

Russia – Emerging Economic Power

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 **ERNST & YOUNG**

Quality In Everything We Do

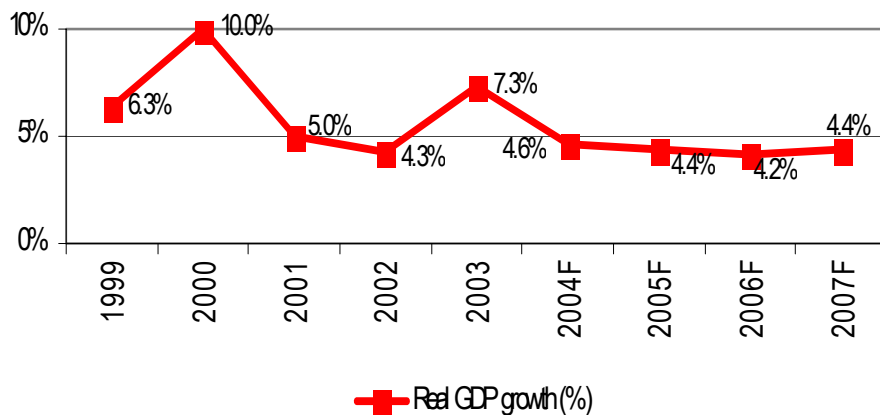
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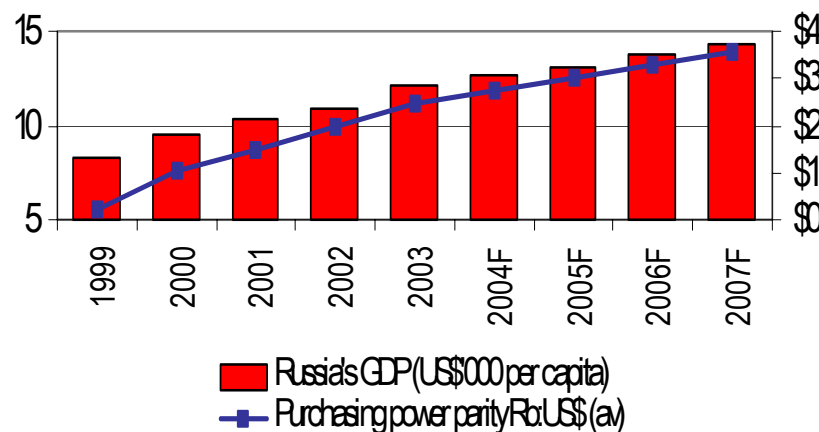
The economy keeps growing faster than expected...

- Devaluation and investment catalyzed **growth surge in 1999-2001**
- **High oil prices** support continued growth
- Domestic consumption surge, as seen in retail and other sectors

Russia GDP
Year-on-Year Change

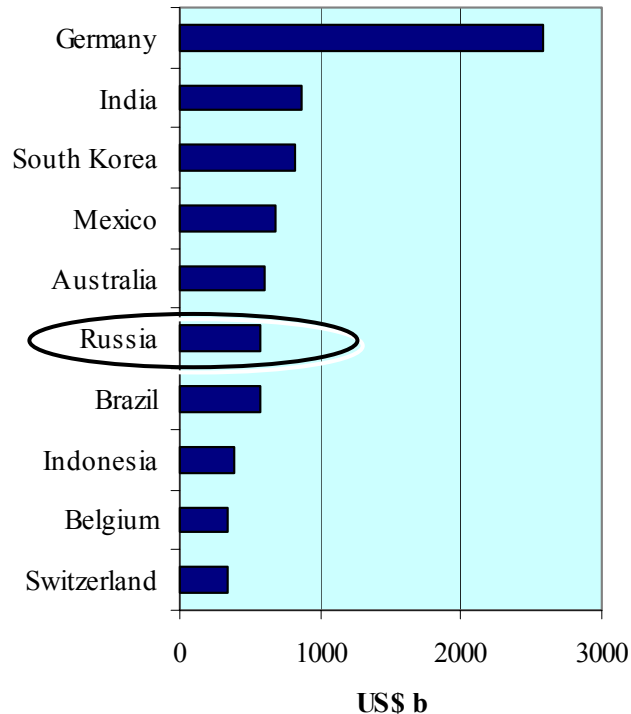


Russia GDP
Nominal & PPP (US\$ '000 per capita)



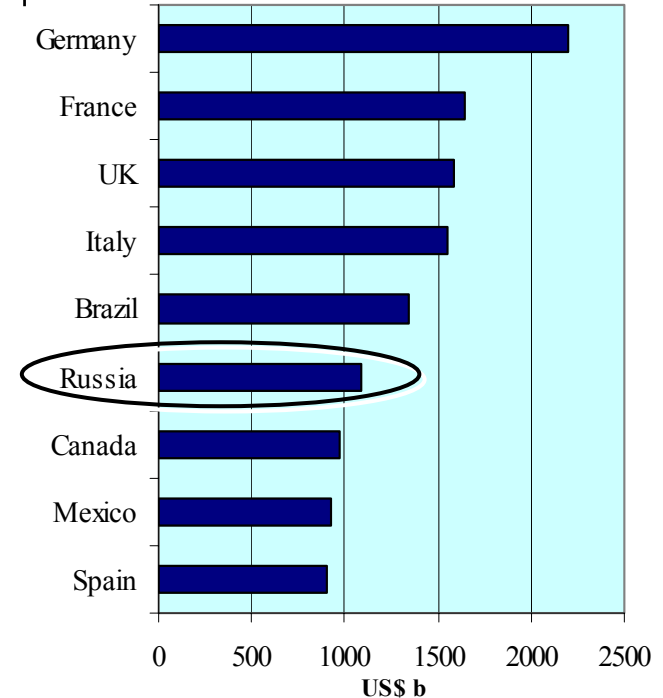
Russia is the 10th largest economy in PPP terms...

Russia's peer group (nominal GDP, 2008F)



Russia expected to overtake Brazil by 2008 and become the 4th largest emerging economy

US, China, India, Japan ↑ Russia's peer group (PPP terms, 2003)

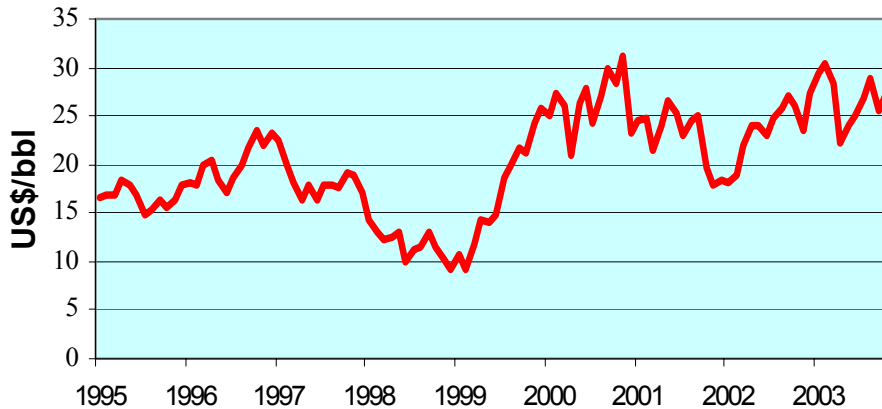


On a Purchase Power Parity (PPP) basis, Russia is already the 10th largest global economy

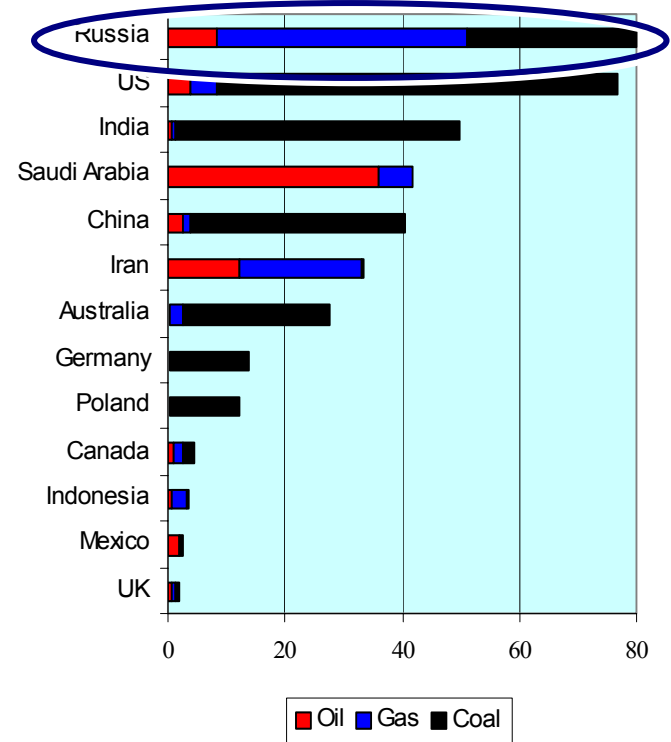
Russia is rich in resources, and trying to leverage this and otherwise diversify for the future

The Russian economy, anchored by substantial **energy resources** is poised for continued GDP growth, even higher than 4-5% if oil & gas prices remain relatively high

Urals oil, US\$ per bbl, monthly avg

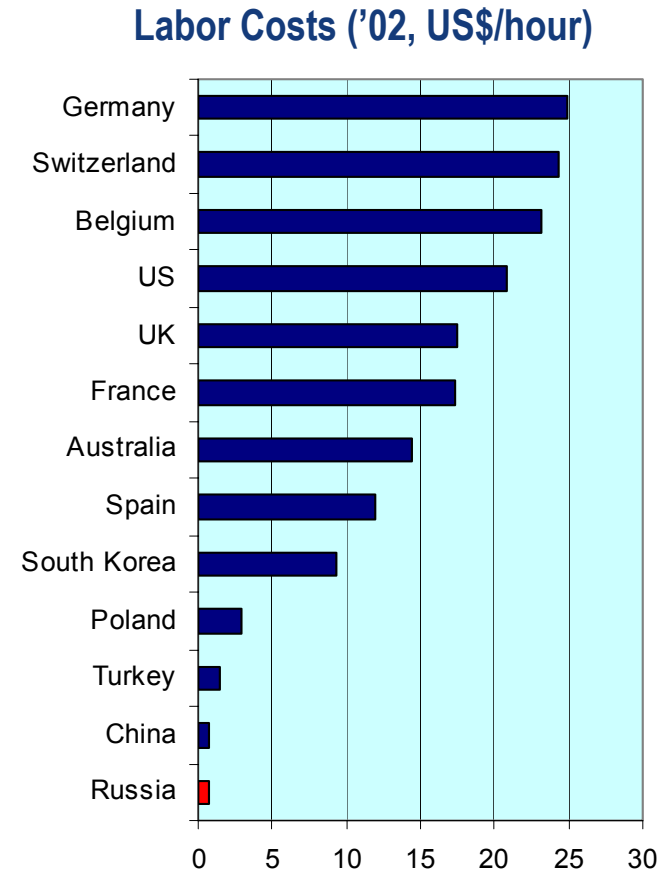


Energy reserves of large countries ('02, Mmt oil equivalent)



Russia can leverage relatively cheap domestic costs

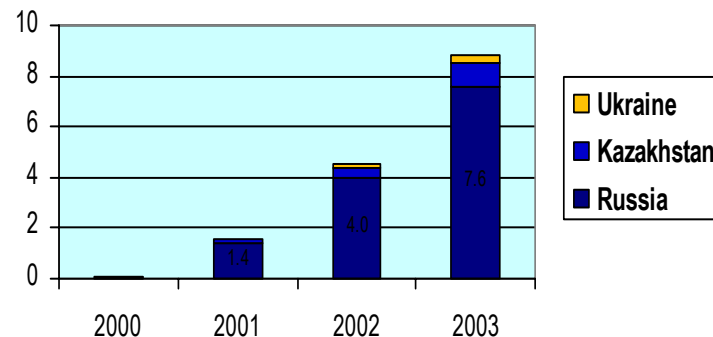
- **Labor costs** in Russia are on the China's level
- **Energy is 2-6 times cheaper** than in the developed markets
- Russia has other important resources in abundance like metal ores, water and forest



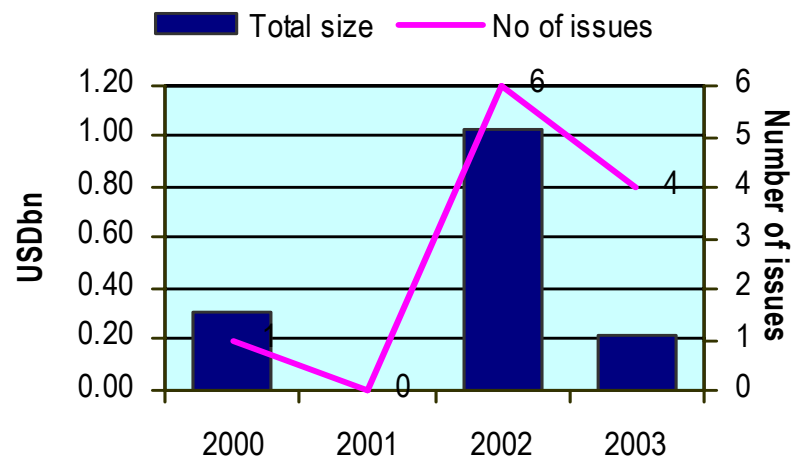
Capital markets are developing

- **Eurobonds** is a dynamic market, and foreign investors lent US\$7.6 billion to Russian companies
- **Moody's** rates Russia investment grade
- **Ruble** bond market develops and it could eventually be used by multinationals to finance Russian expansion
- **Equity financing** is not an important source of capital as yet. This gives advantage to foreign companies that can raise development funds in international equity markets

Gross Proceeds from Eurobonds (US\$ b)



CIS Equity Offerings



Political Development

“Kremlin political intrigues are comparable to a bulldog fight under a rug. An outsider only hears the growling, and when he sees the bones fly out from beneath it is obvious who won.”

