Taking the Investor Perspective

Looking at the regional investment climate through the eyes of foreign businesses

Joint study by
KPMG and RSPP

2013

РСПП

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CONTENTS

FOREWORD

We are delighted to share with you the second edition of the KPMG and RSPP report looking at "Increasing FDI in the Russian regions".

In 2010 we set ourselves the task of analyzing the investment attractiveness of Russia's regions from the point of view of foreign investors, who have global choices about where to invest. We discovered very different levels of attractiveness in Russia and put forward recommendations on how to close the gap between foreign investor expectations and regional realities.

In this study we report back, looking in detail at investor behaviour and taking into account both the 'hard' and 'soft' factors critical to their investment decisions. There is a mixed bag of conclusions, and many contradictory findings. However, we do know that Russia remains an attractive climate for investors with many market opportunities. Work now needs to be done to increase investor confidence and showcase Russia's global appeal.

RSPP and KPMG are committed to providing insights on how the investment situation in the regions is perceived by foreign business investors and we aim to identify the barriers they face when doing business there. In some cases we see that our recommendations have been taken on board by a number of regional governments and investment into those regions has increased. It's these good news stories we feel that will inspire others.

Despite pressing global challenges, we are confident that our findings will help stimulate further investment, debate and action over the next year.

We would like to thank the following people for their valuable contribution to this study: all the decision-makers in the many foreign businesses who gave their time and the many representatives in regional governments without whom this report would lack its insights. And last, but not least, the RSPP and KPMG project teams.

We dedicate this publication to the late Andrei Kuznetsov, Director RSPP, without whose ongoing passion and contribution this work would not exist.

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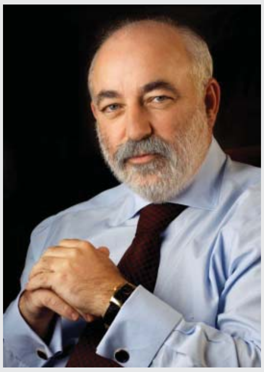
A.N. Shokhin

President of the RSPP

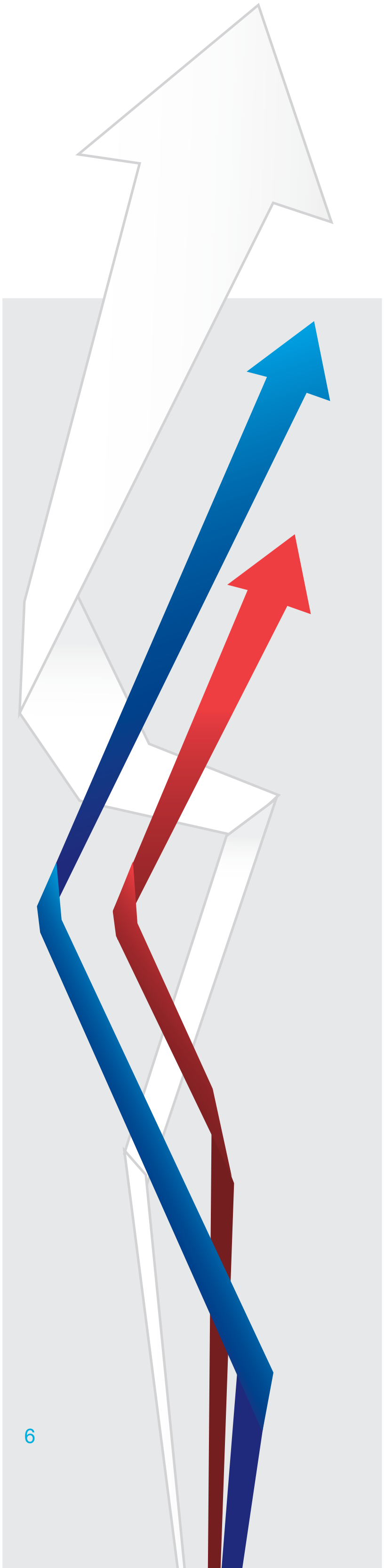


V.F. Vekselberg

Chairman of the RSPP International Cooperation Committee

O. N. Goshchansky

Chairman and Managing Partner of KPMG in Russia and the CIS



Executive Summary

FDI and the Regional Investment Climate Today

Foreign businesses in Russia believe the investment climate in the regions is improving. There has been progress in the '*hard* and *soft factors*' that are key for potential investors. However, it is now time to accelerate this progress if Russia's regions – and indeed Russia itself – are to prosper.

As volatility and uncertainty in global markets continue threats to the regional economies remain and the need for FDI – notably the capital and knowledge it brings – can help them mitigate some of these risks and drive further growth and development. Yet, despite the success stories numerous and diverse regions have had over the last few years attracting more FDI, the overall regional story remains precarious.

The Investor Perspective

In part one we present the insights from 200 experiences business people in foreign firms shared of actually investing in Russia (representing a significant part of Russia's FDI). They suggest there is much to be encouraged by, although many issues still remain:

1. Foreign investors chose Russia predominantly due to its large market opportunities (outside of energy and natural resources), which proves that “Russian potential” is clearly starting to be recognised by the international community and that diversification is underway.
2. Although overall investor confidence is improving it is created by interactions with the regions they are exposed to, which are highly variable.

3. Regional readiness (infrastructure, resources and government support) to attract investors often fails to meet the specific needs of investors from different industries.
4. Corruption – and the mindsets at its core – may be responsible for the failure of as many as 1 in 7 projects.
5. Whilst regional FDI inflows may increase in the near-term as foreign firms already in Russia expand their operations nationwide, to fulfil its potential the country as a whole still has to attract those foreign businesses not yet convinced by Russia as an investment destination.

A number of regions were consistently praised by the foreign investors we talked with and they identified some common themes underpinning the success these regions were having:

- FDI is an economic priority for regions as it helps increase the competitiveness of key industries locally, which is needed to stimulate economic development
- They put the perspective of those investors (and potential investors) at the heart of their strategies
- Key figures take personal accountability for helping investors succeed in the region.

Part two of this report presents the evolving picture of the country's FDI map highlighting the progress made but also aims to re-emphasize the important role FDI plays in the economic development of regions. Our aim is to encourage all regional governors to make attracting FDI a top priority. It is this that will become the engine of economic development and – as our results show – is a viable path for almost all regions.

Synchronising Substance and Form

Russia's regions are currently adopting new measures that will create an attractive and transparent playing field for investors in all regions. These measures – predominantly initiated at the federal level – are crucial to creating a sustainable and competitive eco-climate in Russia's regions. They should also provide the degree of coordination required to support the drive, currently underway, of making the economic potential of Russian regions understood globally. Implemented properly, these measures should be seen not as the introduction of mild state capitalism but the requisite *form* needed to transform a portfolio of very different regions into attractive investment destinations.

However, a cultural change must accompany the *form* improvements in the regions' business climates. Regions must focus on what is required to make current investment projects successful *now*. It is this commitment to delivering positive results that investors define as *substance* and it needs to complement market opportunities to make a region attractive to investors.

Substance is achieved through the 'human factor' with people at all levels of the state apparatus focusing on 'cutting through bureaucracy' to eradicate obstacles to the success of investment projects and commiting to the 'continuous improvement' needed to drive the region's attractiveness long-term. It is this that makes investments happen today.

Yet given the limited resources of people, capital and time there is a risk that the current focus on *form* will absorb many of these resources and starve regions from focusing on *substance*. Furthermore, some resources (e.g. people) may be employed to deliver on the *form* requirements despite lacking the experience or knowledge needed to give real *substance* to this.

Therefore, as the most significant success factors for regions today is the ability to synchronise progress on *form* (delivering sustainability and coordination) with accelerated progress on *substance* (delivering investment today) the challenge must be coordinated from the top but also permeate down throughout the entire state apparatus – from federal to regional, as well as municipal and other state bodies.

Recommendations based on Archetypes*

We have identified four archetypes of Russian regions. These currently have differing levels of *form* and *substance* and therefore should, when looking to synchronise progress in these critical dual areas going forward, prioritise their activities very differently. How each regional archetype can do this is explained in our detailed report, but common themes are of equal importance for all regions:

1. Understand which archetype your region is by taking the investor perspective and effectively prioritising your activities annually if basic conditions stay the same.
2. Have a governor who clearly makes attracting FDI an unquestioned priority of his/her tenure and a senior team that recognises when rules are abused and is willing to end such abuse.
3. Make 'customer-orientation' a key element of recruitment and promotion policies for all staff.
4. Develop a 'hand-in-hand' approach with investors to overcome deficiencies in the business environment and focus on delivering results.
5. Explore synergies with other regions: regularly share knowledge and engage in pan-regional projects that improve labour-force productivity and activites that promote regions abroad.
6. Learn how to differentiate themselves from other regions in the increasingly level playing field that is being established by federal initiatives and knowledge-sharing between regions.

* For more detailed information about archetypes see p.91

Introducing the Investor Perspective

SOFT FACTORS:

Soft factors are those the regional government has considerable ability to positively influence in a reasonable period of time:

1. Aligning regional development goals with businesses' goals.
2. Providing businesses with professional and unbiased support from all government agencies.
3. Making financial and tax incentives worthwhile and obtainable, without hidden strings attached.
4. Creating effective communication channels between businesses and government.
5. Learning from local successes and from best practice in other regions.

In 2010, KPMG and RSPP published research examining what Russian regions were doing to attract Foreign Direct Investment (FDI). We explored how regional initiatives were being received by foreign businesses and why they in turn might invest in Russia and not elsewhere in the world.

Investment attractiveness differs greatly between regions, but foreign businesses suggested attractiveness is highly correlated with the government's attitude towards investors and the support they provide. We labelled this a '*soft factor*' - something regional governments could directly influence.

Importance of 'Soft Factors'

Regions attaching little importance to '*soft factors*' generally fail to inspire confidence in businesses.

If a government shows no progress on key (soft) factors within their control, investors question how the (hard) infrastructure and workforce development challenges will be successfully addressed.

We advised regional governors to accelerate performance of '*soft factors*' to create a window of opportunity for development. This increased

responsiveness to investors should help attract the greater private investment needed to tackle the '*hard factors*' on which future regional development depends.

Aims for this Report

In this updated report we look at the successes some regions[1] have had on this journey. We also explore the actual experiences foreign businesses have had making investments in Russia and share their pragmatic recommendations on how to improve the situation in the regions.

Ultimately, we aim to help regional governors better understand how their development strategies are being received and examine what they need to do to attract more investment to their regions.

1. The regions we look at in this report were highlighted by the foreign businesses themselves as having strategies and policies that were attractive to investors. However, the regions highlighted do not represent an exhaustive list of successful strategies or initiatives by the regions.

HARD FACTORS:

Hard factors are those the regional government has no ability to change, or would need significant resources (time and outside help) to positively influence:

1. Geographical location (impossible to change).
2. Natural resource deposits (impossible to change).
3. Physical infrastructure (resource-intensive change: time, money and outside help).
4. Quality and quantity of workforce (resource-intensive change: time, money and outside help).

We would like to thank the following organisations
for inviting their members to participate in the research

American Chamber of Commerce (AmCham)

Association of Industrial Parks of Russia

CERBA

Economic and Commercial Office of the Embassy of Spain in Moscow

Russian–British Chamber of Commerce (RBCC)

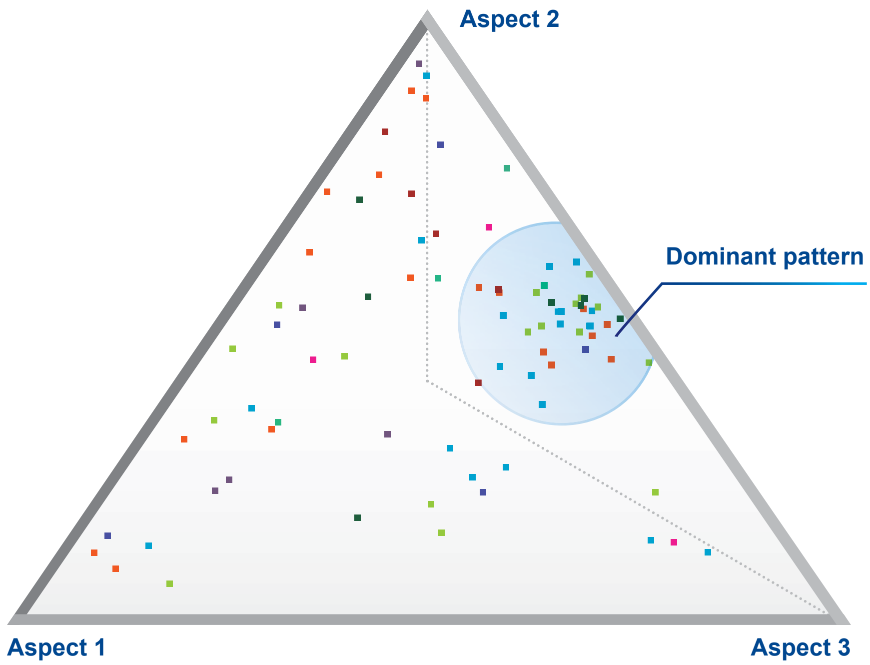
PART ONE
Looking through the eyes of foreign business investors

Research Methodology

To analyse the attractiveness of the business climates in Russia's regions we followed the advice of foreign investors in our 2010 report - to 'look through their eyes' to understand what is happening 'on the ground'. As experienced investors in multiple regions (both in Russia and globally) their insights convey an informed view of what makes a business climate attractive to investors.

During the summer of 2012 we interviewed 200 senior business people in foreign firms to capture their actual experiences of investing in Russia's regions. Part one of this report presents our analysis of those experiences, which builds a revealing and representative picture of the 'investors' perspective' of doing business in Russia's regions over recent years.

Example of Triad



Each dot represents an investor experience. Different colours denote different characteristics related to those experiences or sector/country.

Approach

One of the aims of this research was to avoid simply presenting another set of aggregated numbers (e.g. 70% of foreign firms think the business climate is improving). Instead we provide context revealing why this might be so and what regions can do about it.

We adopted a ‘research-driven’ (as opposed to a ‘hypothesis-driven’) approach and encouraged investors to share any ‘lived experience’ of investing in Russia’s regions they felt was relevant to a true understanding of the reality of investing there. The aim was to uncover the real issues important to investors.

Their experiences were shared in the form of narratives – fragmented stories that are often widely shared within the business community and are therefore important to the perceived attractiveness of the regions. In order to discover the deeper knowledge contained in these narratives, business responders were asked to ‘self-signify’ them - ‘tagging’ them against a framework of supplementary questions (e.g. what was your reason for investing; what role did corruption play?) whilst giving them the option to mark any question as ‘not applicable to their experience’ to reduce the noise in the responses.

The framework itself was a set of visual landscapes (e.g. triads) with multiple aspects allowing the responder to indicate the most dominant aspect(s) related to their experience (e.g. reason for investing was: a market opportunity; local resources; government incentives). This helped build up a deep ‘knowledge-base’ of experiences that was converted into a rich ‘meta-data’ set of multiple data points with thousands of potential links each that was used for analysis.

Using licensed data visualisation software (Sensemaker®) the research team were able to uncover dominant, recurring patterns in the investors’ experiences (reasons for investing, the importance of communication, the role of corruption etc.). These are presented in part one along with some of the triads and the data points. By slicing the demographic data attached to each narrative (investor industry, nationality, number of regional investments etc.) these issues could also be prioritised for different types of investors. Some of these are presented here as ‘weak signals’ - potential insights which could give rise to further areas for conside-ration and research - but require more data than we have before valid conclusions can be drawn.

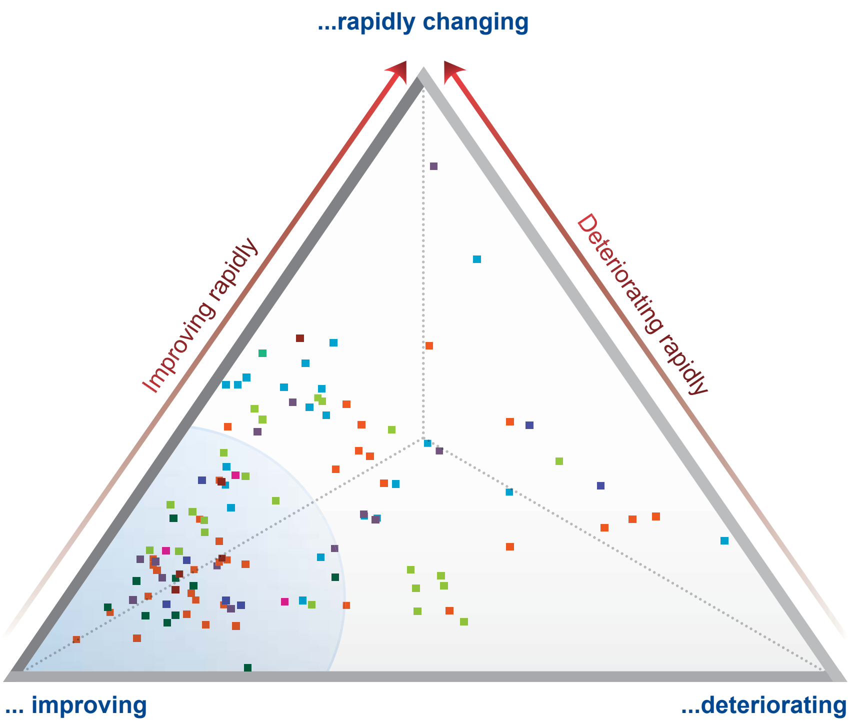
When applying the demographic filters to the different regions and branches of government strong patterns also emerged. These highlighted some of the successful approaches for improving the investor experience and making the region more attractive. The research team approached those government investment teams to learn more and their responses are also presented here as case studies, with the aim of sharing lessons that are potentially transferable to many more regions.

Overall, we believe these findings rep-resent an accurate picture of what investors really consider important in making a region attractive for them and, most importantly, why they think this. We strongly advise regions to take the ‘investor perspective’ when analysing the attractiveness of their own regions, to build up a similarly detailed picture of the ‘reality on the ground’ and customise their own strategies to amplify current attractors and dampen down the barriers to attracting greater levels of FDI in the future.

The investment climate in Russia's regions is improving but not accelerating fast

A majority of respondents (61%) suggested the investment climate in Russia's regions is *improving*; however the lack of experiences in the top left hand part of the triad below indicate that change has not been happening rapidly.

Question: In your opinion the investment climate in Russia's regions is...



Key: each dot represents an investor experience.
Different colours denote different industries.

"We have a really effective relationship with the governor as we work together to improve the situation locally – and we are seeing the results."

North American Investor

"We had very few issues operationally … and the market is also getting stronger. Therefore, due to our experience we have the confidence to consider other Russian regions for our future expansion."

B2B services, Eastern Europe

Accelerated progress is blocked by a number of industry specific issues. For example:

1. Consumer market firms highlighted problems with ‘*time-wasting bureaucracy*’ which eats into their industry’s tight profit margins.
2. Industrial market firms highlighted problems around a ‘*lack of transparency*’ during their large-scale investment projects, which prevents accurate forecasting for return-on-investment (ROI).

Specific industry issues highlight a major challenge regions must overcome to attract more investment. As business investors look for a ‘fit’ between their own business models and a region’s advantages, local government needs to adopt strategies to accentuate this.

For example:

1. Consumer market firms operate in a high volume/low margin industry, so regions looking to attract these investors should focus on providing *quick* and *cost-effective* support and solutions.
2. Industrial market firms are capital-intensive, with large-scale, long-term investments, so regions targeting these investors should focus on *reliability* to help improve transparency during planning.

Regions need to know which industries they want to (and can) attract businesses from and what is most important to them. This will allow them to customise their business climate to meet the critical performance objectives of their target investors and thereby appear more attractive to them.

“I always thought investing in Russia was very time intense. Given our recent experiences, I now realise I seriously under-estimated the delays caused by the standard procedures of the regional administration.”

Consumer Markets, North America

“One issue is the time required to get all of the permits required to build something and if there are any changes the process needs to start from square one again. This makes it twice as long at least to get things done here than in the west, which affects our ROI.”

Industrial Markets, Western Europe

Operations Performance Objectives

Creating the right experience for a potential investor is critical to a region's 'brand' as a great place to do business. Clearly understanding the 'performance objectives' of the investor's industry can help guide the type of support they will value during their entry and help develop a reputation that can attract others.

The 'five performance objectives'*

1. **Quality** - of resources (physical and human assets), information and government support.
2. **Cost** - of setting up operations, including incentives such as tax honeymoons.
3. **Speed** - of response to investor needs and the administration processes for establishing a business.
4. **Reliability** - of information received and delivering on the promises made by the government.
5. **Flexibility** - understanding specific client needs and working with them to overcome obstacles.

All five objectives will be important to investors, but in reality trade-offs will need to be made (e.g. a very flexible administration process may be slow due to the necessity to obtain approvals). Therefore, regions should focus their targeting on certain industries and design support structures to help those firms meet the challenges their industries impose on them.

** Developed by Professor Nigel Slack, Warwick Business School, UK*

1. Managing multiple investment relationships is difficult for firms
   - 44% of foreign businesses with 1-3 investments in regions record having positive experiences
   - 33% of those with 4-10 regional investments are positive
   - Only 14% of those with more than 10 regional investments are positive

2. Changes over time are difficult to track in the short term
   - During the last two years only 25% of investor experiences were tagged as positive or very positive
   - 42% of experiences of more than two years ago were tagged as positive or very positive

3. The origin of investors impacts perceived success
   - Over 50% of North American and Asian businesses had positive experiences
   - Only 27% of Europeans had positive experiences
   - And only 11% of Northern Europeans did
   - 83% of B2B firms had positive experiences – the results for other industries were:
     - 67% for Automotive
     - 30% for Technology firms
     - 28% for Transport & Logistics,
     - And only 20% for both Real Estate and Infrastructure

! Weak signals: Further investigation required

"The process of building a plant was very speedy: 6 months of negotiations and 8 months building the factory without any issues."

