

BRAVO HEINEKEN!

**THE IMPACT OF FOREIGN DIRECT INVESTMENT IN THE
CASE OF THE BEER INDUSTRY IN RUSSIA**



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Introduction

1. The importance of Foreign Direct Investment

What do countries need for growth?

According to certain OECD reports, trade and foreign direct investments (“FDI”) are important vehicles for growth in, especially, developing countries.¹ It shows that in the last decade, countries that have been more open to foreign investment, have achieved double the annual growth of others. Firms and sectors with high FDI levels have higher average labor productivity and pay higher wages. Therefore, FDI can benefit all parties: outward investment enables firms to remain competitive and thus supports employment at home; investment abroad stimulates the exports of machinery and other capital goods, and increases the demand for intermediary products, know-how and specialized services.

The OECD defines FDI as an “ownership of assets in one country by residents of another for purposes of controlling the use of those assets”.² Therefore, when an investor acquires shares in foreign enterprise for the purpose of having an effective voice in its management or when both creditor and foreign borrower belong to the same multinational enterprise, the flows are considered as a foreign direct investment.

FDI occurred mainly among the industrialized countries. During the second half of the 1980s the world FDI increased at an yearly average rate of 41%, whereas the world gross domestic product (GDP) grew only by 3.8%.³ FDI started to play bigger role, and its beneficial nature was realized by countries. However, it seems impossible to please all parties, and the interests of investors and host countries frequently clash.

While expanding abroad multinational firms also face an important decision: in what form to invest? One can choose between exports, licensing or franchising, and foreign production. FDI has become the most popular strategy recent years. However,

¹ The Benefits of Trade and Investment Liberalization, OECD, 1998, p. 9.

² *Ibid*, p. 19.

³ Oscar Bajo-Rubio and Maria Montero-Munoz, “*Foreign Direct Investment and Trade: A Causality Analysis*”, *Open economies review* 12: 305-323, Kluwer Academic Publishers, 2001.

multinational firms are confronted with many questions: how is it better to enter a market? Is it better to build a new factory or to acquire an existing one?

Despite the fact that open trade and investment produces overall gains, some countries can experience adjustment pains and income losses as a result of liberalization. According to Bill Clinton, even "A country that rebuffed Napoleon and Hitler can surely adjust to the realities of the global marketplace."⁴

It is important to note, that people frequently start to think that all the problems in a country arise as a result of the presence of foreigners. It is thought in many instances that liberalization investors and multinationals are attracted only by "pollution havens" or cheap labor, they bring only pollution-intensive production, do not care about sanitary rules. It can influence the policy of a country to a large extent and response can certainly be expected.

The response from a government can be in the form of protection of an industry, for instance, by raising trade barriers. Of course, certain industries must sometimes be protected. For example, restrictions on FDI are generally encountered in military, financial and mass media industries. But here arises the most difficult problem with FDI: How open must an economy be? How to restrict protectionism? Attract or protect? These are not easy questions to answer.

We should mention that governments usually pay a high price when they resort to protectionism, because it raises the price of both imports and domestic products. It slows change and raises its costs, it damages exporting firms by making them less competitive. So, is there a golden middle ground?

These issues arise constantly and every state faces this problem. For developing countries, the question of FDI became especially urgent – FDI brings increased wages, and is a major source of technology transfer and managerial skills⁵. Recognition of the benefits of inward investment is best evidenced by the global competition to attract even greater amounts of FDI. It is also a powerful spur to

⁴ www.theglobalist.com/nor/readlips/2000/01-06-00.shtml [Accessed July 4, 2002].

⁵ Bajo-Rubio, *op. cit.*, p. 10.

competition and innovation, encouraging domestic firms to reduce costs and to enhance their competitiveness.

FDI has become an important source of private external finance for developing countries. It represents investment in production facilities and has a significantly greater importance for developing countries than portfolio investment or lending.⁶

Almost all of the governments of developing and emerging countries have made substantial efforts to attract foreign investors. Amanda Perry from University of London argues that FDI flows are to some extent determined by the effectiveness of the host state's legal system.⁷ The right domestic policies and conditions such as political stability, transparent and accountable government and the prevention of corruption are crucial in order to attract foreign investment.⁸ According to a former general counsel of the World Bank, a legal and regulatory framework is a fundamental element in the stability and flexibility needed for the investment environment.⁹ An effective legal system implements law efficiently and predictably and assists a State to attract FDI.

One of the basics for attracting FDI, especially for newly independent States - is to pass new legislation in order to create a more attractive environment for foreign investment, and which almost all of the countries from former USSR succeeded in doing this. But even with the progress made, it remains difficult to establish and to operate a business because of legal inconsistencies and lack of clarity in their legislation. Legal regimes can raise or lower the costs of foreign investment by determining the types and degree of risk that the foreign investor must bear.

2. Russia – FDI

Now it is clear that most developing countries recognize the role that FDI can play in economic development. FDI is usually associated with industrialization, technology and know-how. The benefits are generally considered to outweigh the

⁶ Padma Mallampally and Karl P. Sauvant, “*Foreign Direct Investment in Developing Countries*”; [web page] www.imf.org/external/pubs/ft/fandd/1999/03/mallampa.htm [Accessed July 4, 2002].

⁷ Amanda Perry, “Effective legal system and Foreign Direct Investments: In Search of the Evidence”, *International Comparative Law Quarterly* (London, 2000), p. 779.

⁸ Perry, *op. cit.*, p.781.

⁹ Shihata, *World Bank in a Changing World* (1995), p. 234.

short-run costs of industrial restructuring and factory closure.¹⁰ Some authors go even further, suggesting that FDI can be even a substitute for trade.¹¹

Russia is among the countries that need FDI. It started a decade to rebuild itself for the new future. After the break-up of the Soviet Union, Russia - as well as all of the former USSR republics, faced the lack of own funding to support and develop production. It was widely realized that foreign capital was needed. The Russian economy was in crises after the break-up of the USSR: most industries were disintegrating, and unemployment was increasing.

The two main possibilities to find money for reconstruction were to borrow funds from international lenders and other governments as well as domestically – as was done by Russia, and to attract foreign investors.

It is important to note, that it was never an easy task for Russia to attract investors. One of the main problems was a psychological barrier: it is not easy to forget ideological ideas regarding the harmful use of foreign capital.¹² The famous Stalin' saying "We were spilling our blood not for the purpose of voluntarily harness into a yoke of global capitalism (*Ne dlia togo mi krov prolivali, chtobi dobrovolno vpragatsia v iarmo mirovogo kapitalizma*)" is still supported by many Russians.¹³ However if we turn back, we would see that before the October Revolution, foreign investment played a major role in the Russian economy. Railroads, chemistry and electricity industries were developed with foreign participation. Foreign investments in Russia until 1913 amounted to approximately 1.3 billion rubles.¹⁴

Talking about legislation, we should mention that there was no legislation dedicated especially to foreign investors, but banking, trade and company legislation created a sound environment for foreign investors.

¹⁰ OECD (1999), *Agricultural Policies, Markets and Trade in Transitional Economies, Monitoring and Evaluation 1999*, OECD, Paris.

¹¹ Paul Brenton and Francesca Di Mauro, "Economic Integration and FDI: An Empirical Analysis of Foreign Investment in the EU and in Central and Eastern Europe", Kluwer Academic Publishers, 1999; [web page] www.kluweronline.com [Accessed June 20, 2002].

¹² Boguslavskiy, M. M., "Inostrannie investizii: Pravovoe Regulirovanie" (Moscow, 1996), p. 1.

¹³ *Ibid.*

¹⁴ *Ibid.*

The second attempt to attract foreign investment was the Soviet New Economical Order. Lenin considered companies with foreign participation and concessions as the main form of attracting capital. In the Soviet system, where everything was public, foreign capital was a “stranger” and special legislative regime was created. Until 1928 foreigners only invested approximately 60 millions rubles in Russia.¹⁵

It is now the third attempt in Russia to attract foreign investments. Boguslavskiy, as well as Amanda Perry, argues that this attempt would be impossible without strong legislative support.¹⁶

Foreigners were already allowed in 1989 to create companies and to invest in existing companies. In 1990 the first Law on Foreign Investments was adopted, encouraging foreign investors to invest in the Russian market. After a year the process of privatization began, but foreigners were not allowed to invest until the second phase, which started in 1994, allowing foreigners to buy shares in privatized Russian companies.¹⁷ The main legislative acts on foreign investment include the law “On entrails”(1992) and the new 1999 law on foreign investment. We should also mention the Presidential decrees “On improvement of the work with foreign investment” (1993), and “On additional measures on for attracting foreign investment into the industrial sector of Russian Federation” (1995). Russia also signed a number of bilateral treaties on supporting and protecting of foreign investment, as well as double tax treaties.

Russia developed new legislation on foreign investment, programs on attracting them, but it is still lacking foreign investment. What is the reason for this? We should look at applicable legislation and the situation in the country in order to understand what is going on. Apart form legislation on foreign investment, we need to examine general company law, competition and tax law, advertisement and environmental issues. It is also important to analyze the effect of the Russian legal regime on foreign direct investments.

¹⁵ *Ibid.*, p. 4.

¹⁶ Perry, *op. cit.* p.781, Boguslavskiy, *op. cit.*, p.7.

¹⁷ Boguslavskiy, *op. cit.*, pp. 7-11.

The benefits derived from FDI are enhanced in an environment characterized by an open trade and investment regime, an active competition policy, macroeconomic stability, privatization and regulatory reforms.¹⁸ We would therefore like to examine the beforementioned ingredients and the impact of its improvement and problems for Russia.

We should also mention that there have always been fluctuations in investment activity. Initially foreign investors were active in the Russian market: they created joint ventures, bought shares in Russian enterprises but after some time they terminated their projects and ceased to invest. Why? Was it because of political instability, corruption, or even the 1998 crises? Are there any changes in current situation?

The attractiveness of investment incentives in Russia is often off-set by the restrictions attached to it. Investors are concerned with incomplete and inconsistent legislation and difficulties with the enforcement thereof. Stable macro-economic conditions and predictable government policies form the cornerstone of FDI. In 2001, international rating agencies, for example, have upped Russia's credit rating to a level that makes Russia at present one of the most attractive emerging markets.¹⁹ It would appear that investors are satisfied with the measures taken by Russian government and signs of improvement.²⁰

It is clear that FDI is essential to Russia in recovering its economy and integrating with world society. The need was realized by the Russians, who accepted certain steps. However, the need for FDI contradicted with the Russian life style, the closedness of the Russian society, the lack of experience in attracting foreign investors and the legacy of the Soviet Union, which can not be washed away overnight. Reform in Russia is slow and economical and political uncertainty, insufficient legislation, contradictions between federal and regional legislation, problems with enforcement,

¹⁸ “*The Benefits of Trade and Investment Liberalization*”, OECD, 1998, p. 13

¹⁹ Forecast Conference “*Russia on the Rise*”; [web page] www.amcham.ru/external/280202.html [Accessed June 20, 2002].

²⁰ In 1992, the Russian Deputy Prime Minister, Alexander Shokhin, declared that the Russian government would seek US 5 billion in foreign investment by mid-1995. But even that amount is very little in the context of Russia's great need for investment. In 2000, despite Russia's growing attractiveness for FDI, they remain low, substantially below the rest of Eastern Europe at only 1.7% of GDP, according to report prepared by the Expert Institute and the American Chamber of Commerce in Russia. However, by the end of September 2001, aggregate foreign investment in the Russian economy had reached USD34.4 billion. 30% of this amount were FDI.

bribery and crime levels are considered as the primary obstacles for attracting FDI to Russia.²¹ Foreign investors normally base their decisions on two factors: profitability and risk.²² In Russia there are great opportunities for high-profit investments, but at high risk. Despite all of this, Russia is still attractive to foreigners. There are many reasons for this: it has immense natural resources, a strong internal demand, enormous investment potential, a highly educated population, investors are supported by federal and regional authorities, and finally, Russia form an ideal bridge between the West and the East.²³

3. Beer

The inflow of FDI to all Eastern European countries increased steadily during the 1990s up to 1997, but fell sharply during 1998 in response to the general upsurge in economic uncertainty. Two-thirds of the total FDI in the region originated from EU countries. Less than 12% of the total FDI inflow has been invested in the food and beverages sector.²⁴ However, in some countries the food sector turned out to be the most favorite target for foreign investors. In absolute terms, Poland and Hungary received by far the highest amounts of FDI in the food sector. Based on an analysis of the privatization and restructuring processes in Eastern European countries, Duponcel evaluates FDI as a positive and highly significant attribute to the modernization of food industries in these countries.²⁵

The main reason of FDI in the Eastern European food sector is the expected market opportunities. Foreign investments are aimed to position investors in these markets to enable them to satisfy local demand for high-value-added food products such as confectioneries and beverages.

²¹ Chris Patten, "Investing in Russia", European Business Club, Investing in Russia Conference – Brussels (October, 2, 2001), [web page];

http://europa.eu.int/comm/external_relations/news/patten/sp01_428.htm [Accessed July 3, 2002].

²² Christian Freberg and others, "Profitability and Risk Measures for Investor-Owned Firms"; [web page], www.adecon.ksu.edu [Accessed July 3, 2002].

²³ "Ten reasons to invest in the Russian economy"; [web page]

www.admlr.lipetsk.ru/eng/invest/assist/why.htm [Accessed July 3, 2002].

²⁴ OECD (1999), *Agricultural Policies, Markets and Trade in Transitional Economies, Monitoring and Evaluation 1999*, OECD, Paris, p. 142.