Sir Winston Churchill on Stalin politics



History of Russian Market Reform

<u>Year</u>	<u>Period</u>	<u>Event</u>	<u>Psychology</u>
1987	“Perestroika”	– First foreign JV	Sky is the limit
1992	“Gaidar Reform”	<ul style="list-style-type: none"> – Market introduced – Inflation skyrockets – Savings evaporate – Salary payments delayed 	Shock and anger Gloom-and-doom
1996	Second Yeltsin Period	<ul style="list-style-type: none"> – “Loan for shares” – Oligarchs emerge – Budget deficits financed by govt bonds 	Return of hope
1998	August crisis	<ul style="list-style-type: none"> – Ruble collapse – Bank crisis – Payment crisis 	Anger and mistrust
2000	Market reform	<ul style="list-style-type: none"> – Ruble devaluation, high oil prices help economy – Restructuring of state monopolies 	

Present and Future of Russian Economy

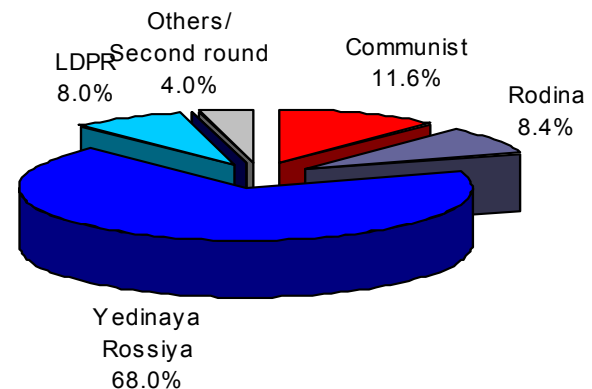
<u>Year</u>	<u>Period</u>	<u>Event</u>	<u>Psychology</u>
2002	Implementation	–Focus on real market reforms	Optimism and Realism – it will take time
2003	Private sector prospers	<ul style="list-style-type: none"> –Clean-up of privatized companies –Focus on core business –Local financing –Oil sector on brink of major FDI foreign investment 	<p>Oligarchs look for profits from investments</p> <p>Positive image in the West</p>
2004 on	FDI unlocked?	<ul style="list-style-type: none"> –Focus on labor, capital and resource efficiency –Russia is increasingly seen as a FMCG production base for CIS, EU and other markets –Foreign and domestic investment in energy 	Regaining self-confidence as an economic power

Political and economic consensus









- Putin has nearly unlimited mandate for the second term with control over Duma and the government and high popular support
- Appointment of the new Prime-Minister Mikhail Fradkov is a sign for reform continuation
- Khodorkovsky case generated negative publicity, but investment impact limited
- A few regional governors and many influential entrepreneurs are xenophobic or see foreign investment as a threat



New Duma composition



Reform agenda

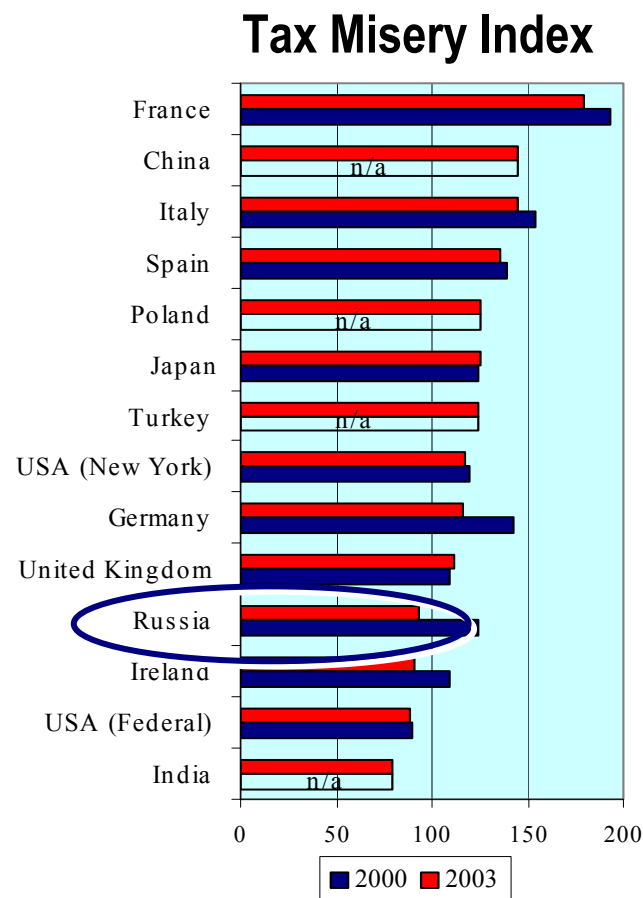
Reform	Progress	Comment
Tax		Generally complete, now being fine-tuned
Banking		Some legislation is passed but Sberbank monopoly will be dismantled only slowly
Electric Utilities		Legislation and strategy in place; reaches critical phase in 2-3 years
Pension		Laws in place; private pension managers' share is low
Land		Legislation is in place; implementation will take a lot of time
Administrative		Advanced on Federal level; weaker on regional level
Judicial		Judges' pay (and qualification) is still poor
Municipal Utilities		Only begins; first foreign contracts are seen
Gas		No reform concept; substantial progress is not likely

Tax reform milestones

Year	Legislation
2001, 2004	Turnover taxes decreased – from 4% before 2001, to 1% in 2001; fully abolished from 2004
2001	Personal income tax rate decreased from 12%-30% to flat 13% for residents
2002	Corporate profits tax rate decreased from 35% (43%) to 24%
2002	Substitution of 4 taxes applicable to oil production to a single Mineral Extraction Tax
2004	Decrease of VAT rate from 20% to 18%; further decrease discussed
2004	Changes to assets tax legislation – rate increased by 0.2%, but the tax base was considerably decreased

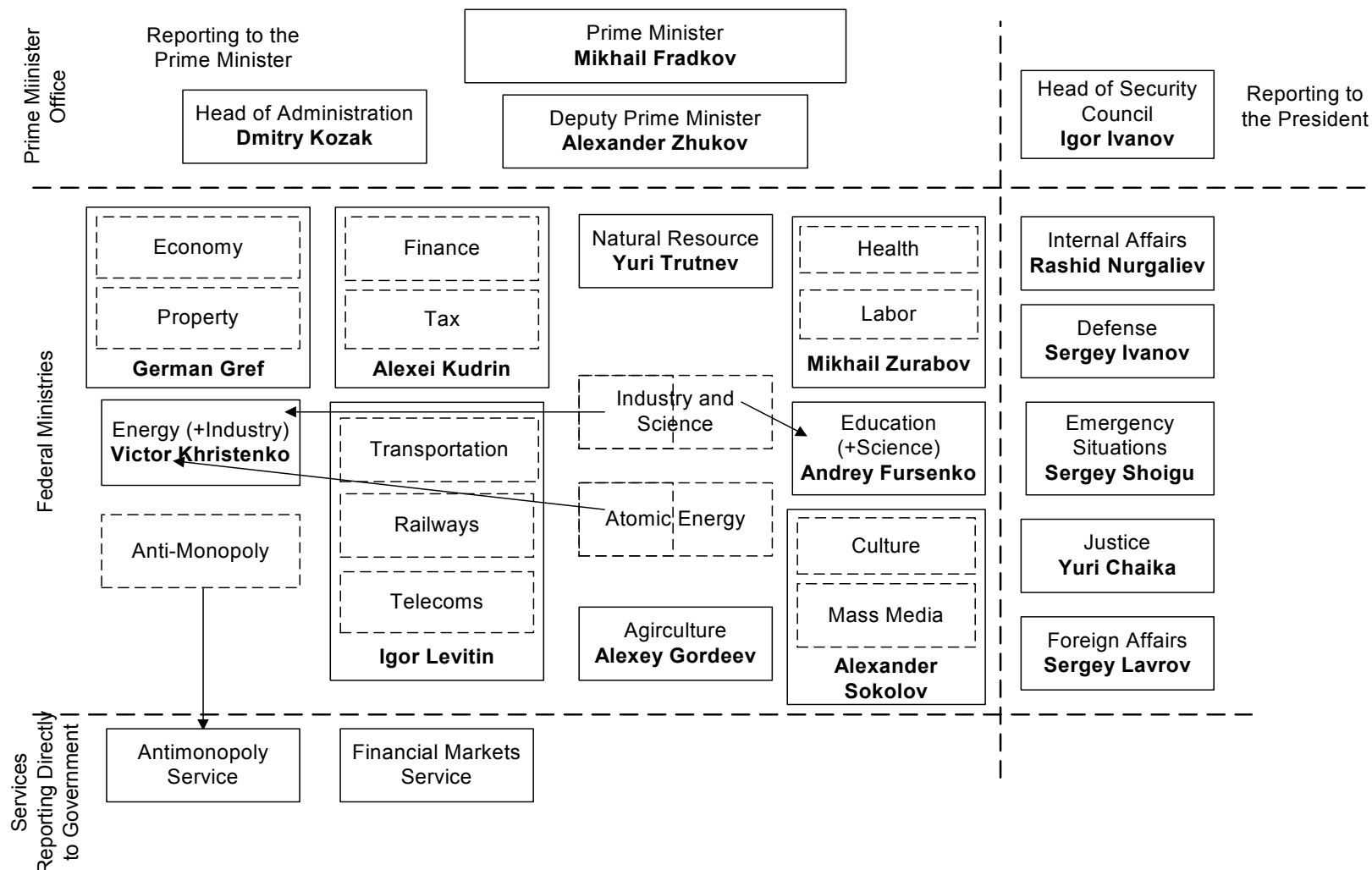
Tax situation improved although problems remain

- If not a “tax heaven”, Russia is among less “tax miserable” places now
- A few problems still remain, primarily related to implementation
 - Still many uncertainties in application of tax law
 - “Form over substance” approach is usually taken by the tax authorities
 - “Budgetary plans” for tax collection
 - Tax audits result in tax litigations in most cases
 - Practical difficulties in VAT refund
 - Advertising tax



Note: Tax Misery Index is a sum of sizes of major tax rates. The higher the index, the higher is the tax load

Government Reform



Administrative Reform

- Government reform highlights
 - A three-level structure is established – Ministries-Services-Agencies with clear subordination – instead of patchwork of ministries, committees, commissions, agencies, services and inspections
 - However, while number of Ministries decreased, the number of agencies increased – potential for more bureaucracy
 - For large projects expect more hands-on approach from the Federal government in the future
- The problem is, however, regional administrative reform – starting actually with the Moscow city government.
- Kremlin tries to promote loyal representatives to key regional governor positions

Foreign Strategic Investment

“The tax and legal systems [in Russia] offer acceptable risks for us”

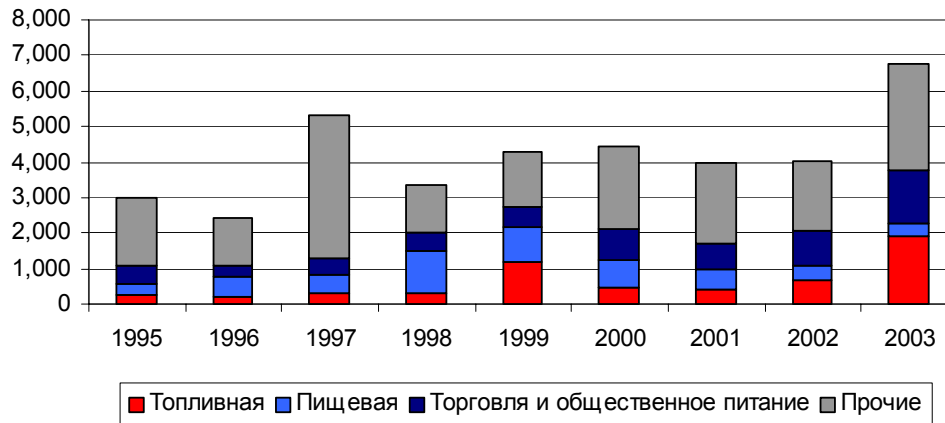
Sir John Brown, Chairman of BP, prior to placing \$7billion into Russia.