More than 2 years ago
Automotive, Western Europe

"All the procedures (migration, getting licenses, permits etc) take too much time to fulfill. Even worse, everything has to be done on paper."

Last 3 months
Infrastructure, Northern Europe

Investors look beyond the resource story to market opportunities

To investors outside, Russia continues to appear dominated by its natural resources, but to those already in Russia the market offers many opportunities: it became the largest automotive market in Europe in 2012[1]; is widely expected to become the largest consumer market in Europe by 2020; and, as GDP per capita continues to rise[2] it may become the fifth largest economy globally[3].

Question: The main attraction for investing in a Russian region was...

Key: each dot represents an investor experience.
Different colours denote different industries.

1. Vesti.ru (http://english.ruvr.ru/2012_05_16/74907165/), CitiGroup analysis, 2012 (http://www.finmarket.ru/z/nws/hotnews.asp?id=2986680)
2. “Russia could become very wealthy. Russian GDP per capita could rise from $10,000 today to $20,000 by 2020 and perhaps close to USD 60,000 by 2050” Jim O'Neill, ‘The Growth Map’
3. Euromonitor International, ‘Top 10 largest economies in 2020’ (2010)

“Russia is our fastest growing market in terms of percentage increase of turnover.”

Transport & Logistics, Northern Europe

“The region's location close to Moscow is an advantage, but support from the regional administration in all areas is what has made the difference.”

Industrial Markets, Western Europe

“The banking sector is an ‘ideal world’ in Russia - you only have to fulfil Central Bank requirements whose instructions are given on a granular level, so it is easy to understand how to meet them. The government is also eager to attract and bring in foreign capital so the opinions of bank CEOs are respected and taken into consideration whenever changes are made.”

Banking, Western Europe

However, exploiting market opportunities in Russia often requires the active support of government. Although only 4% of investors suggested the main attractor *alone* was government support or incentives, a significant number indicated that such support *combined with* market opportunities was a key factor. Government's key role therefore should be as an *enabler* for businesses, focusing on:

1. Targeting the right firms and industries for their region.
2. Delivering the customised support business investors need in order to earn profits.
3. Cultivating a business environment that generates viable market opportunities.

A significant cluster of responses also suggested that *knowledge workers* are an '*asset*' that can attract business investors (especially technology firms) to a region. However, concerns were also raised about the overall quality and quantity of the Russian workforce, which is acute in those regions experiencing an ongoing 'brain-drain' to other cities or countries as limited opportunities persist in the local market.

"The quality of education has fallen significantly… However, the combination of price and quality of employees in Russia is still very high."

Technology, North America

Introducing the Case Studies

Out of all survey respondents three regions stood out: Kaluga, Ulyanovsk and the Republic of Tatarstan. In these regions investors had overwhelmingly positive experiences when doing business there. Strategic initiatives in two further regions – Sverdlovsk and Lipetsk – also attracted very positive responses from investors. Although these regions do not represent an exhaustive list of regions with positive investor experiences it was to these we turned to investigate what they were doing that appeared so right in the eyes of some investors.

What we found was that all of these regions had not only clearly understood the benefits FDI brings to their local economies but they had also taken the investor's perspective when creating and implementing their often highly-innovative strategies to attract and retain FDI.

Using open sources we explored the strategic initiatives these regions had implemented and that had been favourably received by the foreign investors in our survey. We then turned these into brief case studies and sought verification from the regions.

Our aim here has not been to judge these strategies (after all, this is for the business investors themselves to do) but to facilitate a *knowledge transfer* of some well-received strategic initiatives to all regions.

Ulyanovsk

"When we came to Ulyanovsk to consider investing there we were greeted at the airport. Our appointed contact supported us with everything – he was well known and respected in all governmental authorities and the investment process was faster because of him. Furthermore, we felt that everyone we dealt with in Ulyanovsk was happy to see us."

Consumer markets, North America

"The Ulyanovsk government asked us which terms and legislation we would like to work to. As we have a factory in X we suggested the legislation we have there as a benchmark. They listened to us, understood and adopted all the changes."

Other, North America

"Land plots in Ulyanovsk have clear history. You don't have to worry that it belongs to someone else and that they will come and take it away from you."

Other, Western Europe

Republic of Tatarstan

"Our company was very impressed with the regional authorities in Tatarstan. Because our project was considered strategically important it came into the President's direct interest. He promised there would be no bureaucracy burden for us and in fact we found the process to be very streamlined."

Technology, Western Europe

"The infrastructure in Alabuga is ideal - the territory has necessary physical infrastructure you need to run a business or a factory."

Other, Southern Europe

“Kaluga is learning from past experiences and responding to the needs of investors During personal talks with the vice-governor I suggested an idea … a month later I read in the newspaper that they will be doing it.”

Automotive, Western Europe

“Kaluga can be a benchmark for all the other regions as they immediately respond to the investors needs and provide full support. You get the feeling that they know and understand what they are doing and what matters for the investor.”

Industrial markets, Western Europe

Kaluga

Case 1

Regional Development Institutions (Kaluga)

Kaluga recognises they are in competition for investments with other regions and countries and that many of these competitors are rapidly becoming more attractive to potential business investors. Therefore, they are using these competitive pressures to set the higher standards they need to meet to achieve success.

Kaluga regularly speaks to investors who have made successful investments in the region, as well as those considering making investments, *and those who decided* not to. By doing this they can continually improve the quality of support they provide to businesses.

As a result they have developed four 'Regional Development Institutions' (under the Ministry of Economic Development) whose main functions are to provide individual support to investment projects. Integrated project teams are appointed to work closely with investors to deal with specific challenges they may face. The aim is to help them successfully realise their projects for the benefit of the investor and the region.

The four 'Development Institutions' and their aim:

1. The Kaluga Regional Development Agency – attracting and supporting investments.
2. The Kaluga Regional Development Corporation – providing technical and infrastructure support.
3. Industry Logistics – providing and advising on transport and logistics services.
4. The Kaluga Regional Innovative Development Agency – development of high-tech sectors in the economy.

Agency for regional development of Kaluga Region

The Kaluga Regional Development Agency
(reformed in 2009 as an independent institution under the Ministry of Economic Development) is one of the key implementation agencies delivering on Kaluga's strategic initiatives to create an attractive business environment for investment. It acts as a 'concierge', helping businesses (both new and those already working in the region) to resolve issues connected to migration, work permits, finding accommodation and interacting with other state bodies.

Agency Responsibilities:

- Attracting investment and developing the image of the region in foreign and domestic markets
- Providing individual support and advisory to investors at each stage of their investment project
- Cooperating with the independent Institute for PPP (public-private partnerships) developing social infrastructure projects
- Stimulating competitiveness through identifying competitive advantages of districts.

Kaluga Region Development Corporation

The Kaluga Regional Development Corporation (f. 2007) is the state-owned developer for investment projects in the region, including the creation of new industrial parks and zones. It provides legal and technical support through buying and leasing land in industrial parks and is responsible for all utility connections required by both individual investors and industrial sites overall.

Corporation Responsibilities:

- Preparation of documentation for investment projects and coordination with local authorities
- Implementing approved support between regional government and business investors

"We agree with the KPMG/RSPP report of 2010 that the continuous support of the regional administration is the deciding factor for investors choosing where to invest. This is especially so today, when practically every region offers tax and other incentives. In our experience, a favorable administrative environment is the most important factor for investors coming to a region for the first time."

Ilya Veselov,

Director of the Agency for Regional Development of Kaluga region

- Representing the business when dealing with Federal Institutions of Development
- Developing a commercial (not state) based financial model for development of industrial parks.

Industry Logistics (f. 2010) is the state operator for the development of transport and logistics infrastructure in the region, as well as acting as an advisor and provider of transport and logistics support for businesses. Its main focus is to ensure that the development of the region's infrastructure is aligned with the actual needs of the businesses.

Logistics Responsibilities:

- Developing the regional strategy of infrastructural development
- Interacting with federal customs and transport monopolies
- Advisory function helping businesses choose transport and logistics partners.

The Kaluga Regional Innovative Development Agency (f. 2011) provides support to new start-ups: from developing business plans to applying for and getting government support. It also deals with the residency policy for techno-parks and supports innovation in the region.

Agency's Responsibilities:

- Advises SMEs (small and medium-sized enterprises) and will provide seed funding for early stage project development
- Finding partners for the formulation and implementation of innovative projects
- Assisting in marketing, licensing, patenting, and financing of innovative projects
- Organisation of educational programs for the management of innovative enterprises
- Development and implementation of cluster policies and programs.

Main goals of system:

- Create the most favourable and beneficial conditions for business investors to come to the region
- Facilitate their entry and continually streamline the system of supporting them
- Drive the economic development of all the region's territories.

Measuring success:

1. Level of investment attracted.
2. Number of new investment projects.
3. Increase of tax base.
4. Number of new jobs created.

In 2011 Kaluga became a 'self-sufficient' region, no longer dependent on federal subsidies.

"An investor's entry into a region is an interactive process. The region needs to create the most comfortable conditions possible, taking into account, or, better still, exceeding the requirements of each investor. It is equally important to support them throughout the process. Only then can the project be a success and the investment benefit both the investor and the region."

Ilya Veselov,

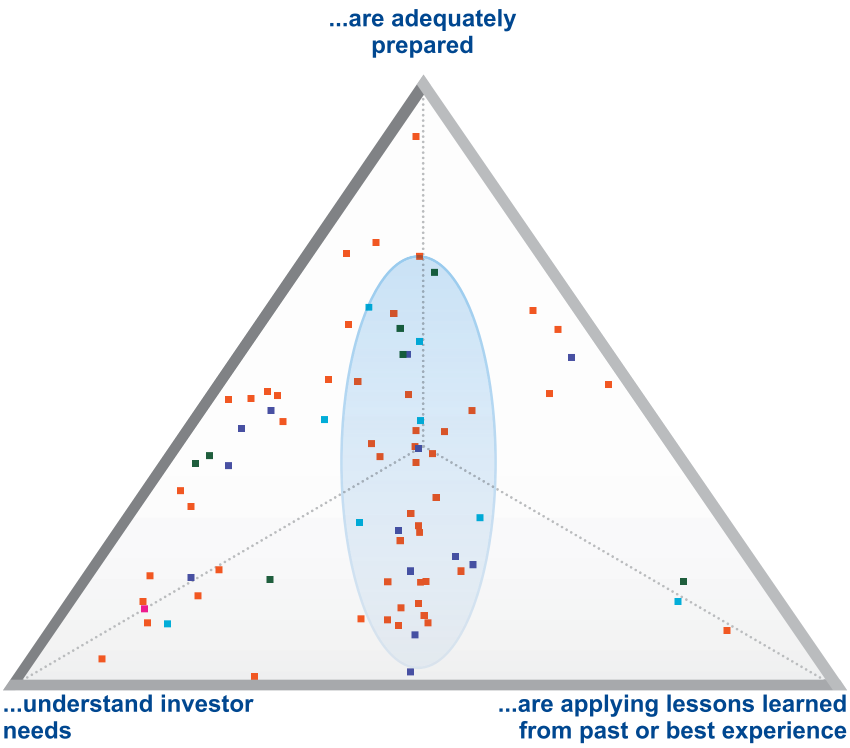
Director of the Agency for Regional Development of Kaluga region

Foreign businesses are concerned whether regions are able to meet their needs

Over half of investors express concerns about ‘soft factors’ in the regions – the readiness or ability of regional authorities to provide the support investors really need.

Continued failure to address this may be contributing to a negative view of the regions amongst those who have not invested there.

Question: Your major concern about the regions is whether they...



Key: each dot represents an investor experience. Orange and blue dots represent experiences investors considered typical or somewhat typical.

“Regional authorities don’t quite understand what is needed. Although they participate in round tables and so on, not much is done yet.”

Industrial Markets, Southern Europe

“We planned to invest in a major green-field food processing site. The authorities in a number of regions suggested we build it in their regions, despite there being absolutely no suitable agricultural infrastructure there at all.”

Consumer Markets, North America

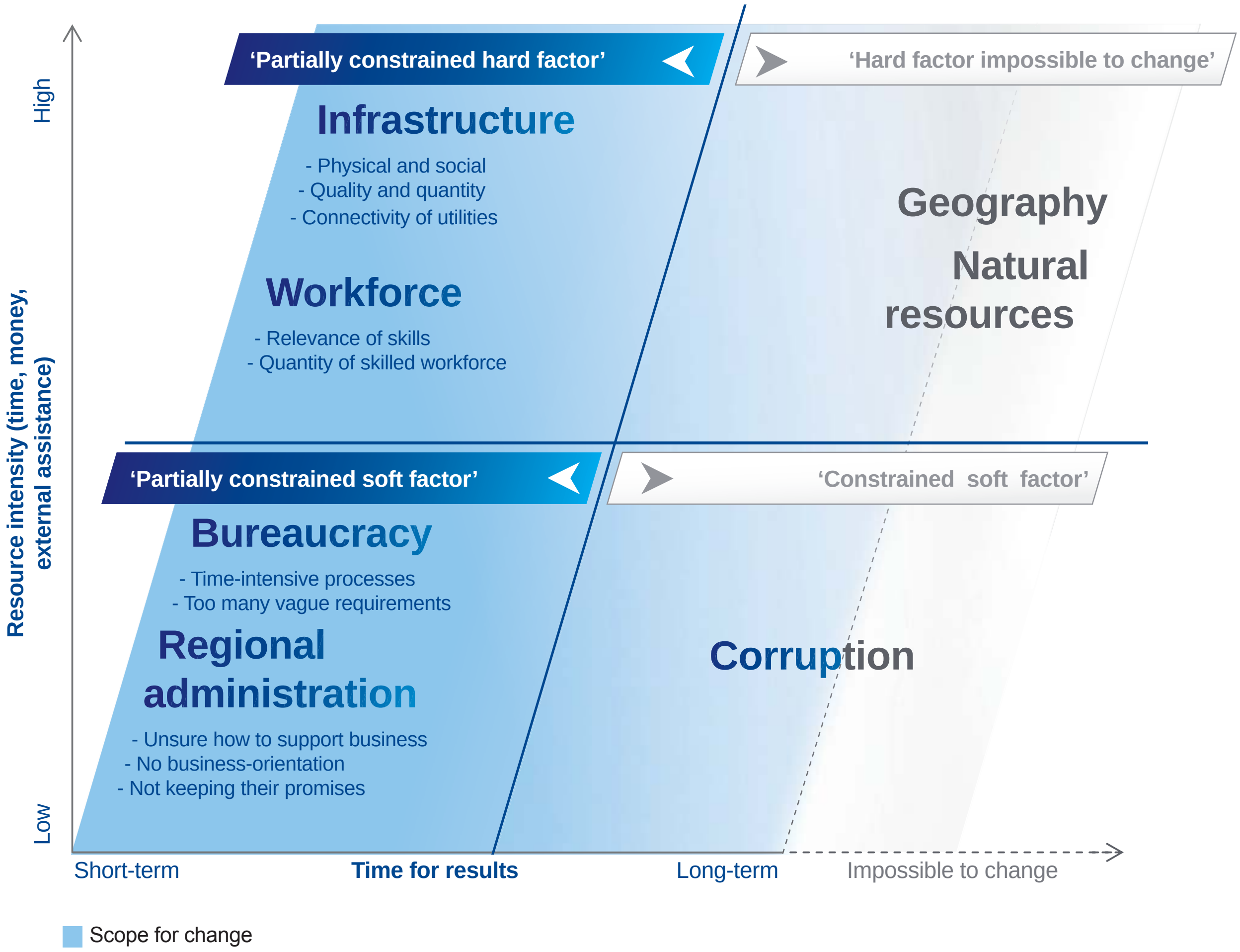
“The regional government didn’t seem to know what they were doing. They tried to be helpful by saying ‘OK, we will do it’ but would then ask ‘can you tell us how to do it?’ ”

Industrial Markets, Western Europe

Encouragingly some regions are successfully addressing '*soft factors*' and tackling the '*hard factors*' that are also important in attracting business investors. Notable in this is Lipetsk, whose *infrastructure development* strategy is helping to attract increased levels of FDI to the region.

This has led us to redefine our hard factors and soft factors model first presented in 2010. We introduce the idea of 'constraints' that influence how quickly 'soft' and 'hard factors' can be addressed.

KPMG's Soft and Hard Factors Model – with major concerns foreign businesses have about the Russian regions he Russian regions



'Constraints' such as financing, know-ledge and behaviour affect how many other resources (e.g. time, political capital) need to be used to ensure development in a particular area.

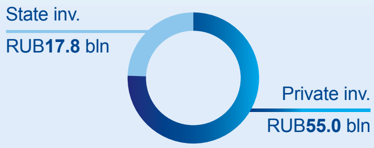
Using this model as a guide, we advise regions to focus on addressing 'partially constrained *soft factors*' (bureaucracy and regional administration issues) as a priority, as they promise the best cost-benefit returns (as factors important to investors but requiring less resources and promising quicker results).

The benefits of this - potentially increased levels of capital and knowledge inflows from greater private investment - will allow regions to lay the foundations for addressing the longer-term, capital-intensive challenges of infrastructure and workforce improvements (partially constrained *hard factors*) and/or the long-term behavioural challenges involved in tackling corruption (a constrained *soft factor*).

A region's actual priorities need to be decided with consideration as to what it may already have achieved and what will be most valued by the type of private investors it is looking to attract. Tapping into the experiences of foreign business investors to prioritise this plan of action therefore is something every region can, and perhaps should, do.

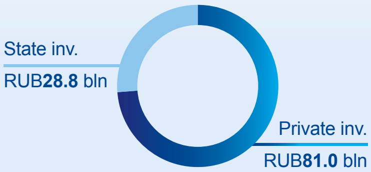
CASE 2

SEZ LIPETSK
(Lipetsk region)



Ratio 3.08

SEZ ALABUGA
(Tatarstan Republic)

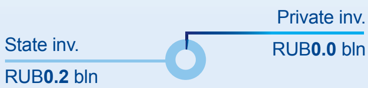


Ratio 2.81

SEZ TOLYATTI
(Samara region)

under construction since 2010

SEZ TITANIUM VALLEY
(Sverdlovsk region)



under construction since 2010

- Private investment
- State investment

Source: (1) OAO ROSSEZ Annual Report 2011;
(2) open source

Infrastructure Development (Lipetsk)

In 2005 Lipetsk was chosen as the location for one of the first two industrial/ manufacturing Special Economic Zones (SEZ) in Russia (along with Alabuga in Tatarstan, with two more being chosen in 2010: Sverdlovsk, Titanium Valley; and Samara, Tolyatti). By 2012 the Lipetsk SEZ had become the most efficient at attracting private investment for each Rouble of state investment.

However, diversifying the economy was also crucial for the region as tax revenues were highly dependent on one major business that contributed over 50%. Therefore in 2006 it introduced the 'law on special economic zones at the regional level' (SEZ RL) in order to stimulate municipal authorities to attract private investment in their districts.

The Lipetsk regional authorities consider the existence of a sound infrastructure to be a priority for businesses looking to invest so have focused on building a comprehensive 3-tier system of infrastructure facilities in the region. The aim is to attract all types of business investments (local and foreign, small to large) and encourage both regional and municipal authorities to become more proactive in attracting private investment and become accountable for results.

1 level

SEZ Lipetsk
Project start: 2005

Total land area: 1,024 ha
Total number of investors: 22
Number of foreign investors: 7

2 level

Special regional economic zones
Project start: 2006

4 **Industrial zones**
Total land area: 2,090 ha
Total number of investors: 23
Number of foreign investors: 6

2 **Tourism & culture zones**
Total land area: 97,931 ha
Total number of investors: 14
Number of foreign investors: 0

1 **Agricultural zone**
Total land area: 96,820 ha
Total number of investors: 3
Number of foreign investors: 0

1 **Engineering park**
Total land area: 4.4 ha
Total number of investors: 0
Number of foreign investors: 0

3 level

Industrial parks
Project start: 2011

Total area: over 85,000 m²
Total number of investors: 7
Number of foreign investors: 3

Special Regional Economic Zones (SREZ)

Since 2006, 8 Special Regional Economic Zones (SREZ) have been created and residents of these receive the same incentives as residents of the federal SEZ's (except for customs relief).

- 4 industrial zones
- 2 tourist zones
- 1 agricultural zone
- 1 new engineering park (under-development).

	Years in operation	Total investment declared (billion RUB)	Total number of local business investors	Total number of foreign business investors	Average Investment per local business (billion RUB)	Average Investment per foreign business (billion RUB)
SEZ LIPETSK	7	55.1	15	7	2.5	2.5
SREZ Industrial	3-6	62.0	17	6	2.8	2.4
SREZ Tourism	6	9.5	14	0	0.7	-
SREZ Agro	6	8.7	3	0	2.9	-
Private Industrial Parks	1	0.3	4	3	0.03	0.06

In 2011 Lipetsk launched an innovative project - Private Industrial Parks (PIPs) whereby any local company with an annual turnover of less than RUB600m who successfully brought a foreign enterprise to Lipetsk to establish operations, could apply for the status of a PIP and receive special tax concessions. This is aimed at developing industry value chains, stimulating the efficient use of brownfield sites, and leveraging local business contacts and efforts to attract foreign investment.

