KCS Country Risk & Threat Advisory

KCS Group Europe
Risk & Threat Advisory Paper

Political Risk Advisory Briefing: Russia
November 2019

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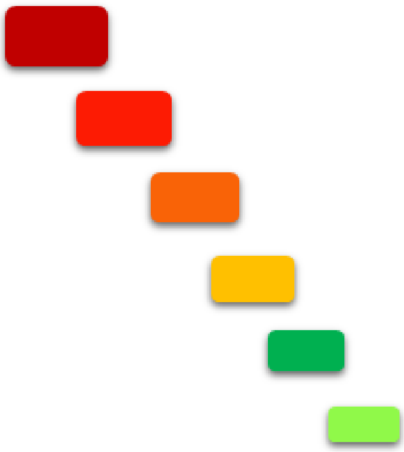
The Investment Environment and Challenges of Doing Business

Country:	Russia
Population:	142,112,776 (July 2018 est.)
Source:	CIA World Factbook

Russia has a Risk Rating of 5.

6	**Very High**	The assorted threats described in the report are almost certain to have a derogatory effect.
5	**High**	The threats are extremely likely to negatively affect the business.
4	**Very Possible**	There is a strong likelihood of problems arising in this country.
3	**Possible**	There is a fair chance of problems arising in this country.
2	**Low**	There is a low likelihood of any threats impacting business.
1	**Very Low**	There are virtually no impediments to successful business in this country.



Putin's Russia – A Tale of Two Decades

This year marks the twentieth anniversary of President Vladimir Putin's rule: for 16 of the last 20 years he has served as President of the Russian Federation (currently on his fourth and final presidential term, unless changes are made to the constitution, not for the first time), whilst for four years (2008-12) he served as prime minister (as well as for five months in 1999). He continues to be, without doubt, the central figure and most powerful person in the Russian political and economic system.

In the first decade of his rule (1999-2008), Putin presided over unprecedented economic growth, supported by high oil prices, with real GDP growth of 95% and a doubling of per capita GDP. The second decade of the Putin administration has been far less economically successful: after outperforming emerging market peers in the 2000s, Russia's growth profile weakened materially, particularly from 2014 onwards. This was primarily driven by the "double whammy" of US / EU imposed sanctions – following Russia's annexation of Crimea in March 2014 – and the precipitous drop in oil prices in the second half of 2014.

Subsequent rounds of sanctions, geopolitical tensions and the ongoing threat of further material sanctions being imposed have contributed to an environment of uncertainty, which has been a brake on both domestic and foreign private investment.

In 2015, Russia entered a recession, with GDP contracting 2.3% in real terms, followed by anaemic growth averaging 1.4% *per annum* in 2016-18 and projected growth (based on IMF data) of 1.1% in 2019. According to official statistics, real disposable incomes have fallen in each of the past five years (2014-18).

On the positive side, the Russian Government continued to pursue sound macroeconomic and prudent fiscal policies, bringing annual CPI inflation below the targeted 4% and strengthening banking sector oversight. In February 2019, Moody's was the last of the major rating agencies to restore Russia's sovereign credit rating to investment grade.

Following re-election, Putin issued a decree in May 2018, setting out a programme of ambitious development objectives for his six-year presidential term. These include reinvigorating the economy, halving poverty and extending life expectancy. These objectives have been embedded in 13 national projects (further broken down into more than 70 sub-projects), envisaging a significant increase in public spending on infrastructure, health and education.

Public sector spending on these national projects is expected to be a key driver in lifting real GDP growth to 1.9% in 2020. Furthermore, the Russian Government has announced its so-called “regulatory guillotine” initiative to reduce the regulatory burden, cut red tape and improve the business environment.

However, in the absence of deeper structural reforms, the IMF projects only moderate real GDP growth going forward of *circa* 2% in 2020-23 and *circa* 1.8% from 2024 onwards. Key structural reforms include tackling widespread corruption and institutional weaknesses, reducing the state’s presence in the economy, cutting excessive regulation and improving infrastructure.

Corruption & Cronyism Endure

In the World Bank’s 2019 Ease of Doing Business survey, Russia ranked 31st out of 190 economies, having made significant progress made over the past half-decade: in 2014/15, the country climbed 30 places to 62nd position, steadily improving thereafter to its current ranking. Russia, with a 2019 score of 77.37 is comfortably above the regional average for Europe and Central Asia of 72.34. It also leads the BRIC pack, with Brazil ranking 109th, India 77th and China 46th in the 2019 survey.

However, despite various anti-corruption campaigns, corruption remains endemic, including at the highest levels of government and of the Putin administration. According to the most recent Transparency International Corruption Perceptions Index, Russia ranked 138th out of 180 countries (dropping three places compared to the previous year). It scored 28 out of a maximum 100, below the average for the Eastern Europe and Central Asia region of 35.