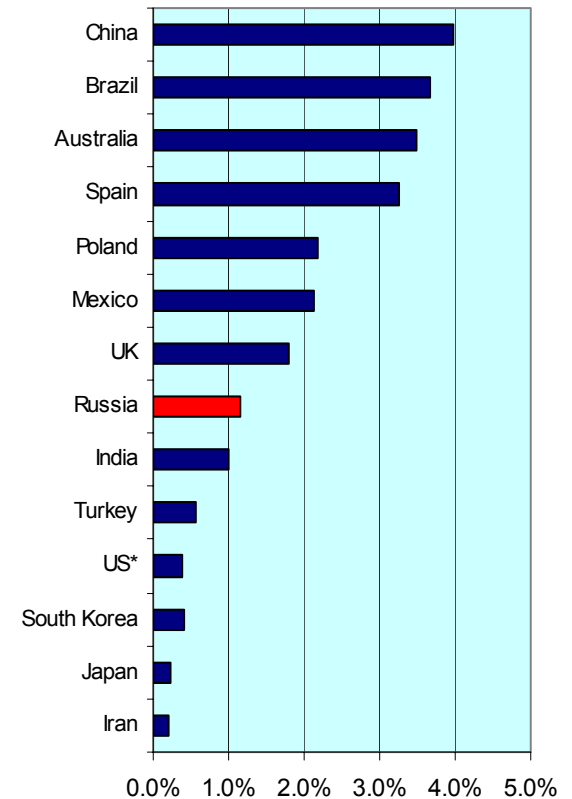
Foreign Direct Investment – relatively low activity

- Most observers comparing Russia to China or Emerging Europe on FDI per GDP note that Russia is lagging behind
- However, Russia accounted for estimated 5% of cross-border food investment projects in 1997-2000

FDI to Russia (\$ billion)



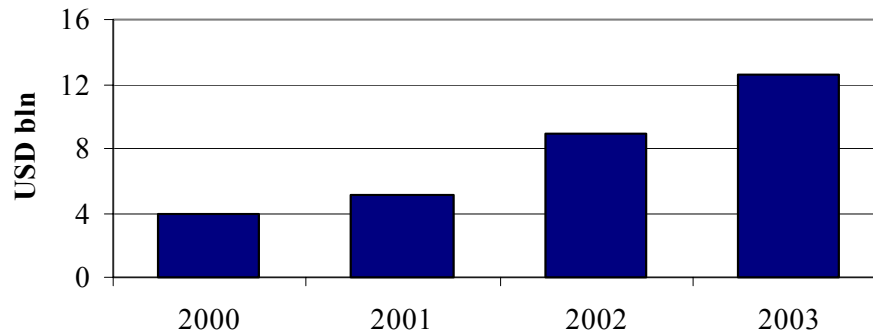
FDI/GDP Comparison



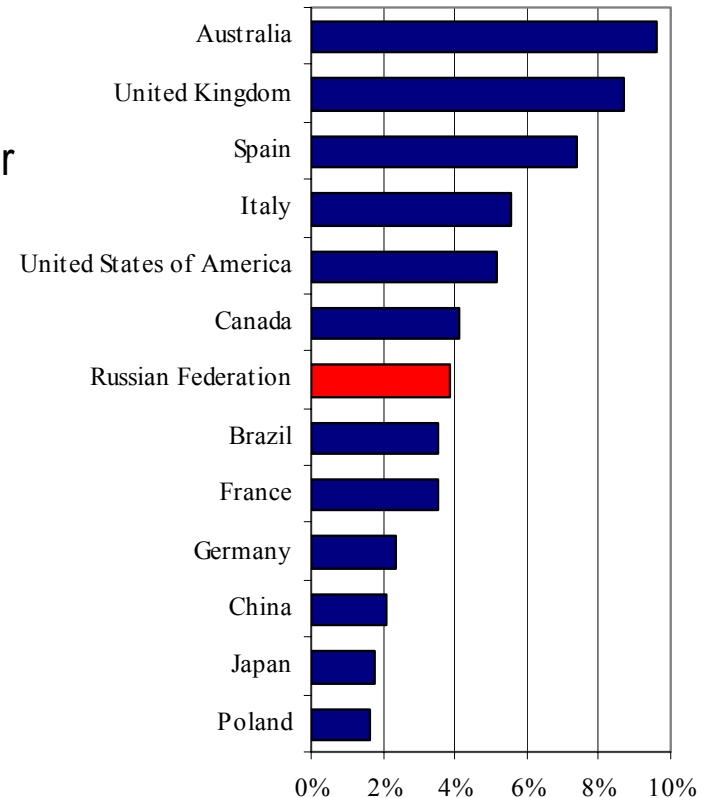
M&A market is growing substantially

- Two thirds of the deals by value and 87% by count were domestic deals
- In about 80% of deals (by value) one of the top 20 Russian groups was at least on one side (buyer, seller or target)

Russian M&A



International M&A market comparison (2003, share of GDP)



Largest foreign industrial investors

Company	Est. size, \$m	Type	Sectors
BP	3800*	M&A	O&G Diversified
Sakhalin Energy (Shell)	2700	Direct	O&G Upstream
ONGC (Share in Sakhalin-1)	1700	M&A	O&G Upstream
Coca-Cola	700	Direct	Soft Drinks
Pepsi	600	Direct	Soft Drinks
Mars	600	Direct	Confectionary, Pet Food
Unilever	500	M&A/Direct	Food, Home and Personal
Philip Morris	500	M&A/Direct	Tobacco
IKEA	400	Direct	Retail
BAT	400	M&A/Direct	Tobacco
JIT/RJR	400	Direct	Tobacco
Heineken	400	M&A	Beer
United Technologies	400	M&A/Direct	Elevators, Engines, Helicopters

* Excluding US\$3.6 billion in stock payment

German Investors in Russia

SIEMENS

- Siemens opened office in Russia 150 years ago. First contracts - telegraph lines and railroad equipment installation. Successfully secured contracts from various Russian and Soviet governments ever since
- On industrial products side - has several important government contracts, and contracts from major monopolies like Gazprom, UESR, railroad and telecoms
- Fujitsu-Siemens had 16% of the Russian cell phone market in 2003.
- Bosch-Siemens Hausgerate is in top three league for many of its products in the Russian market
- Sales in Russia in 2003 exceeded Euro 1 billion (around 1.5% of global revenue). Investment is Euro 125 mln over 5 years. Sales are primarily imports
- Produces in Russia mostly through JVs. Has 5 JVs, 6 daughter companies, regional representations and bureaus in 20 Russian cities. Siemens runs a software development center for mobile phones in St Petersburg

German Investors in Russia



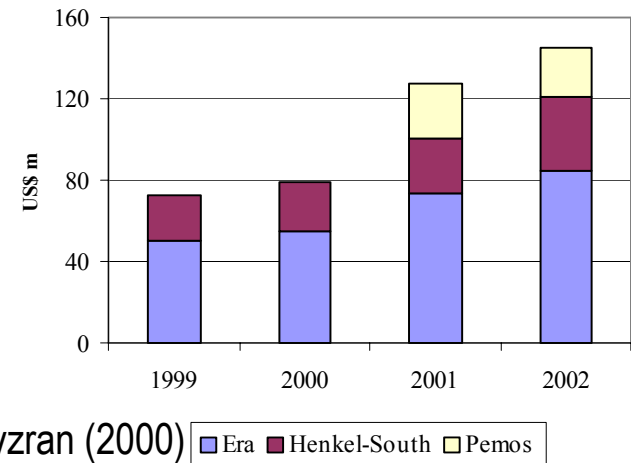
- Russia was the major growth area for Ehrmann over the past decade
- Started to sell to Russia in 1994 and started production in the year 2000 in Ramenskoye near Moscow (2000), with initial investment of DM80 mln. In 2001 US\$40m were invested in extending the plant capacity
- No. 1 in the Russian yoghurt market with 36% share in 2002
- Sales in 2003 expected to amount to Euro 100 mln in Russia, almost a third of the overall Ehrmann AG revenue.
- Similar to other milk processors, Ehrmann invests in agriculture enterprises in Moscow, Ryazan and Vladimir regions for supply of high-quality milk (in 2001 - DM 6 mln)
- Eckes-Granini Russia produces fruit juices for Ehrmann in St Petersburg (a totally new market for Ehrmann)

German Investors in Russia



- Henkel's helped to develop technology for "Moment", one of the most successful adhesive products in Soviet Union, in 1979
- Henkel created one of the first German JVs in Russia – Sovhenk, now Henkel-South in 1990
- Other acquisitions and investments are:
 - ✓ Era plant. Henkel developed adhesives production on the site in 1998 and liquid detergent facility in 2003
 - ✓ Cosmetics production for Shwarzkopf & Henkel on a leased site in Nizhny Novogorod Region (1999)
 - ✓ A JV with a Russian company to produce auto adhesives in Syzran (2000)
 - ✓ Acquisition of Pemos, a large detergent plant (2001)
 - ✓ Construction of chemicals plant in Kolomna (2003)
- Henkel produces in Russia primarily for the domestic and CIS market. It has approximately a quarter of detergents and hair care markets in Russia, up to a half of the local adhesives market
- Russia is estimated to account for just under 2% of Henkel Group revenue

Major Henkel companies' revenue



Russian Media Market



Russian Advertising Market Performance

RARA: Russian Ad Market Analysis, 1997-2005

USD mln	1997	1998	1999	2000	2001	2002	2003	2004F	2005F	2006	2007
TV	546	480	190	270	510	900	1,210	1,780	2,020	2,235	2,440
Printed Media	590	620	260	340	470	600	745	880	930	999	1,046
Outdoor	200	170	90	160	275	400	530	620	650	696	744
Radio	49	75	30	50	70	90	115	120	150	174	201
Direct Marketing	0	65	40	70	110	170	n/a	n/a	n/a		
Other*	410	350	150	230	345	520	n/a	n/a	n/a		
<i>incl. Internet</i>	<i>n/a</i>	<i>n/a</i>	<i>2.0</i>	<i>3.5</i>	<i>6.0</i>	<i>11.0</i>	<i>18.0</i>	24	27	32	38
<i>incl. Cinema</i>	<i>n/a</i>	<i>n/a</i>	<i>n/a</i>	<i>3.0</i>	<i>5.0</i>	<i>8.0</i>	<i>12.0</i>	16	18	22	25
Total Ad Expenditure	1,794	1,760	762	1,126	1,791	2,699	n/a	n/a	n/a	4,103	4,431
Major Media - New Methodology	1,384	1,345	572	826	1,336	2,009	2,630	3,441	3,795	4,157	4,494

New Methodology (adopted in 2004) - Market size measured in line with ZenithOptimedia standards (TV, print, radio, outdoor, Internet, and cinema). Historical data for RARA and ZenithOptimedia is identical.