Main results (as tracked by the regional administration)

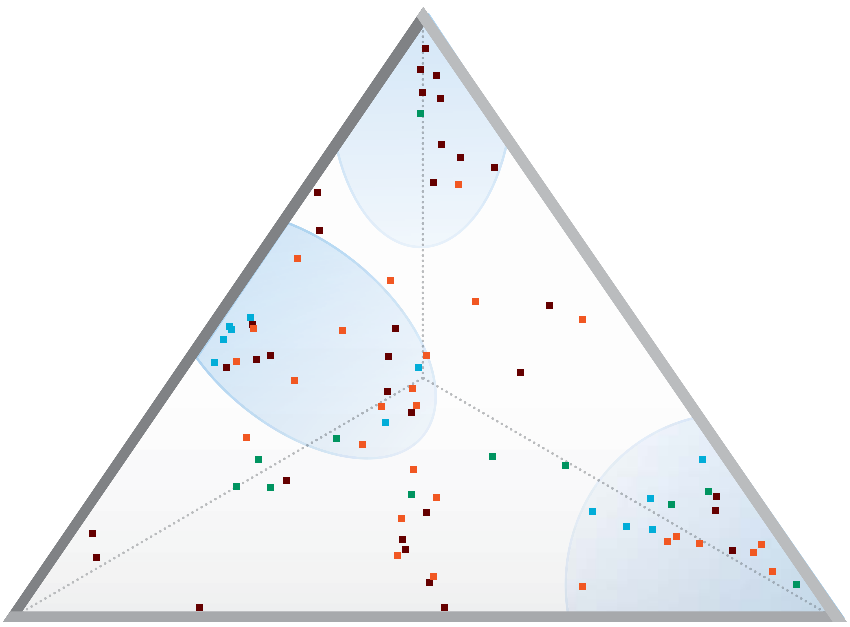
1. Total investment inflow in the region increased by a factor of 2.4 in 2005-2011.
2. Private investment per capita exceeded the national average in 2006, with this trend continuing.
3. More than 41,000 new jobs were created in large and medium-sized companies between 2005-2011.
4. Progress in diversification of the region's economy with NMLK tax contributions as a percentage of total tax revenues falling from 53% in 2005-2007 to 27% in 2012.
5. Creation of a foundation for further cluster development in key industries: production of home appliances, construction materials, agricultural machinery.

‘Hard factor’ concerns need to be addressed if regions are to become attractive

A significant majority (over 70%) of investors have major concerns about resources in the regions that need to be addressed by governments if their regions are to become attractive.

However, it is notable that the concerns of foreign businesses (outlined below) appear to differ markedly from those that local small and medium-sized businesses may have (e.g. such as access to credit and other financial resources) and deeper consideration should be given to the various needs of all investors in a region.

Question: Your concerns about resources in the regions relate to their…



Key: each dot represents an investor experience. Orange dots are from experiences from over 2 years ago, all other dots are experiences in the last 2 years.

“There are problems with the number of qualified workers in the region, especially from Professional Technology Colleges (PTU). People are being taught there on machinery that hasn’t been used for more than 20 years.”

Industrial Markets, Western Europe

“Where there are roads, they are of poor quality and can be closed for 4-8 weeks per year as maintenance of the roads is not properly done. Regional authorities also tend to promise to provide support in relation to infrastructure, but don‘t.”

(Investor information not given)

“We turned to the government for information on how much it will cost us to build a factory in Russia and found out it will be at least 33-50% more expensive than it costs in Europe.”

Consumer Markets

“Energy is of very poor quality. For example, at a recent round table a representative from a major automotive firm said their robots cannot work with such inconsistent energy supplies due to constant outages. Quite often foreign technologies can’t work here due to such poor infrastructure conditions and these standards need to be addressed.”

Industrial Markets

Market- vs. efficiency-exploiting FDI

'Market-seeking FDI' considers a country attractive if it has …	'Resource-seeking FDI' considers a country attractive if it also has …
A large economy (GDP size)	High productivity
High consumer spending (disposable income)	Highly skilled and mobile workforce
Growth potential (real GDP growth rates)	High resource (including agriculture) potential

Foreign investors' major concerns about resources are a mixture of both partially-constrained 'soft' and '*hard factors*' meaning that, once again, accelerated development in the 'softer' areas (e.g. keeping promises) could attract the resources, in the form of investments, needed to address the 'harder' factors. But these concerns may also indicate why the majority of inward FDI into Russia is '*market-seeking*' (looking to exploit market opportunities) rather than '*efficiency-exploiting*' (where a region's capabilities - e.g. labour force, R&D, infrastructure – become part of a firm's global supply chain). The absence of *resource based FDI* may ultimately represent a 'glass ceiling' on the total FDI Russia can attract.

Improving the quality, reliability and availability of a region's key resources is critical to attracting more FDI, especially of the *resource-seeking kind.* For regions with less natural resources, smaller populations or lower levels of aggregate consumer spending attracting FDI that looks to tap into the regions' other resources - workforce, quality of infrastructure, other 'input costs' such as energy supplies - is an approach that has not yet been successfully exploited widely in Russia.

Training for investor facing government employees should also be considered by regions. If business skills are actively developed then competition for such roles could be stimulated amongst a wider group of graduates and professionals seeking dynamic career paths. The result – an increase in positive investor experiences through dealing with business oriented government employees - could be hugely beneficial to all regions adopting this strategy.

Key regional resource concerns for foreign business investors

69% of respondents expressed a concern about the following resources in the regions:

1. Physical infrastructure:
   - utilities – not meeting business needs
   - roads – low-density networks
   - land plots – vague history
   - authorities promising but not delivering.
2. Workforce:
   - few English speaking personnel
   - lack of technical specialists
   - students taught on out-of-date machinery.
3. Social infrastructure:
   - lack of hotels, housing, real estate companies, kindergartens and schools
   - high-price for the currently poor infrastructure.
4. Financial infrastructure:
   - no long-term money market.

Case 3

Public/Private Training Centres (Kaluga)

Through listening to investors Kaluga's administration understood that a major concern for businesses was the quality and quantity of the workforce. If the region was to continue to attract and keep cornerstone business investors in the region they would have to address this problem directly, rather than hoping it would resolve itself. The best way of approaching this was to work *together* with key businesses at each stage of the process.

The ATC Example

Fully equipped with modern technology, the ATC has already trained more than 7,000 people. It offers around 100 programs and has more than 30 laboratory and workshops specialising in fields such as industrial and automotive electronics.

Importantly, it offers training in professions that did not exist in Soviet times and a key part of its work is collaborating through joint projects with equipment and technology suppliers and European educational organisations.

Automotive Training Centre (ATC)

The ATC, on which Kaluga has spent just under one billion Roubles, is located in the Kaluga College of Information Technologies and Management and is therefore part of the state professional education system. The government pays for the education of students (for whom the education is free), while businesses partially subsidise the equipment that is the same or similar to that used in their production facilities. This means students graduate with the precise skills these businesses need, reducing the need (and cost) of re-training them, thereby making them more attractive as employees upon graduation.

Businesses also actively participate in the development of vocational programs, helping establish standards, providing experts to teach at the ATC, and offering internships. The attraction for businesses is that they can re-allocate their training budgets to this enterprise, making it economically efficient for them, especially as costs are shared between government and other businesses. This has helped attract global leaders to cooperate in the program including Volkswagen, Citroen-Peugeot and Mitsubishi Motors.

Pharmaceutical Training Centre (PTC)

The PTC is currently being developed and will be up to full capacity in 2013. The aim of this project is to provide qualified staff to work at modern ('Good Manufacturing Practice') facilities for the region's pharmaceutical manufacturers. A number of agreements have been signed with leading pharmaceutical firms with operations in the region that are interested in using the centre for training staff.

The curriculum will be based on Germany's "dual system" of vocational training, but adapted for Russia. 23 students completed a pilot version of the course, implemented with the help of TÜV Rheinland, and are now working at Berlin-Chemie's plant in Kaluga.

Future Training Centres:

Inspired by the success of ATC & PTC, Kaluga is looking to develop centres for:

- New professions
- Establishing more educational institutions: technical colleges of European levels (in close cooperation with European technical schools)
- Founding new universities and higher schools.

Main goals of Training Centres:

1. Meeting investors' requirements in both quantity and quality of staff required.
2. Increasing the efficiency of education by decreasing the time needed to obtain necessary qualifications.
3. Increasing the size of the qualified labour market and providing a wider variety of opportunities both for employees and employees.
4. Rebuilding the prestige of technical professions and blue-collar jobs.
5. Creating a modern educational infrastructure.

"85% of the trainees in the Centre stay in the region as these highly qualified staff are working in foreign enterprises and using the latest technologies. Furthermore, the Centre helps restore the prestige of the working professions, such as welders."

Alexandr Beglov,

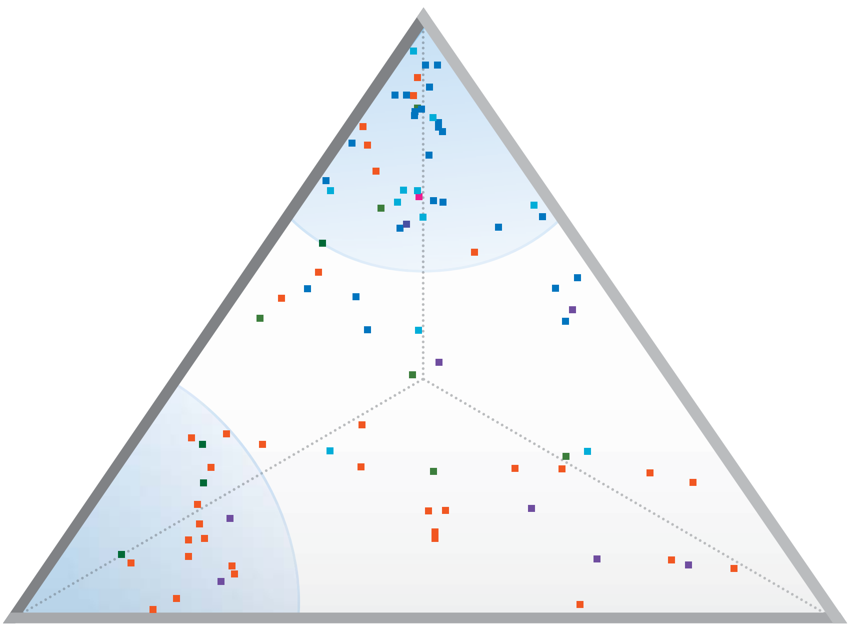
President's Ambassador in Central Federal District

A clear and realistic strategy can help create positive investment experiences

We asked investors to evaluate the *substance* of the regions' strategies to attract investors (rather than for their critical assessment of the *form* - the documented strategies themselves - published by the regions). Our aim was to understand how much impact the regions' activities to attract investors was perceived to be having.

Question: In your experience the region has a strategic drive to attract investors that is...

...clear and realistic



...only reacting to immediate needs

...focusing on an overly–idealistic future

Key: each dot represents an investor experience.

"The regional authorities were ready to work things out. The only request they had was whether our investment would create jobs for local people as they understood their people would be exposed to the latest technologies once we started operating."

Industrial Markets, Northern Europe

Investors are unanimously calling for all regional authorities to adopt a more pro-business approach throughout the regions. Too many foreign firms today have to deal with multiple officials in multiple government offices and state monopolies and many are more obstructive than supportive. This results in delays, extra costs and sometimes the decision not to invest at all.

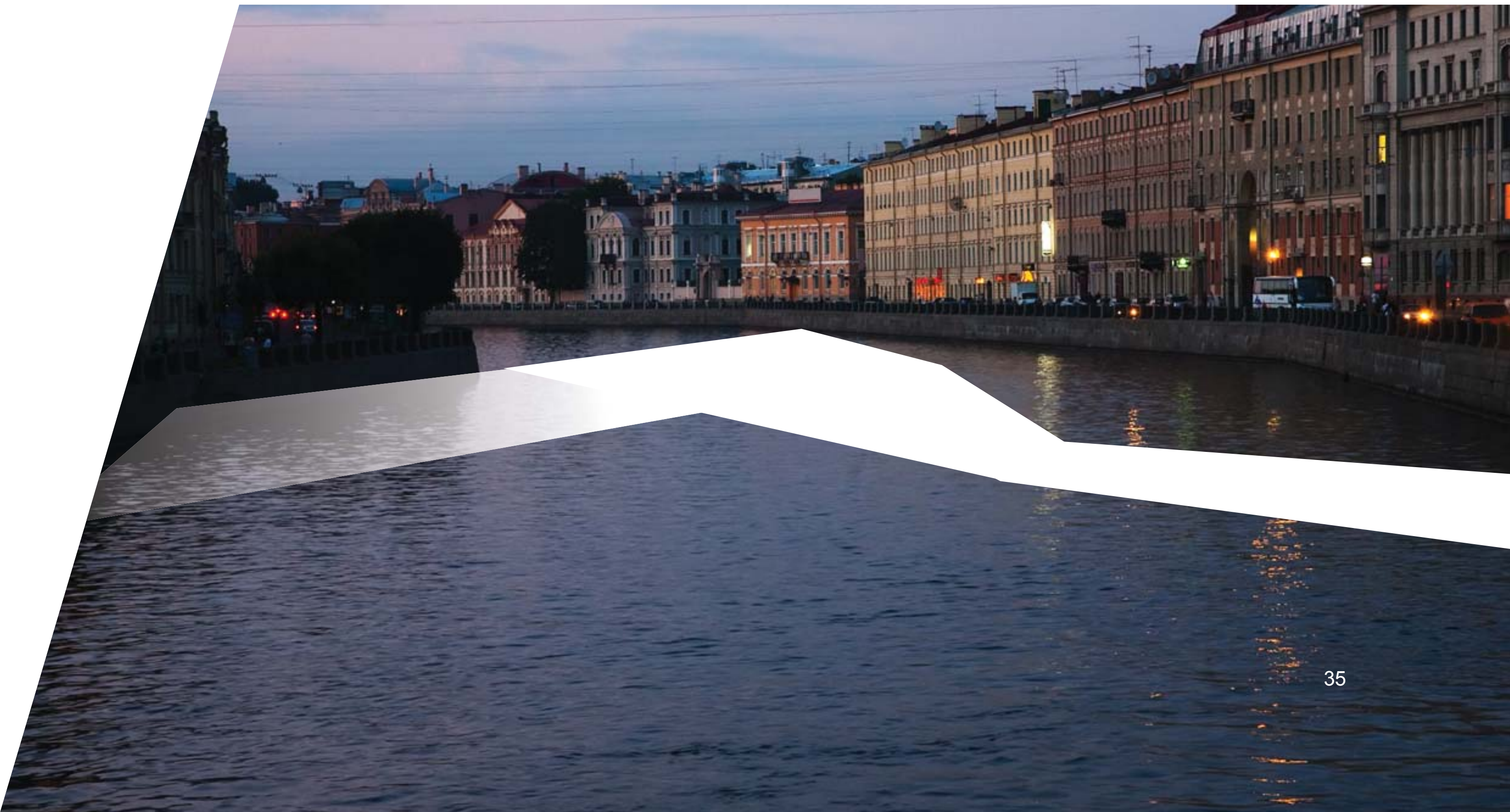
These experiences come against a backdrop of the 'right' strategic messages from the governors and their senior staff but appear to be lost or watered down at other administration levels. The recommendation from business investors is that the governor should directly and indirectly drive the strategy of 'business orientation' throughout the region, at all administrative levels. Developing a clear and realistic strategy is a key first step to making a region more investor focused but this must be continually and widely communicated to all people who have a role in executing the strategy. Having a public figure for this, that all employees in state organs can mobilise around, can be a powerful force for positive change.

"The regional government was absolutely passive - no information was provided and we had to ask for everything. They provided absolutely minimal support."

(Investor information not given)

"The authorities are so enamoured of the fact they are attractive in terms of geography, market size etc…that they leave investors to work through all the problems themselves."

B2B services, Western Europe



CASE 4

Investment Strategy (Ulyanovsk)

In 2005 Sergey Morozov was made the Governor of the Ulyanovsk region and he set attracting private investment as the main instrument of social-economic development of the region. This was announced at a session of the Council for Investment of the Ulyanovsk region – the first regional public council established by Sergey Morozov as head of the region.

Ulyanovsk's 'Investment Strategy' consists of three key documents:

1. Strategy for attracting investment into Ulyanovsk region.
2. Investment Declaration.
3. Investment Memoranda.

Emerging from these documents is an understanding of the underlying capabilities in the region and the industries that can be built on these assets.

These insights enable the region to develop a targeted approach to attract cornerstone business investors who cannot only exploit the local opportunities, but also bring the knowledge and capital the region needs to drive its economic growth and development.

This targeted approach also allows Ulyanovsk to better focus its marketing and business development efforts to build relationships with firms from those countries with noted global leadership in these industires, such as: Germany and Japan for auto-parts; Germany for construction materials; France for aviation; and Italy for agriculture and food production.

Strategy for attracting investment to the Ulyanovsk region (for 2008-2012)

Developed in 2007, this strategy took into consideration the tax and other incentives business investors wanted, as well as addressing their concerns over administrative barriers and the general time and costs of realising a project in the region. It is now being revised for the next five years.

Key elements of the strategy:

- Prioritisation of investment projects according to industry, level of investment and time of realisation
- Prioritisation of clusters: e.g. auto-parts, nuclear technologies, agriculture/food production
- Creating a 'United Project Team' to provide effective investment support (adapted from Kaluga)
- Development of education programs to increase specialised workforce
- Development of infrastructure:
  - Establishment of industrial zones and parks with requisite infrastructure
  - Expansion of transport and logistics infrastructure (including second gas pipeline in 2012).

Investment Declaration

This was adopted in 2010 and documented all the experiences accumulated by the administration throughout 2005-2010. The declaration publically outlined the key principles of dealing with investors (and was taken up by the Agency of Strategic Initiatives (ASI) as one of their 'Standards for Executive Administrations' developed in 2011 and subsequently piloted amongst six experimental regions). The declaration states that:

- We recognise that attracting private investment is the main instrument of regional development
- Both domestic and foreign investments are of equal importance for us

- Our priority are projects with high productivity, energy efficiency and that are environmentally friendly
- We offer investors the most favourable conditions in Russia for their investment projects
- We guarantee the investor will be exempt from all costs not directly related to the project
- A ‘Unified Project Team’ of government and business partner together to realise projects effectively
- We strictly adhere to the investor's right to freely chose third-party contractors and suppliers
- We strive to create the necessary conditions to provide businesses with a highly qualified workforce
- A key goal is to create a comfortable living environment for residents and visitors to the region
- We aim to respond to new challenges and implement any necessary changes to make our investment policy effective.

Investment Memorandum

This is renewed each year and analyses the previous year’s results, sets targets for the coming year and outlines the approach to achieving them. The Memorandum for 2012 included the following targets:

- Growth of fixed-capital investment not less than 105% from 2011 (at least 60 billion Roubles)
- Attraction of 10 cornerstone investors in the region
- All Ministries tasked to attract investors (from 1 to 3 each per year)
- Attracting investors into municipal districts: From 1–3 depending on the district
- Creation of 3,500 new jobs through investment projects.

Main goal of the Investment Strategy

To bring the most profitable investments to the region by: highest value added, highest wages; and the highest tax return.

Measuring success:

1. Increase in level of investment.
2. Share of investment in GRP – 31% (comparable to Singapore and exceeds targets set by Putin of 25% by 2015).
3. Growth of tax basis.
4. Decrease of unemployment.
5. Average salary rates.

In measuring the results the region understands there is a ’*lagging effect*’: the influence of new investment projects will be felt only in a 3 to 4 year period from the moment of attracting the investor in the region.

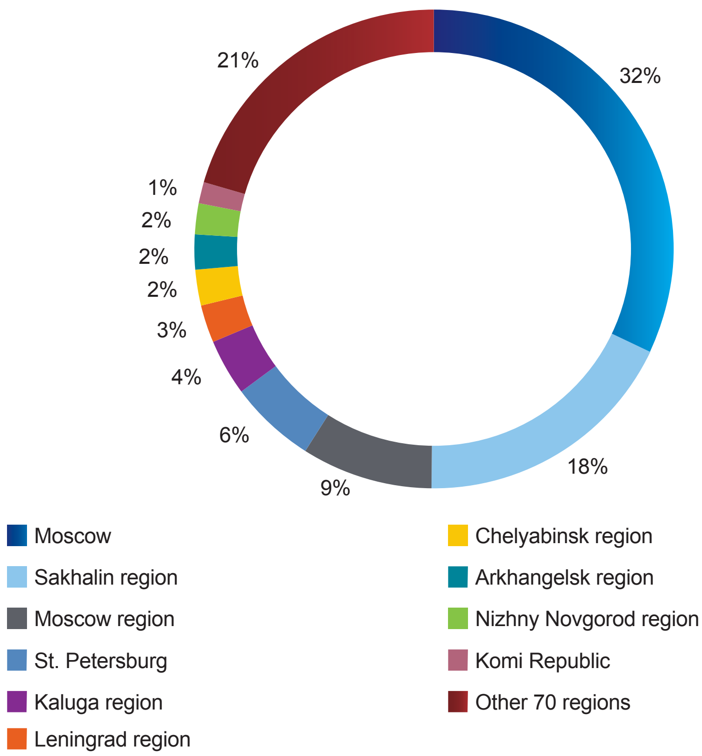
Moscow and St. Petersburg play a critical role in attracting FDI for the entire country

The strategies of Moscow and St.Petersburg to attract investors need to be clear and convincing as investors experiences of Russia often start with these two regions.

As 50%[4] of total FDI stock in Russia in 2006-2011 was absorbed by Moscow and St. Petersburg alone these two cities are, for many foreign businesses, their main or only experience of Russia, which can impact on Russia's overall profile and the level of FDI in the country. Recent initiatives to more widely communicate what these economic locomotives can offer investors should therefore be welcomed.