In December 2018, Russia’s long-serving Prosecutor General Yuri Chaika reported 7,800 convictions for corruption during the course of 2018, including of 837 law enforcement officials, 63 elected officials at the sub-federal level, and 606 federal, regional, and municipal officials.

Recent high-profile cases include Colonel Kirill Cherkalin, head of the banking sector oversight team in the economic security department of Russian’s domestic intelligence service (the FSB), who was arrested on bribery charges in May 2019; following his arrest, *circa* USD$180 million in cash and jewellery was found in his apartment and other properties. In recent years, there have been arrests and convictions of government ministers (e.g. former Economy Minister Alexei Ulyukayev in 2017), regional governors, other senior state officials and prominent businessmen.

However, given the well-documented evidence of corruption across the ruling elite, compiled by anti-corruption campaigner and opposition politician Alexey Navalny among others, including within Putin's circle, the arrests and convictions to date look less like a systematic crackdown and more politically motivated, or the product of inter-agency rivalries, conflicts between elite groups etc.

Russia's legal system remains strongly weighted in favour of the state, leaving investors with limited recourse in legal disputes with the government. In addition, well-connected businessmen are able to manipulate the court system in order to resolve their business disputes.

FDI inflows into Russia have been modest in the past five years, averaging 1.3% of GDP *per annum* over the period 2014-18. In the previous five-year period (2009-13), they averaged 2.8% of GDP *per annum*. However, the peak period was the five years running up to the global financial crisis (2004-08) when average annual FDI inflows were 3.4% of GDP.

Case Studies

Below, we briefly present two cases that highlight some of the challenges which foreign investors face in doing business in Russia – the cases of: (1) Baring Vostok Capital Partners and its investment in Vostochnii Bank; and (2) BP's Russian joint venture (2003-12), TNK-BP.

Baring Vostok Capital Partners

Baring Vostok Capital Partners (BVCP), launched in 1994, is one of the largest private equity funds in Russia / the CIS, having invested *circa* USD$3 billion into 80 companies in Russia and other CIS countries, including as an early investor into Russia's most successful tech company, Yandex. BVCP tends to avoid politically sensitive sectors in favour of tech, financial services and consumer goods companies. In February 2019, BVCP's founder, US citizen Michael Calvey, was arrested on fraud charges and held in pre-trial detention, along with several colleagues, becoming the most prominent Western businessman to be incarcerated in post-Soviet Russia (although he was subsequently released to house arrest).

The case stems from a dispute that BVCP, as the majority shareholder of a Top 30 Russian retail and corporate lender, Vostochnii Bank, had with its key Russian minority shareholders. Prosecutors alleged , based on a complaint filed to the FSB by minority shareholder Sherzod Yusupov, that Calvey and associates had defrauded the bank of *circa* USD$40 million, asserting that the valuation of collateral transferred to the bank when a BVCP-related party defaulted on a loan had been greatly inflated.

Prior to this, BVCP had accused the key minority shareholders, Artyom Avetisyan and Yusupov, of asset-stripping to the tune of USD$300 million another bank (Uniastrum Bank), which they owned ahead of it being merged with Vostochnii Bank in 2017. It is alleged that the asset-stripping transactions occurred between completion of due diligence by BVCP, and its advisors, and the signing of the merger agreement. In April 2018, BVCP initiated arbitration at the London Court of International Arbitration (LCIA), seeking US$300 million in compensation.

Furthermore, as part of the deal, BVCP had granted Avetisyan an option to acquire an additional 9.9% in the bank which, if exercised, would enable the minority shareholder group to gain majority control of Vostochnii. After the asset-stripping transactions came to light, BVCP sought to prevent the option from being exercised until they had received compensation.

Avetisyan reportedly used his connections in the Putin administration and within the FSB to initiate a case against Calvey and associates. This resulted in them being held in pre-trial detention, both to put pressure on BVCP to abandon its LCIA arbitration and to accelerate gaining majority control of the bank.

Although not yet resolved, this case clearly sends a strongly negative message to foreign investors. If an experienced foreign investor in Russia can be held in pre-trial detention over a commercial dispute like this (on charges that look questionable), it suggests the Russian authorities are not particularly concerned about attracting FDI into the country.

However, BVCP could also have done more to minimise the potential risks in preparing for this deal. There are three main lessons that come out of this conflict: (1) choose your partners carefully and perform detailed background / reputational checks; (2) write into the deal documentation, thorough legal protections, to guard against situations such as pre-merger asset-stripping; and (3) avoid committing upfront to an option which may transfer control over the company or bank to the other party.