*Other includes production of advertisement and sales at points

ZenithOptimedia: Russian Ad Market Analysis, 1997-2005

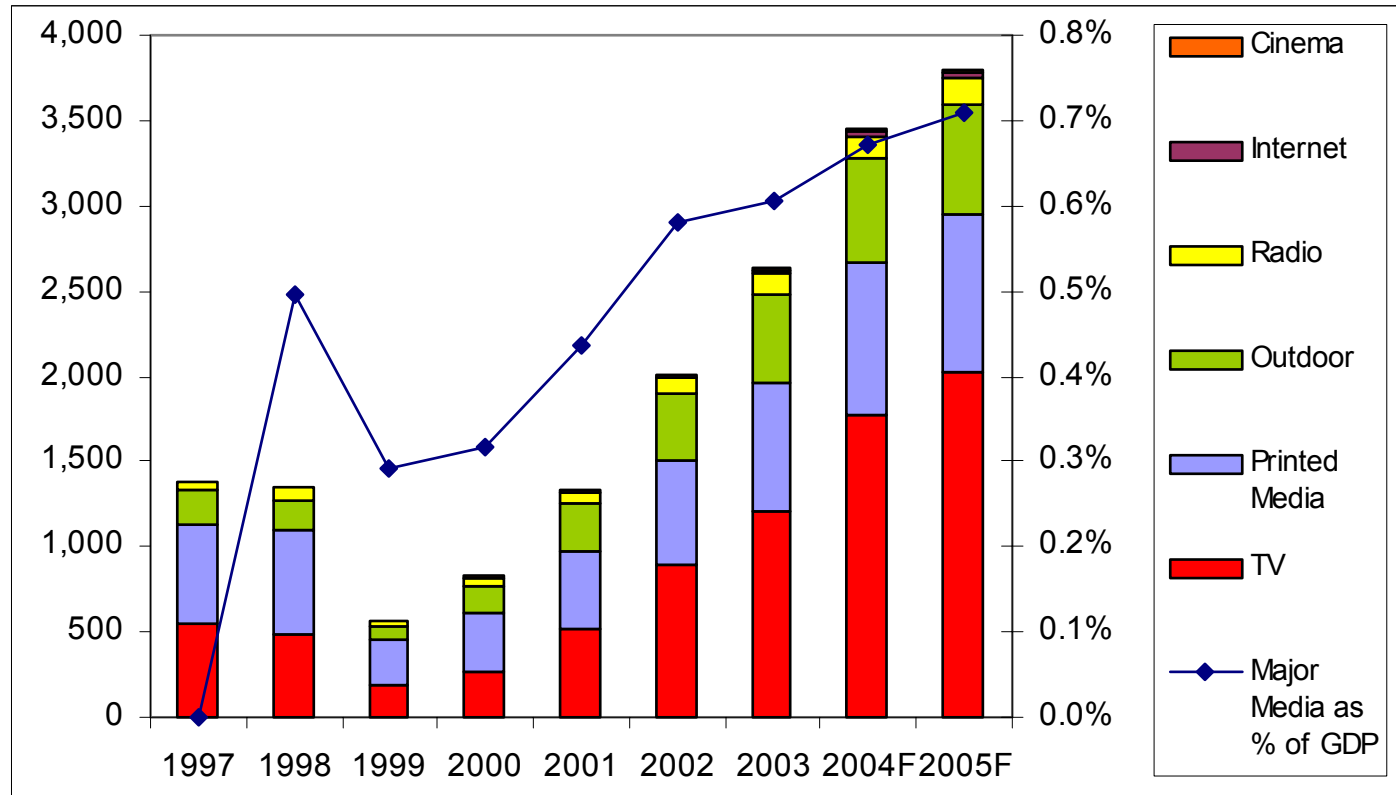
USD mln	1997	1998	1999	2000	2001	2002	2003E	2004F	2005F
TV	550	480	190	270	510	900	1,258	1,650	1,959
Printed Media	600	570	260	340	470	600	752	853	947
Outdoor	180	170	92	165	275	400	510	610	685
Radio	70	80	30	45	70	90	110	130	155
Internet	<i>n/a</i>	<i>n/a</i>	<i>1.0</i>	<i>3.0</i>	<i>6.0</i>	<i>11.0</i>	14	18	22
Cinema	<i>n/a</i>	<i>n/a</i>	<i>n/a</i>	<i>3.0</i>	<i>5.0</i>	<i>8.0</i>	10	12	15
Major Media	1,400	1,300	573	826	1,336	2,009	2,654	3,273	3,783

Russian Advertising Market Performance (*continued*)

- The 1998 financial crisis led to a significant decline in advertising spending in 1999, but the overall advertising market in Russia has been developing quite rapidly since then. As estimated by RARA, the major media ad market fell from \$1.3 billion in 1998 to \$572 million in 1999. Yet the market has rebounded to pre-crisis levels in 2001, and in 2002 grew by a further 50% to \$2 billion.
- Part of the explanation is, as usual, the strengthening ruble and overall Russian economic growth. Russian GDP grew 123 percent in US dollar terms from 1999 to 2002, which explains about half of the growth. However, the advertising market grew by more than 250 percent over the same period.
- Strong growth has continued in 2003. As estimated by RARA, 2003 major media ad expenditures grew by 31% (up to \$2.6 bln), which far outstrips worldwide ad spending growth, which is estimated at 3.4% in 2003.
- While growth in the Russian ad market shows signs of slowing down from the hyper growth in 2000-2002, market analysts still believe that the ad market will develop further yet at a slower rate of 10% - 16% by 2005.

Russian Advertising Market Performance (continued)

Russian Major Media Ad Market, 1997-2005 (US\$ mln.)



Advertising Market Trends and Expected Developments

The following **trends in the Russian ad market** are seen and expected to continue:

- **Ad spending grows much faster than GDP, but the ad spending growth will slow down towards the GDP growth by 2005-2006:** in terms of ad spending as % of GDP, Russia has to catch up with the rest of the world.
- **Redistribution of advertising budgets between media segment categories:** in 2000-2003 outdoor, radio have retained their share of total ad spending, the share of printed media declined, while TV media is increasing its share compared to previous years.
- **Increasing role of Russian advertisers vs. multinational advertisers:** the portion of advertising budgets of Russian advertisers¹ vs. multinational advertisers is increasing. Advertising budgets of Russian advertisers are growing at a higher rate than budgets of multinational advertisers.
- **Expansion to regions:** the share of local advertising market increased to 26% in 2002 from 24% in 2001.
- **TV ad pricing leads the market:** TV ad pricing impacts the increase of ad pricing in other media.

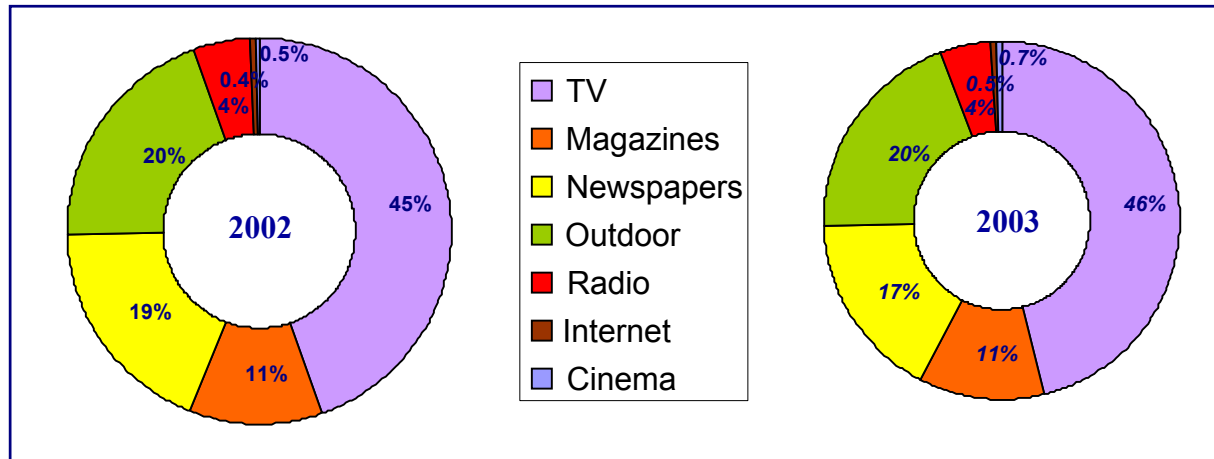
¹The definition of the term “Russian advertisers” emerged in the 1990s, and refers to companies whose budgets are approved in Russia. This definition does not take into account company ownership structure.

Russian Advertising Market by Media

- Ad spending in Russia is growing across all media, with TV taking an increasing share, which sets the pace for the growth of pricing in the market. **TV** and **Internet** exhibited the highest growth rate in 2003 of **34% and 64%** versus 76% and 83% in 2002 respectively.
- **TV is traditionally the first medium** advertisers turn to when they have more to spend because it offers high national coverage, viewer attention and trust. The supply of TV time is limited by law, and most major stations are at or near full sell-out.
- Unfulfilled demand for TV airtime has often been turning to outdoor, which is generally considered the best substitute for television to build brands. **Outdoor advertising increased by 33%** in 2003, after 45% growth in 2002.
- **Magazines** have been growing rapidly in early 2003 after the launch of several new titles. **Most newspapers** are less attractive to advertisers as they often are highly focused on politics. However, business dailies attract a larger share of ad market. **Printed media increased by 24% in 2003.**
- **Radio** is traditionally considered to be a tool for supporting promotions, not building brands. The radio ad spend growth rate in **2003 was 28%**, down from 29% in 2002.
- **Cinema and Internet** are rapidly increasing their reach. The cinema and Internet ad market comprised **50% and 64% growth in 2003** with the budgets of \$12mln \$18mln respectively.

Russian Advertising Market by Media (*continued*)

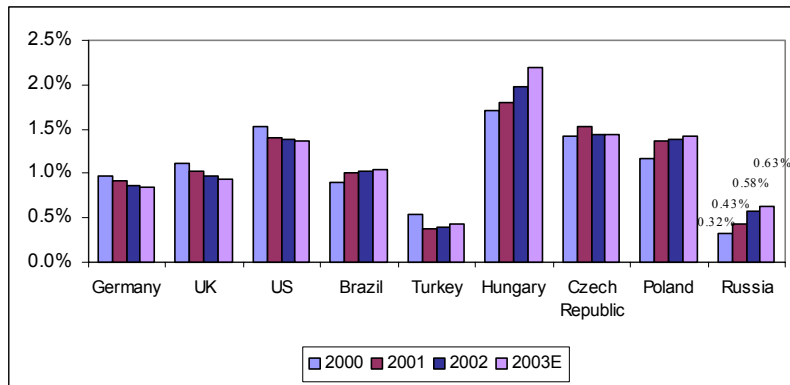
- TV advertising is the largest category in advertising spending representing 46% of the major ad spending in 2003.
- Printed media is the second category in importance with newspapers comprising 19% and magazines 11% of total ad spending in 2003.
- Another important area is outdoor, which represents 20% of the total advertising spending in 2003.
- Radio is the smallest category of major media with 4% share in 2002.
- Internet and cinema advertising currently represent the smallest portion of total ad spending in 2003 of 0.7% and 0.5% respectively.



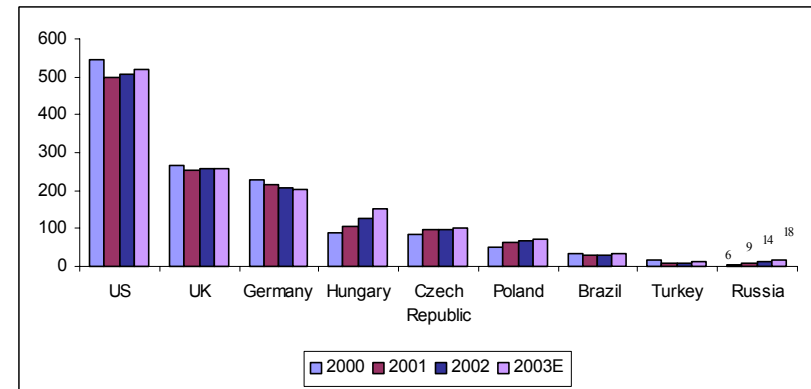
Russian Advertising Market vs. US and Europe

- Despite the recent rebound, the Russian ad market still has room to “catch up” to developed and more mature emerging markets (Central and Eastern Europe) in terms of ad spending per capita and as a percentage of GDP.
- Ad spending in Russia as % of GDP is 0.58% in 2002 (0.63% in 2003) compared to an average of 1.3-2.0% in CEE.
- Total ad spending per capita in Russia amounted to only \$14 in 2002 (\$18 in 2003) compared to \$66 in Poland, \$96 in Czech Republic and \$206 in Germany, as shown below.

Advertising spending as percent of GDP (%)



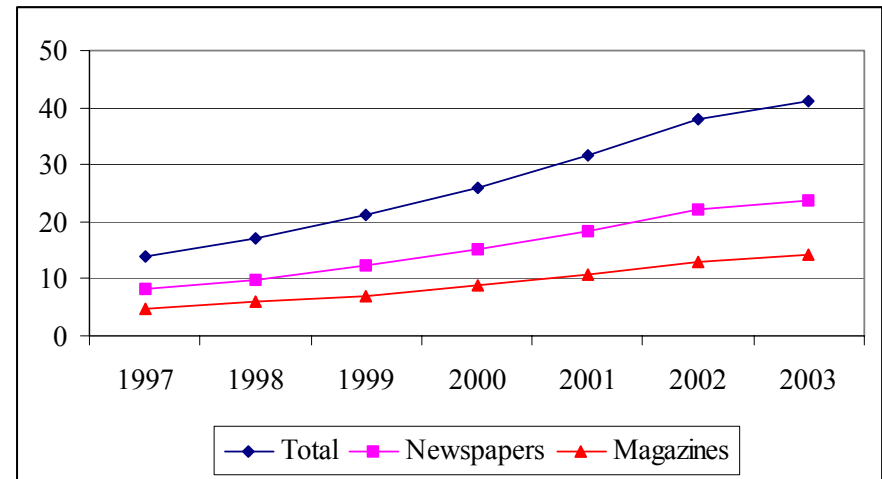
Total advertising spending per capita (USD)



Publishing Advertising Market: Overview and Estimates

- Printed media is the 2nd largest ad segment by revenues: newspapers at 17% and magazines at 11% of total ad spending in 2003.
- Magazines have been growing rapidly in early 2003 with launch of several new titles. Business dailies attracting slice of ad spending.
- Printed ad revenues totaled US\$ 745 million in 2003: with newspapers pulling in US\$ 445 million and magazines US\$ 300 million.