4. Rosstat (total FDI stock in 2006-2011, excluding off-shore zones Cyprus and British Virgin Islands)

Russian FDI Stock (2006–2011)



As business investors' confidence is highly-correlated with how viable they consider a country's or region's development strategy to be, it is important that investor confidence is stimulated in the two main metropolises which often act as a gateway to the rest of the country. The current low level of *FDI expansion* in Russia (12%) – the percentage of foreign firms expanding operations within a country after initial entry – compared to a global average of 16% is something that Moscow and St.Petersburg can help stimulate through the continued and successful implementation of their current initiatives.

"The overall attitude of the St. Petersburg authorities is always "no". They place obstacles in your way, trying to point that if you badly need access you should pay for it."

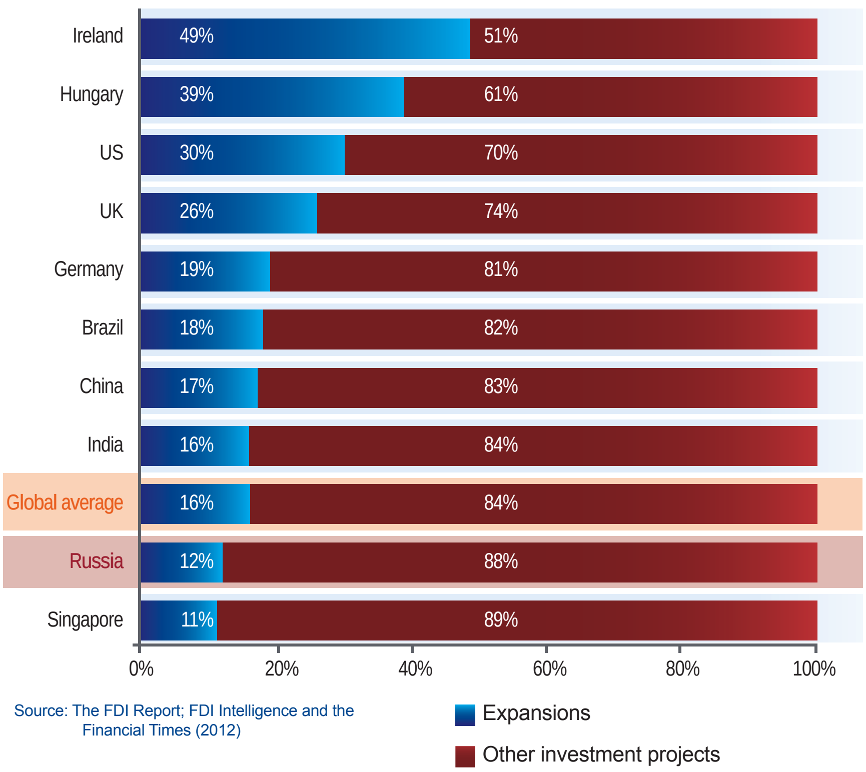
Northern European investor*

"It seems that the Moscow government is not interested in our business at all. There is no help, no incentives, and no finance. I would even say they keep their distance from us."

Western European investor*

**Both stories refer to experiences that occurred more than two years ago*

FDI Expansion



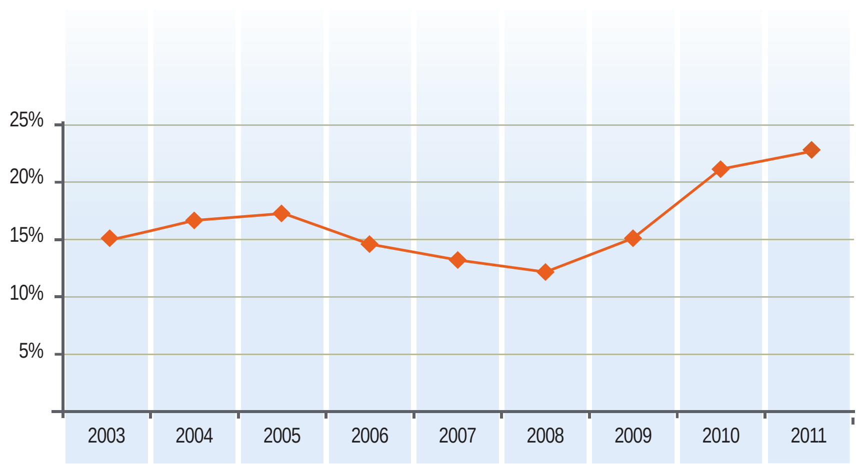
Source: The FDI Report; FDI Intelligence and the Financial Times (2012)

If a more risk-averse global economy encourages FDI expansion beyond 2012, (rather than riskier FDI entry into new countries) new opportunities may exist for many of Russia's regions to target the FDI stock built up in the major metropolises. So, the development of regional brands to communicate convincingly with potential investors that Russia is more than the 'two capitals' may now be needed.

As it may be counter-productive to promote up to 80 different Russian brands at once (too much 'noise' for investors) regions may consider creating 'geographical' or 'industry-focused' brands; combining assets in multiple regions to make compelling propositions in order to:

1. Get multiple regions 'onto the map' of the global business community.
2. Facilitate business visits to the multiple regions to build relationships.
3. Create more self-awareness in regions as to which of their assets are attractive to business investors.

Expansion as a percentage of total FDI globally (2003–2011)



Source: The FDI Report; FDI Intelligence and the Financial Times (2012)

Case 5

INVEST ▸ TATARSTAN

"One of the barriers we need to overcome is the lack of awareness of the region abroad. Today Tatarstan is not very well known abroad; sometimes it is even confused with Kazakhstan. We need to work in this direction...."

Linar Yakupov,

Head of Tatarstan Agency for Investment Development

Building a Regional Brand (Tatarstan)

Creating a strong regional brand with the "Invest in Tatarstan" project will raise awareness of the region to investors and develop a clear statement about what Tatarstan is, what it isn't and what it stands for.

The approach is to reach out to global investors through broadcasts on leading international TV channels to publicise the investment potential of the region. Tatarstan's 'Agency for Investment Development' was tasked with leading this project, while Tatarstan's President, Rustam Minnikhanov is actively involved in attending events such as the Annual Investment Meeting 2012 in Dubai, and personally meeting potential investors.

Distribution channels:

- The Agency promotes the region at International Expo's, Investment Forums and Conferences in countries such as the United Arab Emirates, Singapore, Malaysia, the UK and Finland
- Advertisements outlining Tatarstan's investment climate and potential are broadcast on major international television channels, such as CNBC - the world's most-watched business channel, with 380 million viewers worldwide
- In future, the 'Tatarstan Export and Investment Corporation', which is currently being set up and will support export-oriented companies in Tatarstan, will also contribute to the campaign, by developing and strengthening the region's brand in other countries via a network of permanent representative offices abroad.

Strategy roll-out

A large-scale PR campaign supporting the brand ’Invest in Tatarstan’ was officially launched at the International Investment Forum ’AIM 2012’ in Dubai in May 2012. The ‘Agency for Investment Development’ (AIR) of Tatarstan joined the ‘World Association of Investment Promotion Agencies’ (WAIPA) in 2012. The ’Tatarstan Development Corporation’ is working on the Kazan SMART city project, whose project goals are:

- To develop a modern infrastructure to accommodate major international, Russian and Tatarstan-based companies in specific industries
- To create international standard facilities and specialised sites: exhibition and conference centre, education and research zone, private clinics, shopping and leisure centres, residential and commercial property, and recreation zones.

Measurement

The main KPI (key performance indicator) developed by the Agency for measuring the project's success will be the increase in the level of investment and the overall image of the region in terms of attractiveness for potential investors to Russia.

There is a need to improve investor confidence at the early stages of investment

A business investment is often a long-term project with clearly defined stages (*the Investment Project Cycle*). To be successful, such projects require support throughout all its stages, especially early ones. Too often this is lacking and investors are quick to walk away before they sink more money and time into a project, meaning regions are often losing investors as quickly as they attract them.

Understanding the *investment project cycle* and addressing any weak links a region suffers from (e.g. weak brand for step 2; availability of key government individuals for step 3) can be an excellent way to build an end-to-end value chain that will impress potential investors, especially during the key early stages (steps 1-7).

The Investment Project Cycle

Each industry (and each firm) has its own process for making an investment that largely follows an eight-step process (below) which we have labelled the investment project cycle.

If regional teams are aware of these stages, investors' needs, as well as having clear strategies for supporting them, they can increase their chances of turning potential investments into real projects.

1. Preliminary (internal) company talks
2. Initial market scanning
3. Preliminary talks with regions
4. Due diligence (of the investment decision)
5. Decision
6. Establishing a legal entity
7. Opening operations
8. Operations

"There is a general belief that corruption is everywhere in Russia and that this will prevent you being able to do business in a normal way."

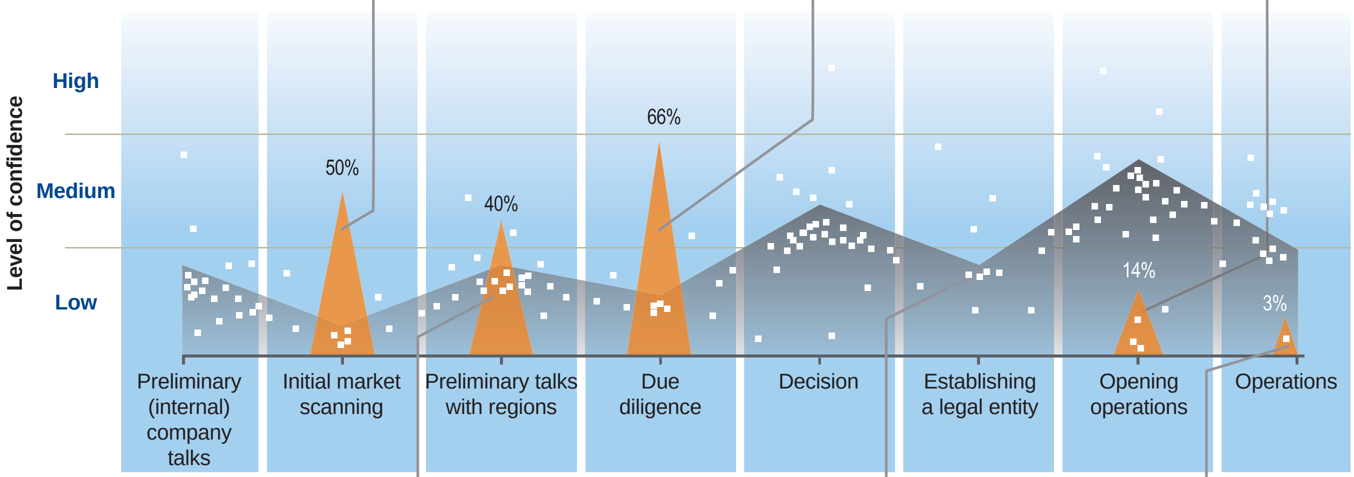
B2B Services, Western Europe

"When you start looking at techno parks in Russia you realise people understand this term differently. We were offered a piece of land and when we asked what the legal rights were some guy told us 'if you agree to come here, I'll work it all out for you'. Not very encouraging."

Investor information not given

"In the final stages of an investment project, after essentially all terms had been agreed the local government suddenly brought up additional requirements for the project creating immense frustration at even more time and money wasted."

Investor from Western Europe



"We scheduled meetings with different stakeholders at the regional level. The outcome of these meeting caused a lot of confusion: information was conflicting, incomplete or not up to date."

Consumer markets, Western Europe

"In Russia there is no protection of property rights, intellectual rights or any judicial protection. This is why so many companies register in Cyprus because if a business becomes interesting to large Russian companies, they can use their power to seize it."

Investor from Southern Europe

"We are in a JV and our partners, who have strong government connections, use this influence to try and bully us when we do things they disagree with – often using governmental resources, the judiciary, or mass media."

Investor from technology sector

Key: each dot represents an investor experience.

Level of investor confidence

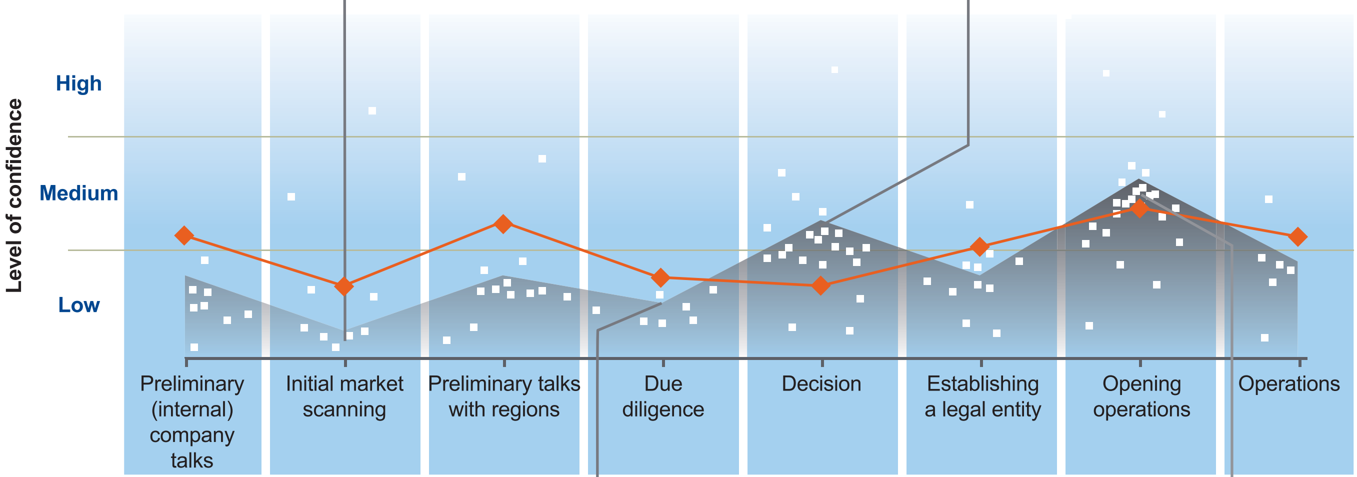
% of stories about a potential deal that didn't go ahead at this stage

“In Japan, Russia has a very negative business image. It should start making serious step-by-step efforts to change the situation. Russia wants more SMEs but they simply won’t invest here for, when considering all the issues, this would be a dreadful country for them.“

Industrial markets, Far East Asia

“When investing we consider a total of 22 factors. At the top of this list is whether we will get the full support of the authorities and this is that we found here.”

Construction, Western Europe



“We needed help on infrastructure that would meet our operational needs. The local government promised to resolve this, then delayed and then finally admitted they had no influence on the matter.”

Forestry, Northern Europe

“The regional government has actively supported our investment project: it assumed responsibility for all the work in preparing the construction site, made infrastructure available and provided free connection to the power lines. It has also cleared, at its own expense, the site of the former plant that had hazardous waste.”

Automotive, Western Europe

Key: each dot represents an investor experience.

Level of investor confidence

Level of investors’ felt-support

The role of the state and the culture of the business investor's home country strongly influence their expectations of and dealings with governments aboard:

- 35% of Europeans consider government to play a key role in their investment: but only 42% of experiences with government in Russia were positive
- 38% of Asian businesses consider government to play a key role: and 100% of experiences with government were positive
- Only 20% of North Americans consider government to play a key role in their investment: but 67% had positive experiences with government.

!

Weak signals: Further investigation required

Case 6

"An important and sometimes decisive factor, in the opinion of investors, are friendly and responsible authorities. We try to fulfil all our obligations faithfully, efficiently and on time, we highly value our reputation as a reliable business partner.

The task I set before myself and all members of our team is to work in a way that any person who has invested at least a dollar, euro or rouble in the Kaluga region, will never regret that."

Anatoliy Artamonov,

Governor of Kaluga region

"We were convinced a long time ago that local authorities who are genuinely interested in their investment are often crucial for businesses. Here in Kaluga there are no unimportant projects; we appreciate every one of them, and it does not depend on how much an investor puts in – 1 Euro or 1 million Euros. We care about the project, as parents care about their child."

Ruslan Zalivatsky,

Vice-Governor of Kaluga region

"There are a number of fundamental principles that everyone on the project team should adhere to. They form the basis of Kaluga's investment philosophy. The first principle the regional government follows is that investors should have total freedom in choosing contractors and partners. The second is that we need to be objective about our capabilities and not make empty promises. That is unacceptable for us."

Vladimir Popov,

Kaluga Region Minister of Economic Development

Investment Philosophy (Kaluga)

Kaluga has never had a special economic zone, significant natural resources and, as a federally subsidised region, they could not compete with other regions offering extraordinary incentives. However, the regional authorities understood that growing competition amongst regions (and countries) to attract greater private investments meant they should seek out and build a competitive niche for the region. This would require an understanding of the region's competitive advantages and the development of a unique value proposition for investor:

"The region which understands what the investment market needs will be the winner." (Ilya Veselov)

Where many regions promote their existing industrial capabilities, infrastructure (e.g. the number of universities) or natural resources as their competitive advantages, Kaluga took a different approach and looked at their region through the eyes of those making investments and sought to understand their needs. After much consideration, the region decided to focus on building and leveraging the following competitive advantages:

1. Having a client-oriented approach.
2. Establishing clear guidelines for working with investors.
3. A continuous focus on developing the region's infrastructure.
4. A beneficial geographical location near the Moscow region.

Kaluga defines its client-orientation by treating the business coming into the region as a partner and supporting them as they look for returns on the money they are investing. The government's role therefore becomes one of selling '*products*' that their clients (the investors) value:

- The most important products are the industrial parks, which enable production to be localised and operating within transparent legal conditions
- Providing a choice of suitable sites to meet the requirements of the investment being made
- A developed transport/logistics infrastructure
- A consistent investment policy – with the region guaranteeing equal treatment for all investors
- Transparent investment processes and clearly defined support from Regional Development Institutes
- Relevant, obtainable tax incentives, free from additional obligations.

The Project Family

The Kaluga 'investment philosophy' is the first step in building an outstanding culture of dealing with businesses in the region. In Kaluga a key term – 'The Project Family' – is used and describes how, when an investor decides to invest, the project becomes a common cause between the business and the region. This principle is central to Kaluga's investment philosophy.

The philosophy itself is widely-transmitted throughout all governmental bodies – from governor to municipal officials. The governor himself adheres strictly to the ‘golden rules’ and insists everyone does the same. This helps create a ‘corporate culture’ in the regional authority, which is not formalised into a document but instead lives as a tradition, a way people do things in this particular place.

Kaluga’s Golden Rules:

Kaluga must:

- Provide investors with a genuine choice of suppliers
- Fulfil all our obligations to investors without any exceptions
- Work as a single project team on investments as their operations are re-established
- Not only reduce administrative barriers but eliminate them totally.

Kaluga mustn’t:

- Discriminate between important/less important investors, or large/small investments
- Allow bureaucracy to flourish as this often leads to opportunities for corruption
- Create additional obligations for investors (e.g. ‘build us a kindergarten’).

Main goals:

- Attract more investors to the region
- Create and foster a business mindset in local authorities based on a “partner-partner” approach to business rather than a “business-government” one
- Focus on results
- Make sure everyone understands that it is in everyone’s interests to make the project successful and profitable
- Make the process transparent for all parties to prevent any unknown officials or intermediaries appearing and creating additional costs for the investor
- Promote openness to make the process predictable for investment with anything impossible being declared right away.

Measuring success:

1. Number of new investment projects.
2. Level of attracted investment.

“We regularly hold forums where we meet business people who have invested in the region in order to get an understanding of the problems they face and find out what, in their view, we need to do to resolve them. We use literally every opportunity to talk directly to investors, including informal meetings and discussions as part of our preparation for meetings of the Presidential Investment Council, one of which took place in Kaluga this year.”

Ilya Veselov,

Director of the Agency for Regional Development of Kaluga region

Government might benefit from including other stakeholders in creating messages

"We invested in Kemerovo to establish a technical support centre... When searching for suitable sites we initially used a private real estate firm but with little success ... When we approached the government they were very helpful and cooperative and found us a suitable site quickly and helped us get it ready for operations."

Industrial Markets, Far East Asia

"Foreigners often look at the experiences other companies are having first. For example, there are two German firms who are planning to enter this market but they are waiting to see how we get on first."

Industrial Markets, Western Europe

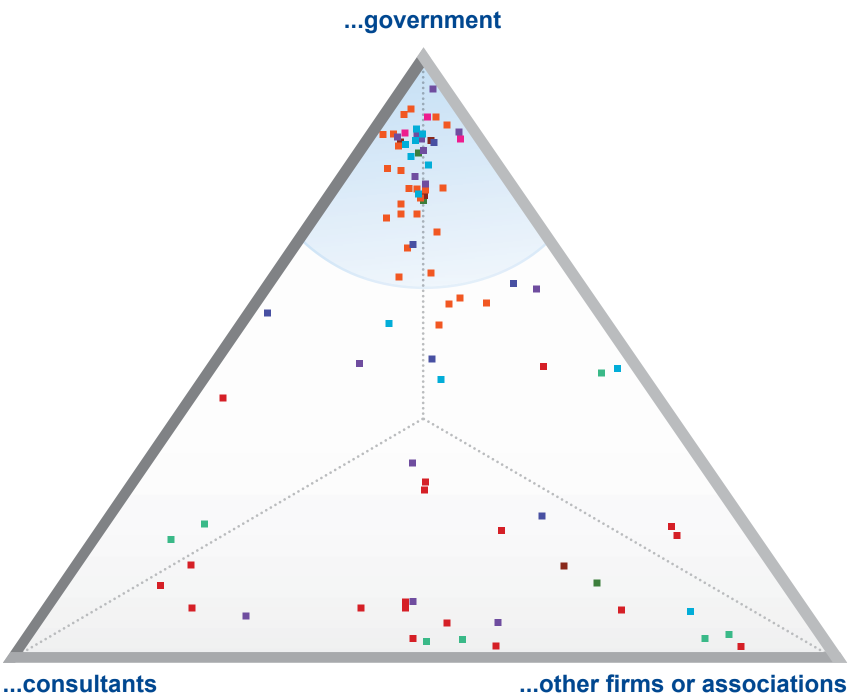
"A problem in Russia is lack of information, which is a huge obstacle when entering the market."