²⁵ Duponcel, M., "Restructuring of Food Industries in Five Central and Eastern European Front-runners towards EU Membership: a comparative review", CERT, Heriot-Watt University, Edinburgh, 1998

There are many about FDI motivations²⁶, however we should point out that FDI is not motivated by the aim to benefit from lower production costs due to cheap labor, to use but one example. FDI is driven by the prospect of a growing demand of food products in the market and is argued by some to rather be complementary to exports than as a substitute.²⁷ We should caution against such statements – Heineken, for instance, cancelled its exports because of high tariffs in the Russian Federation and decided to buy the factory in Russia instead.

One would ask: “Why beer?” The beer industry is important to many governments and nations. The culture of drinking beer is an age old tradition. Beer is even associated with some nations, e.g. the Germans and Irish. The beer industry is an important source of income is state budgets. In Belgium one cannot imagine some entertainment without beer, every small region produces its own local beer - if you were to drink one kind of Belgium beer per day, you would need more then a year to taste all the different kinds.

In Russia beer had never been this important. Russians are known to be alcohol lovers, but vodka is deemed to be the Russian traditional drink. The production of vodka plays an important role in the life of the State, Russians will drink vodka in war and peace, poverty or prosperity. Russians used to drink, on average, sixteen liters of vodka per year, compared to 20 liters of beer per year.²⁸ In comparison, the Dutch drink approximately eighty four liters per year, the Bulgarians approximately forty three liters per year.²⁹

“Beer without vodka it is just spending money”- Russians used to say. The quality of beer during Soviet times was poor, if you wanted to get a fresh beer, you had to go to special kind of bar (*pivnushka*) and drink it there, if you wanted to take it home, you had to bring your own container along and fill it with this fresh beer. The most famous brand was called “Zigulevskoe”, it tasted horrible and was disliked by everyone!

²⁶ S. van Berkum, “*Patterns of Intra-industry Trade and Foreign Direct Investments in Agro-food Products: Implications for East-west Integration*”, Agricultural Economics Research Institute, The Hague; [web page] www.kluweronline.com [Accessed June 20, 2002].

²⁷ *Ibid.*

²⁸ “Vodka chasers”, *The Economist*, June 24, 1999; [web page] www.economist.com [Accessed May 20, 2002], From The Economist print edition.

²⁹ www.beerunion.ru

It is interesting to note, that the quality of the beer can significantly influence the consumption thereof. A good example is the sharp decline in the beer market after the end of World War II. It seems as if consumers lost their confidence in beer as a product because of the poor quality of the beer brewed during the war.³⁰

Like many imported products from the West, imported beer was very popular during Soviet times. However it was difficult to get, because of the limitations imposed upon foreign trade. When some European brands appeared on Russian market, in the first years after the reform, - it became fashionable to drink imported brands, nobody wanted to drink “Zigulevskoe” anymore. Beer was imported generally from Germany, but other European brands could also be found. It might have been the wake-up call to Russian breweries, which began to work hard on improving quality in order to gain share of the rapidly expanding beer market. In the mid-1990’s, domestic brands became popular, it was good quality, presented in nice bottles and the beer was well advertised. With the improving quality of the beer, production was increasing and foreigners started to enter the beer market. During the 1998 crises imported brands became very expensive, and it was a good opportunity for Russian breweries to fill the gap.

However there are other reasons explaining the shift to beer in Russia. Jan van de Merbel argues that it is the result of an increase in population income.³¹ When a person’s income reaches an appropriate level, a person does not want to drink vodka anymore. Different cocktails, mixed drinks and beer are becoming popular. People prefer to have a good cocktail or a high quality beer on a nice party, instead of vodka, that is of course, if you have enough money to pay for it. Vodka can be bought for cheap prices in Russia, because of illegal production. Sometimes it could cost twice the price of one beer. The second reason is the State’s policy in the field of health care, the State started special programs in order to reduce the consumption of strong alcoholic drinks by people. This was supported by social commercials on television. The Russian health protection policy and promotion of sport is a big achievement of the Russian government. Merbel argues that these factors were important as preconditions for the shift from vodka to mixed drinks and beer.

³⁰ “The History of Heineken”; [web page] www.heinekencorp.com [Accessed June 3, 2002].

³¹ Interview with Jan van de Merbel, Heineken’s investor’s relations specialist. June 25, 2002, Amsterdam, The Netherlands.

Specialists from Heineken are sure that there are some other factors that influenced the growth of the Russian beer market: effective marketing and improved urban distribution; favorable pricing vis-à-vis vodka; wider social appeal and a rush to embrace the Western lifestyle, and the improvement in the quality of beer.³²

Moreover this is a worldwide trend: the consumption of beer in Germany increased, the number of schnapps drinkers reduced, and the consumption of whiskey has been influenced as well. According to Heineken's N.V. Investor Relations Presentation, the world beer market growth in 2001 was 2%.³³

The consumption of beer in Russia increased dramatically. Even the crises of 1998 did not influence the growth. However, consumption in Russia, especially in the regions, is lower than in other countries with a similar social situation, and this creates a favorable prospect for growth.³⁴ The Russian beer market is now one of the fastest growing sectors of the Russian economy. However, some argue that the market will stop to grow in 2005. Thus, the war between world biggest beer producers for the Russian market began.

According to a Merrill Lynch analyses, Russia is now classified as a high alcohol consumption market (8.8 ltr/capita), which is 5th largest world beer market, with historically substandard beer. It is also a fast growing market: in 2001 it grew by 18%, and in 2002 the growth estimated at 10%. The most important factor for Heineken, for instance, is the strong shift towards better quality beer. It will take up to 50% of the Russian beer market in 2005. All-market beer growth rates do not reflect the full extent of growth expectations in the premium local market segment. Since Heineken's brands belong to this category of beer, this most important to them.

4. The task of the thesis

There are numerous debates in literature about the connection between FDI and the growth of a country, obstacles for FDI, especially in developing countries. The most frequently mentioned obstacles are: implementation and enforcement of the legislation, financial systems, corruption, absence of independent judiciary and

³² *Ibid.*

³³ Investor Relations Presentation, Heineken N.V. and Heineken Holding N.V., June, 2002.

³⁴ "Investitionii potencial Rossii na rinke pivovarenoi produkzii", [web page] www.beerunion.ru [Accessed May 10, 2002].

corporate governance issues.³⁵ Some researches argue that the most important obstacles are political instability and decentralization.³⁶ Other are not satisfied with the tax code and privatization laws (which discriminate against foreign investors)³⁷, speedy bankruptcy procedures and the level of protection of intellectual property rights.³⁸

However, literature tends to focus on legal problems with FDI and legislation. In our work we would like to show what is happening in practice, using a particular industry as the case in point.

We would like to contribute to the mentioned debates, by studying the industry which provides an example of how foreign investments can be attracted. But most research focuses on Russian problems and obstacles for FDI in Russia, like in medicine, for example, where most of the studies are dedicated to all kinds of illness. We think it is important to mirror best practices, to show not only the mistakes and the wrongdoings, but to show an example of success.

The Russian beer industry is a good example of how investments could be attracted. It is a good illustration of the general problems in the Russian Federation, showing the way how the problems can be overcome. It creates an example of how foreign investors are coming and are making it work in Russia.

The Russian food and brewery industry is very attractive to investors and it has already proved it. The beer industry had not been developed until foreign investors came to Russia. A preliminary review shows that foreign investments translated into consumer and state benefits. FDI was a precondition for improving the quality of Russian beer and together with the State's social policy, it influenced the consumption of beer in Russia. Moreover, the market is still growing. The growth of the market explains also its underdevelopment, changes in social patterns (increased income and governmental health policy) and its symbolic value of a new style of life.

³⁵ www.russiajournal.com/weekly/article.shtml?ad=6193 [Accessed May 20, 2002]

³⁶ Fallon G., Jones A & Golov R., "*Post-communist Russia - political and economic obstacles to inbound foreign direct investment and their implications for economic transition, transformation and development*". Kingston: Kingston University Faculty of Human Science, 1999, p. 37. See also: www.northampton.ac.uk/mmb/busman/staff/ajpublic.html

³⁷ www.mhhe.com/business/management/hill/student/olc/ch07s_cdq.html [Accessed June 25, 2002]

³⁸ Chris Pattern, *op. cit.*

It should be noted that investments in the Russian beer industry were not only successfully attracted, but that they contributed to consumers in the form of quality and to the government in the form of taxes, thus success on several scores. The Russian beer industry proves that Russia can attract foreign investments, investors can make a profit in Russia and all parties benefit from it.

This makes the chosen topic very interesting and actual. We would like to take a greater look at the industry, the issues and problems arising from it and show what can be learned from the Russian beer industry's example.

In order to do it we will describe the method we used for our research (Chapter I), make a relapse into the foreign direct investments in transitional economies and Russia in particular (Chapter II), further tear the successful Russian beer industry to pieces and do the case study of two particular companies (Chapter III) before we reach our final conclusions.

Chapter I

1. Background of the research method

Gennady Seleznev, Russian State Duma speaker is sure that the beer industry is a “special” industry, it has everything for supporting the growth of a whole country’s economy. “It is important for our legislators to pass legislation for supporting the development of the industry, or even to work out government program on supporting of the industry”, he argues.³⁹

Further in the thesis we will give a background on Russian beer industry and show its investment potential.⁴⁰ According to EBRD the investment into the Russian beer industry created a miracle: “Russia was a big empty market, domestic breweries had old fashioned production facilities and now everything is changed.”⁴¹ Moreover, the beer sector gives a quick return on capital for investors and this is important in the economies with high levels of risks.

We already mentioned that the Russian beer industry is a good example of how foreign investment can be attracted. It is important to note that every industry is linked to other sectors of economy. In our particular case investors revived the beer industry and now face problems in other industries which are closely linked to the beer industry and have to be developed in order keep the beer production at high level. The question of reviving agricultural sector and glass production is of the great importance for investors. Talking about agriculture, we should mention that until now most raw materials for the production of beer were imported, thus influencing the price of beer. Due to the competitive situation on the Russian beer market, producers have to look for cheaper raw materials, but of a good quality, thus improving the agriculture sector. It means that investments into the beer industry could only be the prerequisite for the flow to other sectors of economy, therefore making the Russian beer industry an example of how the economy could be revived.

In order to reflect on the example of how foreigners are coming to Russia and what they introduce to the Russian economy, we decided to consider two particular

³⁹ “Imperia piva”; [web page] <http://www.samara.ru/paper/41/2483/36190> [Accessed June 11, 2002].

⁴⁰ See p. 59.

⁴¹ “Pivnie zakaty Evropi”, *Expert* (December, 5, 2002).

breweries. In our opinion, the picture would only be complete if we chose two companies of different legal form, market and investment policy in order to illustrate the differences on possible entry and operating in the market. Considering that the research was done in the Netherlands we decided to use the acquisition of Bravo International in Saint-Petersburg by Heineken and the biggest brewery in Russia “Baltika” as examples.

Baltika belongs to Scandinavian Baltic Beverages Holdings (BBH) and is currently a leader in the Russian beer industry. The Soviet company was privatized in 1992 and has since then expanded its production across Russia. It is an example of a new Russian company with good management and high quality products and it is, well known in Russia.

Bravo International is much smaller and only started to produce beer in 1998. It was a new entrant to the market, which quickly found its own consumers. Compared to Baltika, the company was owned by foreigners from the beginning and was the fastest growing brewery in Russia. An important point is that it was acquired by the most famous international brewer in the world. Heineken brands are sold in more than 170 countries and the company owns over 110 breweries in more than 50 countries. This helps to explain why it chose Russia and Bravo, in particular, and can be used to explain the attractiveness of the market, the problems and the needs of the investors.

In order to collect information relevant to the thesis we interviewed senior lawyers of Saint-Petersburg breweries Bravo and Vena, as well as Baltika’s quality departments. In order to compare the information received to the investor’s position, we met with Heineken’s officials in Amsterdam. We made research on the web and at the libraries of Leiden University. During our research we used the technique of comparison, historical analysis and statistical overview.

We have chosen to present the information gathered by on focusing chronology:

- the situation on the companies before the privatization / acquisition;
- the deal;
- the changes introduced after the privatization / acquisition.

In doing so we would like to find answers to the following set of questions: what is the best way to come into the Russian market; what are the main problems and obstacles for entering and operating in the market, and ways of overcoming these; what changes were introduced by foreigners and are there any visible improvements in the Russian investment climate.

Chapter II

Foreign direct investment in Russia

1. Perspectives of foreign investors

Attracting FDI is one of the key policy goals of developing countries. There is substantial empirical evidence regarding the role FDI in the process of transition. Hunya found that foreign investment enterprises had higher endowments of capital and higher labor productivity than domestic firms.⁴² FDI is at the forefront of economic policy decisions in Central Europe, as it is expected to accelerate enterprise restructuring and aid successful transition to a market economy.

The long term nature of FDI forces investors to take an active part in the decision making process and in all likelihood to lead to some restructuring of the firm. This feature gave rise to widespread expectations that FDI had an important role to play in the economic transition of Central and Eastern Europe.⁴³

Ray Barrel and Dawn Holland argue that FDI had a positive but insignificant impact on the total factor productivity growth, but that the inflow of FDI increased labor productivity. FDI increases competitive forces in the economy, forcing domestic firms to adopt more efficient techniques, being a useful tool in technology transfers.⁴⁴ Moreover, Barrel and Holland conclude that FDI helped to expedite the process of enterprise restructuring in Central and Eastern Europe.⁴⁵

We should mention that one of the important goals of governments in transition economies, is to increase the productive capacity of the economy. And attracting foreign capital can help to accelerate this process. It is especially important in sectors such as food, chemicals, and beverages.⁴⁶

⁴² Hunya, G., "Large Privatization, Restructuring and Foreign Investment", in Zecchini, S. (ed.), *Lessons From The Economic Transition: Central and Eastern Europe In The 1990's*, Paris: OECD and Kluwer Academic Publishers, 1997.