Number of Periodicals: '97-'03 ('000)

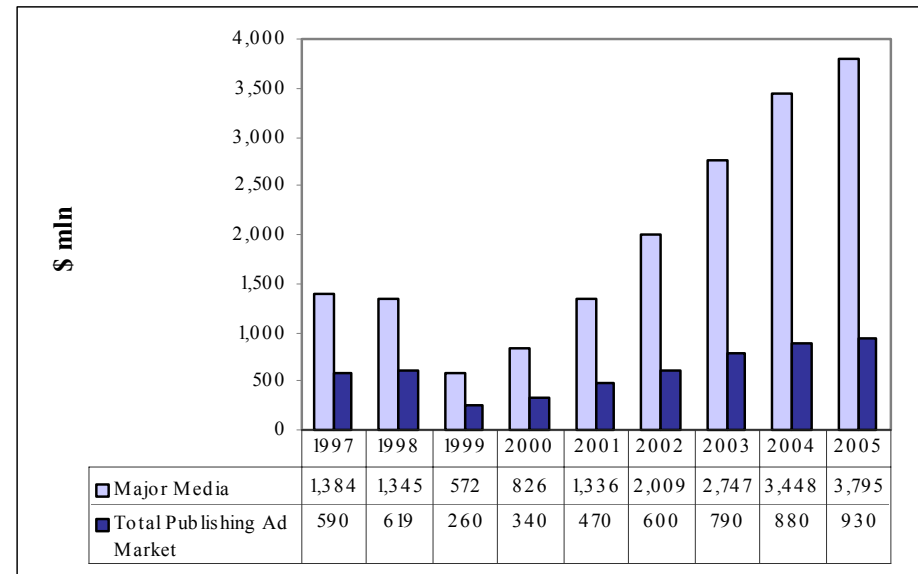


Source: RARA, 2003; Ministry of Press: Vedomosti as of 1 Oct 2003

Publishing Advertising Market: Overview and Estimates

- RARA estimates Russia's 2003 publishing growth at 24 percent, down from 28 percent growth in 2002
- According to BBDO Advertising Group ad prices increased by 10%-15%.
- In 2002 there was a rapid growth of new print media titles, especially small editions. This growth, however, was not accompanied by growth in circulation and audience; rather it has merely resulted in the re-distribution of readers among existing titles.

Publishing Ad Market in Russia




Source: RARA, 2003; Ministry of Press; Vedomosti as of 1 Oct 2003

Publishing Market

	Publishing House/Media Group	Approx. share of publishing ad rev. (2003)	Number of Titles
Russian Investors	Gazprom Media	N/a	10
	Kommersant	5%	6
	Prof-Media	5%	6
	Sistema Mass Media	N/a	6
	Seven Days	6%	N/a
	Argumenti I Facti	1%	N/a
	Moskovskiy Komsomolets	2%	N/a
Foreign Investors	Hubert Burda Medien	7%	14+
	Independent Media	9%	12
	Bertelsmann (Gruner & Jahr)	N/a	2
	A-pressen	N/a	3
	Hachette Filipacchi Presse	5%	7+
	Conde Nast	3%	3


CIS Media & Entertainment: Strategic Advisory

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A-pressen

A-pressen ASA
has acquired a stake in




КОМСОМЛЬСКАЯ ПРАВДА

Closed 2002

Ernst & Young* acted as advisor to A-pressen ASA

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ZAO Journal Expert

Strategic advisory

2002

Ernst & Young Corporate Finance acted as advisor to the company

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TV3

Strategic Advisor

2002 - 2004

Ernst & Young acts as advisor to TV3

Contact: Mark Sanor/Hans Kuepper
Ernst & Young (CIS) Ltd.,
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Quality In Everything We Do

This announcement appears as a matter of record only **TRANSACTION ADVISORY SERVICES**


Russian Television Network

Valuation advisory

2003

Ernst & Young acted as advisor to the company

Contact: Mark Sanor/Hans Kuepper
Ernst & Young (CIS) Ltd.,
Sadovnicheskaya Nab., 77, bld. 1, 115035 Moscow
Tel: +7 (095) 755 9700



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This announcement appears as a matter of record only **TRANSACTION ADVISORY SERVICES**

International gaming industry investor

Feasibility study for large-scale gaming project in Moscow

2003-2004

Ernst & Young acted as advisor to the investor

Contact: Hans Kuepper
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Investment Fund

Advisory on acquisition of a leading independent television production company

Ongoing

Ernst & Young acts as advisor to the fund

Contact: Hans Kuepper
Ernst & Young (CIS) Ltd.,
Sadovnicheskaya Nab., 77, bld. 1, 115035 Moscow
Tel: +7 (095) 755 9700



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CIS Media & Entertainment: Transaction Support / Due Diligence

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Leading European Consumer Publishing Group

Transaction Support Advisory on Russian JV Partner Due Diligence

2002

Ernst & Young acted as advisor to the company

Contact: Paul Murphy/Tatiana Shustova
Ernst & Young (CIS) Ltd.,
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Tel: +7 (095) 755 9700

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Leading European Advertising Company

Transaction Support Advisory

2002

Ernst & Young acted as advisor to the company

Contact: Paul Murphy/Elena Lebedeva
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Sadovnicheskaya Nab., 77, bld. 1, 115035 Moscow
Tel: +7 (095) 755 9700

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European Equity Fund

Transaction Support Advisory on Acquisition of Media Assets in Russia

2003

Ernst & Young acted as advisor to the company

Contact: Paul Murphy
Ernst & Young (CIS) Ltd.,
Sadovnicheskaya Nab., 77, bld. 1, 115035 Moscow
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Leading European Publishing Group

Transaction Support Advisory on Investment into one of the Leading Publishing Groups in Russia ongoing

Ernst & Young acted as advisor to the company

Contact: Paul Murphy/Elena Lebedeva
Ernst & Young (CIS) Ltd.,
Sadovnicheskaya Nab., 77, bld. 1, 115035 Moscow
Tel: +7 (095) 755 9700

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Leading European Marketing and Research Group

Transaction Support Advisory

2001

Ernst & Young acted as advisor to the company

Contact: Paul Murphy
Ernst & Young (CIS) Ltd.,
Sadovnicheskaya Nab., 77, bld. 1, 115035 Moscow
Tel: +7 (095) 755 9700

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This announcement appears as a matter of record only **TRANSACTION ADVISORY SERVICES**

Russian Financial Industrial Group

Transaction Support Advisory on Acquisition of Media Assets

2003

Ernst & Young acted as advisor to the company

Contact: Paul Murphy/Elena Lebedeva
Ernst & Young (CIS) Ltd.,
Sadovnicheskaya Nab., 77, bld. 1, 115035 Moscow
Tel: +7 (095) 755 9700

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Key Points on Investing in Russia

“It is hard to evaluate company situations [in Russia, Ukraine and Belarus] when 70% of the business is conducted via shady links to offshore accounts and tax safe-havens. We might just wait until these smaller companies disappear and then start our own subsidiaries.”

Helmut Struger, Neuber Brenntag CEO, after searching for CIS acquisitions



Greenfield vs. M&A – General

Type	Pros	Cons	Balance
Subsidiary/ Greenfield	<ul style="list-style-type: none"> • Control... • Control... • ...And control! 	<ul style="list-style-type: none"> • Time required for licenses/ utilities • Need to handle government relations/ administrative issues • Financial and operational risks 	<ul style="list-style-type: none"> • Was major entry strategy for MNCs in 1990s • Now slowly replaced by M&A
JV/PSA	<ul style="list-style-type: none"> • Financial risk sharing • Russian partner handles administrative/license issues 	<ul style="list-style-type: none"> • Corporate governance risk • Technology and brand transfer issues • Control may be lacking 	<ul style="list-style-type: none"> • Not frequent except for PSAs • Control is a difficult issue
M&A	<ul style="list-style-type: none"> • Time saved • Buying established company • Could still be reasonably cheap • M&A market becomes better established 	<ul style="list-style-type: none"> • Difficult to negotiate transfer of control • “Skeletons in the closet” • Post-integration difficulties unless Russian target was built and operated to Western standards • Corporate governance and counter-party risk 	<ul style="list-style-type: none"> • M&A increasingly used entry strategy in 2002-2003 • A lot of due diligence needed, nothing could be taken for granted

Current M&A Environment (1)

	European M&A environment	Russian M&A environment
Current levels of activity	<ul style="list-style-type: none"> ➤ Relatively subdued given economic uncertainties and low economic growth rates 	<ul style="list-style-type: none"> ➤ Substantial growth (but from a low base) given continued domestic consolidation and foreign direct investment
Time frames	<ul style="list-style-type: none"> ➤ Transaction timeframes are relatively quick (usually up to 6 months) 	<ul style="list-style-type: none"> ➤ Transaction timing can often be in excess of a year; building relationships is important
Transaction process	<ul style="list-style-type: none"> ➤ Established history and usage of M&A; 'standardized' transaction procedures 	<ul style="list-style-type: none"> ➤ Russian parties being unversed in deal-making, and frequently do not seek professional advice
Deal structures	<ul style="list-style-type: none"> ➤ Predominantly 'clean' transactions with a single purchaser selling a 100% stake 	<ul style="list-style-type: none"> ➤ Structures more complex, often with the use of off-shore vehicles for tax, ease of exit, financing considerations
Financing	<ul style="list-style-type: none"> ➤ A variety of financing options available 	<ul style="list-style-type: none"> ➤ Mostly cash consideration; ➤ Sophisticated financing instruments emerging, yet legislation lagging behind
Market data	<ul style="list-style-type: none"> ➤ Market data (in terms of market size, growth, market shares etc) readily disclosed and available 	<ul style="list-style-type: none"> ➤ Market data less readily available and is often out of date given rapid changes in market place

Current M&A Environment (2)

	European M&A environment	Russian M&A environment
Valuation	<ul style="list-style-type: none"> ➤ Liquid M&A market facilitates benchmarking to comparable transaction multiples ➤ Focus on earnings / cash flow multiples 	<ul style="list-style-type: none"> ➤ Minimal disclosure of deal details complicates benchmarking valuation ➤ Traditional focus on book values (slowly changing)
Financial data	<ul style="list-style-type: none"> ➤ Strong financial / management information systems in place; reliable historical data ➤ Analytical review and performance monitoring along a range of key performance indicators ➤ Rigorously assessed future projections 	<ul style="list-style-type: none"> ➤ Generally weak finance functions ➤ Analytical review and performance monitoring focused on a small number of key performance indicators ➤ Future projections are rarely forecast in detail and are often not fully thought through
Negotiations	<ul style="list-style-type: none"> ➤ Tend to be commercially focused and 'result-driven' 	<ul style="list-style-type: none"> ➤ Negotiations may concern objectives which are not purely commercial
Regulatory Environment	<ul style="list-style-type: none"> ➤ Minimal interference on private deals ➤ Regulations highly transparent ➤ Usually easy to enforce 	<ul style="list-style-type: none"> ➤ Rapidly improving, but still opaque by international standards ➤ Numerous regulatory and corporate compliance requirements (antimonopoly approval of transactions, Federal Securities Commission filings etc.) ➤ Low level of enforceability

Structuring M&A transactions

Structuring of an M&A transaction often involves:

- Vendor/purchaser due diligence (mitigation/cure of risks not always possible)
- Pre-acquisition reorganization of the target activities subject to due diligence and deal structuring considerations, including tax drivers (reduction of capital gains, unrealized capital gains issue, valuation and transfer pricing vendor concerns)
- Intra-group restructuring to introduce foreign holding (e.g. Cyprus) for tax optimization and ownership rights protection purposes, with types of off-shore structures ranging from management to financing and licensing companies
- Elaboration of diverse payment schemes and related security instruments

Due Diligence is essential...