Banking, Western Europe

"Having dealt with the local regional administration my worst fears for the region were realised as they fundamentally don't understand that it is business that creates value and economic growth, not bureaucrats."

Western European investor

Question: Critical information and communication for investors came from…



Key: each dot represents an investor experience. Each colour represents a different investor nationality.

Managing the flow of information about the region is a critical task for governments: if it does not do this it risks someone else (other firms, consultants, etc) occupying this role instead. Currently, most foreign businesses approach the government first, to find information crucial to their investment decision directly. This gives regional governments the chance to positively influence the image the investor has of their region. Increased efforts to create and maintain this information flow can be a critical success factor.

Government needs to improve the quality of the information business investors receive about their region:

- 70% of businesses turn to government for critical information
- 60% of the time they have negative experiences, of whom 83% believe is a typical experience for all investors
- When information from government is lacking North Americans turn to consultants
- Western Europeans turn to consultants and seek the opinions of other firms as well.

Government should also try to extend the scope of their communications to ensure more industries see them as the first point of contact for critical information, as technology firms do:

- Technology (100%)
- Transport & Logistics (80%)
- Industrial Markets (78%)
- Real Estate (75%)
- Consumer Markets (50%).

! Weak signals: Further investigation required

"Looking back, we were happily surprised with the level of involvement of the administration and service we received. Now 2 years down the road they have kept their promise and things are going smoothly."

Industrial Markets, South Asia

Case 7

"Many regions have similar development programs for increasing investment attractiveness, but we also have a real budget and real timeframes for implementing it."

Elena Novotorzhentseva,

First Vice-Minister for investment and development

Communication Strategy (Sverdlovsk)

The development of an effective communication strategy is a new initiative in the Sverdlovsk Oblast. The project was launched in 2009-2010 to make cooperation between the regional authorities and business more transparent and effective. The strategy aims to improve the quality and timeliness of information provided to investors at the two main stages of the investment process:

1. **Initial market survey:** Providing rapid and easy access to all the information needed.
2. **Pre-operations:** Establishing direct contact between the investor and the authorities to provide essential set-up support.

Interaction between the investor and the regional authorities is seen as a two-way process, with the authorities acting on investors' feedback to improve the entire process.

The Communication Strategy consists of four main elements:

1. U2020 – a 'one-stop' entry point for investors.
2. Investment Council - headed by the governor.
3. Investment portal – with interactive investment map of the region.
4. Electronic investment passports to municipalities.

These elements underlie the region's strategic "Programme for Developing the Investment Potential of Sverdlovsk Oblast (2011-2015)", which sets clear time frames, assigns responsibilities for implementation and allocates budgets.

1. **The U2020 System (launched 2010).**

This has been developed as a 'one-stop' entry point for investors coming into the region.

- Potential investor register on the site and upload a brief project description
- Each project is appointed a mentor from the regional authority to provide advice
- Project applications are processed and tracked online
- Investors can address any questions online directly to the person responsible for dealing with the specific issue.

The main aims of U2020 are:

- Reduce bureaucratic entry barriers for new investors
- Make document turnover faster by using an electronic document approval system
- Make the process transparent for all parties as the system allows the investor, all officials and Ministers to track progress online and identify bottlenecks
- Establish better control and provide better support
- Become an instrument to track the historical dynamic of business activity in the region.

2. Investment Council (launched 2012)

Coordinates the work of the Sverdlovsk Oblast Commission for Economic Modernisation and Technological Development and the Sverdlovsk Oblast Foreign Investment Advisory Council. It meets at least every two months and brings together officials from all ministries, business and NGO representatives, and experts. Its main task is to make the region's investment policy more transparent and to build partnerships with business.

The Council serves as a platform for:

- Discussing the socio-economic development priorities of the region in relation to investment activity
- Developing new approaches to implementing the investment policy and stimulating investment in the region
- Coordinating all the stakeholders in the investment process and addressing investors' problems promptly.

3. Investment Portal (under development)

The portal will be updated annually and will provide investors the latest information online covering the region's demographics, roads, infrastructure and utilities, investment sites, current and planned investment projects (on both brownfield and greenfield sites).

4. Electronic Investment Passports

The investment passports are based on more than 400 statistical indicators, completed by the municipal administrations on an annual basis, which in turn produce an annual ranking of the investment potential of the municipalities in the region. The ranking of the investment potential of the municipalities is thereby an objective and comprehensive assessment of the conditions and opportunities for investment and business activities as well as a platform for the municipalities themselves to actively promote their investment sites and projects.

The ranking criteria are ultimately an assessment of the potential in the region of the following key factors in each municipality:

- Socio-demographic potential (i.e. local workforce)
- Economic potential (i.e. development levels)
- Resource potential (i.e. availability of natural resources and utilities)
- Infrastructure potential (i.e. level of transport, financial and utilities infrastructure)
- Investment potential (i.e. level of investment activity).

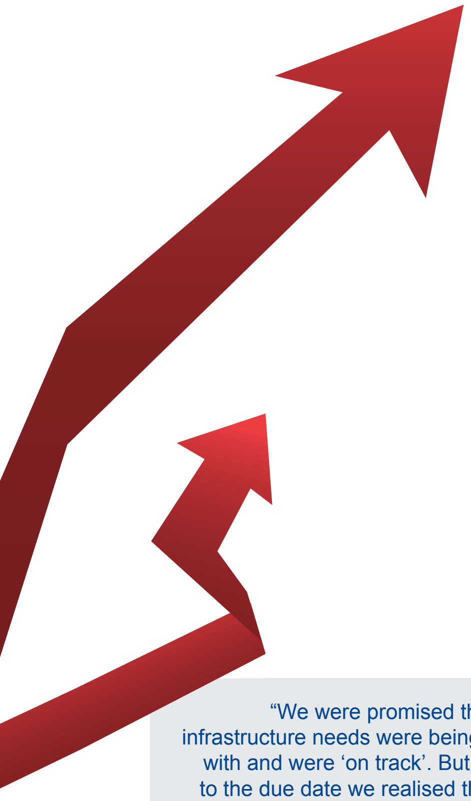
The municipalities are then assessed by static (resource + infrastructure potential) and dynamic (socio-demographic + economic + investment potential) factors and grouped into four archetypes for investors to consider:

- 'High-growth' (dynamics higher than regional averages, high level of resources available)
- 'Stable development' (dynamics higher than regional averages, limited availability of resources)
- 'High potential' (dynamics lower than regional averages, high level of resource available)
- 'Limited potential' (dynamics lower than regional averages, limited availability of resources).

"The municipal authorities have a lot of powers that can either promote the project or block it. Therefore, developing investment passports to the municipalities is a priority project, as this will make it possible to encourage municipal heads to work actively on increasing the investment potential of their territories and on active cooperation with business."

Dmitry Nozhenko,

Minister of Economics, Sverdlovsk Oblast



Regional governments are creating investor confidence; federal and municipal less so

Investor confidence when dealing with regional government tends to the extreme. Responses cluster around '*very confident*' or '*not confident at all*' with very few responses in the 'balanced middle' (e.g. confident about some things but not others). This suggests some regions are *bending over backwards* to help business investors (resulting in '*highly-confident*' responses) whilst others are doing little or nothing.

When dealing with federal or municipal government however the investor experience is wholly more negative. We question whether the improvements made in regional governments to be more business-friendly have not yet spread to other branches of government.

To counteract such negative experiences regional government should either seek to limit the number of officials a business needs to deal with when making an investment or coordinate these steps with federal, municipal authorities and state monopolies more effectively to influence the service levels they provide to businesses. Ultimately this may require a negotiation of the roles and responsibilities that must be undertaken and executed by all government officials in order to present a unified and effective support system for investors into the region.

"We were promised that our infrastructure needs were being dealt with and were 'on track'. But closer to the due date we realised that the promised work had not even been planned for yet, let alone being nearly ready."

Industrial Markets, Western Europe

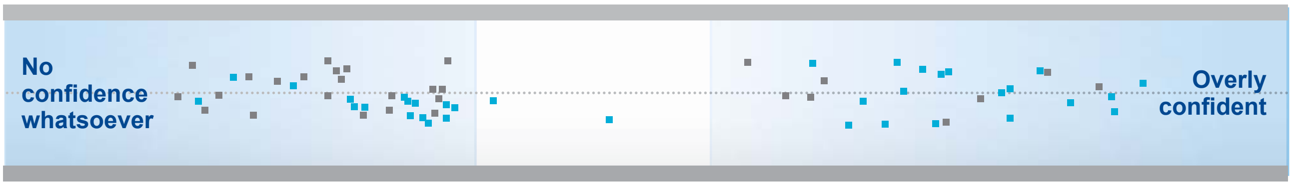
"Aside from the normal bureaucratic procedures we saw no significant barriers. Furthermore, regional government provided us with attractive tax incentives and built a by-pass road to link up one of our factories."

Consumer Markets, Western Europe

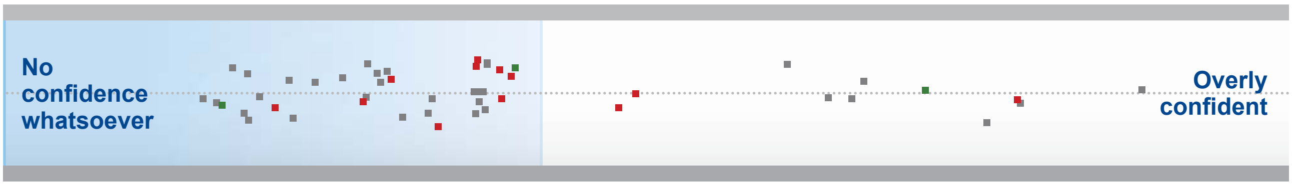
"It seems that the municipal bodies don't know their job well. We have to check everything with our solicitors."

Western European investor

Regional government



Federal and municipal government

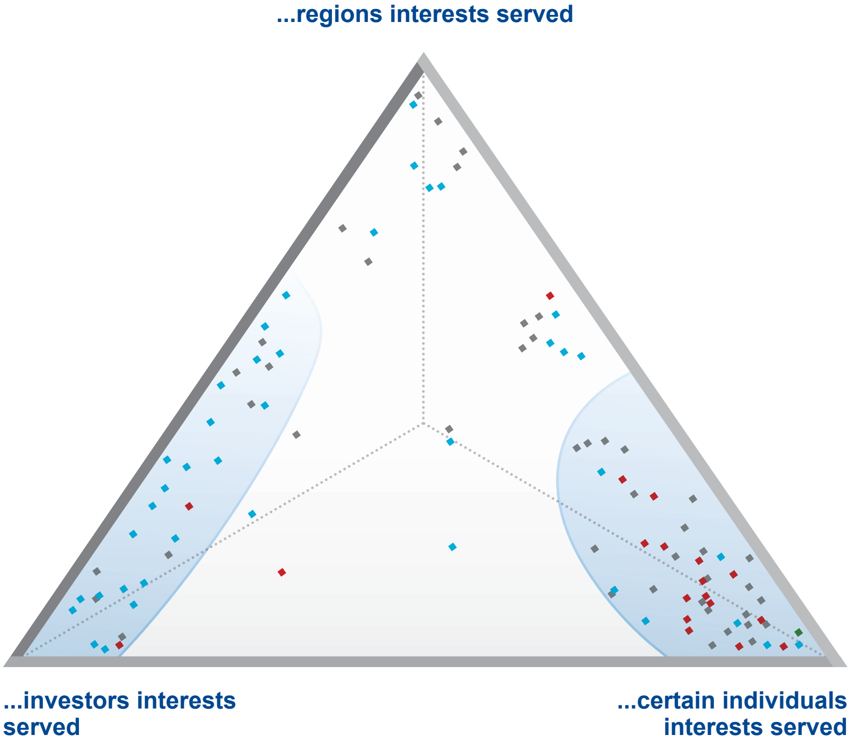


Key: blue dots represent experiences with regional government, red with municipal, green with federal (and territorial), grey with a mixture of all governmental bodies

Russia must get to grips with corruption by dealing with the 'money pot' mindset

Corruption is still a major issue in Russia, with the country as a whole ranked 133rd out of 176[5] in 2012 by Transparency International. Over 40% of foreign businesses looking to invest in Russia experienced some level of corruption. One of the aims of this research was to understand the root causes of corruption in an effort to help those regional governors determined to stamp it out to better understand its causes and find ways to best approach minimising it.

Question: Whose interests were being served most in your experience?



Key: each dot represents an investor experience.

A common problem for foreign businesses in many regions is that government repeatedly expects them to make further direct investments in the region, despite there being no business incentive for the firm to do so. Tax incentives are often tied to compliance with these requests, making many investors suspicious of such incentives. Some businesses have even experienced government dictating the actual investment they must make to ensure it meets the region's social development plans.

Investors in their business, not in the region

Many regional authorities appear to be seeing foreign businesses as *investors in the region* rather than as *investors in their own business* that *happens to take place in that region*. This can also extend to well meaning activities such as 'forced corporate social responsibility' where firms are expected to donate to selected social projects or organisations. For too many regions the indirect benefits of FDI do not seem to be enough and instead they see foreign businesses as '*money pots*' that should directly supplement regional budget shortfalls or favoured social projects of key regional personnel.

This mindset may not only be driving many investors away (to more business friendly regions or countries) but also fuelling corruption. If this widely held view exists (and the investor perspective suggests it does) at senior government levels, that investors should pay extra for the 'privilege' of doing business in a region, it may only be a small step for multiple officials to also expect personal payments.

What is required is an understanding and wide acceptance of the very real benefits FDI brings as it is, without further demand for payments – for individual or regional purposes.

5. The Corruption Perceptions Index (CPI) ranks countries based on how corrupt their public sector is perceived to be. The sources used in the CPI are a mixture of business surveys, assessments by commercial risk analysts and country experts from international institutions.

"Being the only foreign company and the largest taxpayer in the region, the government is forever sending us letters telling us what they would like us to finance."

North American investor

"We considered investing in X but the head of the municipal government made it clear we should only be working with the subcontractors they told us to work with."

Industrial Markets, Western Europe

Corruption may be responsible for 1 in 7 of all investments failing

Corruption across the project life cycle

"When we met with the representative responsible for allocating land plots in X he clearly coveted my camera. When we were leaving he told me to 'only come back if I bought one for him, with a GPS built in."

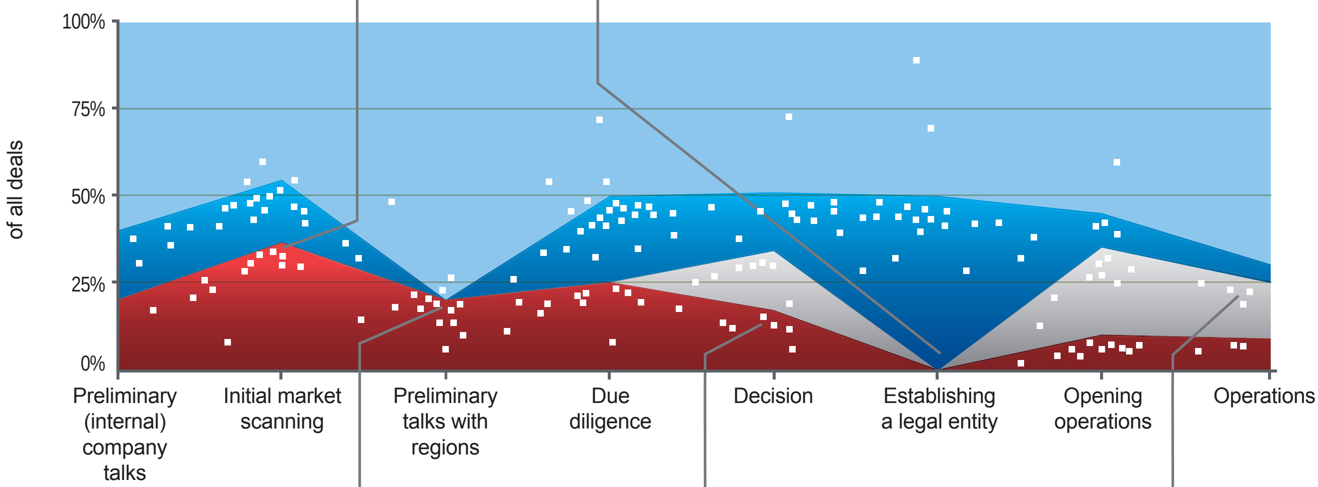
Consumer markets, Western Europe

"The problem we had with the gas supplier is indicative of Russian regulation. You can't get a permit until you do start to do something; but you can't do it legally without a permit. The only way round this is to pay bribes."

Consumer markets, Western Europe

In your experience, corruption...

- ...didn't play a role
- ...occurred on a small scale
- ...happened, but the deal went ahead
- ...broke the deal



"We were told we would have to pay bribes to a non-for profit organization in order to get the tax incentives offered."

Consumer markets, North America

"The Regional Administration intervened and 'advised' us to use a certain contractor or 'there could be issues'… Initially we refused, but then started facing artificial problems and in the end had no choice but to use that contractor."

Automotive, South East Asia

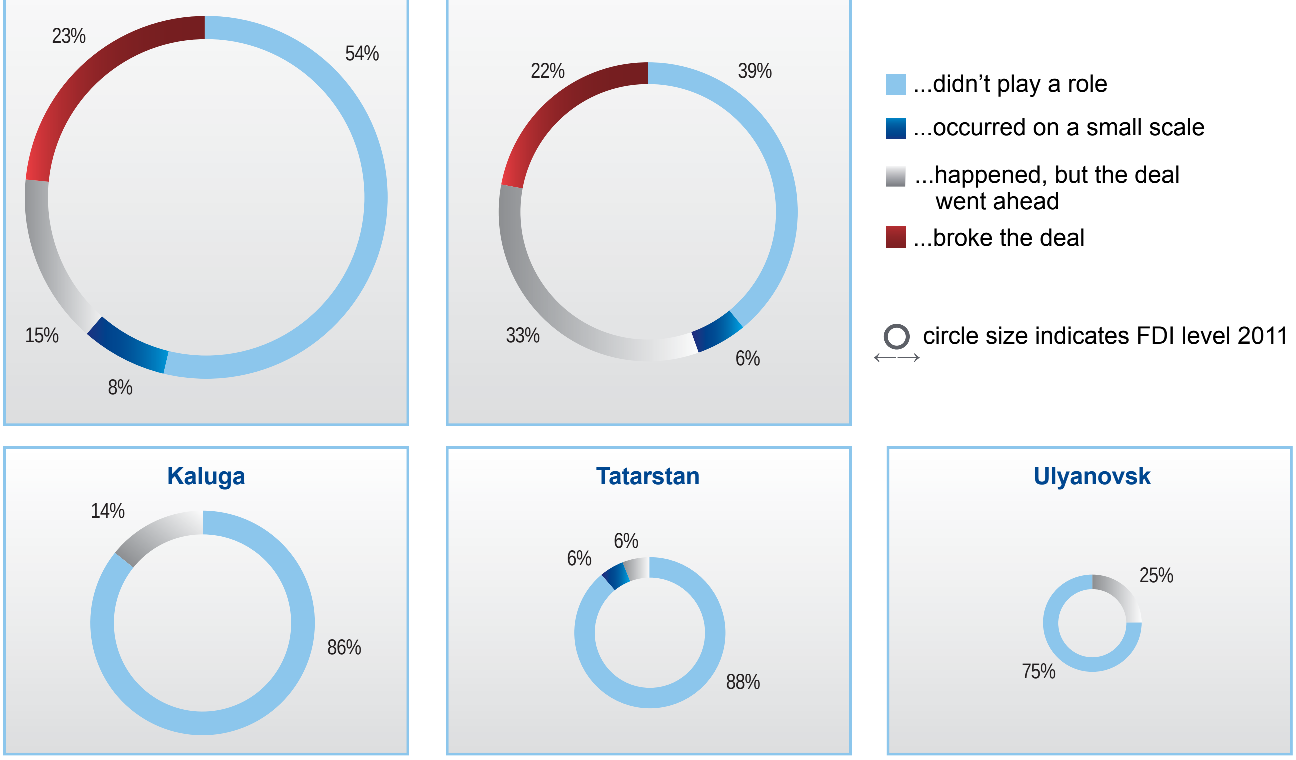
"It is pointless participating in tenders. It is well-known beforehand who will win the tender…we often sue the government bodies for not being objective and win these cases, but then still our products are not bought."

Technology, North America

Key: each dot represents an investor experience.

Corruption may become a bigger problem as regions grow

In your experience*, corruption...



* Investors' experiences over recent years

The root of corruption appears to be grounded in a mindset that sees private investment as an opportunity to extract payments - beyond the scope of an ordinary business investment - for personal or regional gain. Overall, corruption appears to be responsible for as many as one in seven of all investments failing during the project lifecycle; representing a significant loss of investment revenue for the country.

The fight against eradicating corruption therefore is a key battleground in the regions. The adoption and successful execution of international best practices to address this will be an important step in improving the global perception of Russia as a leading investment destination for business.

But the fight must also be conducted around *preventative measures* in regions where opportunities are currently rarer - due to lower levels of private investment - and corruption has not yet taken root. Part of the growth strategy for these regions should include clearly defined initiatives that prevent corruption becoming engrained in the mindset and practices of governmental representatives in the first place.

Corruption was an issue for all nationalities:

1. However, firms from countries with strict corruption practice acts (e.g. US) are clearer about not paying bribes – but it is unclear whether this means corruption happens less, or whether they are more reluctant to invest in regions with corrupt reputations.

