1 The "perceived" attractiveness of the extended Europe (including Russia) and its competitors by foreign investors.

We define the attractiveness of a location as a combination of image, investors' confidence and the perception of a country or area's ability to provide the most competitive benefits for FDI. The field research was conducted by Institute CSA in January and February 2011, via telephone interviews, based on a representative panel of 812 international decision-makers.

2 The "real" attractiveness of the extended Europe (including Russia) for foreign investors. Our evaluation of the reality of FDI in Europe is based on Ernst & Young's European Investment Monitor. This unique database tracks FDI projects that have resulted in new facilities and the creation of new jobs. By excluding portfolio investments and M&A, it shows the reality of investment in manufacturing or services operations by foreign companies across the continent.

Ernst & Young in Russia

Ernst & Young was the first professional services organization to establish operations in Russia in 1989. Our Russian practice has 2,400 employees working in eight offices located in Moscow, St. Petersburg, Ekaterinburg, Novosibirsk, Togliatti, Kazan, Krasnodar and Yuzhno-Sakhalinsk.

Ernst & Young is dedicated to helping its clients identify and capitalize on business opportunities throughout Russia and the world. Our key market sectors are: financial services; retail and consumer products; industrial products; energy; technology and communications; government, real estate, transportation and infrastructure.

Our professionals are recognized for their leadership, know-how and understanding of our clients' business. In more than 20 years in Russia, we have provided critical information and resources to improve business performance and profitability.

Country and institutional development

Ernst & Young actively supports the development of the institutions and economics where we operate. We participate and support the Foreign Investment Advisory Councils (FIAC) in Russia, where Ernst & Young co-chairs with the Prime Minister of the Russian Government.

Ernst & Young has also demonstrated its leadership in the Russian business community with the Russian Union of Industrialists and Entrepreneurs, Association of Russian Banks, International Tax and Investment Center, Moscow International Business Association, Association of European Businesses and the American Chamber of Commerce, and by interaction with Russian legislative and ministerial processes affecting business.

Our clients

We know that growing markets require innovative thinking and evolving practices for businesses to succeed. Many leading companies in Russia and the CIS have chosen Ernst & Young to advise them on the most demanding aspects of the fast-evolving business climate. Ernst & Young provides audit services to a large number of Russian and CIS companies listed on Forbes Global 2000.

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