- Substantial due diligence is required at acquisition of a Russian target.
- Russian Accounting Standards (RAS) are now fairly close to international standards (in theory). In practice, however, almost very few Russian companies adhere to these principles, as compliance would require substantial volumes of extra effort and complicate the calculation of the tax base.
- Despite the shortcomings of Russia's statutory accounting system, accounting data are still the fullest source of information on an enterprise.
- Management accounting reports are often inconsistent
 - Frequently contain substantial misstatements
 - Do not adhere to double entry principle
 - Do not properly reflect irregular transactions
- Practically all major Russian manufacturers have a complex trading structure that allows the shareholders to control cash flows and optimize their tax burden.
- It is of utmost importance at the earliest stages of negotiations to identify every company to be included in the scope of the deal

...even when IAS/GAAP accounts are presented

- Russia slowly moves to international accounting standards. Quite a few large Russian companies have Western financial and management accounting systems. Even if the target has international audited statements, due diligence is still needed
 - Risks related to potential changes in ownership are not reflected (debt from “affiliated” structures outside the deal scope may turn into bad after ownership change)
 - No requirement of separate disclosure of once-off transactions in the statement of income if such expenses have been incurred in the normal course of business
 - Audited financials throw no light on trends in raw material prices, payroll costs, and energy prices; nor do they provide information on main suppliers and customers, changes in sale prices, or other data needed to project the future performance of an enterprise
 - Parimalat and Enron had audited accounts under international standards
- Workshop cost accounting and allocation per finished product unit at each workshop is used in Russia versus international item based analysis practice (materials, payroll, electricity, etc.).

More key risks

- Legal issues in privatization documents
- Legal issues in the previous acquisitions
- Most companies were involved in the aggressive tax optimization schemes over recent years. Significant tax risks may be inherited
- Long outstanding receivables with insufficient allowance for doubtful accounts
- Poor inventory management and stock obsolescence problems
- Some companies have significant volumes of off-book transactions
- In most cases the companies do not follow debt covenants
- No detailed and thoughtful budget for capital expenditures often indicates inadequate future development planning
- Some companies incur significant expenditures on maintaining of social infrastructure and have unrecorded social obligations

Legal Considerations in Transacting M&A Deals

- Perception of legal uncertainties and risks linger on but waning down as more deals get done
- We have observed a very diverse pattern of acquisition techniques depending on a number of factors, including
 - Scale of transaction and market visibility
 - Players and sources of acquisition finance (foreign vs. domestic, private equity vs. IFC/EBRD type deals)
 - Industry (regulatory considerations, industry practice)
 - Jurisdiction (Russian vs. foreign)
- Accordingly, acquisition instruments are increasingly sophisticated and diverse
 - Share acquisition – cash for shares
 - Shares swap
 - Share options
 - Convertible instruments
 - Combination of above

Documenting M&A transactions

Deals can be documented adequately through instruments, which meet requirements of more sophisticated and demanding actors

- Choice of foreign law
- Availability of arbitration and enforcement
- Security Instruments (non/limited recourse deals)
- Liberalization of land legislation
- Increased predictability of tax consequences

Potentially limiting factors remain

- Numerous regulatory and corporate compliance requirements (e.g., antimonopoly approvals, Federal Security Commission filings), which are cumbersome and costly
- Stringent currency control rules (constraints to structuring options, disclosure obligations)
- Corporate and regulatory environment still low on predictability in design and implementation of the more sophisticated transactions

M&A deal-makers in Russia start to look at debt components

- Until recently, debt has been far too short-term and expensive. Most deals have been funded with cash flows or share swaps
- But we are starting to see some debt components
 - Sistema's acquisition of shares from Deutsche Telecom was largely financed from debt capital markets (Eurobonds and Ruble bonds), using a call option window to gain flexibility to place the bonds
 - We have seen deals structured with bank guarantees, or with limited debt financing of the target post-closing
 - Inteko, a Russian construction firm, said it will finance acquisitions with 3-year ruble bonds
- Ruble bonds are already reaching maturities and yields generally acceptable for financing of Russian projects (8% per year on 3-year bond is not unrealistic for a high quality borrower)
- Still, we are not yet in the era of Russian leveraged acquisitions or greenfield investments

Private equity availability

- There is not a vibrant venture capital culture in Russia
- However, availability of private equity in Russia is improving
 - Intel Capital and Warburg Pincus made their first investments
 - Carlyle re-opened office in Moscow and said it will look for opportunities
 - Baring Vostok has got about US\$200 million in new money
 - AIG Brunswick say they plan to raise US\$150 million
 - Russia Partners was reported to be raising up to US\$210 million in a new fund
 - AIG and Brunswick separately announced plans to raise \$500 million in joint ventures with Russian partners
- Many Russian groups (including Millhouse, Interros, MDM and Alfa) are essentially of private equity type (see the next slide)

International Direct Investment Funds

Fund manager	Estimated total assets in Russia, US\$ m
EBRD*	3,000
Capital Research Intl**	1,200
Sputnik Group	400
Baring Vostok	400
AIG Brunswick	300
NCH Advisors**	250
TPG Aurora	225
DeltaCapital	200
ESN	200
Russia Partners	150
SUN Capital	150

* Including investment in public sector and venture funds

** Primarily stakes in traded companies but also some private equity-type investments

Special investment considerations

- **Investment Incentives.** Russian legislation guarantees foreign investors rights equal to those enjoyed by Russian investors. Large investments (over US\$41 million) are protected from unfavorable changes in tax or other legislation for a period of seven years, however, these protections have yet to come into effect since implementation regulations are lacking
- **Investment Restrictions.** Investments in the sectors perceived to affect national security (natural resources, insurance, banking, defense-related industries) may be limited
 - Law on aerospace industry limits foreign ownership to 25 percent of an enterprise
 - Majority-foreign-owned insurance companies are allowed to operate, but prohibited from selling life and compulsory insurance. Overall foreign capital in the insurance industry is limited to 15%
 - Foreign investments are limited to no more than 10% of total banking capital, etc.
- **Corporate Governance.** Corporate Governance Code in place, of recommendation nature in general, with certain components mandatory for listed companies. As a minimum, a blocking stake acquisition is recommended to outside investors allowing to negotiate sufficient level of corporate control

Types of legal presence in Russia

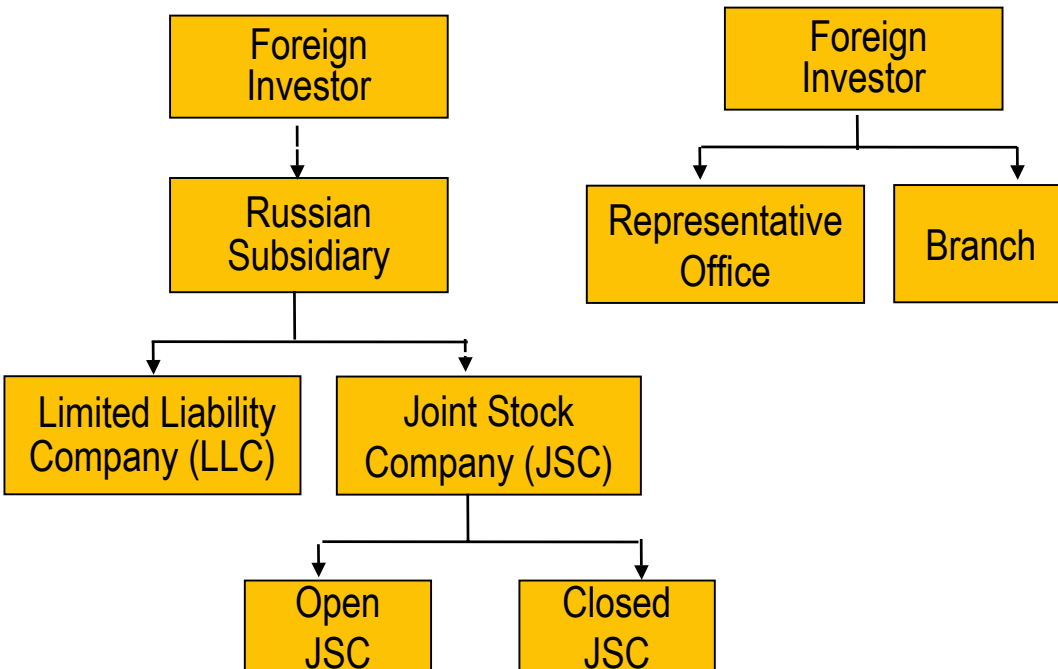
• There are **different forms** through which a foreign investor can undertake business activities in Russia

• Particular type of presence may be pre-determined by the major factor - the need to have a **Russian partner**:

- Russian partner helps obtaining licenses and permits -> usually possible in the form of **Russian legal entity**

- If no need to have Russian partner, then **Rep.office/Branch** of a foreign company is sufficient

- Rep.office is attractive when no sale of goods made within Russia



Labor Issues

Foreign Citizens:

- Work permit is a mandatory requirement of the Russian legislation for the foreign citizens working in Russia
 - Issued for foreigners working on the basis of a labor contract or a secondment agreement
 - Complicated 3-step procedure (opinion of State Federal Employment Service, obtaining of permit for involvement of foreign personnel by the Company, obtaining of individual work permit for personnel)
 - Multiple state authorities involved in the procedure (State Federal Employment Service, State Federal Migration Service, Territorial Migration Service)
 - Time consuming procedure – takes from 3 to 6 months to obtain
- Visa, invitations, quotas for expatriates quantity, registration with the Ministry of Interior Affairs, tax authorities notification etc.

Russian Employees:

- Rep. office/ Branch/ Russian legal entity may have Russian employees
- Russian employees are subject to Russian labor law rules
- Cheaper workforce
- High level protection of employees' rights – risk to face problems in case of termination of contract with employee

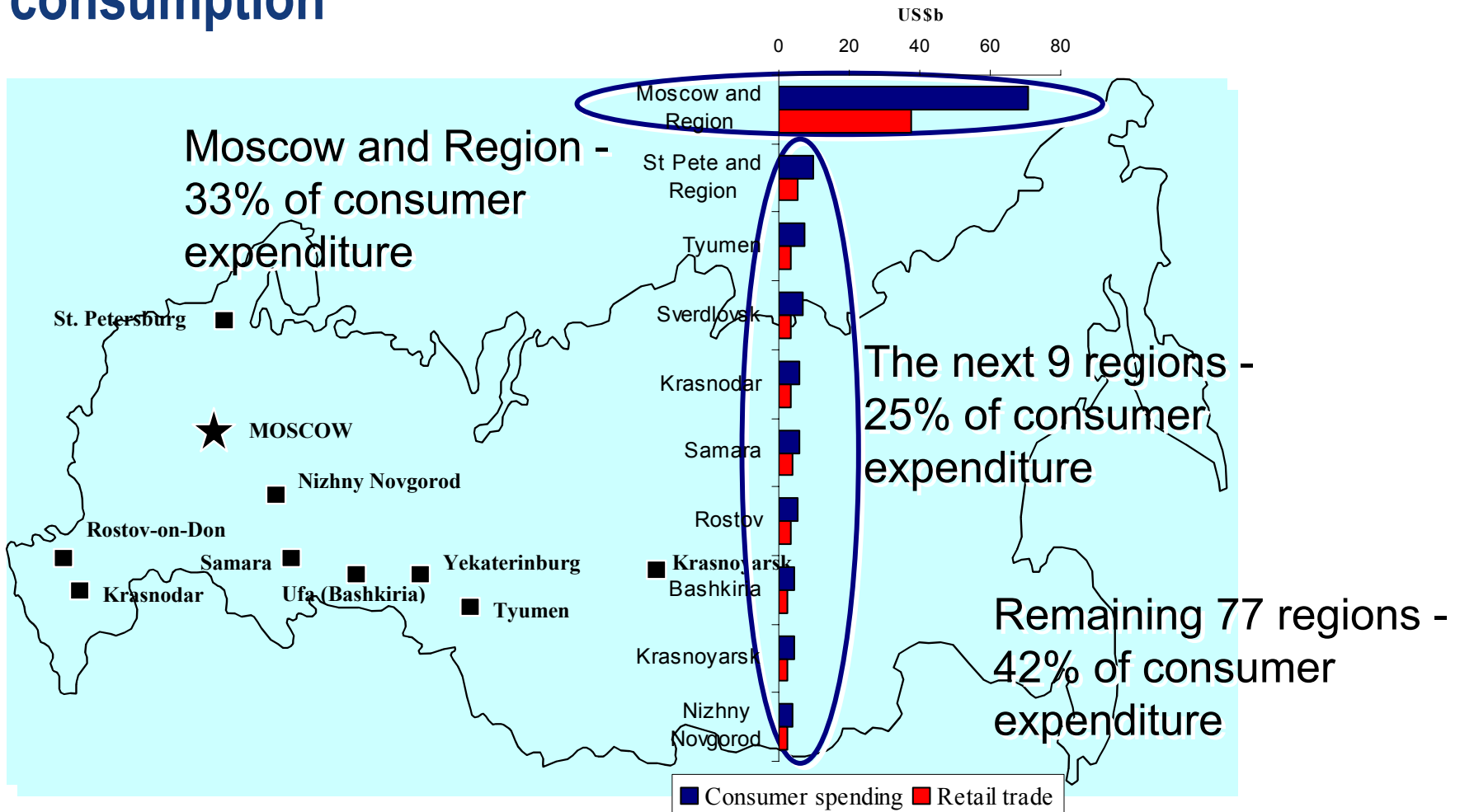
General Provisions on Licensing

- Authorization to perform certain types of activities
- Validation period
- Personification (issued to a particular legal entity, transfer is not allowed as a general rule)
- Term for taking a decision on license issuance (minimum 60 days)
- Limited grounds for refusal to issue a license
- Different licensing authorities, depending on the type of activity