2. Corruption is also not industry-specific, although it was most prevalent for consumer markets, where it occurred in 60% of cases.

3. Corruption also appears to occur less in dealing with Regional government:
    - Regional government = 30% of cases
    - Municipal authorities = 60% of cases
    - Federal and territorial government = 70% of cases.

! Weak signals: Further investigation required

"Corruption is not an issue for us as we declare to all our partners that we are a white public company and under FCPA rules we don't give bribes."

Technology, North America

"To get permission to build a warehouse we tried for about 2 years to get the process done legally. But the municipal authorities made us come again and again with different documents that they refused to accept, forcing us to bribe."

Consumer Markets, Western Europe

РСПП

KPMG

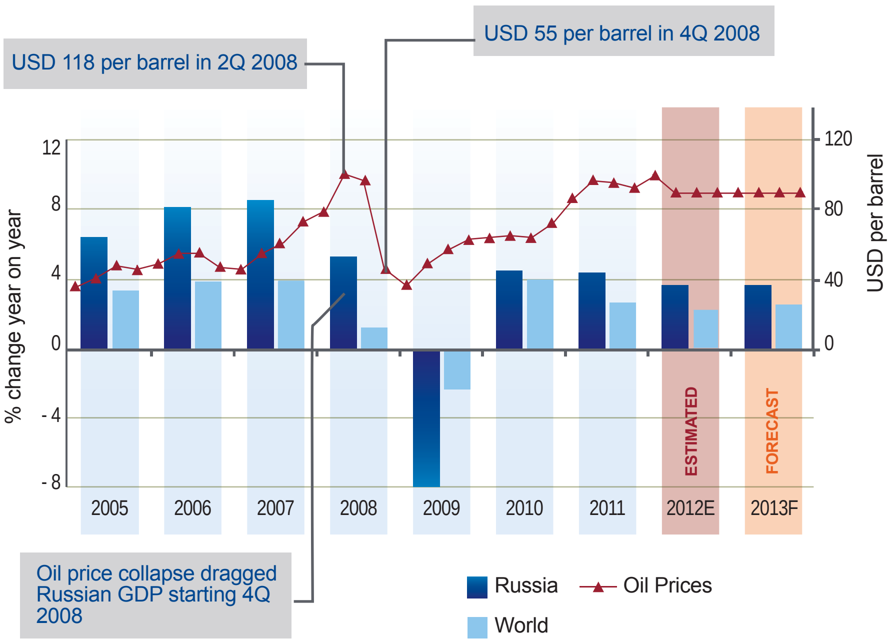
cutting through complexity

PART TWO
The importance of FDI

Russia's uncertain economic future

Russia's greater integration into the global economy has helped fuel its rapid growth over a decade but has also exposed it to the *headwinds* facing the world economy today. GDP fell almost 8% during the global economic crisis, as oil prices collapsed, and current World Bank forecasts suggest even a slight decline in the price of oil in 2013 (to USD$80 per barrel) would restrict Russian GDP growth to 1.5%.[1] Indeed, as of April 2013 the Ministry of Economic Development has revised down its GDP forecast for the year to 2.4%[2].

Russian and global GDP growth vs. oil prices (2005–2013)

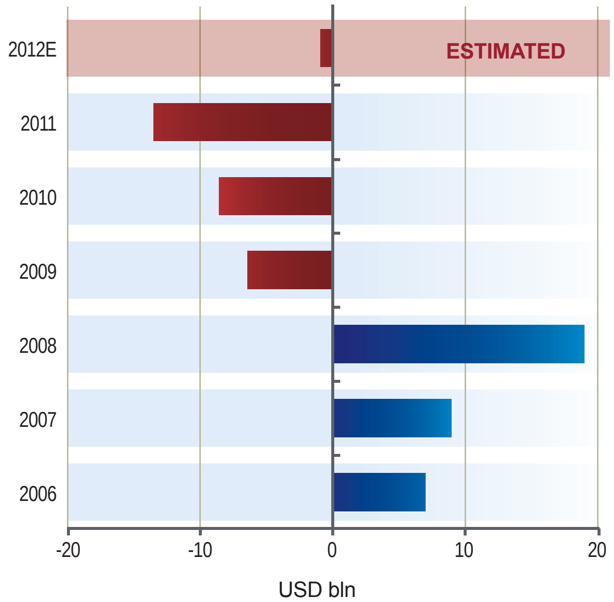


Source: EIU, World Bank, Bloomberg

1. Reinvigorating the economy. Russian economic report; no. 28. Washington D.C. - The World Bank. http://documents.worldbank.org/curated/en/2012/10/16814608/reinvigorating-economy p.24
2. Estimation was presented by vice-minister of economic development A.N. Klepach on 11 April 2013.

Russia's current economic position is precarious and the capital required to modernise continues to flow out of the country since the crisis. Without reversing this, the country may have to adjust to the lower growth levels experienced in 2012, which was Russia's lowest growth[3] rate in a decade and a half with 2013 unlikely to look much better, which is sobering, especially since oil prices are currently near record levels.[4]

Russian net capital flows (2006–2012)



Source: EIU

3. With the exception of the crisis years of 1998 and 2009
4. Reinvigorating the economy. Russian economic report; no. 28. Washington D.C. - The World Bank. http://documents.worldbank.org/curated/en/2012/10/16814608/reinvigorating-economy p.2

Naked in the Marketplace

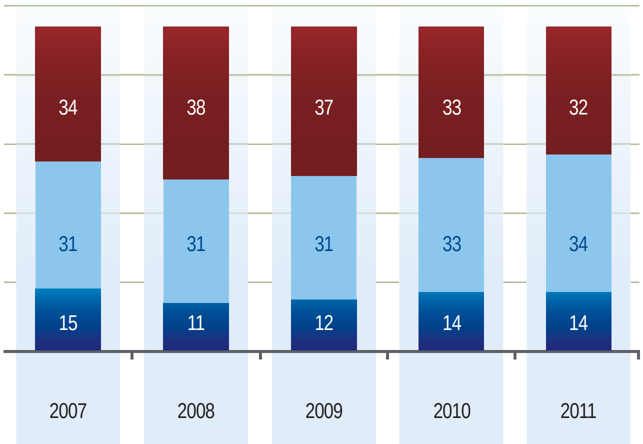
The sharp downturn in the Russian economy in 2009, as the global crisis took hold, exposed its '*nakedness in the global marketplace*'. An over-reliance on revenue from oil and gas exports left the Russian economy with little ability to deal with the sharp downturn in global demand for its dominant export. It also re-opened the debate whether Russia's economic growth prior to 2008 was in fact transitory: built on an impermanent foundation of high oil prices and trapping everyone in the illusion that structural reforms to deal with the economy's lack of robustness could wait. While structural investments grew "robustly" prior to the crisis, they "remained low in relation to GDP compared with other rapidly catching-up economies."* This revealed Russia's dependence on raw material exports and leaves it facing the question whether this apparent 'nakedness' will be exposed by future external shocks?

** OECD*

The Threat for Russia's Regions

A renewed global economic slowdown, let alone collapse, could result in more regions requiring increased federal subsidies. The current number of '*subsidised*' regions has largely returned to pre-crisis levels but this trend could rapidly reverse at a time when the fiscal tools available to the federal government to respond to this are reduced. The Reserve Fund was significantly drawn upon in response to the crisis in 2009 and a sudden shock could severely impact the economic position of many, if not all, Russia's regions.

Regions receiving federal subsidies (2007-2011)



Source: Rosstat

- Heavily-subsidised (federal subsidies >10% of regional budget)
- Subsidised (federal subsidies 1-10%)
- Economically sufficient regions

FDI's importance to local economic development

Not all regions seem to appreciate that FDI is a key component of economic development. Although it can help drive increased local productivity through increased competition, greater technological adoption and increased workforce skills, some regions strongly emphasise the negative factors: that international firms outperform less experienced local ones, occupy the best talent and repatriate profits back home.

However, common responses to the concerns about FDI can ultimately be detrimental to the local economy. 'Protecting' local firms at taxpayers' expense through subsidies or open hostility to competitors hinders the evolution of local firms as these not only fail to maximise their potential (and tax revenues) but also occupy key resources (locations, utilities, capital and labour) that could be put to more productive economic use.

One cannot state categorically that FDI is beneficial for all economies everywhere. But, when the world's largest and fastest growing large economies (the US and China) also attract the largest levels of FDI it is possibly a mistake for Russia not to do everything it can to maximise its own FDI inflows.

Is FDI a good thing?

Both positive and negative effects are outlined here and while the negative effects are real they are limited to the short-term and to those economies that are uncompetitive. In the long-term FDI helps stimulate sustainable economic growth and should therefore be a key component of regional development strategies.

Positive effects of FDI	Negative effects of FDI
■ Increases long-term fixed capital, which is less prone to volatile or cyclical behaviour, resulting in large capital flights out of the country	■ Occupies the best workforce talent and other finite resources, pushing up the costs for local firms
■ Improves the local labour force through training in modern working techniques	■ Out-competes local firms, especially in the area of innovation
■ Helps transfer new technologies and approaches	■ Local firms may choose not to compete against more productive firms and close operations
■ Can increase demand for locally-supplied goods and through cooperation helps providers thereof produce better quality goods more efficiently	■ Costs of attracting FDI (direct sales costs and incentives) may be higher than the direct benefits, particularly if there are no spillovers into the local economy
■ Increases competition in a market, which leads to productivity growth of all competing firms	
■ Stimulates development of new local SMEs as they become more confident in their own skills to start a business; but also provides reliable ready-made clients for new products or services	

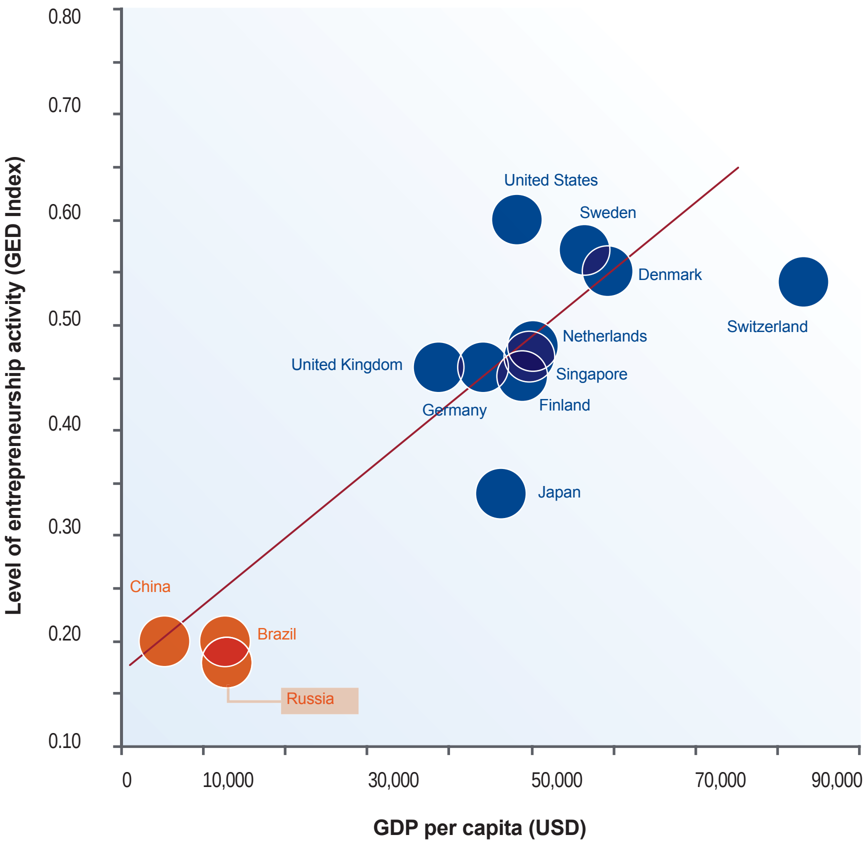
FDI spillovers

FDI inflows bring fresh investments of capital and knowledge - of the latest technologies and business practices - which Russia's regions need to develop. They help *raise the bar* in the local economy, compelling all firms to be more productive and generating much needed local wealth.

Increased FDI brings many benefits to the economy. One key benefit is in the form of improved business knowledge that helps develop the technical and business skills of the local workforce. This in turn makes them more adept at recognising and exploiting new business opportunities and drives local private investment.

A subsequent explosion of new small and medium-sized enterprises (SMEs) can emerge from these 'spillovers': driving the greater productivity improvements and economic growth seen in the world's leading economies, which are conspicuously absent in Russia.

Correlation between SME activity and GDP per capita



Source: EIU database, Global Entrepreneurship Monitor 2011-2012 (GED Index – Global Entrepreneurship Development Index)

Absorption capacity

Capturing positive FDI 'spillovers' requires a well-developed '*absorption capacity*' consisting of:

1. Strong human resources - developed through educational institutions providing the local workforce with the *relevant* skills to prosper in a modern work environment.
2. Positive business climate - business-oriented institutions supporting all businesses and stimulating productivity drivers (e.g. R&D, financial structures and entrepreneurial training) that create a vibrant market of suppliers and consumers enabling private investment to build profitable businesses.

The Business Environment

The business environment is, in the eyes of many private investors, the key part of the overall investment climate of the regions, making up the '*soft factors*' of how business gets done.

*"The business environment includes the myriad of inputs, rules, incentives, and supporting entities that directly influence productivity and innovativeness of company competition." **

Business Environment	Investment Climate
■ Institutions (e.g. education, publicly funded Research & Development labs)	■ Physical infrastructure (including utilities)
■ Legal environment (e.g. protection of physical and intellectual property)	■ Natural resource deposits
■ Administrative environment (e.g. transparent procedures, absence of red tape)	■ Geographical location
■ Level of competition (e.g. SME regulations, existence of functioning financial markets)	■ Size and development of local markets
■ Level of technological development and quality of trained workforce	■ Quantity of workforce

**** Competitiveness at the Crossroads: Choosing the Future Direction of the Russian Economy, Michael E. Porter, 2012***

Governments should accept the multiple benefits FDI can bring and focus on creating effective 'absorption capacities' to capture the positive 'spillovers.' In the long-term this creates conditions in which the local workforce develops the skills and confidence to make their own investments (in the form of SMEs) to:

1. Exploit commercial opportunities missed by the larger firms.
2. Utilise the supply and value chains built by larger foreign firms.
3. Create complementary or support products or services for which there was no market before.
4. Create substitute products or services.
5. Eventually rival the foreign firms head-to-head in local and export markets.

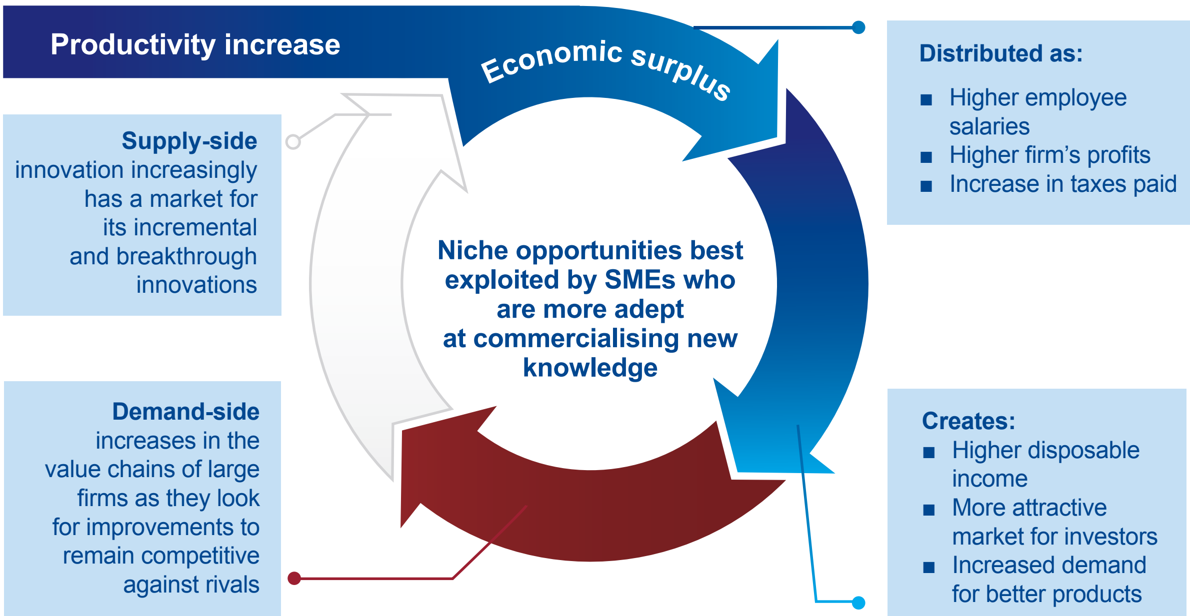
It is this 'virtuous cycle' that regional governments should be looking to foster.

"We estimate that for each new job created at a big new enterprise, SMEs create 4-5 workplaces – not only in producing SMEs but also in services: catering, cleaning etc. We see that recently more hotels, restaurants and other HoReCa facilities have appeared in Kaluga."

Ilya Veselov,

Director of the Agency for Regional Development of Kaluga region

The 'Virtuous Cycle'



Spillover example

Spillovers: Indesit in Lipetsk.
Utilising the supply and value chains built by larger foreign firms.

Some investors highlighted positive experiences they had come across in Lipetsk, which we explored further to consider how regions can exploit positive spillovers from FDI.

In April 2004 Indesit launched a washing machine manufacturing plant in the Lipetsk region and in the following year built the largest warehouse for home appliances in Europe. Since then an industrial cluster has developed around these, with SMEs from Lipetsk and other Russian regions specialising in the production of components for 'white home appliance goods'[5]:

1. In 2004 the Yeletsky Elta plant launched a production line for washing machine components to meet Indesit's demand and subsequently started fulfilling external orders: **Investment – RUB42 million, currently employing 62 people.**
2. Prior to 2004 the local Assol toolmaking plant in Lebedyansk was in poor condition with old machinery and experiencing significant losses. It then invested in new equipment to open a new production line making components for Indesit washing machines. Production levels increased and quality was optimised: **Investment – RUB245 million, currently employing 679 people.**
3. In 2008 Turkish investors founded the Ekinler plant on a brownfield site. It produces cables for home appliances used by the Indesit plant and others: **Investment - USD2 million, currently employing 132 people.**[6]
4. In 2008 another group of Turkish investors launched the Tetra plant (since 2011 - EvroTech), producing rubber and plastic components for washing machines built by Indesit and other companies: **Investment - USD3,5 million, currently employing 52 people.**[7]

Currently, 57 Russian companies from various regions supply components to Indesit International, 11 of them are located in the Lipetsk Region. However, according to Indesit, 50% of the components are still imported. As the strategic goal is to increase the share of components purchased locally, there should be significant room for further investment and job creation around this one cornerstone investment.

5. Source: report on implementation of social-economic development strategy of Lipetsk region in 2006, presenter: vice-head of Lipetsk administration Glukhovkina T.A. (report published at minregion.ru)
6. Source: analytical portal 1RRE.ru
7. Source: analytical portal 1RRE.ru

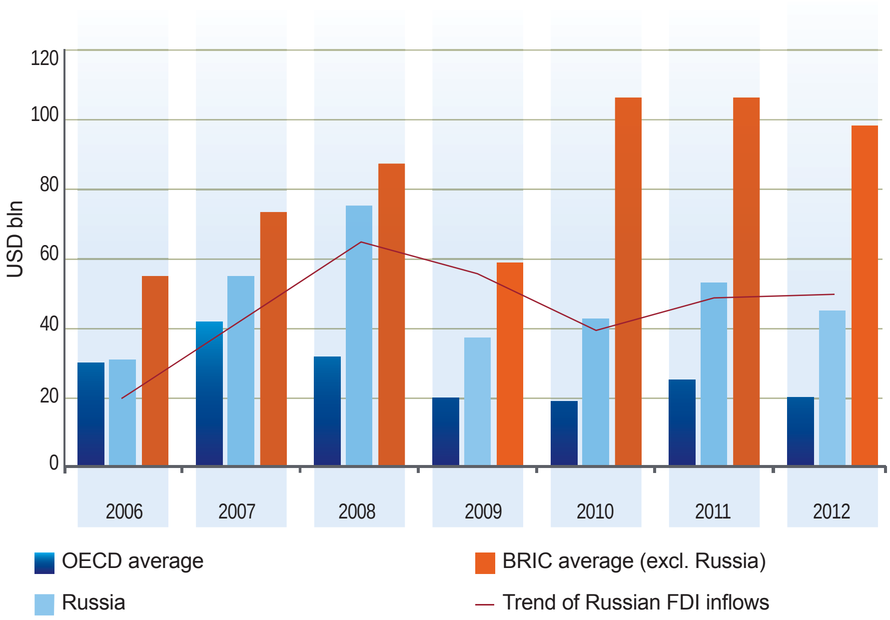
Russia faces greater competition globally for FDI

To accomplish the challenge of diversifying, modernising and driving Russian economic growth all regions need to attract greater levels of private investment.