⁴³ Ray Barrel and Dawn Holland, "Foreign direct investment and enterprise restructuring in Central Europe," *Economics of Transition* (Volume 8 (2), 2000), p. 478.

⁴⁴ *Ibid.*, p.488.

⁴⁵ *Ibid.*, p.500.

⁴⁶ *Ibid.*, p. 502.

Given the potential role FDI can play in accelerating growth and economic transformation, developing countries are strongly interested in attracting them. Padma Mallampally argues that in order to do this, it is most important to determine the factors which can attract investors and then to improve them.⁴⁷

The flow of FDI into Central and Eastern Europe declined proportionally compared to the world FDI flows in 1998. The decline of more than 60% for the region as a whole, was as a result of the drop in FDI directed at Russia. Russia received relatively high levels of FDI, with total inflows to be roughly equivalent to those of Hungary by end-1998. However, when compared to GDP this is much less impressive.⁴⁸

The Russian crisis of 1998 played its role in the drop of FDI. Foreign investment in Russia plummeted from USD4 billion in 1997 to USD1.7 billion in 1998.⁴⁹ The crisis combined a devaluation of the ruble, default on both domestic and foreign debts, and a collapse of the stock market. The ruble fell from around 6 per USD in the first half to about 21 per USD at the end of 1998. The collapse of the major commercial banks effectively deprived most Russians of their savings and once more undermined the trust of the population in financial institutions.⁵⁰ Naturally the trust of foreign investors in the country's stability was also undermined.

With the seemingly large window of opportunity for improving the investment climate in the Russian Federation, it is important to have a clear idea of whereabouts of the most significant obstacles encountered by investors lie.⁵¹

Among the obstacles for foreign investment in transition economies, and Russia in particular, the following are frequently named: economic, political and social

⁴⁷ Padma Mallampally and Karl P. Sauvant, "Foreign Direct Investment in Developing Countries"; [web page] www.imf.org/external/pubs/ft/fandd/1999/03/mallampa.htm [Accessed July 4, 2002].

⁴⁸ Ray Barrel and Dawn Holland, "Foreign direct investment and enterprise restructuring in Central Europe," *Economics of Transition*, Volume 8(2) 2000, p.481.

⁴⁹ *Ibid.*

⁵⁰ Michael Lokshin and Martin Ravallion, "Welfare impacts of the 1998 financial crisis in Russia and the response of the public safety net", *Economics of Transition* (Volume 8 (2), 2000), p.270. For the effects of the 1998 crises see: Thierry D. Buchs, "Financial crisis in the Russian Federation: Are the Russians learning to tango?", *Economics of transition* (Volume 7(3) 1999), p. 687-715.

⁵¹ "The Investment Environment In the Russian Federation: Laws, Policies and Institutions", OECD, May 2001; [web page] www.oecd.org/EN/document/0,EN-document-0-nodirectorte-no-15-5025-0,00.html [Accessed June 23, 2002].

stability, privatization and tax policies. One of the main obstacles for FDI is corruption and administrative inefficiency, Mallampally argues.⁵²

Chris Pattern, is sure that the necessary elements for improving investment climate include: improved corporate governance, especially minority's treatment; predictable tax legislation; improved bankruptcy procedures; and the protection of intellectual property rights.⁵³ These changes must be accompanied by improved accounting rules and judicial reform, to be fully effective. Pattern furthermore considers organized crime as one of the important barriers for foreigners.

The existing literature includes a large number of surveys and case studies, which conclude that the main factors which have driven FDI in Central and Eastern Europe have been the need to secure market access, the timing and form of the privatization processes and the degree of political and economic stability.⁵⁴

According to Resmini, FDI is very sensitive to risk perception. The prospects of political and macroeconomic stability together with transparent legal regulations concerning foreign ownership and profit repatriation, are crucial to potential investors. The empirical evidence has shown that these factors play a role also in transition economies. Risk perception is closely correlated with the transition indicator, i.e., the *Operation Risk Index*⁵⁵. It measures a country's business environment by weighting 15 different criteria, including policy continuity, attitude towards investors and profits, degree of privatization, bureaucratic delays, currency convertibility, enforceability of contracts and labor issues.

The ability of enforcement institutions to ensure that the laws are used and followed in practice is very important for transitions. In Russia, for instance, three-

⁵² Ray Barrel and Dawn Holland, *op.cit.*

⁵³ Chris Pattern, "Investing in Russia", European Business Club, Investing in Russia Conference – Brussels (October, 2, 2001), [web page]; http://europa.eu.int/comm/external_relations/news/patten/sp01_428.htm [Accessed July 3, 2002].

⁵⁴ See: Lankes, H. P. and A. J. Venable, "Foreign Direct Investment In Economic Transition: the Changing Pattern of Investments", *The Economics of Transition* (Volume 4(2), 1996), pp. 331-347.; Holland D. And N. Pain, "The Diffusion of Innovation in Central and Eastern Europe: A Study of the determinants and Impact of Foreign Direct Investment", NIESR Discussion Paper no. 137, London, 1998: NIESR.

⁵⁵ Laura Resmini, "The determinants of foreign direct investment in the CEEC's", *Economies of Transition* (Volume 8, 2000), pp. 676.

quarters off all enterprises do not trust the legal system to enforce their rights.⁵⁶ “The most important aspect of the substantial variation in legal effectiveness across the region is that the high levels of formal legal protection achieved in many CIS countries are not mirrored in similar improvements in the legal institutions”, Pistor argues.

Russia is attracting investors in different ways and manners. It seems as if the Russians are doing everything necessary to attract them, however investors are still not satisfied with the measures implemented in Russia. In the mid-1990’s foreign investors were complaining on frequent changes in economical, political instability and legislation as well as the high level of criminalization of the Russian society.⁵⁷ In 1994, for example there was a decrease in FDI in Russia. The London finance journal “Euromoney”, positioned Russia in 138th place (out of a list of 169) in the list for investment attractiveness. Russian researches suggested introducing a new tax policy, tariffs and investment legislation.⁵⁸ When asked about his company’s future plans, the President of Renault, Louis Schwetzer said “We are going to work in Latin America and Eastern Europe, except Russia. “Even in taking risks there must be limits”, he said.⁵⁹

One of the most important tasks in eliminating Soviet-era barriers to foreign investment in Russia was to construct a free enterprise system. The question was not whether, but where and how to begin. According to the US Advisory Group, to move from the Soviet Union's state-controlled economy to a free enterprise system the following should be done:

- New legal protections for private property and private contracts would have to be enacted, and the courts would have to build public confidence that private contracts would be enforceable;
- Private banks that paid for deposits at market rates, evaluated credit risks according to market criteria, and served as genuine intermediaries between sources of capital and start-up private enterprises would have to be legalized;

⁵⁶ *Ibid.*, p. 342.

⁵⁷ Svetlanov A. G. Ed., *Pravovoe Regulirovanie Inostrannih investizii v Rossii* (Moscow, 1995), p.4.

⁵⁸ *Ibid.*, p. 7.

⁵⁹ Aleksey Kamensky, “Koshki - mishki s investorom”, *Kommersant*, No. 3 (February 6, 1996), p. 30.

- A workable bankruptcy procedure creating the "freedom to fail" would have to be established, in order to end wasteful subsidies and subject commercial enterprises to market discipline; and
- A lower tax rate and simpler tax code would have to be enacted to demonstrate that the new Russian government was not bent on redistributing income but rather sought to promote a market economy.⁶⁰

In addition, foreign investors faced capital controls limited a foreign firm's ability to return earnings from Russia to their stockholders, government regulations discriminated against what activities foreign firms could engage in, creating uneven competition between foreign and domestic participants in the Russian market.⁶¹

2. Investment climate

Attracting foreign investors one should not forget about creation of favorable investment climate. The higher the risk, the lower the attractiveness of the country for foreign investors. On the other hand, investors to expect adequate returns for the risks involved. Investment risks can be defined as “a possibility of loosing an investment as a result of actions of the government of a host state, decreasing profit margins or changes in economic conditions in the territory of a host state because of actions of the government of a host state.”⁶²

In addition, there is no unified economic space in Russia because of the different administrative barriers and obstacles encountered by investors, particularly at regional level, often in contravention with federal legislation and regulation.⁶³ Unforeseen licensing or permission requirements, license fees in excess of what is legally required, “voluntary” contributions to extra-budgetary funds, etc., can serve as examples of unpredictable hurdles at the regional level.⁶⁴

⁶⁰ <http://policy.house.gov/russia/notes.html> [Accessed July 4, 2002].

⁶¹ *Ibid.*

⁶² Pankratov A., *Lectures on Foreign Investments in the Russian Federation*, Moscow State University, 1996.

⁶³ “*The Investment Environment In the Russian Federation: Laws, Policies and Institutions*”, OECD, May 2001; [web page] www.oecd.org/EN/document/0,EN-document-0-nodirectorte-no-15-5025-0,00.html [Accessed June 23, 2002].

⁶⁴ *Ibid.*

There are enough studies and recommendations on improving Russian investment climate. Anders Aslund, for example, argues that the Russian investment climate remains poor because of bureaucracy and corrupt law enforcement.⁶⁵ According to the report prepared by the US Advisory Group the main problems in Russia are corruption and the spread of organized crime.⁶⁶ Kroll argues that since the adoption of the Law “On Foreign Investments in RSFSR” in 1991, the investment climate should have improved. Violation of stockholders and minority rights is a major obstacle.⁶⁷ In order to improve the Russian investment climate, the World Bank recommended the following policy recommendations:

- amend the newly enacted FDI law so as to give “national treatment” for both the right of establishment and for post-establishment operations;
- improve dispute resolution mechanisms; and
- improve corporate governance; simplify foreign investor registration procedures.⁶⁸

Johannes Linn argues that Russia can improve its investment climate through:

- transparent privatization and license awards;
- reduction in red tape and arbitrary interventions;
- introduction of International Accounting Standards;
- strengthening of minority shareholder rights;
- effective bankruptcy legislation and implementation; and
- credible bank restructuring.⁶⁹

2.1. Taxation

Many foreign companies operating in the Russian market refer to the Russian tax system as “a labyrinth that is both confusing and expensive”.⁷⁰ The main problem

⁶⁵ Anders Aslund, “*Think Again: Russia*”; [web page] www.foreignpolicy.com/issue_julyaug_2001/TAjulyaug.html [Accessed July 4, 2002].

⁶⁶ <http://policy.house.gov/russia/notes.html> [Accessed July 4, 2002].

⁶⁷ Kroll K., “The legal regulation of Foreign Investment in Russia: The Early Years”, *Sudebnik* (Simmonds & Hill Publishing Ltd.), Volume 6, March 2001, p.27.

⁶⁸ Joel Bergsman, Harry G. Broadman and Vladimir Drebentsov, “*Improving Russia’s Policy on Foreign Direct investment*”; [web page] <http://econ.worldbank.org/doc/1083.pdf> [Accessed July 3, 2002].

⁶⁹ <http://lnweb18.worldbank.org/eca/eca.nsf/66d6f5004ed085ca852567d10011a8b8/000586d46773d4eb85256a1e006cc817?OpenDocument>

⁷⁰ Murray M., “*Inside Russia’s Tax Labyrinth*” (1997); [web page] <http://www.itaie.doc.gov.bisnis/> [Accessed March 8, 2002].

with taxes was the instability in legislation. The legislator firstly favors investors and then decided to equalize it with domestic entrepreneurs. According to a Deloitte & Touche report, taxation in Russia was considered as a major obstacle for FDI in Russia.⁷¹

Already President Yeltsin affirmed in the Helsinki Joint Economic Declaration that tax reform was his highest economic priority.⁷² Even before this, the Russian government was giving different kinds of guarantees to foreign investors. However, joint venture operators making their investments in the early 1990s with promises from the government of only minimal taxes suffered a great deal as their tax burden was increased.⁷³ For the greater part of the 1990's, approximately 50 federal, and local taxes and social fund payments have applied in Russia.⁷⁴

It is important to note that the fairness and effectiveness of the tax enforcement function were limited because of a lack of modern facilities (computers for example). In addition, some of the tax inspectors were not adequately trained and the judges hearing tax cases lacked sufficient knowledge about tax issues.⁷⁵

In an attempt to improve the Russian investment climate foreign investors required the following: removal all tax and other exemptions as well as protectionist measures in order to create fair and equal competition for all businesses; prevention of any increase in the tax burden.⁷⁶ OECD specialists added: improvement of the administrative mechanisms for implementing transfer pricing rules and double taxation

⁷¹ Deloitte Touche Tohmatsu International, "Investment Experience in Central and Eastern Europe", December 1995.

⁷² <http://www.ita.doc.gov/media/Speeches/russbc.htm> [Accessed June 12, 2002].

⁷³ <http://www.ita.doc.gov/td/energy/ruso&g.html> [Accessed May 28, 2002].

⁷⁴ "The Investment Environment In the Russian Federation: Laws, Policies and Institutions", OECD, May 2001; [web page] www.oecd.org/EN/document/0,EN-document-0-nodirectorte-no-15-5025-0,00.html [Accessed June 23, 2002].

⁷⁵ *Ibid.*, p. 24.

⁷⁶ Forecast Conference "Russia on the Rise"; [web page] www.amcham.ru/external/280202.html [Accessed June 21, 2002].

treaties; provision of a clear definition of taxpayer's rights and duties with the possibility for judicial and non-judicial dispute resolution.⁷⁷

A few years ago the World Bank characterized Russian tax system as "the most damaging element".⁷⁸ The new Russian Tax Code will help in this regard, but more needs to be done, they argue.