Regions and CIS countries



Ten largest markets account for almost 60% of Russian consumption



Largest Russian Regions by Output

Region	Population, mln	GRP, \$ bln	Key Industries	Key Foreign Investors
Moscow and Region	17.0	60.3	Financial Services, Real Estate, Consumer Goods	McDonald's, Coca-Cola, Unilever, Mars, IKEA, etc.
Tyumen	3.3	26.1	Oil&Gas	BP, Marathon Oil
St.-Petersburg and Region	6.3	11.4	Machinery, Consumer Goods, Automotive	Coca-Cola, BBH, Philip Morris, JIT, Heineken, Ford, etc.
Krasnoyarsk	3.0	7.6	Nickel, Gold, Coal, Aluminum	Coca-Cola
Tatarstan	3.8	7.0	Automotive, Oil&Gas, Chemicals	BASF, Ramstore
Ekaterinburg	4.5	6.9	Ferrous metals, Copper, Chemicals	Coca-Cola, Pepsi Co, ABB
Samara	3.2	6.5	Automotive, Oil refining, Consumer Goods	General Motors, Nestle, Danone, Coca-Cola
Bashkortostan	4.1	5.9	Oil&Gas, Chemicals	n/a
Perm	2.8	5.9	Oil&Gas, Pulp&Paper	Sun Interbrew, Pratt & Whitney, Nestle
Krasnodar	5.1	5.9	Tourism, Agriculture, Food	Bonduelle, Philip Morris, Tetrapak, Nestle

Overview of major CIS Countries

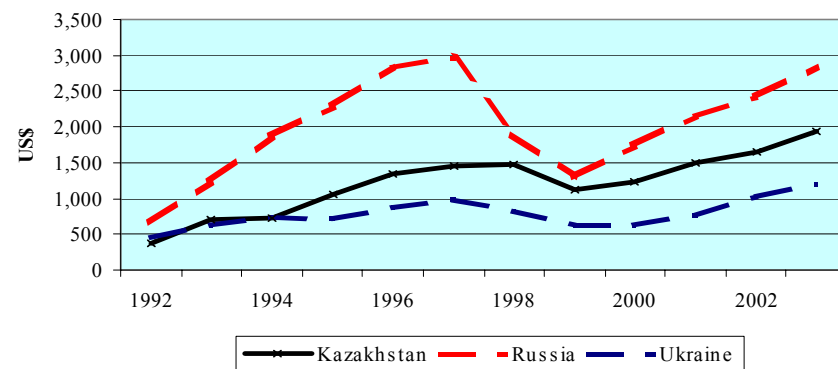
Corruption perception index (2002)

Rank	Country	Index
53	Belarus	4.2
78-82	Armenia	3.0
86-87	Russia	2.7
100-105	Kazakhstan	2.4
100-105	Moldova	2.4
100-105	Uzbekistan	2.4
106-112	Ukraine	2.3
118-121	Kyrgyzstan	2.1
124-128	Azerbaijan	1.8
124-128	Georgia	1.8
124-128	Tajikistan	1.8

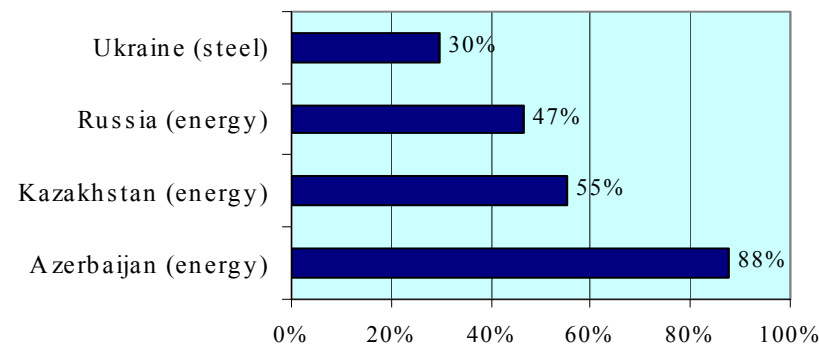
Country credit ceilings (Oct-03)

Country	S&P	Moody's	Fitch
Russia	BB+	Baa3	BB+
Kazakhstan	BB+	Baa3	BB+
Azerbaijan	n.a.	n.a.	BB-
Ukraine	B	B1	B+
Turkmenistan	n.a.	B2	CCC-
Moldova	n.a.	n.a.	B-

GDP per capita



Share of the core commodity in exports

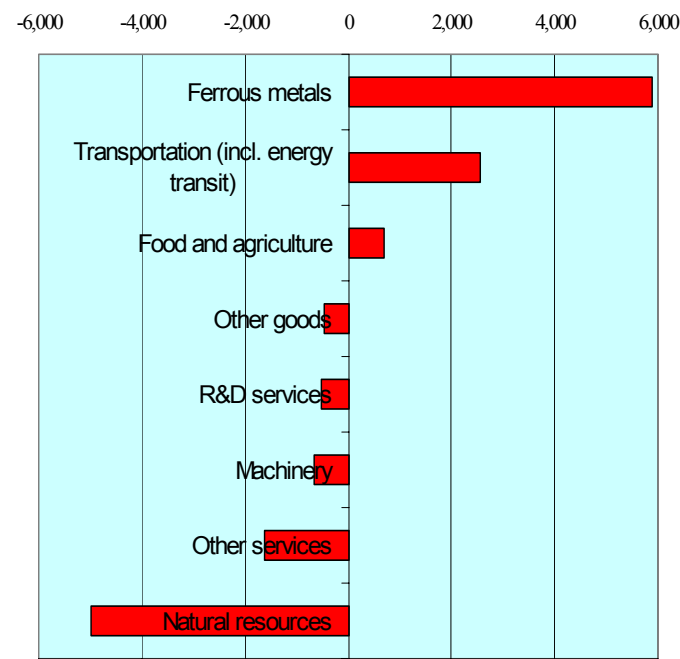


Ukraine



- Ukraine has three major sources of hard currency: steel; energy transit from Russia; food and agriculture
- Food and retail have attracted majority of foreign investment, with operations primarily targeting the local market (the 2nd largest in CIS):
 - Confectionary: Kraft, Nestle
 - Beer: BBH, Sun Interbrew, Soufflet
 - Packaged Food: Orkla
- Steel industry is restructuring to improve transparency but no major foreign players are yet present

Ukraine's Net Exports/(Imports),
2001 (US\$ b)

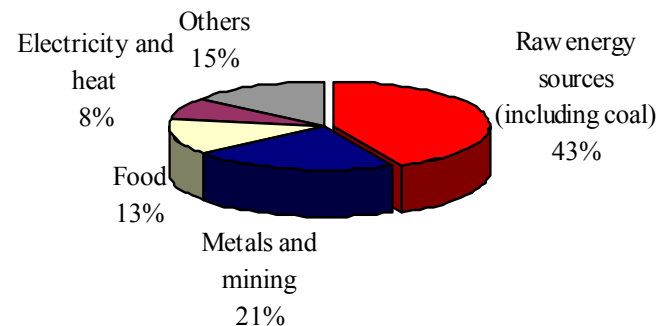


Kazakhstan

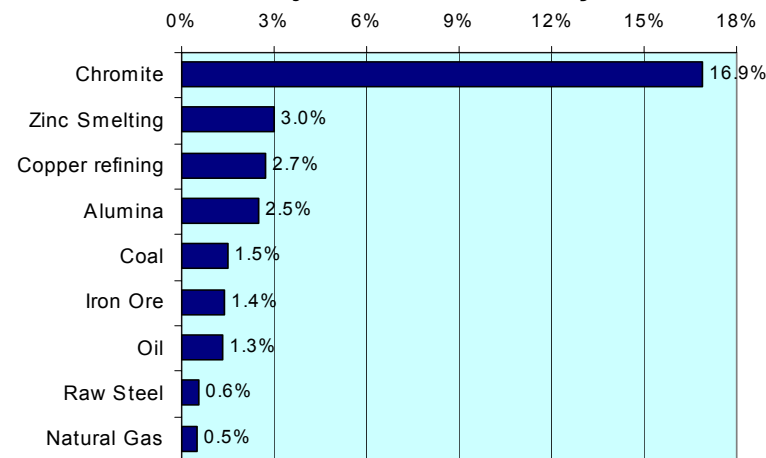


- Industry structure in Kazakhstan is concentrated around two major sectors – raw energy sources (including coal), and metals and mining
- Kazakhstan is the second largest oil producer in the CIS
- The country is advanced in terms of market reforms
- Several Western and Asian multi-nationals and small players are involved in O&G and metals projects in Kazakhstan

Industry Composition by Revenue in 2002



Kazakh share in major world commodity sectors

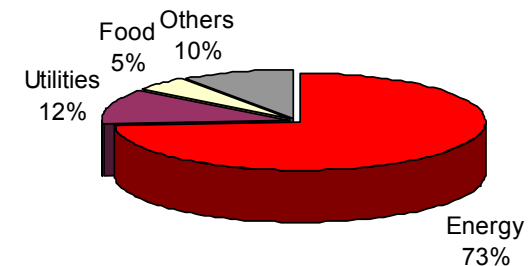


Azerbaijan

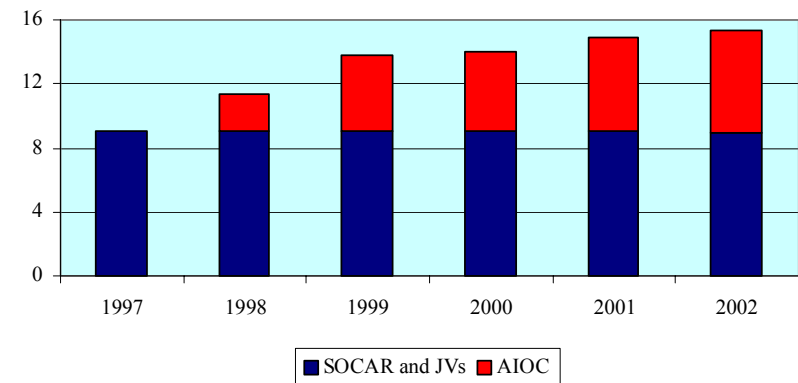


- Azerbaijan is primarily known for its oil reserves – the 3rd largest in CIS, and natural gas reserves (5th place)
- While almost 20 foreign prospectors were looking for oil and gas in the country, only BP-led AIOC (oil) and Shakh Deniz consortiums (gas) were successful as yet
- Turkey is a major investor in the country. Projects include Ramstore supermarkets and management contract for Baku power grid by Barmek

Azerbaijan industry structure (2001)



Azerbaijan oil production (million ton)



Ernst & Young Cross-Border Transaction Advisory in Russia/CIS



A Unique World-Wide Organization



Founded in 1989 by merger of two international professional services firms, Ernst & Whinney and Arthur Young & Company, each with almost ninety years of operation in professional services market

In 2002, after Ernst & Young combined its practices with Andersen in over 50 countries, it has

700 offices in 132 countries

More than 100,000 personnel world-wide

Over 13 USD billion in annual revenues

Ernst & Young Service Portfolio

Assurance & Advisory Business Services

- Audit and Business Advisory
- Business Risk Services
- Technology & Security Risk Services

Business Consulting*

- Organization / Selected Business Process Design
- Activity-based Costing Solutions
- Change Management
- Information System Strategy
- Strategic Advisory & Business Planning
- Performance Management Solutions
- Budgeting and Reporting Implementation

Transaction Advisory Services

- Acquisition Advisory
- Transaction Support
- Capital Markets
- Project Finance / Structured Finance
- Investment Advisory
- Financial Strategy / Strategic Finance Advisory
- Corporate Restructuring
- Privatizations
- Asset / Business Valuation