TNK-BP: Risk vs Reward

In June 2003, a deal was signed establishing Russia's third largest oil company, TNK-BP – a joint venture between BP and Alfa-Access-Renova (AAR), a consortium of Soviet born tycoons led by Mikhail Fridman. It was a 50:50 joint venture, with neither party holding control. BP had attempted to negotiate the acquisition of a 51% shareholding but had been blocked.

Soon after the deal was done, tensions started to build up due to diverging views on strategy.

In 2008, the shareholder dispute entered the public domain, with TNK-BP paralysed by labour inspections and audits, whilst CEO Bob Dudley had to leave Russia citing a campaign of “sustained harassment” against him, all of which was allegedly instigated by the well-connected Russian partners. Under the terms of a “peace deal” in 2009, BP effectively ceded operational control over the joint venture to AAR, with Bob Dudley stepping down as CEO and AAR gaining the right to appoint his successor.

After some further conflicts between the shareholders, in 2012 both BP and AAR exited, selling out to Russian oil major Rosneft. Although it had not been a particularly pleasant journey, it was one of the most lucrative investments in BP’s history. BP had earned US$19 billion in dividends over TNK-BP’s almost 10-year life and received US$12.5 billion in cash and a *circa* 20% stake in Rosneft upon exit, all from an initial outlay of US$7.5 billion in 2003.

This case highlights the potential risks of entering a joint venture where the foreign investor does not have control, although BP understood from the outset that control would not be possible for political reasons.

Nonetheless, BP made a number of unnecessary mistakes which could have been avoided if they had done their homework properly with regards to better understanding their Russian partners and the environment in which they were operating.

Other Market Entry Issues

With regards to teaming up with an appropriate local Russian partner, besides full general due diligence, background checks, reputational scrutiny etc, it is very important to assess the risk of US or EU sanctions being imposed upon a potential partner.

APPENDIX

GREY AREA DYNAMICS

Over the years, KCS has made it their business to find workable solutions to impossible problems. To do this, KCS has sought to establish clearly the intelligence gap between perception and reality.

In today's market where terrorism, organised crime, cybercrime and government sponsored cyber espionage and war appear to confront us daily, we need reliable tools to identify the risks well in advance. It was for these reasons that KCS created and developed the analysis of risk by Grey Area Dynamics or GAD's, as they are often referred.

GAD's are all the risks, weakness and threats that will, at one time or another, interfere, disrupt or at worst close down businesses. In the projects and work in which KCS have been involved in all over the world, it has been evident that the GAD's identified, can and do kill. This method of risk assessment and measurement goes well beyond standard due diligence and is a collective description of factors, which can be passive and non-passive, legal and illegal. Because GAD's are difficult to quantify or assess from a purely economic viewpoint, these considerations do not normally feature in most credit ratings, investment and banking reports, which focus only on sovereign risk.

The main categories of Grey Area Dynamics usually encountered are:

Passive/Legal

- Language & Dialects
- Local Customs & Traditions
- Local Staff – motivation and training
- Tribalism and Integration
- Cultural & Local sentiment
- Regulations, Taxes and Duties
- Currency & Capital exposure – payment methods and banking practice
- Environmental Hazards
- Pressure Groups
- Media Relations

Non-Passive/Legal

- Industrial & Labour Relations

- Absence or effectiveness of Legal Safeguards
- Government Policy and Nationalisation
- Overt and disguised/beneficial ownership
- Bureaucracy and Local Government
- Public or Media hostility

Passive/Illegal

- Bribery & Corruption
- Vested Interests and Cronyism
- Patronage
- Product diversion
- Parallel Trading
- Hidden Barriers to entry

Non-Passive/Illegal

- Counterfeit & Fraud
- Pilferage
- Unfair Market Competition
- Product Piracy
- Ethics and Corporate Espionage
- Organised Crime
- Threats to physical assets
- Kidnap & Extortion
- Religious Extremism
- Terrorism
- Civil Unrest
- Product Contamination

For a risk assessment to be thorough, it must encompass the potential for a broad array of economic, political and business situations that might affect a business venture. Evaluations limited just to political issues or financial factors may be completely misleading.

The degree of severity of a risk portfolio will also depend on the origin of the investing entity; for example, European companies often face different risk profiles to American corporations considering the same investment opportunity.

Grey Area Dynamics pose a challenge of diagnosis[1]. The key to avoiding problems before they occur or solving them after they have begun to take a toll on performance, lies in their early identification and evaluation. Ignoring the impact of GAD's can be a costly business.

[1] KCS Group Europe won the European Service Provider of the Year, 1999-2000 at the European Risk Management Awards magazine International Risk Management for their work on GAD's. In 2004, the company won an award for Product of the Year from StrategicRisk.