2.2. Political issues

Political risk is defined as the probability of political actions to influence commercial operations. Political risk in Russia is perceived of the highest in the world. Foreign investors usually try to avoid this risk by inserting certain provisions in agreements with their host states. The key guarantee of this nature in Russian legislation is the "grandfathering" provision of the law "On Foreign Investment" (1999). It provides an investor with certain guarantees if the State authorities are to change the legislation in such a way that it would deteriorate the business climate for the foreign investor.⁷⁹ However, it can lead to the existence of different tax regimes, for instance, and create different conditions for different investors who began their business at different times. It is preferable that the regime applicable to a foreign investor should not differ from the national regime, because it can affect the attitude of domestic investors to business in a country negatively. Topornin suggests to change the regime, for example, as far as different kinds of compensation are concerned.⁸⁰

Susan Collins argues that political and economic uncertainty is one of the main obstacles for FDI in Russia.⁸¹ The political situation in Russia remained quite uncertain until recent years. In the early 1990's many new parties appeared, however, nobody was sure how to govern them. It was difficult to predict Russia's future and this is why foreigners paid such attention to all kinds of elections in Russia. According to the

⁷⁷ *The Investment Environment In the Russian Federation: Laws, Policies and Institutions*, OECD, May 2001; [web page] www.oecd.org/EN/document/0,EN-document-0-nodirectorte-no-15-5025-0,00.html [Accessed June 23, 2002].

⁷⁸ Joel Bergsman, Harry G. Broadman and Vladimir Drebentsov, *op. cit.*

⁷⁹ Federal Law "On Foreign Investment in the Russian Federation", N.160-FZ, 9 July 1999, Legal Data System "Garant", art. 9.

⁸⁰ Topornin B. N., "Rossiiskoe pravo I inostranie investizii: aktual'nie problemi", ed. A. G. Svetlanov (Moscow, 1995), p. 17.

⁸¹ Susan Collins and Dani Rodrik, "Eastern Europe and The Soviet Union in the World Economy", *Institute for International Economics*, 1991.

“White Paper” of the American Chamber of Commerce in Russia, political issues are the main reasons for uncertainty in Russia.⁸²

The difference in the focus of the leadership under Yeltsin and Putin is becoming increasingly clearer. While Yeltsin seemed to spend most of his time on political matters such as the fight against communism and checks and balances in the Kremlin and government, Putin is devoting a considerable part of his time on the real economy and the government and corporate governance.⁸³

It is important to note that the communists still maintain their radical tone, thus upsetting the Russian government. “We are also worried by the increasing redness of the provinces and the Communist successes in regional elections,” said a senior official in the Presidential Administration.⁸⁴ The Kremlin knows how to deal with the Duma⁸⁵ Communists. The idea is to scare the Communist leaders with threats to review the chairs of the various Duma committees. But keeping the Communists in the regions under control is far more difficult. The experience of regional elections over the last year has shown the ineptness of Kremlin spin-doctors in the provinces.⁸⁶

According to Shevtsova, the communists are still the best organized political power. But they have done almost everything they could in order not to come to power again. They are comfortably installed in their position as opposition where they do not have to take any responsibility.⁸⁷ Pinsker, on the other hand, argues that there is no serious political opposition in Russia, and the voice of the independent media is fading away.⁸⁸

⁸² “Rossiiskie zakonodateli nadeutsia na uchastie interventov”, *Kommersant*, No. 3 (February 6, 1996), p. 52.

⁸³ www.prosperitycapital.com/pdf/MonthlyJanFeb01.PDF [Accessed June 1, 2002].

⁸⁴ Dmitry Pinsker, “Curtain of political stability conceals unpredictable future”, *The Russian Journal*; [web page] <http://www.russijournal.com/weekly/article.shtml?ad=5088> [Accessed July 14, 2002].

⁸⁵ Duma – is the Russian parliament’s lower house.

⁸⁶ Dmitry Pinsker, *op. cit.*

⁸⁷ Lilia Shevtsova, “Yeltsin’s Russian: myths and reality”; [web page]

<http://www.cosmopolis.ch/english/cosmo2/shevtsova.htm> [Accessed July 14, 2002].

⁸⁸ Dmitry Pinsker, *op. cit.*

2.3. Organized crime and corruption

According to Gregory Brock, FDI will increase substantially with lower crime levels.⁸⁹ Based upon the outcome of his research, he argues that crime is one of the important FDI factors. According to his Gross FDI Regression Results Table, crime is ranked in the one of the first places as far as Russia is concerned.⁹⁰ Corruption at the level of the “powers to be” also plays a major role – this is the reason why laws so often exist only on paper. Corruption in Russia exists both on federal and local level. Some studies show that countries with higher corruption level have a lower ratio of both total and private investment to GDP.⁹¹ Investors, doing business in Russia usually keep a “reserve fund” of cash in order to bribe governmental officials if questions are raised.⁹²

Corruption usually arises when institutions occupy dominant positions and accountability is weak. The additional laws are inadequate and will not bring about a significant reduction in corruption. World Bank specialists argue that effective reform must be directed at changing the system: the introduction of independent overseeing agencies; clarification and transparency on the extent of official discretion; and utilizing rewards and penalties for good and bad behavior.⁹³ Hong Kong and Singapore, for example, have independent anti-corruption authorities. Surely this could serve as an example for Russia.

We should mention that in Russia bribery occurred as far back as the reign of the Czar. William Simons argues that bribery grew to serious proportions in the end of 19th century in Russia and this problem is still alive as ever.⁹⁴ However in Russia, bribery features prominently in economic activity not only because of the tradition that it represents. Russian bureaucrats are paid extremely low salaries, therefore they often

⁸⁹ Gregory J. Brock, “Foreign direct investment in Russia’s regions 1993-95. Why so little and where has it gone?”, *Economies of Transition* (Volume 6 (2), 1998), p. 349.

⁹⁰ *Ibid.*, p. 360.

⁹¹ Shleifer A., and Vishny, R. W., “*The Grabbing Hand, Government Pathologies and their cures*”, Harvard University Press, Cambridge, Mass., 1998, p. 91.

⁹² Richard N. Dean, “*Three Critical Ingredients for Success in Foreign Investment in Russia*” (June 6, 2002); [web page] www.russianamericanchamber.org/newsletter/new_russian_investment_law.html [Accessed May 2, 2002].

⁹³ Joel Bergsman, Harry G. Broadman and Vladimir Drebensov, *op. cit.*

⁹⁴ William B. Simons, “*The Privatization of State Enterprises in Russia and Kazakhstan: a Milestone in the Introduction of Market –Type Reforms*”, Leiden, 1997, pp. 294-295.

see these “extra” payments as nothing more than salary supplements bringing their compensation up to “market levels”, Simons argues.⁹⁵

Heineken’s officials are sure that crime presents the key obstacle to foreign investors.⁹⁶ The beer industry, especially, is heavily criminalized in Russia. This factor explains their choice of Bravo brewery in Saint-Petersburg. “Bravo International is clear from it and Heineken, in its turn, do not want to deal with crime at all”, Merbel argues.⁹⁷

Organized crime in Russia replaced the state as property distributor and dispute arbiter. “As the Soviet Union was reinvented as Russia the Russian problem was redefined from being one of organized power into one of organized crime”- James Kurth argues.⁹⁸ A supply of private “enforcers” arose to meet the demand for a system of dispute resolution. Thus, organized crime became responsible not only for violence, but also for functions as diverse as enforcing contracts and court judgments, providing personal security, and even allocating scarce resources (naturally through bribes to corrupt officials).⁹⁹

Government and its policy played its role both at federal and local level. Government imposes a daunting array of transaction costs on normal business activities. Rather than pay the fees for countless licensing and permit requirements, firms choose to avoid official red tape by paying less costly bribes. The mafia often plays the role of middleman in these situations, facilitating transactions between businessmen and corrupt government officials.¹⁰⁰ “Crime used to be a monopoly of the State under the old system,” Russia scholar Richard Pipes testified to the House Armed Services Committee. “It is now privatized”.¹⁰¹

According to the Analytic Center of the Russian Academy of Sciences, “55 percent of the capital and 80 percent of the voting shares were transferred, during

⁹⁵ *Ibid.*, p. 300.

⁹⁶ Interview with Jan van de Merbel, Heineken’s investor’s relations specialist. June 25, 2002, Amsterdam, The Netherlands.

⁹⁷ *Ibid.*

⁹⁸ <http://policy.house.gov/russia/notes.html> [Accesses July 5, 2002].

⁹⁹ *Ibid.*

¹⁰⁰ Aaron Lukas and Gary Dempsey, “*Mafia Capitalism or Red Legacy in Russia?*”, CATO Institute, Mar. 4, 2000, p. 4

¹⁰¹ <http://policy.house.gov/russia/notes.html> [Accesses July 5, 2002].

privatization, into the hands of domestic and foreign criminal capital".¹⁰² Organized crime was both a cause and an effect of Russia's corrupt "privatization" process. Disappearance of government revenues due to corruption and organized crime, encouraged the government to pursue its notorious "loans-for-shares" insider privatization auctions in 1995. All these were responses to the lack of the rule of law. Organized crime became "the dark side of private ordering - an entrepreneurial response to inefficiencies in the property rights and enforcement framework supplied by the state".¹⁰³

The most significant cost of Russian organized crime has been its contribution to the widespread loss of confidence in the nation's economy. Louise I. Shelley suggests that in order to improve the situation in Russia the following must be done:

- implement economic and legal assistance programs;
- coordinate legal reform in the criminal and civil areas, including enforcement measures, banking and tax reform.¹⁰⁴

2.4. Privatization

The organization of the privatization process has played an important role in attracting FDI. It serves as a strong signal of the commitment of the government to private ownership. Opportunities offered by the transfer of state monopolies into private sector, gave a strong incentive for strategic investments. Privatization pushes firms towards their production possibility frontier.¹⁰⁵ Privatization gives a country the opportunity to attract foreign investors. It is supposed to become over time a major benefit to the economy in general and the state budget in particular; more importantly, it may also open up an additional source of human and financial resources to privatized state enterprises themselves.¹⁰⁶ Revenues from privatization can be an important source for country's budget. For instance, in 1995 Austria reduced its budget deficit by one-

¹⁰² CSIS, "*Russian Organized Crime: Global Organized Crime Project*" (Washington, D.C.: Center for Strategic and International Studies, 1997), p. 3.

¹⁰³ <http://policy.house.gov/russia/notes.html> [Accessed July 5, 2002].

¹⁰⁴ Louise I. Shelley, "*Tag of Russia's Organized Crime*", [web page] www.worldbank.org/transitionnewsletter/janfeb97/art4.htm [Accessed July 5, 2002].

¹⁰⁵ Ray Barrel and Dawn Holland, "Foreign direct investment and enterprise restructuring in Central Europe," *Economics of Transition*, Volume 8(2) 2000, p.484-485.

¹⁰⁶ William B. Simons, op. cit., p. 287.

fifth as a result of privatization. In 1996 France reduced its budget deficit by one-eighth due to the revenues received from privatization.¹⁰⁷

From the perspective of foreign firms, investing into the privatized enterprise draws those firms into the swamp of privatization regulation.¹⁰⁸ Governments were the “sellers” of the firms being privatized. The direct involvement of government in the selection of foreign partners and the required approval of privatized proposals has caused confusion and uncertainty for many foreign investors.¹⁰⁹ Gray and Jarosz conclude that regularized procedures for official decision making are often lacking in East European countries: “Those turned down in the privatization process are generally given neither a statement of cause nor any opportunity to appeal the decision. In addition it opened the door to corruption”.¹¹⁰

Privatizations in transition economies have frequently been governed by incumbent managers, who accumulated implicit controlling rights as the result of weak state monitoring. That is why privatization often simply led to the explicit recognition of these controlling rights through the allocation of ownership titles to insiders.¹¹¹ A highly politicized setting contributes to unstable and inconsistent legislative practices resulting in uncertainty and discriminatory treatment for many foreign investors.¹¹²

In Russia most privatized enterprises became in control of badly organized shareholders or members of work collectives. Privatization never focused on providing information: many people did not know what to do with their vouchers and how to manage a business.

The European Bank for Reconstruction and Development reassessed the first years of economic reform in Russia and Eastern Europe, concluding: “The consequences of the privatization strategy adopted in Russia have been highly adverse for the governance of enterprises and the allocation of resources, not least because of

¹⁰⁷ Aleksey Kamensky, *op. cit.*, p. 30.

¹⁰⁸ Cheryl W. Gray and William W. Jarosz, “Law and the Regulation of Foreign Direct Investment: The Experience from Central and Eastern Europe”, *Columbia Journal of Transnational Law Association*, 1995.

¹⁰⁹ *Ibid.*

¹¹⁰ *Ibid.*

¹¹¹ Katharina Pistor, Martin Raiser and Stanislaw Gelfer, *op. cit.*, p.331.

¹¹² *The Investment Environment In the Russian Federation: Laws, Policies and Institutions*”, OECD, May 2001; [web page] www.oecd.org/EN/document/0,EN-document-0-nodirectorte-no-15-5025-0,00.html [Accessed June 23. 2002].

the clear failure to break the political constraints on restructuring and company closures."¹¹³

William B. Simons argues that the major question with regard to privatization in Russia is whether the rules governing ownership are to be found in a clear and predictable legal system that can act as a counterweight against political arbitrariness.¹¹⁴ He argues that the success of privatization depends on other aspects of legislation such as on foreign investment, restriction of monopolies and systematizing and recodifying civil legislation, as well as a degree of stability in the legal system needed to support political and economic reforms.¹¹⁵

2.5. Corporate Governance

Coffe and La Porta argue that only those legal systems that provide significant protections for minority shareholders can develop active equity markets.¹¹⁶ Without this protection, most investors will invest only if they are participating in a powerful blockholder group. The legal hypothesis views dispersed ownership as evidence of the law's success in fostering the trust and confidence necessary to convince minority shareholders to make and hold an equity investment. For a transition economy such as Russia good corporate governance enhances the confidence of domestic and foreign investors and helps to attract the long-term investment needed to sustain economic growth.