Tax

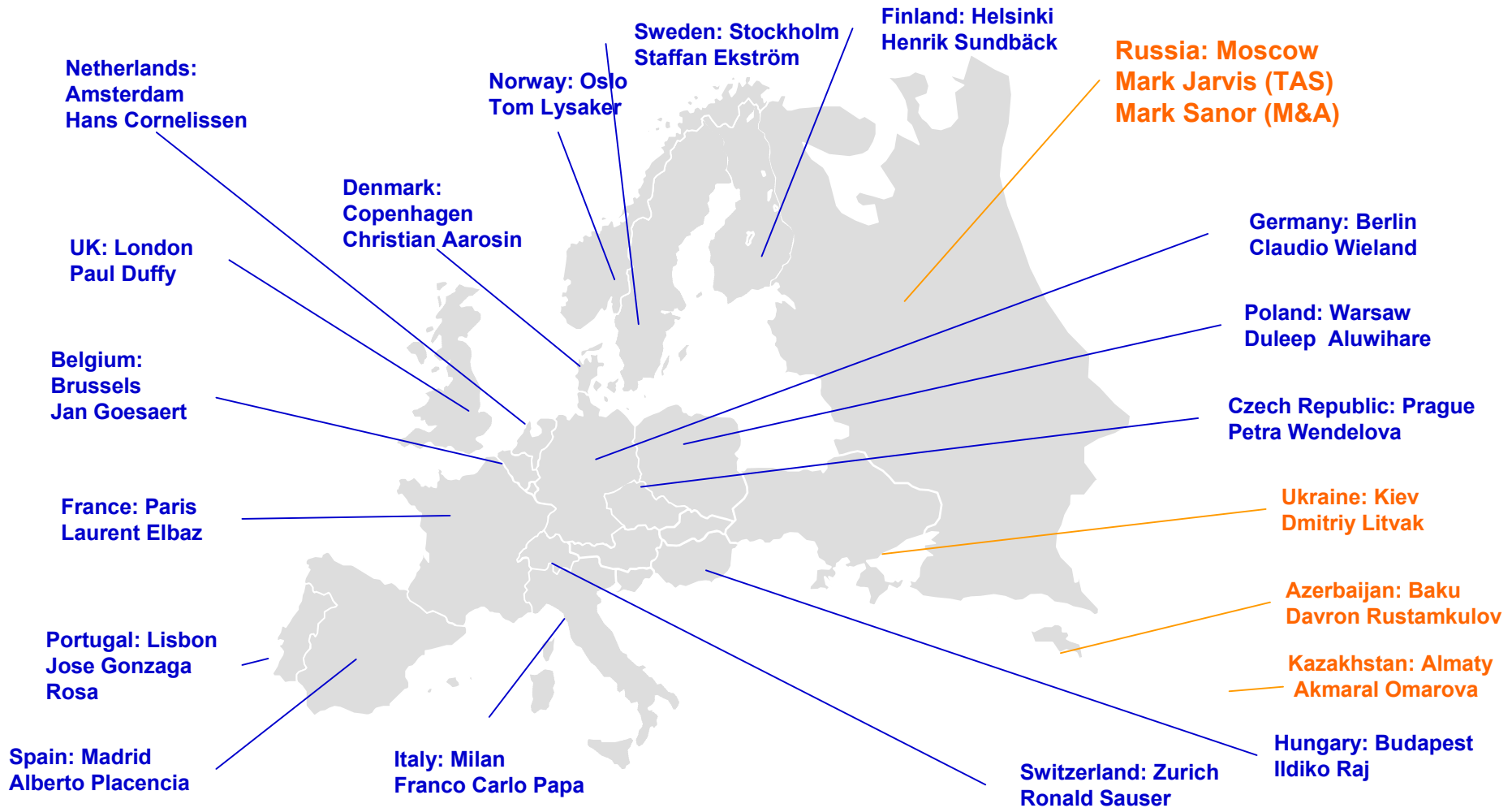
- International Tax Services
- Indirect Tax
- Global Employment Solutions
- Tax Due Diligence

Legal

- Corporate / Commercial Transaction
- Regulatory Approvals
- Litigation / Arbitration

*Business Consulting Services are offered in selected markets, including Russia and CIS.

Ernst & Young's Global TAS Team: European Network



Ernst & Young TAS is well-positioned to serve clients

Transaction Experience

- Extensive experience in completing domestic and cross-border transactions across all industries
- Closed over \$32 billion in aggregate deal value

Industry Knowledge

- Intimate knowledge of multiple industries
- Firm-wide expertise
- Industry operating experience

Engagement Team

- Deep executive involvement
- Experienced professionals dedicated to each client relationship
- Diverse team of professionals with targeted skills
- Confidentiality permeates our culture
- Commitment to provide absolute objectivity

Access to Extensive Network

- Relationships with a significant number of potential, strategic and financial buyers throughout the world
- Intimate knowledge of potential buyers' strategic goals
- Leverage worldwide business contacts

Integrated Services & Technical Resources

- Mergers & Acquisitions
- Capital Markets
- Restructuring Advisory Services
- Valuation and Transaction Support Services
- Tax
- Accounting

Middle Market Focus

- Global leader in advising on transactions with values of \$10-20 million to \$500 million
- Target growth companies with motivated management teams
- Serve more middle market companies than any other firm

Ernst & Young in CIS

With the opening of our Moscow office in 1989, Ernst & Young was the **first international professional services firm** to establish operations in Russia and the Commonwealth of Independent States.

Ernst & Young provides services to the top Russian companies listed on the Financial Times' FT 100 Top Eastern European Companies and the leading Russian companies on the Russian Trading System, which can be illustrated by the graphic below:

Companies	Y2002	
FT-100 Eastern Europe	12	33%
RTS	85	34%

As of May 16, 2002 Ernst & Young and Andersen combined their practices in Russia and other CIS locations under the Ernst & Young name. Today the company is a **powerhouse** with:

- 14 offices in 9 CIS countries
- More than 1,000 audit, tax, legal, and Transaction Advisory Services professionals.



Ernst & Young TAS CIS Organization

Products

Product Leaders

Mergers and Acquisitions	Mark Sanor
Transaction Support	Paul Murphy
Capital Markets	Alexander Sapojnikov
Valuation Services	Hacob Sarkissian
Corporate Restructuring	Viktor Ovsyannikov

Industry Leaders

Energy, Chemicals, Utilities
Viktor Ovsyannikov

Retails & Consumer Products
Evgueni Sidorenko

Global Financial Services
Alexander Sapojnikov

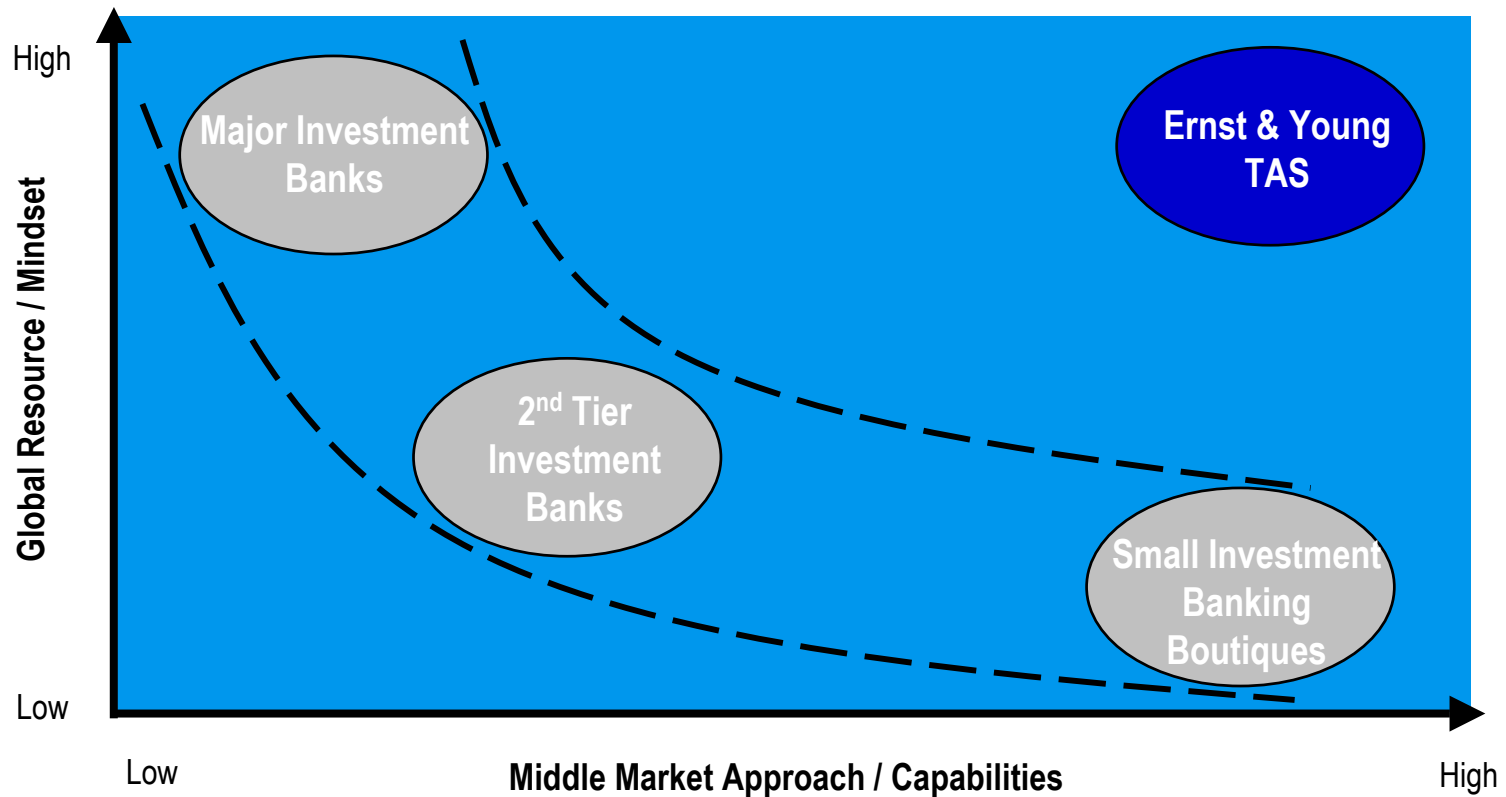
Automotive and Industrial Products
Paul Murphy

Technology, Communications & Entertainment
Mark Sanor

Real Estate
Gerald Gaige

Ernst & Young M&A – Competitive Positioning

- Within the middle market cross border M&A segment, EY TAS is uniquely positioned relative to its competitors. Proactive collaboration within the EY Global Network allows EY TAS to leverage this competitive advantage.



Ernst & Young M&A – Competitive Advantages

M&A Approach Comparison

One-stop-shop:

The E&Y M&A-Advisor serves as coordinator for the entire range of services within a M&A transaction (Audit, Tax, Legal and Corporate Finance)

Ernst & Young	Investment Bank
M&A-Advise	M&A-Advise
Business Plan Support	Business Plan Support
Legal Advise	Legal Advise
Due Diligence	Due Diligence
Tax	Tax
Valuation	Valuation
Acquisition Finance	Acquisition Finance
Post-Merger Integration	Post-Merger Integration

 Integrated services, executed by company professionals

E&Y Corporate Finance in Russia/CIS



Mark Jarvis – Partner – Managing Director of Corporate Finance for Ernst & Young in the CIS. Mark has been active in the Russian market for over 11 years. He spent eight years at Robert Fleming & Co in London and Moscow where he was a Director of Fleming Asset Management, which globally managed over US\$100bn. Following Fleming’s merger with Chase Manhattan Bank in 2000, Mark was COO of Flemings and Chase Manhattan’s operations in Russia and the Ukraine before joining Ernst & Young to head up Corporate Finance.



Mark Sanor – Partner- M&A Group Leader and TCE Group Co-Leader. Mark Sanor is a Partner leading the TCE Group in Transaction Advisory Services, and the Technology Group for the firm in Russia and CIS. A graduate of the University of Michigan School of Law, Mark has over 10 years of corporate finance and legal advising experience. Working in Russia for the last 6 years, Mark has managed several TCE-related advisory matters for international and domestic companies. In addition, he has advised on structured financing, including the arrangement of a \$200 million syndicated line of credit for the City of Moscow.



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Hakob Sarkissian – Partner -- Leader of Valuations Group. Hakob is a Partner with the Ernst & Young Valuation Group, based in Moscow. He has a strong background in project management experience and has performed valuations of industrial property for many years. As an appraiser, Hakob has been involved in industrial property valuation projects in Russia, Ukraine, Kazakhstan and Uzbekistan. His clients include major oil and gas, transportation, engineering and communication entities. Prior to joining Ernst & Young, Hakob was employed as a building structures research engineer, developing calculation methods and software in areas such as structural dynamics, continuum mechanics, seismic stability and building structures. Hakob is the author of several articles published in scientific periodicals and compilations of international conferences. He also penned a paper on dynamics theory and analysis and seismic stability of structures. Hakob is a full member of the Russian Society of Appraisers and member of the American Society of Appraisers.



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