In 2010 we suggested the regions themselves would play a major role in the future economic development of Russia as each region had the potential to actively attract more FDI and, therefore, jointly increase the total FDI flowing into Russia. However, this scenario has not been fully realised, which provoked the Minister for Economic Development, Andrey Belousov, to remark in summer 2012:

"We have reached the level of about USD53 billion a year of FDI[8], but this is absolutely not enough."[9]

Russian FDI inflows vs benchmark groups (2006–2012)



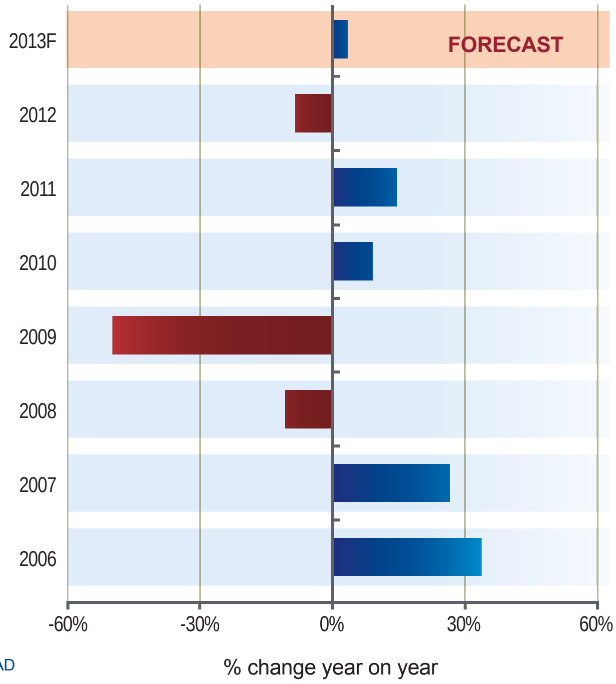
Source: EIU, OECD

8. The figure referred to here is based in calculations from the Central Bank of Russia, which include direct investment in financial institutions. For the purposes of our report we Rosstat data, which excludes this.
9. International Economic Forum speech, St. Petersburg, June 22, 2012 (http://forum2012.vesti.ru/news/show/id/140)

Yet, attracting greater private investment now is juxtaposed in an environment where foreign businesses have become choosier about where to invest, with global FDI levels remaining flat in recent years.

Furthermore, the global marketplace has become more competitive, with multiple economies striving harder to attract the finite capital and knowledge they all need to stimulate growth.

Global FDI levels (2006–2013)



Source: UNCTAD

Defining Private Investment

Private investment refers to all non-governmental investment made in an economy by private business, including: foreign-direct investment, investment from other regions of Russia, and all local investment in new or existing firms. This investment often takes the *form* of:

1. Direct investment – made by legal entities in order to own at least 10% of an organisation (including Joint Ventures, Mergers or Acquisitions, or establishing a new legal entity).
2. Fixed asset investment – subsequent spending on facilities, technologies, and workforce training.

"Why would an Asian business invest in Russia? When there is gold in your backyard you don't look at other places with less opportunity and where it is harder to do business."

International Investment Management Company (Asia)

"Companies within our fund do not see the Russian market as attractive as the Chinese one, nor many other Asian or South American markets. What is more, corruption levels in the country seem very high. We have discussed opening an office and a plant in Russia many times but every time we have decided that we have little reason to trust potential Russian partners and it seems safer to invest in other parts of Eastern Europe (Slovenia, Bosnia, Hungary). Despite the higher tax rates we feel more comfortable there and are ready to pay for that."

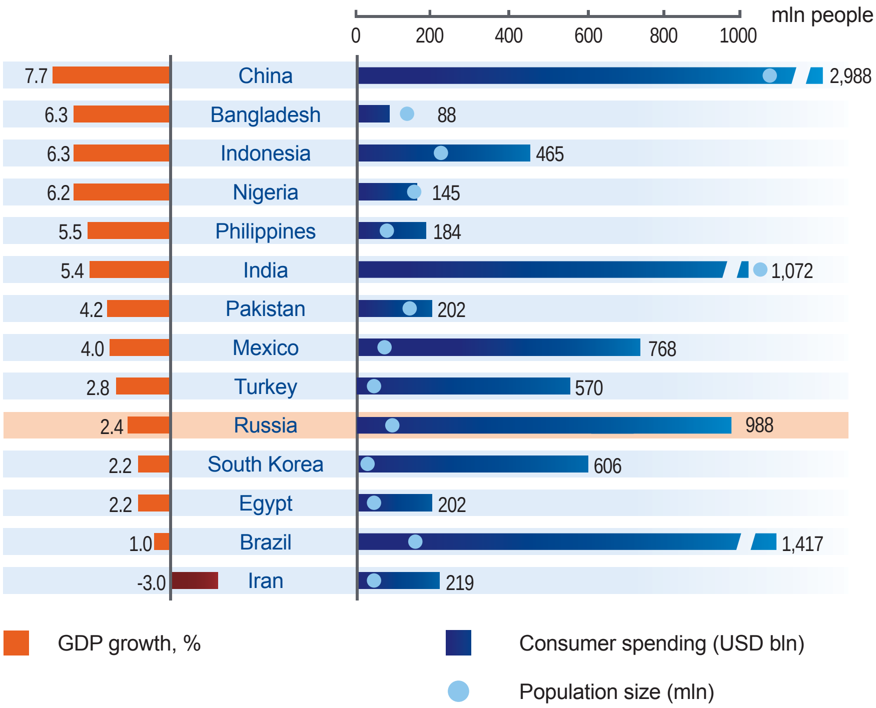
Private Equity Firm (Asia)

"We have heard of many companies that invested in real estate in Russia a few years ago, but we never heard any success stories. Overall we don't have a lot of confidence in Russia's market potential, whereas investing in Asia is the new trend. Russians who live abroad advise us not to invest in Russia and they don't want to go back there – this is a pretty strong signal."

Private Equity Firm (Europe)

Whilst private investors are looking beyond anaemic 'developed' markets to 'emerging' ones in their search for more attractive returns, the choice of attractive locations is also growing. Investors are looking beyond the BRICs to the 'Next Eleven'[10] rapidly growing economies and others. The threat for Russia is that some of these economies have potentially larger consumer bases, greater GDP growth rates and an image of being more investor friendly – all key attractors for private investors.

Growth in GDP and consumer spending (BRIC and 'Next 11' 2012)



Source: EIU

Unless Russia's regions start focusing on improving the attractiveness of their business environments now they may find their window of opportunity passing forever. In this scenario, hopes of driving the Russian economy forward will be limited by an inability to attract sufficient levels of capital and knowledge needed to stimulate this. The result would be an economy that remains over-reliant on volatile energy exports and unattractive to future, diversified investments.

10. Bangladesh, Egypt, Indonesia, Iran, Mexico, Nigeria, Pakistan, Philippines, Turkey, South Korea, and Vietnam — identified in 2005 by Goldman Sachs investment bank and economist Jim O'Neill as having a high potential of becoming, along with the BRICs, the world's largest economies in the 21st century, with promising outlooks for investment and future growth.

Updated Regional FDI Attractiveness

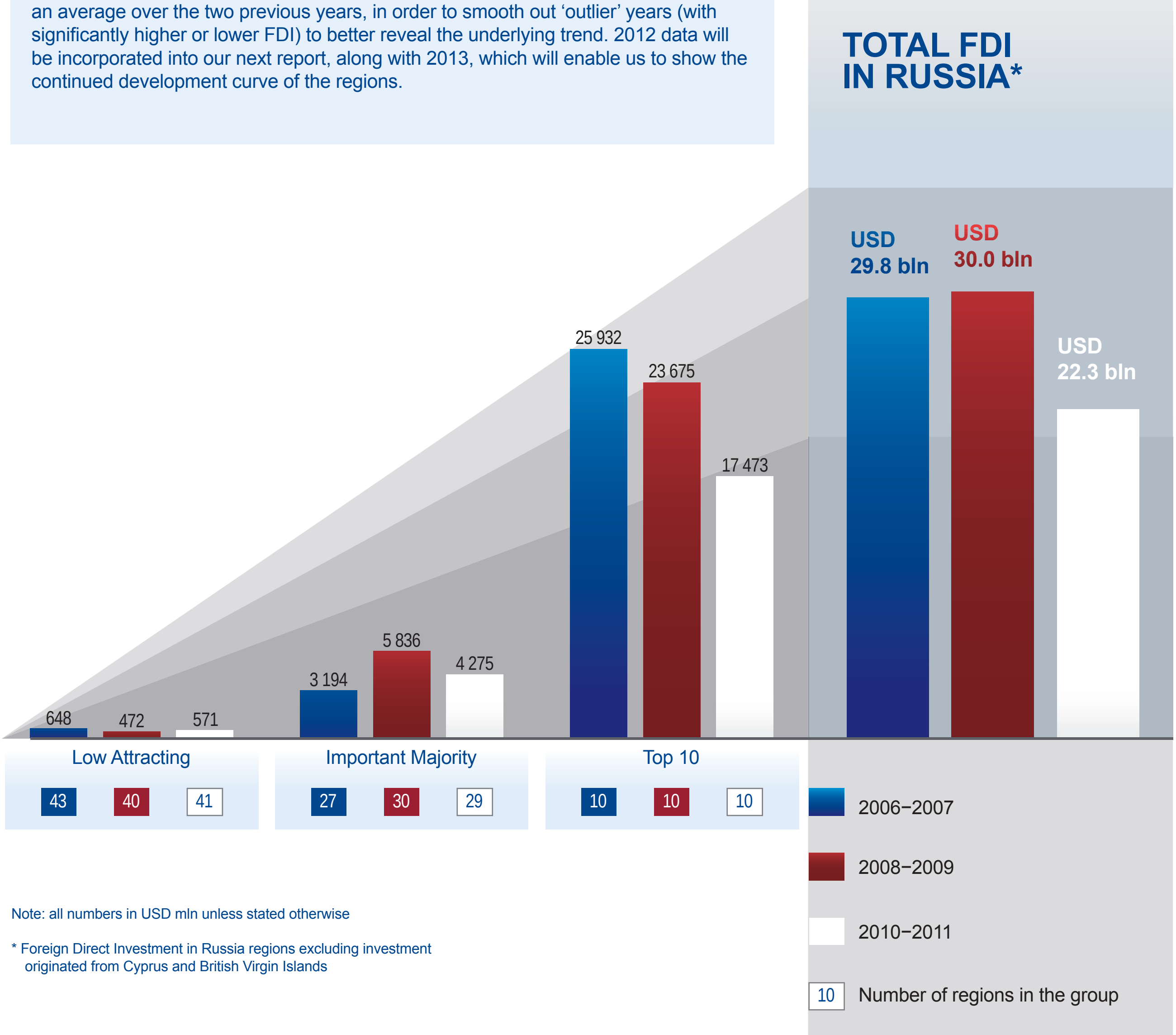
Our 2010 report noted that Russian FDI inflows were concentrated in a few regions. Furthermore, nearly half the regions had failed to attract more than a modest USD100mln of FDI[11] in the previous four years. Updating the next two year figures for FDI inflows (2010 and 2011)[1] shows the lowest annual average over the six years covered by our reports. We can also start to see that regions over these six years fall into three broadly distinct bands with some, though little, movement between them:

	Description	Question
«Top 10»	The regions currently attracting the majority of inward FDI into Russia	Are the 'Top 10' regions set in stone - or can other regions (executing the right strategies) become highly attractive to FDI as well?
«Important Majority»	The regions attracting modest to significant FDI inflows (above USD25mln p.a.)	Are the 'Top 10' attracting the same share of all inward Russian FDI – or is there a greater diversification of foreign private investment across the regions into the 'Important Majority'?
«Low Attracting Regions»	The regions attracting little or no FDI inflows (below USD25mln p.a.)	Are any previously 'Low Attracting Regions' learning the lessons about attracting FDI and kick-starting their own future development through increased FDI inflows?

11. Excluding investments from Cyprus and the British Virgin Islands
12. Source: EMISS database (fedstat.ru) - data from Rosstat

Regional Attraction Development Model

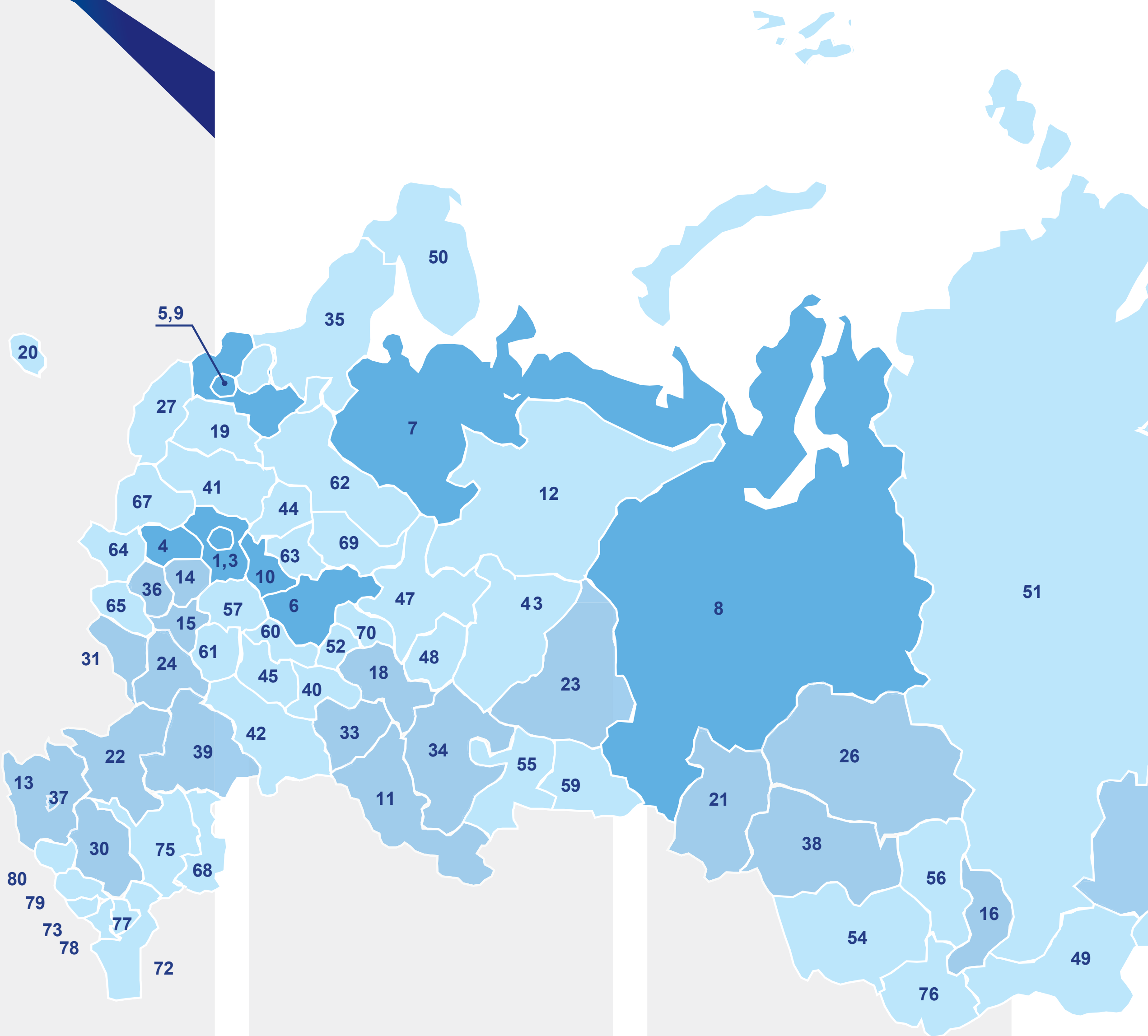
The ‘Regional Attractiveness’ model takes 2006 as its starting point - a year with a significant increase in FDI into Russia. We calculate the annual FDI per region as an average over the two previous years, in order to smooth out ‘outlier’ years (with significantly higher or lower FDI) to better reveal the underlying trend. 2012 data will be incorporated into our next report, along with 2013, which will enable us to show the continued development curve of the regions.



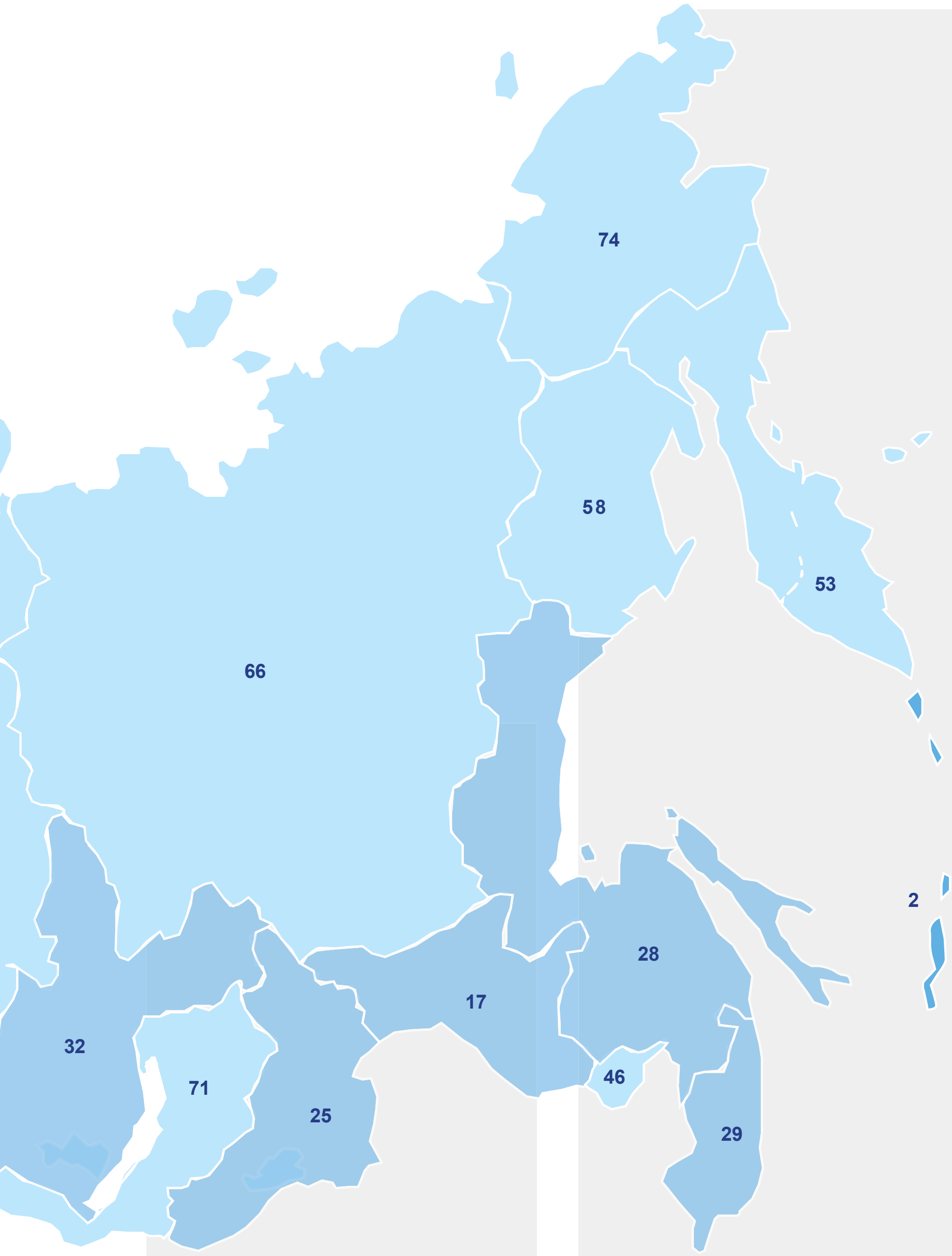
Note: all numbers in USD mln unless stated otherwise

* Foreign Direct Investment in Russia regions excluding investment originated from Cyprus and British Virgin Islands

Russian map of FDI



1	Moscow
2	Sakhalin region
3	Moscow region
4	Kaluga region
5	Saint-Petersburg
6	Nizhny Novgorod region
7	Arkhangelsk region
8	Tyumen region
9	Leningrad region
10	Vladimir region
11	Orenburg region
12	Komi Republic
13	Krasnodar region
14	Tula region
15	Lipetsk region
16	Khakasia Republic
17	Amurskiy region
18	Tatarstan Republic
19	Novgorod region
20	Kaliningrad region
21	Omsk region
22	Rostov region
23	Sverdlovsk region
24	Voronezh region
25	Zabaykalsky Kray
26	Tomsk region
27	Pskov region
28	Khabarovsk region
29	Primorskiy Kray
30	Stavropol Kray
31	Belgorod region
32	Irkutsk region
33	Samara region
34	Bashkortostan Republic
35	Republic of Karelia
36	Orlovsky region
37	Republic of Adigeya
38	Novosibirsk region
39	Volgograd region
40	Ulyanovsk region
41	Tver region
42	Saratov region



Bands based on 2010–2011 data*

- Top-10 regions
- Important Majority
- Low Attracting

43	Perm Kray
44	Yaroslavl region
45	Penza ergion
46	Jewish Autonomous region
47	Kirov region
48	Republic of Udmurtiya
49	Tyva Republic
50	Murmansk region
51	Krasnoyarsk Kray
52	Republic of Chuvashia
53	Kamchatsky Kray
54	Altayskiy Kray
55	Chelyabinsk region
56	Kemerovo region

57	Ryazan region
58	Magadan region
59	Kurgan region
60	Republic of Mordovia
61	Tambov region
62	Vologda region
63	Ivanovo region
64	Bryansk region
65	Kursk region
66	Republic of Yakutia
67	Smolensk region
68	Astrakhan region
69	Kostroma region
70	Republic Mariy El

71	Republic of Buryatia
72	Dagestan Republic
73	North Ossetia-Alaniya Republic
74	Chukotka Autonomous region
75	Republic of Kalmikiya
76	Republic of Altay
77	Chechen Republic
78	Ingushetiya Republic
79	Cabardin-Balkarskiy Republic
80	Karachaevo-Cherkes Republic

* 2012 data will be incorporated into our next report on 2012-2013

The ‘Top 10’ are not ‘set in stone’

Despite certain regions enjoying a privileged position attracting the majority of FDI, it is possible for a region *successfully executing* the right strategies to break into the ‘Top 10.’ Three regions (Nizhny Novgorod, Tyumen and Vladimir) experienced significant FDI increases in this period. The especially notable case of Nizhny Novgorod - a non mineral-rich region - demonstrates what many other regions can potentially achieve.