Bernard Black in his work - "The corporate governance behavior and market value of Russian firms" argues that corporate governance behavior has a powerful effect on market value, especially in a country where legal and cultural constraints on corporate behavior are weak.¹¹⁷ It means that, especially in Russia, firms can greatly improve their own share values, and thus reduce the cost of raising equity capital, through improving their corporate governance.

¹¹³ European Bank for Reconstruction and Development, Transition Report 1999: Tens years of Transition, p. 110.

¹¹⁴ William B. Simons, *op. cit.*, p. 1.

¹¹⁵ *Ibid.*, p. 83.

¹¹⁶ Coffe, *op. cit.*, p.7.

¹¹⁷ Bernard Black, "The corporate governance behavior and market value of Russian firms", Stanford Law School, *Emerging Markets Review*, vol.2; http://papers.ssrn.com/paper.taf?abstract_id=263014. [Accessed 20 April 2002].

Katharina Pistor analyzed the legal changes in the protection of shareholder and creditor rights in transition economies and its impact on the propensity of firms to raise finance. She argues that legal changes have substantially improved shareholder and creditor rights, however in Russia legal institutions still prefer to use external finance. She concludes that legal transplants and extensive legal reforms are not sufficient for the evolution of effective legal and market institutions.¹¹⁸

Some scholars have recently argued that the classic corporate governance paradigm with its focus on the control of management by outside investors, is too narrow to capture the specific problems of transition economies and other emerging markets.¹¹⁹ In transition economies, the behavior of blockholders, as famous Russian oligarchs, for example, suggest an alternative approach.

Some scholars argue that the protection of minority shareholders from blockholders, is as important for developing of equity markets as is the protection of shareholders against management.¹²⁰ Among the main problems of corporate governance in transition economies the following are mentioned:

- External finance to replace state findings under the central plan is almost completely absent;
- Incumbent enterprise management retain effective control rights even where privatization has shifted ownership to outsiders; and
- The State retains influence over corporate decision-making through a nexus of subsidies, regulatory favors, and tax.¹²¹

OECD specialists argue that attention should be given to widening the monitoring capabilities exercised by the board of directors and minority shareholders of the executive organs; developing more effective legislation prohibiting insider dealing; and strengthening the requirements for independent audits.¹²²

¹¹⁸ Katharina Pistor, Martin Raiser and Stanislaw Gelfer, *op. cit.*, p. 326.

¹¹⁹ Berglof, Erik and Ernst-Ldwig von Thadden (1999), "The Changing Corporate Governance Paradigm: Implications for Transition and Developing Countries", in *Proceedings of the Annual Bank Conference on Developing Economies*. Washington DC: The World Bank.

¹²⁰ Katharina Pistor, Martin Raiser and Stanislaw Gelfer, *op. cit.*, p.327.

¹²¹ *Ibid.*, p. 332.

¹²² "The Investment Environment In the Russian Federation: Laws, Policies and Institutions", OECD, May 2001; [web page] www.oecd.org/EN/document/0,EN-document-0-nodirectorte-no-15-5025-0,00.html [Accessed June 23. 2002].

However, it is important to note that the scope of legal change in transition economies is also impressive on an international scale. Within a period of only six years, the average level of shareholder rights has improved from substantially below world average to well above world average.¹²³

2.6 Banking

Given the economic importance of investment, it is clear that in the transition process of the formerly socialist countries the introduction of the market incentives is crucial. One way to stipulate this is to have a financial system that allocates financial resources efficiently.¹²⁴

The banking system plays a great role in a country's investment climate. Investors must be sure that nothing will happen to their accounts, that they can at anytime transfer their funds to another country, to buy or sell FOREX. The Russian banking system was damaged by the 1998 crisis, many banks went bankrupt. However foreigners complain about all banking regulations in Russia, its currency policy, speculation with Russian government debt, bribes. The status of the Central Bank status raised disputes even within Russia. The general problems are lack of transparency, under-capitalization, absence of properly defined risk management tools.¹²⁵

Russian banks tend to be small, badly run, and do little deposit-taking and lending. Many of them used to be organized as treasury departments for large companies, involved in organized crime. This is why most lending resources go to enterprises within the financial and industrial groups of which they form part.

Russians still prefer cash and remember all the tricks of first, the Soviet, and thereafter the Russian banks. Nowadays banks start to offer more facilities to pay accounts online and to perform plastic card transactions, but it rather exception than the rule.

¹²³ Ibid., p. 333.

¹²⁴ Nina Budina, Harry Garretsen and Eelke de Jong, "Liquidity constrains and investment in transition economies: The Case of Bulgaria", *Economics of Transition* (Volume 8 (2), 2000), p.454.

¹²⁵ Forecast Conference "Russia on the Rise"; [web page] www.amcham.ru/external/280202.html [Accessed June 20, 2002].

We would like to mention particular areas where policies were improved or could be improved. In this context, we have chosen to focus on the following issues as areas of priority: developments in tax reform, privatization, legislation on foreign investment at the banking sector.

3. The Russian response

3.1 Experience in attracting of foreign investors

First, we should mention that Russia lacks experience in the area attracting investment. However Kroll, for example, argues that Russia has had a significant experience in attracting foreign capital since the end of the nineteenth century. The analyses of these past experiences can be helpful in attracting FDI nowadays. He argues that the situation in Russia today is very similar to the economic situation of the 1880's – insufficient capital and technological backwardness in many branches of the economy. One of the reasons for the industrial boom in Russia during the last years of the nineteenth century, was the flow of foreign capital. Industry in Russia had only begun to develop, the volume of products produced was comparatively small, but demand was big. Thanks to high custom duties on foreign goods, Russian industry was in a dominant position and could maintain high prices for its products without fear of competition.¹²⁶

It is interesting to note, that there was no special legislation on foreign investment. The Russian State was guided by the *Svod Zakonov Rossiiskoi imperii*, volume X. However, some determined privileges and advantages were granted to foreign investors by special contracts concluded by the investor with the Government – for instance, large industrial orders for rail.¹²⁷

As the total result of attracting foreign capital from a country that even in 1877 ordinary sacks were brought in, Russia has transformed into a country where 56% of its

¹²⁶ Kroll, K., “The legal regulation of Foreign Investment in Russia: The Early Years”, *Sudebnik* (Simmonds & Hill Publishing Ltd.), Volume 6, March 2001, p.9.

¹²⁷ *Ibid.*, p.12.

needs for machine tools and equipment were satisfied from internal production, Dogranov argues .¹²⁸

In order to find money to revive the Russian economy in 1990s, there was possibility to borrow money and to attract investments. Russia applied both methods. However in the early 1990's already, specialists argued that unless state-owned industries are privatized quickly, and unless the ruble is made convertible and unless there is a modicum of internal stability to attract foreign business, no external aid package will suffice.¹²⁹

The Russian entrepreneurs working with foreign elements also lack experience. During the first years of the reform state bodies, dealing with international trade, also served as consultants for Russian firms, which were going enter into trade with foreigners. It was a good idea: they had experience and connections. Experience can play a significant role in attracting investments. For example Central Europeans countries opened their economies much earlier than Russia and they are far ahead now in attracting FDI. Hungarian national redevelopment plan announced in 2000 and named after Count Istvan Szechenyi, is a good example.¹³⁰ It suggests hiring a consulting firm that can navigate potential investors through the maze and provide valuable practical lobbying at the processing level. Interestingly enough that firm is already working for law firms that have clients interests in Hungary but have no local office. They are working particularly with CMS Cameron McKenna and Coudert Brothers, for instance. "We find working with other law firms very efficient, as we speak the same language", the firm's director says "and we speak Hungarian, too".¹³¹ The language is not the only advantage. Knowledge of the business environment, customs, and culture is a big advantage for investors coming in the market without experience. Is this question important for Russia?

In the beginning of 1990's, the socio-economic situation in the country became extremely acute. The fall in production affected virtually all sectors of the national economy. The finance and credit system was in a crisis. The consumer market

¹²⁸ Donganov A. G., "*Inostrannii capital v Rossii i SSSR*" (1990), p.42.

¹²⁹ <http://policy.house.gov/russia/notes.html> [Accessed July 4, 2002].

¹³⁰ "Hungarian Economic Review", *The world in 2002, The Economist*, 2001, p. 86.

¹³¹ *Ibid.*, p. 87.

was disorganized, the food shortage was felt everywhere and the population's living conditions changed considerably.¹³²

3.2 Basic guarantees for foreign investors

The first law of the Russian Soviet Federative Socialist Republic “On foreign investments” was adopted on 4 July 1991. Of course, it was a very important step towards the attraction of foreign capital. The main purpose of the law was declared to be the attraction and the effective use of foreign material and financial resources. The Federal Law of the Russian Federation “On Foreign Investments in the Russian Federation” adopted on 9 July 1999 focuses on the establishment of state guarantees of rights to foreign investors operating on the territory of the Russian Federation. The 1999 law distinguishes between foreign investments and direct foreign investments. The direct foreign investments are defined in the 1999 law as:

- the acquisition by a foreign investor of 10 % or greater interest in an existing or newly created Russian commercial organization for a period of at least six month;
- the investment by a branch of a foreign legal entity;
- the implementation of financial leasing;

The status of a foreign investor simply guarantees the equal treatment of a foreign investor and its investments in the Russian Federation, *i.e.*, the doctrine of national treatment applies. Originally the law of 1991 was not detailed and as a result thereof the law was revised and amended all the time.

A further step was the Presidential decree “On Improvement of the work with Foreign Investments” from September 27, 1993. It introduced a three year moratorium for foreign investors on newly promulgated Russian legislation.¹³³

Another attempt by the Russian Government was the adoption in 1994 of Resolution “On activation of the work on attracting of the foreign investments into the Russian Federation’s economy”. The attraction of foreign investments was highlighted

¹³² <http://policy.house.gov/russia/notes.html> [Accessed July 4, 2002].

¹³³ Topornin B. N., “*Rossiiskoe pravo I inostranie investizii: aktual'nie problemi*”, ed. A. G. Svetlanov (Moscow, 1995), p. 11.

as an important task for state bodies, which should develop attractive legal, tax and customs legislation. The Ministry of Economics started to prepare the State Program on investment stimulation.

It is important to note that in the Russian Federation, preference was given to international legislation. According to Article 15 of the Russian Constitution, international treaties are considered to be a complementary part of the Russian domestic legislation. It means that international principles accepted by the Russian Federation are supposed to have priority upon the domestic legislation

During the early stages it was extremely important to provide foreign investors basic guarantees. Among them the Russian legislator provided guarantees from changes in the legislation, nationalization, movement in currency, and all kinds of compensations for foreign investors. Boguslavskiy provides a very interesting example from the Tadzik law. According to the Tadzik law, the protection of the foreign company's interests are secured by the State's gold, brilliant and foreign currency reserves. Bogusalvskiy argues that in the case of nationalization, for example, foreign investors can be compensated from such reserves.¹³⁴

Insurance can serve as a safeguard for the investments of investors. This safeguard measure was recommended by Musin even in 1991.¹³⁵ In the US, for example, it is quite popular to pass the rights of private investors to the US government. In the "Agreement on investments protection" (1992) between the US and the Russian Federation an opportunity is provided to US investors to insure their projects with a special governmental insurance agency. In the case of insurable event the Agency will pay the insurance amount and then can recover the obligated amount from the Russian Government.¹³⁶ Bank guarantee and collateral can also serve as safeguards.

3.3 Comparison of the 1991 law and the 1999 law

A good example of changes in Russian investment policy can be shown by comparing the two Russian laws on foreign investment.

¹³⁴ *Ibid.*, p. 78.

¹³⁵ Musin V. A., "Pravovie voprosi inostrannih investizii v SSSR", *Pravovedenie*, No. 4, 1991, p. 30.

¹³⁶ Boguslavskiy, M. M., *op. cit.*, p. 187.

In comparing these two laws, we find the definition of *foreign investors*. In 1999 law, the definition is more specific. The definitions in the 1999 law were formulated in a more precise manner and there is less confusion among foreign investors when applying the norms of that law. In fact, the 1999 law finally defined FDI. Until then there was no legislative definition and different kinds of instructions were used in order to determine what is FDI.¹³⁷ However, Kucher argues that the definition is quite vague: “It is not correct to determine FDI through the share in the capital, first of all. Second, there is no division between the buying of shares during formation of a company and secondary market deals. The last one is not FDI”.¹³⁸ Moreover the law includes the buyout of privilege shares (without voting power) to form part of FDI. According to Russian legislation a company can issue up to 25% privileged shares. Therefore, a foreign investor can buy all of privilege shares plus one ordinary share and obtain all the guaranties and privileges provided by the Law, for priority projects.¹³⁹

The new law makes provisions for the division of the competence in accordance to which subjects of the Federation are authorized to adopt their own legislation on foreign investments. Significant powers and controls were given to the subjects of the Federation.

Both laws make provision for exceptions. An interesting fact is that Article 6 of the 1991 law provided that exceptions from the national treatment could only be made by the Law itself. Paragraph 1 of the Article 4 of the 1999 law provides that exemptions may be made by different federal laws. Limiting exceptions may only be made by Federal laws to the extent in which it is necessary to protect the fundamentals of the constitutional order, morals, defense and security of the state. Encouraging exceptions may be established in the interest of the social and economic development of the Russian Federation. It is important to note that Article 17 of the 1999 law also provides the right to the subjects of the Russian Federation and bodies of local governance to establish encouraging exceptions within their competence at their own budgets' expense. This provision may be very attractive for some regions, however many thereof depend on the federal budget, and it could be difficult for them to

¹³⁷ Ramilova A., “Priamie inostrannye investitsii kak ob’ekt gosudarstvennogo regulirovania”, *Rossiiskii Ekonomicheskii Zhurnal*, # 7, 2000, p. 75.

¹³⁸ Kucher A. N. and Nikitin M. S., “Novii rezim inostrannih investitsii”, *Zakonodatel'stvo*, No. 11, 1999, p. 39.

¹³⁹ *Ibid.*, p. 44.

establish a rule which will even temporarily empty their budgets. However in 1999 in Saint-Petersburg, for instance, there were some tax incentives granted in relation to profit tax, property and the maintenance tax on housing stock.¹⁴⁰

Foreign investors, in assessing the prospects for investing in the Russian Federation, place significant value in guarantees against expropriation; it appears that the 1999 law grants a higher number of such guarantees. Compared to the 1991 law, it limits the possibility of expropriation to federal laws only and only to the extent to which it is necessary for the protection of fundamentals of constitutional order, morals, health, rights and legal interests of other persons, defense and security of the state.

The 1991 law established a detailed procedure for the creation and liquidation of legal entities. According to Article 17 of the law, enterprises with foreign participation must be registered with Ministry of Finance or other authorized body. The 1999 law makes provision in Article 20 for the creation and liquidation of commercial enterprises with foreign investments, which creation and liquidation to be carried out in the procedure and on the terms and conditions stipulated by the Civil Code of the Russian Federation and other Federal laws.

The legislator attempted to control the activities of foreign investors to the maximum extent during the early stages. That is why the 1991 law contained provisions governing labor, financial, customs, currency, insurance, and other matters of commercial enterprises. The 1999 law, on the other side, does not govern all matters of foreign investors but rather relies on the special legislation (tax, customs, labor, etc.).

3.4 Other legal factors

Russia also adopted many new laws in order to attract foreign investors. Is it enough? The major determinant for FDI flows is the legal system of course. It influences labor costs and cost of capital. Transaction costs are also an important determinant. First of all, it is the costs associated with setting up the venture and government approval. Thus, where the legal system or separate industry requires a

¹⁴⁰ “*Formation of the Legislative Base at the Federal Level*”, Foreign Investment promotion center (FIPC) under the Ministry of Economy of the Russian Federation, Internet www.russia.legisbase.html [Accessed March 8, 2002].

procedure of registration and licensing the costs of an investment through government bureaucratic systems can be significant and discourage firms from market entry. Furthermore, after the formation of the business problems with settling disputes could arise.

In order to regulate foreign investment, it is not enough to adopt only special acts and laws. Civil, tax, customs and company legislation must be appropriate also. However there are many disputes on this issue in the literature: what is better? to adopt a special legislation on foreign investments or to let it be regulated by national legislation? We already mentioned that the biggest issue arose between protectionism and the need to attract investments. Boguslavskiy argues that in the situation, when foreign investments are needed on one hand, but on the other hand you need to protect your own entrepreneurs, the best opportunity is to create special legislation on foreign investments, foreign capital in the domestic economy could be an “unknown body (*inorodnoe telo*)”.¹⁴¹

Talking about instability in the legislation, we would suggest that more attention should be paid to bilateral and multilateral treaties. It could be an opportunity for investors to solve the problem of changing legislation, by giving guarantees to use a specific regime for investments in future. The second important issue - is double tax treaties. It frequently influences the entry choice of investors, legal entity form.

An interesting example of a guarantee against changes in legislation , is the famous case of “Severnoe Sianie”, a company with foreign participation. When its American counterparty had already invested USD 40 million, the legislation was changed: taxes increased and custom duty was introduced. However, upon the request of the company, the Russian Government granted the American counterparty favorable conditions, because of such a practice in international relations and the importance of the company for the region. However, this decision was attacked by the Social-Environmental Union as conflicting with national and regional interests. The Supreme Arbitration Court denied the procedure, but on most amazing grounds. The court stated that the social organization can not pretend to defend State interests, according to Russian legislation and that is that.¹⁴²

¹⁴¹ Boguslavskiy M.M., “*Inostrannie investitsii: pravovoe regulirovanie*” (Moscow, 1996), p.16.

¹⁴² *Ibid.*, pp. 44 - 45.

The progress in improving legislation governing economic, business and investment activity is becoming visible in Russia. In 2002, the Russian government will reduce tax burden on business, to create more liberal currency regulation system, and implement a further diminution of administrative barriers: simplified procedures for registering legal entities, inspection procedures, and fewer licensing requirements. In 2001, the Duma approved a number of important social and economic laws and new labor and land Codes were adopted.

3.4.1 Taxation

After President Boris Yeltsin's resignation in December 1999, Russia's Center for Strategic Research was tasked with drafting an economic reform program for the incoming Putin government. Headed by German Gref, whom Putin subsequently appointed as Russia's Minister for Economic Development and Trade, the Center released its report in June 2000. It emphasized:

- Reducing government spending;
- Balancing the state's budget;
- Eliminating many state subsidies;
- Implementing a 13% flat income tax; and
- Reducing turnover taxes on business.

The most important innovation in this field is the Tax Code. One of the important provisions of the new Code is a transfer pricing provision. It is very important because Russian companies were manipulating many transfer pricing transactions. The largest Russian oil company "LUKoil" can serve as a good example. It wanted to be listed on the New York Stock Exchange and wanted to comply, on the face of it, with all the requirements: accounting practices were in accordance with the U.S. GAAP, minority shareholders were elected to be board members. But in Bulgaria, where "LUKoil" owns Neftokhim refinery, the Company was acting unfairly towards minority

shareholders, shifting assets through transfer pricing.¹⁴³ Of course, investors all over the world paid a great attention to it and drew their own conclusions about “LUKoil”.

However, Irina Zvekova, for example, believes that even new tax code will not resolve all the problems, however will reduce the tax burden and expenses of the companies.¹⁴⁴

The 13% flat income tax, in particular, has partly gained popular support because it is seen as a way to eliminate tax evasion by wealthier Russians. The flat rate tax was overwhelmingly passed by the State Duma on July 19, 2000, and it was passed seven days latter by the Federation Council with an unexpected strong vote of 115 votes against 23.¹⁴⁵ President Putin signed the flat tax into law on August 7, 2000, calling it "the most important event in the country's life."¹⁴⁶

The new tax code changed taxation of profit earned by legal entities. The procedure for taxing profit was also amended. The tax rate applied to profit, has been reduced from 35% to 24%. However, the tax burden and social funds contributions on payroll are still up to 35.6%. That is why employers do not want to declare the real income paid to employees.

The new provisions will enable foreign companies to benefit from the exemptions from Russia’s dual tax treaties. The American Chamber of Commerce gives an example where foreign representative offices will be permitted to deduct expenses incurred on their behalf by a parent company located abroad.¹⁴⁷

The reduction in customs duty on imported equipment, including equipment imported under lease agreements, is among the positive changes. It can lead to an increase in equipment imports under lease agreements, as well as a contribution to share capital.

¹⁴³ “*LUKoil vedet sebja v Bolgarii kak nastoiashaia TNK*”; [web page] www.lenta.ru/economy/2002/01/18/lukoil/. [Accessed 22 March 2002].

¹⁴⁴ Irina Zvekova, “*Taxation of Foreign Investors Income in the Russian Federation*”, Master’s Thesis, Leiden, 1999, p. 41.

¹⁴⁵ Michael Wines, "Russia's Powerful Regional Chiefs Yield Meekly to Putin," N.Y. TIMES, July 27, 2000, p. A3

¹⁴⁶ Graff, "Putin Signs Revolutionary Russian Tax Overhaul," Reuters, Aug. 7, 2000.

¹⁴⁷ Forecast Conference “*Russia on the Rise*”; [web page] www.amcham.ru/external/280202.html [Accessed June 5, 2002].

Investors consider the progress in tax reforms of the past two years as significant.¹⁴⁸ Heineken's officials, for example, argue that they are absolutely satisfied with Russian tax legislation. However the new tax legislation does not mean that the tax system will be effective. Improvements in tax administration and customs are needed.

3.4.2 Political issues

The investment climate in Russia has suffered from the contradictory interpretation and discriminatory implementation of existing legislation resulting from an unclear and contested separation of powers.¹⁴⁹

The executive branch has notably consolidated its positions in Russia. The ban on regional governors representing their regions in the Federal Council and the ending of gubernatorial influence has reduced the scope for regional leaders to influence politics. It mirrored on the political weight of decisions made at federal level. As we mentioned already, it was considered as a major Russian problem a couple of years ago, regional legislation frequently contradicted with federal legislation as well. It can be listed as one of the achievements of President Putin, who gave a deadline to regional leaders to revise their legislation in order to eliminate all contradictions. It is important to note that the Russian Constitution contains a provision (Art. 85) according to which the President can withdraw any legislation act of a subject of federation, if it contradicts with federal legislation or international obligations of the Russian Federation.

Not long ago, the lion's share of the Russian economy was controlled by so called "oligarchs" and for the foreign investor it was quite difficult to understand what the rules of the game were to be.¹⁵⁰ The work in the direction of regional leaders and "oligarchs" is already visible. Putin removed Pavel Borodin, the head of presidential property office, Vladimir Gusinsky, a media tycoon, and Boris Berezovsky, a former Kremlin' insider – should they return, they would be facing arrest. Rem Viaherev and Gerashenko retired. Putin also forced Nazdratenko to change his local governor's

¹⁴⁸ *Ibid.*

¹⁴⁹ "The investment Environment In The Russian Federation: Laws, Policies and Institutions", OECD, May 2001; [web page] www.oecd.org/EN/document/0,EN-document-0-nodirectorte-no-15-5025-0,00.html [Accessed June 21, 2002].

¹⁵⁰ Kudina M. V., "Inostrannie investitsii v Rossiskuu ekonomiku: za I protiv", *Finansi* (No. 2, 2001), p. 16.

position in the far –east on the place in the fish industry. This immediately raised Putin’s score when it came to cleaning up Russia and was an important symbol, even Yeltsin wanted the governor removed.¹⁵¹ But removing the “oligarchs” from government altogether looks unlikely, at least in the short run, *The Economist* argues.¹⁵²

However, centralization of state power in the context of poor transparency and a lack of accountability constitutes a ground for corruption and gives the possibility to officials to abuse privatization process, for example, for their personal enrichment.¹⁵³ That is why the system need to be more transparent and better regulated. The harmonization of legislation and implementation practices affecting investors at regional and federal level, as well as the formulation of region-specific investment policies are of great importance.¹⁵⁴

3.4.3 Judiciary and enforcement

Judicial reform is particularly needed for the establishment of an effective legal system in Russia, for ensuring proper enforcement, and to ensure fair competition. The loopholes in judicial system lead to ineffectiveness of Russian legislation. The judges are usually influenced by criminals or the executive branch, the prosecution bodies are out of the control of the judiciary. The reform of the Russian judicial system attracts a lot of attention, the President and his administration also pay a great deal of attention to it: the Gref’s Program contains certain provisions relating to this; the meeting of judges is usually held; a new Code of Criminal Procedure has been adopted. It is an interesting fact that some Russian researches argue that Russian judicial system meets all international standards.¹⁵⁵

In fact, in the early stages of the reformation, foreign investors disputes could be resolved in a court, in a state arbitration court or in an international commercial arbitration. However, emphasis was placed on Russian courts. Of course the judges

¹⁵¹ www.prosperitycapital.com/pdf/MonthlyJanFeb01.PDF [Accessed June 3, 2002].

¹⁵² “The Chaos at the door”, *The Economist* (December 30, 2002); [web page] www.economist.com [Accessed May 20, 2002].

¹⁵³ Forecast Conference “*Russia on the Rise*”; [web page] www.amcham.ru/external/280202.html [Accessed May 29, 2002].

¹⁵⁴ “*The investment Environment In The Russian Federation: Laws, Policies and Institutions*”, OECD, May 2001; [web page] www.oecd.org/EN/document/0,EN-document-0-nodirectorte-no-15-5025-0,00.html [Accessed June 21, 2002].

¹⁵⁵ Topornin B. N., “*Rossiiskoe pravo I inostranie investizii: aktual’nie problemi*”, ed. A. G. Svetlanov (Moscow, 1995), p. 11.

were not prepared to such disputes, they were busy with the criminal and other cases, and language was a serious problem. Access to State Arbitration courts for foreigners was limited until the Law “On Arbitration Courts in Russian Federation”, dated April 28, 1995 appeared. It eliminated all exemptions with regard to foreign investors. On paper it appeared attractive for the foreigners, however the major surprise was on the enforcement stage. First, there was confusion between Arbitration and State arbitration. The second, how to enforce its decisions: if they are not covered by New York convention, but only by CIS treaties?

The first Law on “International Commercial Arbitration” appeared in 1993. It was based on UNCITRAL Model Law. The International Commercial Arbitration Court (ICAC) appeared at the Moscow chamber of Commerce. Soon institutional arbitration courts appeared in Saint-Petersburg and other cities, ad hoc courts became popular. Arbitration courts in Moscow and Saint-Petersburg became quickly well-known because of the quality of the decisions given and respectable arbitrators.

For investors it is of prime importance to have appropriate tools for dispute resolution. Foreign investors prefer arbitration and with enforcement of foreign arbitral awards in Russia there were always problems. Arbitration courts and courts of general jurisdiction often refused to recognize foreign arbitral awards.