‘Top 10’ Regions for Attracting FDI

Current Ranking (2010-2011)	Ranking Change*	Top 10	Average FDI attracted p.a.		
			2006-2007	2008-2009	2010-2011
			USD mln	change on previous period	change on previous period
1	0	Moscow	6,499	*-34%*	*-46%*
2	0	Sakhalin region	3,809	*-45%*	*-29%*
3	0	Moscow oblast	954	*37%*	*4%*
4	+2	Kaluga region	97	*464%*	*67%*
5	-1	Saint-Petersburg	492	*152%*	*-47%*
6	NEW	Nizhny Novgorod region**	90	*149%*	*143%*
7	+1	Arkhangelsk region	162	*123%*	*22%*
8	NEW	Tyumen region**	48	*91%*	*369%*
9	-2	Leningrad oblast	356	*8%*	*-22%*
10	NEW	Vladimir region**	138	*43%*	*11%*

*Compared to previous two-year period (2008/2009)
**Regions not in the ‘*Top 10*’ in 2008/09

The ‘Top 10’ share of attracting inward FDI is diluting, slowly

The total percentage of FDI captured by the ‘Top 10’ regions decreased from 87% in 2006-2007 to 78% in 2010-2011. This may suggest the beginnings of a positive dynamic towards FDI expansion into other regions outside of the *traditional strongholds* of major metropolis and energy-rich regions. This trend could be accelerated further through knowledge-sharing between regions and ruthless implementation of the right strategies.

Becoming part of the 'Important Majority' may be attainable for most, if not all, regions

A number of regions previously included in the 'Low Attracting Regions' group (attracting less than USD25mln of FDI p.a.), enjoyed significant progress in 2010 and 2011. Most notable was Voronezh, demonstrating the potential many regions have - if they get their strategy and its execution for attracting FDI right.

Regions with Positive Dynamics – Important Majority

Current Ranking (2010-2011)	Ranking Change*	Important majority ('High-Flyers')	Average FDI attracted p.a.		
			2006-2007	2008-2009	2010-2011
			USD mln	change on previous period	change on previous period
15	+9	Lipetsk region	43	*11%*	*143%*
24	+60	Voronezh region**	6.3	*18%*	*908%*
27	+13	Pskov region	21	*25%*	*116%*
30	+19	Stavropol Kray**	8.8	*6%*	*358%*
32	+15	Belgorod region**	33	*-67%*	*246%*
36	+20	Orlov region**	30	*-77%*	*367%*
37	+17	Republic of Adigeya**	0.5	*1,223%*	*351%*
39	+32	Volgograd region**	47	*-99%*	*3,204%*

*Compared to previous two-year period (2008/2009)
** Regions not in the '*Important Majority*' in 2008/09

Current ‘Low Attracting Regions’ can develop rapidly

A few notable regions in the ‘Low Attracting’ band have enjoyed an impressive amount of growth in the previous two years, suggesting that many regions should be capable of attracting greater levels of FDI.

Most notable amongst these is Ulyanovsk, which has become a far more attractive region in the period 2010-2011 and was close to becoming part of the ‘Important Majority.’ Ulyanovsk attracted USD29mln in 2011 alone and should be set to break into the ‘Important Majority’ band when we publish our updated findings for the two year period 2012-2013 if its performance in attracting FDI continues to improve at its current pace.

Regions with Positive Dynamics – Low Attracting Regions

Current Ranking (2010-2011)	Ranking Change*	‘High-Flyers’	Average FDI attracted p.a.		
			2006-2007	2008-2009	2010-2011
			USD mln	change on previous period	change on previous period
40	+8	Ulyanovsk region	21	*-54%*	*146%*
42	+16	Saratov Region	1.7	*250%*	*240%*
43	+23	Perm region	7.5	*-71%*	*836%*
46	+24	Jewish Autonomous Region	0.9	*16%*	*1,055%*
49	+11	Republic of Tyva	0.0	*Increased to $4.4m*	*158%*
52	+17	Republic of Chuvashia	25	*-95%*	*778%*

* Compared to previous two-year period (2008/2009)

Although the FDI stock (the accumulated amount of FDI over time) in these regions is low, meaning they will only be experiencing the early positive impacts on their productivity and GRP growth, it is the dynamic of the growth that is important to note at this stage. Should this dynamic continue (although possibly at lower percentage rates) they will emerge from this band and become part of the overall picture of increasingly attractive destinations for FDI in Russia.

Those being left behind

Unfortunately, around half of Russia’s regions are still ‘Low Attracting’ despite some of the success noted above. There is a danger that these regions may get left behind in the country’s big push towards modernisation.

FDI brings the tools and impetus to drive productivity higher in Russia, raise tax returns and fund further economic development through physical infrastructure improvements, new technology adoption and more highly-skilled workforces. Those regions starved of this today may get permanently left behind. This leads us to pose the question whether half of Russia’s regions will be left without any competitive advantages to attract FDI in the future; with populations looking to emigrate for economic reasons and in search of an increased quality of life.

It may be that some regions will simply never attract significant levels of FDI or local private investment and will always be dependent on federal subsidies. However, in the more competitive global environment, it is perhaps incumbent on those regions that can become attractive investment destinations for business that they do so *now* before the opportunity passes by and they become locked into permanent dependence on the federal government’s resources and a drain on other regions.

РСПП

KPMG

cutting through complexity

PART THREE
Setting the right priorities

Setting the Right Priorities for Regional Growth: Synchronising Substance and Form

Russia's regions are in the process of building structures to bridge the gap of investor expectations: improving the rule of law; minimising rampant bureaucracy; increasing transparency and tackling corruption. Their approach - guided by Federal initiatives - is leveraging best international and local practices: reducing administrative barriers; increasing incentives; developing infrastructure; and investing in the workforce. This is the *form* crucial for a sustainable development of the Russian regions.

However, what comes through clearly from the experiences shared in this report is that it is the *substance* – what makes 'things happen' during the investment process – that really makes a region attractive to investors. *Substance* appears to be most prominent in those regions that:

1. Have clearly put FDI at the top of their list for economic development.
2. Strive to see the investment process 'through the eyes of the investors'.
3. Try to understand not only the investors' needs but also the reasons behind these needs and work together to make the investment happen.

The concern that shines through the feedback from international investors is that regional governments may focus too much on the *form* of the new requirements (building an attractive rule-based business climate) at the expense of their *substance* (executing the daily tasks that enable investors to successfully do business in the region). The biggest obstacle to success therefore will be how well the regions can combine progress in *form* and *substance*. But the challenge in achieving this *synchronisation* will differ substantially depending on a region's development position today. Regions that have not yet developed the deep *substance* to attract FDI will likely spend too much time complying with the *form* of the strategy only - ticking off tasks on the checklist - whilst no real improvements in *substance* will be delivered.

Of even more concern are those regions that have developed significant *substance* for foreign investors but are lacking the *form*. The risk here is that they could lose their regional dynamic by shifting limited resources to comply with the *form* aspects. Although universal formal requirements and tools are important to achieve sustainable alignment across a large economy, they are likely to fail unless the priorities of the regions, which are at different stages of development, are addressed and help is provided to enable them to differentiate and really attract investors.

Within our study foreign investors have identified the three main areas that add *real substance* to the regional investment climate: *the human factor, cutting through bureaucracy* and *continuous improvement*. Which of these areas requires the most focus is very much dependent on the region's position in the economic life cycle. One conclusion though is very clear for all regions. To become the backbone of Russia's future the regions need to get both the *form* and *substance components right*. For it is *substance* that attracts FDI, while the *form* will allow them to maintain this dynamic over the coming years as they develop a sustainable ecosystem.

Key Elements of Form and Substance

Regions recognise that in order to build attractive business-investment climates they ***must have* the following *form*** in place:

1. *CLEAR VISION*
2. *EXECUTABLE STRATEGY*
3. *EFFECTIVE COMMUNICATION*
4. *SUPPORTIVE REGULATIONS*
5. *ADMINISTRATIVE EFFICIENCY*
6. *REDUCING CORRUPTION*
7. *KNOWLEDGE-SHARING*
8. *DEVELOPED WORKFORCE & RESOURCES*
9. *LONG-TERM FOCUS*

The political will to build these foundations exists and has resulted in concrete actions currently being undertaken to implement them. But building a better *form* alone will be insufficient to make the business climates of the regions attractive to investors.

Increasing FDI to the regions requires more than just a better structural *form* – it also requires *substance*.

The investor perspective highlights **the *substance* successful regions possess** to attract business-investors.

'The Human Factor' to ensure the '*must haves*' will be implemented

'Cutting through bureaucracy' to assist in overcoming rule-based obstacles

'Continuous effort' to make improvements in response to investors needs

These elements make the regions' strategy work by meeting investors' needs and creating the positive experiences that make a region a genuinely attractive place to do business.

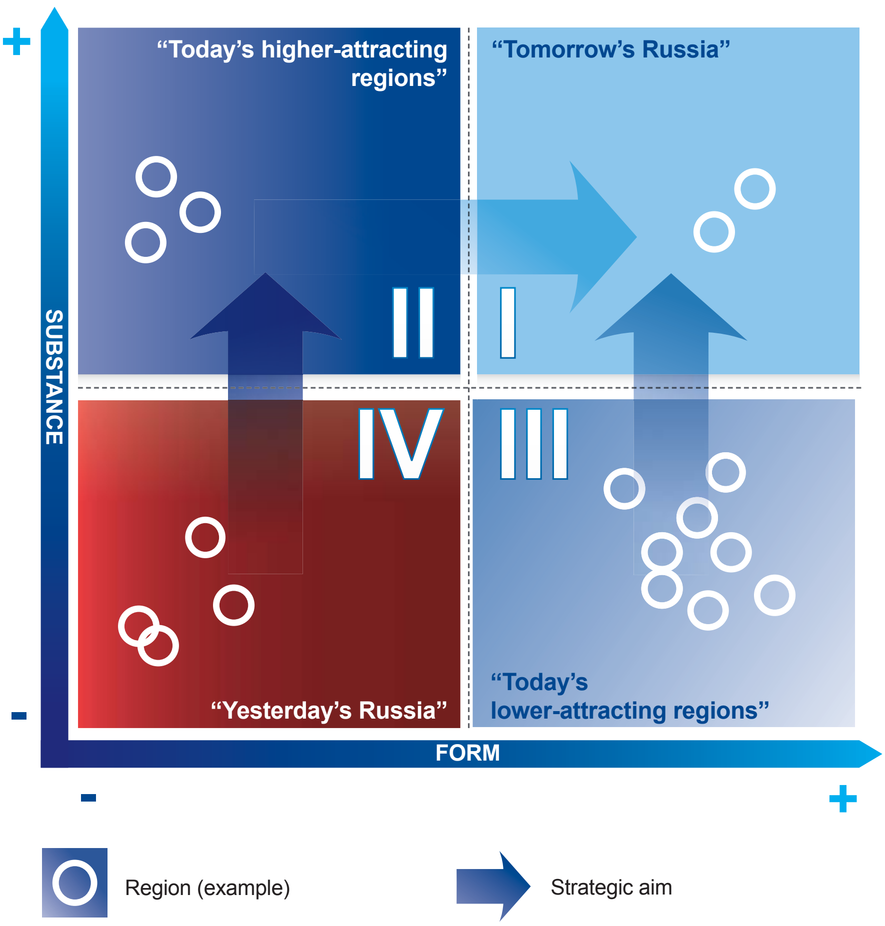
Synchronising Substance and Form

Although the right *form* is essential for the development of an attractive business investment climate throughout Russia it will only result in increased FDI if the *substance* making that *form* work for investors is of equal quality.

Regions have two important criteria to benchmark their progress against: *form* and *substance*:

- the *form* the regions are / will be required to adopt for sustainability and national alignment
- the *substance* the regions have to offer international investors to enable them to invest.

Looking at both criteria, we can *observe four different archetypes* of regions:



I **“Tomorrow’s Russia”** explores the region's potential for FDI to the full extent and has structures that ensure sustainable and coordinated development

II **“Today’s higher-attracting regions”** explores today's potential of the region to the full extent but might fall behind in challenging times as structures are missing

III **“Today’s lower-attracting regions”** leaves the region’s FDI potential unexplored by maintaining the status quo by applying *form* over *substance* approach

IV **“Yesterday’s Russia”** steers towards low or one-dimensional economic growth and risks political chaos

Introducing more *form* will benefit regional development. It will lead to better coordination and more sustainability (i.e. less dependence on individuals and short economic cycles). However, international investors air a concern that those regions could become too focused on formal aspects and therefore lose some of the dynamics developed recently.

For the regions it is therefore paramount to understand the key elements of and difference between *form* and *substance*, how they currently perform on *form* and *substance*, how the *substance* is changing and where to focus in order to develop successfully through the *form* and *substance* matrix.

Strategic Initiatives for 'Moving through the Substance and Form Matrix'

1. In order to remain dynamic regions forging 'tomorrow's Russia' should expand their 'competitive field' to learn best and emerging practice from international rivals for attracting investors.
2. 'Today's higher-attracting regions' should adopt the new *form* initiatives that will institutionalise key elements of the local investment climate to build a sustainable attractive future.
3. 'Today's lower-attracting regions' need to rapidly uncover the investors' perspective to understand what is and isn't working and quickly introduce *substantive* initiatives that meet the real needs of actual and potential investors now.
4. Regions representing 'yesterday's Russia' that did not recognise any need for attracting FDI should be monitored by a federal task force to oversee the implementation of strategies for improving the business investment climate, whilst simultaneously looking for ways to provide substantive incentives to potential investors now.

Building the Form – the Rule of Law in the Regions

Regions have a clear series of *form* or '*must-have*' elements to build the foundations of an attractive business-investment climate:

Vision	■ National 'Doing Business' ranking target of 20th by 2018[1] ■ 40-50% increase in FDI to $75-80 billion p.a.[2] ■ Regional heads accountable for FDI levels
Strategy	■ 'Regional Investment Strategy & Declaration' ■ Focusing on industries key to region's economy today ■ Developing foundations for industries of tomorrow
Communication	■ Online bilingual regional passports ■ Promotion of regional brands ■ 'Business missions' for establishing connections ■ Business and language skills trainings for civil servants
Regulations	■ Liquidate administrative barriers ■ Increase general protection of investor rights ■ Provide relevant tax honeymoons and subsidies for key investors (based on investor size, profile and in accordance with region's strategy)
Improving Efficiency	■ Launch online 'one window' investment process ■ Outsource management of industrial parks to businesses and extending tax concessions to private parks

1. President's Executive Order N 596
2. S. Belyakov, Vice-Minister for Economic Development. Russia Today channel, November 2012 (Central Bank of Russia FDI calculations)

Transparency and corruption (including 'voluntarily' enforced social responsibility')	■ Implement B20 findings on 'governance and corruption' ■ Flag project delays directly to governor for resolving ■ Challenging the mindset that sees investors as 'money pots' ■ Refrain from using legal powers to hinder investors
Knowledge-sharing	■ 'Pan-regional investment forums' to substantively analyse best practice ■ Formalize the procedures for investors participation in the preparation of legal acts, social and economic regional strategy; their expert review; monitoring implementation ■ Recruiting civil servants with business experience to facilitate understanding
Workforce	■ Training university and college students in modern technologies ■ Increasing graduation speed of students from applied science courses ■ Tax incentives for businesses providing modern training opportunities for all applicable members of the local workforce in the region
Long-term Focus	■ Building *long-term* relationships with potential investors ■ Aligning regional development with business needs ■ Developing industrial parks and clusters and utilising brownfield sites ■ Long-term investment in transport and utilities infrastructure

Whether these strategies will improve the attractiveness of the regions' investment climates will largely depend on how well they are implemented and whether regional governments use them to increase and improve their interaction with potential investors rather than passively expecting change to happen by itself.

Adding the Substance

Currently, foreign investors observe three main areas that add significant *substance* to a region's investment climate for foreign investors: the human factor, cutting through bureaucracy and continuous improvement.

Depending on the positioning of a region in the *form* and *substance* matrix, a different focus of *substance* activities seems important:

Priorities according to archetypes

✓ - strategic priority*

Focus / Group	Tomorrow's Russia	Today's higher-attracting regions	Today's lower-attracting regions	Yesterday's Russia
Human factor				
Governor / Values	✓	✓	✓	✓
Investment Crews			✓	✓
Regional Administration		✓		
Municipal / State Bodies	✓	✓	✓	✓
Cutting through bureaucracy				
Taking the investor perspective			✓	✓
Overcome obstacles		✓	✓	
Understand the individual investor			✓	✓
Drive service mentality through state organs	✓		✓	
Continuous improvement				
Learn from sharing own mistakes	✓	✓		
Stretch goals jointly with businesses	✓			
Improve competitiveness of key sectors	✓	✓		
Lifecycle communication with investors	✓	✓	✓	✓

* absence of a strategic priority doesn't mean that this area should be ignored

A key step for regions is to understand today where they are on the *form* and *substance* matrix in order to understand where their main focus should be next.

Although 'league tables' such as those presented in part two of this report indicate the development stage a region could be at, this fails to take into consideration the potential each region has today.

Therefore, we recommend regions take a similar approach that we undertook for this report and understand how investors perceive their business investment climate.

The Human Factor

The *human factor* is the key differentiator in making the regions' strategies to attract investors work. 'Living' the strategy has to start at the very top and be driven consistently and continually throughout the regional administration and related state organs.

The Human Factor	Investor Perspective
Governor (Values) ■ Sets increased FDI target as the main priority of the governor's tenure ■ Becomes first 'point-of-contact' for key investors and assigns a team to take care of other investors ■ Guarantees timely decisions and implementation of decisions	"Because our project [in Tatarstan] was considered strategically important it came into the President's direct interest. He promised there would be no bureaucracy burden for us and in fact we found the process to be very streamlined"
Investment Crews (Skills) – dedicated teams to run the investment process ■ Industry specialists who know what investors need ■ Has political *gravitas* to cut through complexity to deliver results ■ Accountable for getting investment projects 'over the line'	"When we came to Ulyanovsk to consider investing we were greeted at the airport. Our appointed contact supported us with everything – he was well-known and respected in all governmental authorities and the investment process was faster because of him"
Regional Administration (Attitude) ■ Highly customer-oriented in all business interactions ■ Understands investors mindset and approaches ■ Proactively share lessons learnt from previous investments regionally with the new investors	"In Kaluga they immediately respond to the investors needs and provide full support. You get the feeling that they know and understand what they are doing and what matters for the investor"
Municipal Authorities/State Bodies (Behaviour) ■ Coordinates and aligns municipal priorities with a wider regional investment priorities ■ Works collaboratively with all parties ■ Focus on the rules *substance*, not their *form*	"The regional administration offered us a brownfield land plot for our factory but the utilities (especially electricity) supply could not meet our operational needs. The local government delayed helping us before finally admitting they had no influence on this matter. They then referred us to the municipal administration who were less than interested, or incapable of helping us"

A strong business-orientation amongst all who work with potential investors can stimulate the positive investment experiences that help a region become an attractive place for businesses to invest and operate in.

Cutting through Bureaucracy

Once a region has the right structure, people and 'business-oriented' attitude its challenge will be to customise their offerings to investors by cutting through any historical legacies constraining business.

Cutting through Bureaucracy	Investor Perspective
Take the *investor perspective* to identify the rules that are holding back business, regular monitoring of investors issues and solving typical/systemic problems	"I have lots of issues but a key one is the time required to get all the permits to build something. Then, if there is a change everything needs to be reapplied for again from the beginning. This means things take at least twice as long to get done as in the west and this affects the investment return KPIs."
Pre-empt and overcome obstacles by having senior people take responsibility for them	"The governor personally intervened and helped overcome the clearance issues we were having with customs - this was very important for us."
Operate in ways that better serve the needs of the actual businesses looking to invest in the region by striving to understand the individual investor and why the investor says what he does	"The governor was prepared to enter a long-term deal that meant we would not have to buy the factory, but could lease it, which met our global standards for investing in operations but not buildings."
Drive the new service mentality throughout all state organs to deliver results	"Although the governor and deputy governor are fully aware of the importance of improving the regional investment climate - know what to say and how to act in front of 'foreign' investors – the people who execute the process are clearly less interested."

Continuous Improvement

It is important that regions understand it will take time to improve their business investment climate, for foreign businesses to become aware of these improvements and for the economic benefits to impact on the region. In the absence of an alternative to FDI driven growth, regions need to take a long-term perspective and make continuous improvements towards achieving their goals.

Continuous Improvement	Investor Perspective
Seek investor feedback to understand what could have been done better and share these lessons widely to facilitate learning	"I have heard positive stories from investors in Permskiy kray, Orenburg, Ekaterinburg where they have different committees that are actively working on improving the local situation."
Understand clearly the benefits of the business relationship and set achievement goals	"We went to Karelia to open operations and were surprised (after our experiences in other regions) to find the regional authorities there very reasonable. They were ready to compromise and work things out. The main question they had was whether we would create jobs for the people."
Understand which industries are key to the region's economic growth and development and seek to improve their competitiveness by focusing on developing key inputs such as skilled workforce	"There are problems with an unqualified workforce in the region. No qualified people from vocational colleges. People are taught on machinery that hasn't been used for 20 years now. However the government is asking us what specialists we need, which specialties to create and what they should be taught. So, measures are being taken."
Accept that effective relationships with investors are built on open and honest two-way communication engaged over time	"A one off presentation of a region is not helpful. When it comes to decision-making we rely on the people we know best, with whom we have built a relationship and trust. And it is obvious that frequent contact with a region helps build this mutual understanding."