Jeffrey M. Hertzfeld points out that Russian legislation does allow shareholders in companies with foreign investments to have their disputes settled through international arbitration if they so provide in their foundation agreements or the charter of their joint entity. “The possibility of submitting shareholder disputes to a neutral third country forum has been widely applauded as providing a further assurance that foreign shareholder rights in Russian companies are well protected”, he argues.¹⁵⁶

However, international arbitration without reasonable assurance of local enforcement may turn such protection into an illusion. As we mentioned, Russian courts around the country have regularly refused to recognize and enforce international arbitration awards. Local courts refuse to enforce awards even despite Russia’s obligations under the New York Convention on the Recognition and Enforcement of

¹⁵⁶ Jeffrey M. Hertzfeld is a senior partner in the international law firm, Salans Hertzfeld Heilbronn. He is a member of the OECD Steering Committee on foreign investment in Russia and the ICC European Arbitration Group. See: www.iccwbo.org/home/conferences/reports/budapest/book_articles/hertzfeld [Accessed July 14, 2002].

Foreign Arbitral Awards.¹⁵⁷ Foreigners usually looking for recovering their damages by seizing assets in other countries, however not all Russian debtors have assets abroad.

OECD specialists argue that in order to create the “larger role and greater authority for the judiciary” advocated by President Putin it is necessary to increase the prestige of the judicial power, attract qualified specialists, guarantee real independence of the judges and pay special attention to the system of execution of legal rulings.¹⁵⁸

3.4.4 Corruption

It is interesting to note that corruption in Russia continued on all social levels. For example, in 1995 CIA officials dispatched a secret report documenting the corrupt practices of then-Russian Prime Minister Viktor Chernomyrdin to the White House. Chernomyrdin's private assets accumulated in his official position, according to Russian security sources, ran into the billions of dollars. However Vice President Gore did not accept it. He sent it back to the agency with the word "BULL****" scrawled across it. He could not believe that corruption is possible on such a high level.¹⁵⁹

Putin understands that graft is costing Russia billions in foreign investment. Of course, entrepreneurs sector can never achieve its potential without a full-scale battle against corruption.¹⁶⁰ We would mention that there is a good work in that direction. A new package of reforms aims to cut down on courtroom bribes by increasing judge's woeful salaries fivefold and to limit their immunity against corruption charges.¹⁶¹ The number of business activities that require licenses will be reduced. Putin created the anticorruption coalition in the face of western shareholder right's activist Mattias Westman, director of Prosperity Capital Management; Dmitri Kozak liberal policy activists and Sergey Stepashin, Duma Audit Chamber chief.¹⁶² At least it is a good sign

¹⁵⁷ *Ibid.*

¹⁵⁸ “*The investment Environment In The Russian Federation: Laws, Policies and Institutions*”, OECD, May 2001; [web page] www.oecd.org/EN/document/0,EN-document-0-nodirectorte-no-15-5025-0,00.html [Accessed June 21, 2002].

¹⁵⁹ “Bull****: Gore and Other Administration Policy Makers Systematically Ignore Evidence of Corruption of Their “Partners””; [web page] <http://policy.house.gov/russia/notes.html> [Accesses July 5, 2002].

¹⁶⁰ Paul Starobin and Catherin Belton, “Cleanup Time”, *BusinessWeek*, January 14, 2002, p. 46.

¹⁶¹ *Ibid.*, p.46.

¹⁶² *Ibid.*

that something is starting to do. We are sure that having solved the problem of corruption, Russia will significantly raise its rating.

3.4.5 Organized crime

The impact of organized crime in Russia is very big. Russian officials estimate that up to 50% of the nation's economy is in some way connected to organized crime.¹⁶³ According to Russia's Ministry of Internal Affairs, organized criminals owned or controlled about 40% of Russia's private businesses, 60% of state enterprises, and 50% to 85% of banks by 1997. Russian firms are often faced to pay 10% or more of their revenues as protection money to criminal organizations and bribes to corrupt officials.¹⁶⁴

Among the main obstacles for all foreign direct investments Heineken's officials mentioned criminalization of the Russian society, especially of the beer industry. That is why they spend so much time to find a factory which is more or less independent.¹⁶⁵ It plays a great role especially in the case of FDI. One of the important factors of choosing an investment entry mode is control. However in a criminalized society, these two contradict. You never know what will happen tomorrow with your ownership and voting power, if you are dealing with organized crime.

The question is especially urgent talking about Saint-Petersburg - the "crime capital of Russia". Saint-Petersburg is frequently characterized as *banditskiy* (gangsters). The crime elements are quite independent in the city and do not depend on mafia's decision in Moscow, for instance. That is why they are more cruel, do not respect the "traditions" of the Russian mafia world. And it is more difficult to deal with them.

However, Andrey Bushev, senior lawyer of the Vena brewery in Saint-Petersburg, who have been working in the beer industry for many years, argues that he

¹⁶³ Francis T. Miko, "*International Crime: Russian Organized Crime's Role and U.S. Interests*", CRS Report to Congress, Oct. 30, 1998

¹⁶⁴ *Ibid.*

¹⁶⁵ Interview with Jan van de Merbel, Heineken's investor's relations specialist. June 25, 2002, Amsterdam, The Netherlands.

never faced this problem.¹⁶⁶ This problem is more urgent for regions - he argues and “all the talks are frequently much exaggerated by the press”.

The following can serve as a good example of the situation in the Saint-Petersburg beer industry, in particular: 10 January 2000, when Ilya Vaysman, 36 year old director of the St. Petersburg Baltika brewing company, was shot in the head and heart from a fifth-floor ledge a few feet from the kitchen window of his apartment. Suspected motive: a dispute over the disposition of expected investments. Baltika's general director of marketing, Aslanbek Chochiyev, was shot to death as he was getting out of his Mercedes on July 1, 1999. And all this with respect to a company which is an example of a new Russian company, example for foreign investors and Russian entrepreneurs.

One more example is the attempt on Maxim Tkachev's life in Moscow. This case is important because he was working for Ruppert Merdok, the owner of “Times”, “New York Post” and “XX Century Fox”. It means that killers are creating barriers for one of the biggest entrepreneurs in the world. Of course, it was a bad sign for foreign investors and influenced their decisions on investment. Maybe in another country the profits would be lower, but at least they are not killing competitors, - Boris Shirokov argues.¹⁶⁷

The most significant cost of Russian organized crime has been its contribution to the widespread loss of confidence in the nation's economy. Louise I. Shelley suggests that in order to improve situation in Russia the following must be done:

- economic and legal assistance programs are needed;
- coordinated legal reform in the criminal and civil areas, including enforcement measures, banking and tax reform.¹⁶⁸

It proves one more time that the reforms must be held in all the directions in one time, with taking into consideration the interests of all fields.

¹⁶⁶ Interview with Andery Bushev, Vena Brewery's senior lawyer, July 5, 2002.

¹⁶⁷ Boris Shirokov, “*Devet' gramov dla investora*” (June 6, 2002); [web page] www.sobkor.ru/obzor/obzor38.htm [Accessed July 5, 2002].

¹⁶⁸ Louise I. Shelley, “*Tag of Russia's Organized Crime*”, [web page] www.worldbank.org/transitionnewsletter/janfeb97/art4.htm [Accessed July 5, 2002].

However the situation can change with the new Russian President. His KGB past has contributed significantly to a public perception that he will "get tough" on organized crime. His election was a gamble for Russians, nonetheless: they have only hope, and no guarantee, that he will not similarly crack down on civil liberties, freedom of speech, and democracy. Which way Putin and Russia will go, is yet unclear. However on the other hand, it can give an unlimited power and to lead to authoritarianism.

3.4.6 Privatization

Russia's privatization process began in July 1992, when president Yeltsin signed a Decree requiring all large-scale enterprises to transform themselves into joint stock companies by October 1, 1992.¹⁶⁹

The purpose of privatization was to make the former state entities available and attractive for private investments. However this question was widely discussed by different authors, that is why we just want to show the impact of it on foreign investments.

There were two stages in Russian privatization process. From 1994, privatization entered into its second phase, which opened up opportunities for foreign investors to take equity stakes. Foreigners met a serious problem, when many Russians have become convinced that western corporations are gaining control of the country's most profitable industries and going to steal all their money.

The privatization model, used in Russia, became the source of many conflicts among shareholders. The appropriate corporate governance was not developed and many violations of shareholders rights occurred. "Unwanted" shareholders were crossed out of the register, banned from shareholders meetings.¹⁷⁰

The "privatizations" of the 1990s did not disintegrate the network of inefficient Soviet command economy: the management remained the same, but just as important, because the incentives to change were missing. Thus, the Soviet enterprise network continued to operate in almost the same manner even after the fall of the Soviet Union.

¹⁶⁹ "Doing business in the Russian Federation", PricewaterhouseCoopers, February 1, 2001, p. 10.

¹⁷⁰ Robert Cottrell, "Corporate governance and shareholder activism in Russia", [web page]; www.corp-gov.org. [Accessed 25 April 2002].

Products were still produced in qualities and quantities unrelated to market realities. And while a market economy would have quickly bankrupted inefficient companies, in Russia these companies continued to operate, often because of state subsidies.

"Privatization" is impossible without a functioning market economy into which formerly state-owned assets can be sold. In a free enterprise system, government referees the game, but it is not a player. It proves that privatization issues are closely linked to the legal system. For example, without enforceable property rights, the proprietors of "privatized" firms lacked the incentive to run companies efficiently and in accord with economic reality.

A popular Russian pun equates privatization to the grabbing of state assets. Privatization is referred to as *prikhvatizatsiia*, from the Russian *khvatat'* (to grab).¹⁷¹ Almost all enterprises were privatized by insiders, and the foreigners were left with nothing, however one of the objectives was to attract foreign capital into the country. According to Michael Alexeev's classification of ownership in privatized enterprises foreign investors took only 0.99 % of all privatized entity's shares.¹⁷² OECD specialists argue that in practice foreign entrepreneurs have mostly opted for joint-ventures, direct acquisition of companies from management or share purchases on the primary or secondary markets to establish an investment base in the Russian Federation.¹⁷³

3.4.7 Corporate governance

The problem becomes more urgent in Eastern Europe in recent years. The need to attract foreign investors was always important to these countries, but only now do they start to recognize the link between the investor's protection, appropriate corporate governance system and dispersed ownership. The last one can produce a more transparent securities market and may yield better monitoring of management. The lack of sufficient minority legal protections may reduce the number of equity investors in a country.

¹⁷¹ Michael Alexeev, "The effect of privatization on wealth distribution in Russia", *Economics of Transition* Volume 7(2) 1999, 450.

¹⁷² *Ibid.*, 490.

¹⁷³ "The Investment Environment In The Russian Federation: Laws, Policies and Institutions", OECD, May 2001; [web page] www.oecd.org/EN/document/0,EN-document-0-nodirectorte-no-15-5025-0,00.html [Accessed June 21, 2002].

Actually, Russian companies seeking to raise financing, have become aware of the relationship between a corporate governance system and attitude towards investors, and in particular, attitude towards minority investors. There was great work on improving of the legislation in Russia in this field.

The Joint-Stock Company law appeared in 1996, a bit late of course, but it made some progress at least. We can count “The Federal Securities Market” Law from April 22, 1996; The Federal Law “On Protection Of Rights And Legitimate Interests Of Foreign Investors” from March 5, 1999 as achievements. Dmitry Vasiliev, Chairman of the Board of Directors of the Investor Protection Association notes that the key point in Russia today is not adoption of new laws, but the improvement in the quality of their execution.¹⁷⁴

A number of companies accepted the Codes of Corporate Behavior, introduced representatives of outside shareholders to Board of directors and investor protection association appeared. It seems that the oligarchs are changing their attitudes to minorities and minorities becoming more active. Yukos, the oil company, has been called a leader in raising standards. It publishes quarterly financial statements according to U.S. GAAP, and has foreigners as its board members.

On the other hand, when representative of a very large company was asked: "What benefits do you derive from the Code of Corporate Behavior?" The answer was: "We do not need anything - we already have all we need, we were simply told to participate in the development of the Code - so here we are."¹⁷⁵ It may be very difficult to change this Russian approach, especially when equity investment is still far away from own capital and debt financing.

President Putin knows that Western investment will not pour in without a major improvement in corporate governance. Western shareholders rights' activists are working with the Kremlin to protect minority shareholders in biggest Russian monopolies. The Chief Executive Anatoly B. Chubais of Unified Energy System, Russia's electricity monopoly, received a refusal to restructure, because in their planning

¹⁷⁴ “*There are quite many good laws in Russia, but very often they are not observed*”, [web page];

www.corp-gov.org. [Accessed 25 April 2002].

¹⁷⁵ *Ibid.*

there was a possibility to sell assets cheaply to political cronies, thus damaging the rights of minority shareholders.¹⁷⁶

The trend of gradual increase of the participation of an independent Board is recently has been growing in Russia, and the idea of independent directors activities enjoy serious attention from the business community and media.¹⁷⁷ Both managers and investors find significant advantages in the presence of independent board members.

The Russian Investor Protection Association did research on the practice of appointing independent directors in Russia, and in a peculiar Russian way found the presence of independent directors is a positive factor in the opinion of the investors and as far as preferred, stands after international credit rating and international audit.¹⁷⁸

In recent years much was done to improve corporate governance in Russia. Attention, in our mind, must be given to the White Paper on Corporate Governance in Russia, which contains recommendations from the OECD and the World Bank. The presentation of the Paper was held on 15 April 2002. Senior officials represented Russian government on it proving the interest which government pays to the Paper and to the question of corporate governance.¹⁷⁹

It is very important that the Russian government finally paid some attention to the question and started to support the development of corporate governance, especially in the field of minority' protection. We believe that minorities will only benefit from this governmental support.

We should also mention the amendments, which have been made to the law "On Joint Stock Companies", aimed to protect shareholder's rights, making managers more accountable, and providing an increased role for minority shareholders in company operations. The main ones are:

¹⁷⁶ "Cleanup Time", *BusinessWeek*. Outlook 2002, January 14, 2002, pp.46-47.

¹⁷⁷ "The role of independent directors in Russian enterprises", Investor Protection Association, Moscow, 2001, p. 4.

¹⁷⁸ *Ibid*, p. 7.

¹⁷⁹ For a copy of White Paper ask Natalia Vishnevskaya: vishnevskaya@oecdmoscow.org.

- an amendment requiring a unanimous decision by the board of directors prior to any additional share issue, replacing the simple majority decision that previously applied. It becomes impossible to adopt a decision on an additional issue if a group of shareholders is against it. By the way, it was popular way of eliminating foreign counterparty from decision making process;
- an amendment extending the list of documents that a joint stock company is required to maintain and to which shareholders must have access;
- an amendment giving preferential share purchase rights to shareholders who have voted against or who have not voted in the event of a closed subscription.

A few years ago nobody in Russia cared about minority shareholders. Managers were acting without thinking about minority's interests. Recent years showed that there is a clear tendency of corporate governance improvement in Russia. Of course, a lot must still be done. Enforcement and legal protection are very important. Information support and advice could be useful for minority shareholders.

3.4.8 Banks

The Economist argues that the single biggest obstacle to the development of a proper banking system in Russia was probably Victor Gerashenko ended on March 16, 2002.¹⁸⁰ Jeffrey Sachs, an American economist, dubbed him “the worst central banker in history”, and said that it is an important step on the slow evolutionary path of Russia's financial system. The new central banker Sergey Ignatiev is the hope of Russian reformists. After his appointment he said: “I just cannot take bribes. I feel bad after”. But it means that he already tried, and knows this feeling!

We should mention that the Central Bank of Russia is an institution that combines safe regulatory powers with for-profit activities through its stake in Sberbank, Russia's largest commercial bank. “This conflict of interests creates a huge field for

¹⁸⁰ “Mr. Rouble quits”, *The Economist*, March 23, 2002, No. 8265, p. 69.

corruption”, says Dmitri Vasilyev, a former head of Russia’s Federal Securities Commission.¹⁸¹ The problem still remains unsolved. Vasilyev argues that Putin have to do something about it.

However it is important to note that the problems with banking in Russia concern basically domestic entrepreneurs. For example, Jan van de Merbel argues that Heineken was absolutely satisfied with the level of the banking system in Russia. “Russian banks work quickly and on world standards”, he argues.¹⁸²

3.4.9 Labor

Recent OECD research has shown that low labor standards deter, rather than attract FDI, this is why OECD specialists argue that principles and standards set by the International Labor Organization must be supported and promoted among the countries.¹⁸³

The real costs of labor to a foreign investor in a country in which the hourly wage rate is comparatively low, may actually be significantly higher because of legal rules that place limits on the employer’s ability to hire or fire workers or that requires significant tax contributions to employee welfare programs.

In 2001 a new Labor Code has been introduced in Russia. The need for it appeared since the beginning of the reforms, because the old one was adopted approximately 30 years ago in a socialist planned economy. The American Chamber of Commerce in Russia evaluates it as “a legal basis for balancing the interests of all parties”. One weakness of the Labor Code is the absence of special collision of law provisions governing the employment of foreign citizens. That is why now, foreign employees working in Russia are governed exclusively by Russian labor law. This approach ignores the generally accepted principles and existing international agreements applied in the sphere of labor law.¹⁸⁴

¹⁸¹ Paul Starobin and Catherin Belton, “Cleanup Time”, *BusinessWeek*, January 14, 2002, p. 47.

¹⁸² Interview with Jan van de Merbel, Heineken’s investor’s relations specialist. June 25, 2002, Amsterdam, The Netherlands

¹⁸³ *The Benefits of Trade and Investment Liberalization*, OECD, 1998, pp. 59 - 62.

¹⁸⁴ Forecast Conference “*Russia on the Rise*”; [web page] www.amcham.ru/external/280202.html

Labor relations of foreign citizens are governed by the Presidential Decree “On attracting and using of foreign labor force in Russian Federation” (1993, No.2146). However subjects of Federation can adopt some additional rules, determining labor relations with foreign citizens.

On the basis of the Presidential Decree, employers must obtain a special general permit if they wish to hire foreigners. Each employee or prospective employee must receive confirmation from the Migration Authorities before being allowed to work in the Russian Federation. A foreign citizen wantly be employed in Moscow, for example, have to get confirmation of his right on employment in Moscow, and after that he also must be registered with the internal affairs body.¹⁸⁵ The company must first get permission to attract foreign labor. This procedure is quite difficult and takes several months.¹⁸⁶ Thereafter the migration police will check the company all the time. It seems to us that it is easier to change citizenship. However, there are exceptions for companies with foreign capital, which can attract high quality specialists in the management positions without any Confirmation. Of course, the law which regulates the relations of foreign labor force is quite old and not in touch with today’s realities and needs.

There are now two drafts which are proposed to the State Duma.¹⁸⁷ Both are quite liberal and try to equalize the interests of all the parties. An important step, in our mind, would be to allow the involvement of arbitration as part of the labor law disputes resolution. For instance, Musin argues that according to Russian legislation citizens can solve any dispute between them in arbitration court, except labor and family issues.¹⁸⁸ However, labor regulation is becoming international and soft corporate law is becoming more efficient. In May 2002, a seminar was held on accelerating the process of using dispute settlement and ADR in labor law in Haag. The conclusion was that the issue is very urgent and need to be developed.¹⁸⁹ It could be a sign to Russia to take part in this work and implement the new trends in its legislation in order to improve its investment climate.

¹⁸⁵ “*Inostranez v vashei firme: poridok oformlenia razreshenia na raboty v Moskve*”; [web page] <http://your-lawyer.newmail.ru> [Accessed July 4, 2002].

¹⁸⁶ *Ibid.*

¹⁸⁷ www.akdi.ru

¹⁸⁸ *Grazdanskiy prozes. Uchebnik*, in Musin ed. (Moscow, 2001), p. 477.

¹⁸⁹ International Law Seminar: “*Labor Law Beyond Borders: ADR and Internalization Of Labor Disputes*”. Permanent Court of Arbitration, The Hague, May 7, 2002.

It is important to note that labor force in Russia is well educated and highly skilled. Russians are eager to work for foreign firms; however, many retain a casual work ethic that is not shared by the foreign employer.¹⁹⁰

3.4.10 Environment

In Russia it is still widely accepted that multinationals are moving to developing countries in order to take advantage of the lower environmental standards and lower operating cost from it. Some argue that increased business activity resulting from trade and investment results in increased consumption and production and, therefore, in lowered environmental quality. However in fact, trade and investment usually have a positive impact on the environment.¹⁹¹ Of course, environmental policies must be set at appropriate levels. The benefits are “clean” production, environmentally-friendly technology and equipment. That is why investment is more likely to raise environmental standards in developing countries. Studies show that pollution intensity has grown faster in countries that have remained relatively closed to world market forces.¹⁹²

On the other hand, some countries could be attracted by the idea of relaxing the level or the enforcement of their environmental laws in order to attract certain types of foreign investments. Maybe it could be a good idea for Russia! However, very few companies, investing overseas, seek to reduce environmental compliance. Surveys show that companies generally seek consistent environmental enforcement rather than lax enforcement and that they are usually willing to make new investments to improve the environment if their competitors must meet the same standards.

It is interesting to note that the old Law “On Foreign investments” contained provisions according to a state environmental expertise must be held before organizing a company with foreign participation in the field that can influence environment (reconstruction).¹⁹³ However, there is no such a provision in the New Law.

¹⁹⁰ “*Doing business in Russia*”, PricewaterhouseCoopers, February 1, 2001, p. 13.

¹⁹¹ OECD, “*The Environmental Effects of Trade*”, Paris, 1994.

¹⁹² Low, P., and Yeats, A., “Do Dirty Industries Migrate”, *International Trade and the Environment*, World Bank Discussion Paper No. 159, World Bank, Washington, DC.

¹⁹³ Boguslavskiy M. M., *op. cit.*, p.36.

According to Merbel, Heineken cares a lot about environmental problems and water treatment, in particular. This field may be also attractive for companies not only about their attitude to environment, but for tax considerations. Boguslavskiy, for example, points to the possibility of reducing taxable income of a company to the amount which is spend on environmental goals limited to 30%.¹⁹⁴

3.5. Lacking elements

In 1990, FDI in Russia was USD 4.2 billions, i.e. 44.6% of the total amount of investments. In 1995 FDI was 0.2 per cent of GDP in Russia. In 1995 Russia was a leader in attracting FDI among the former USSR countries. The inflow has been estimated at USD 700 million for 1993, but it increased in 1995 to more than USD 2 billions and over USD 6 billion in 1997.¹⁹⁵ In 1998 FDI was USD 3.3 billions, in 1997 – USD 5.3 billions.¹⁹⁶ In the first half of 2000 FDI was 1.7 billion, in that first half of 2001 it was already USD 2.5 billions.¹⁹⁷ The facts show that some progress have been achieved, however some problems remain yet unsolved.

Almost all emerging countries adopted new legislation, in order to attract foreign investments, however it appears to be not enough. The law enforcement must be credible. Assessments of the legal environment in transition tend to conclude that the quality of law enforcement is at least of equal importance to the extensiveness of the law.¹⁹⁸ New laws were often drafted by foreign advisors and adopted by legislatures without change. Katharina Pistor argues, that Russian corporate law, which is transplanted and modified Anglo-American model of corporate law can be used as an example.¹⁹⁹

Transition economies started to transplant law from developed countries. However the law needs to be properly understood before it can be applied. Despite

¹⁹⁴ *Ibid.*, p. 181.

¹⁹⁵ Klaus E. Meyer and Christina Pind, “ The slow growth of foreign direct investment in the Soviet Union successor states”, *Economies of Transition*, Volume 7 (1) 1999, p. 205.

¹⁹⁶ “Rossiiskii statisticheskii ezegodnik”, Moscow, 2000.

¹⁹⁷ Department of investment policy of the Ministry of Economic Development of the Russian Federation. www.gov.ru

¹⁹⁸ EBRD, *Transition Report: Ten Years of Transition* , London : European Bank for Reconstruction and Development, 1999.

¹⁹⁹ Katharina Pistor, Martin Raiser and Stanislaw Gelfer, ”Law and finance in transition economies”, *Economics of Transition* (Volume 8 (2), 2000), p.340.

impressive achievements in formal legal change many transition economies can not use their new legislation effectively.

According to the report prepared by the Expert Institute and the American Chamber of Commerce in Russia, the main trend now in Russia is stabilization. The State is consolidating its control functions, the economy is expanding and political and macroeconomic risk factors have been significantly reduced. The Russian stock market was one of the fastest growing and most profitable markets in the world in 2001.

Russia has now passed through the first phase of the economic transformation process – macroeconomic stability has been achieved and a basic market environment has been created. The Russian government developed its Social & Economic Policy Program 2000-2010. The Program was widely welcomed by the business community in Russia, and refers to the task of improving the investment climate as one of the most important issues facing Russia today.²⁰⁰

Supporting this idea the World Bank, for example argued that Russia should “phase out the three core pillars of the current FDI policy”:

- all existing high tariffs and non-tariff protection for the domestic market;
- tax preferences for foreign investors; and
- the substantial number of existing restrictions on FDI (make them applicable only to a limited number of sectors).²⁰¹

OECD specialists argue that Russia must improve the administrative mechanisms for implementing domestic taxation rules and double taxation treaties as well as provide clear definition of taxpayer’s rights and duties with possibilities for judicial and non-judicial dispute resolution.²⁰² American Chamber of commerce adds that with a small improvement in the statutory basis for foreign investment, Russia would be far better advised to address some of the more serious issues that face potential investors, land ownership, corruption, and the enforcement of judicial decisions.

²⁰⁰ Forecast Conference “*Russia on the Rise*”; [web page] www.amcham.ru/external/280202/html [Accessed June 20, 2002].

²⁰¹ Joel Bergsman, Harry G. Broadman and Vladimir Drebensov, *op. cit.*

²⁰² “*The Investment Environment in the Russian Federation: Law, Policies and Institutions*”, OECD (May, 2000), p.26.

The new Russian Law on foreign investment reveals a small, tentative step forward the creation of an investment climate that will attract foreign capital. It also uncovers some potential pitfalls that foreign investors should be aware of, and shows that Russia has once again failed to address the most important concerns of foreign investors in this risky market.²⁰³ According to the American Chamber of Commerce in Russia the application of the new law is limited, and its language both unclear and contradictory. In addition, the law is full of vague definitions, unclear terms, and contradictory provisions, all of which contribute to an investment climate that is renowned for its uncertainty and instability.²⁰⁴ Moreover, the opportunities proposed to foreign investors frequently are blocked by other legislative acts. For example, the measures accepted for stimulation and protection of foreign investment refer first of all to the projects which amounted more than USD 4 millions.²⁰⁵ Lebedev argues that the new Law did not improve the Russian investment climate, it is not directly applicable and most of provisions are unclear.²⁰⁶

It important to note that the Russian foreign investment regulations regarding permissible activities, prior authorization and notification requirements are confusing and contradictory. The Ministry of Finance, local authorities and various central government bodies all register foreign investments.²⁰⁷

However some investors have started to look at Russia as a more stable place. However what foreign investors want to see might be different from that what the majority of Russians want. Neither housing reform (phasing out of subsidies) nor land sales are widely popular. However, an important point is that the government realizes the need for reform.²⁰⁸

²⁰³ Mark S. Vecchio and Peter Chessick, “*The New Russian Foreign Investment Law: Old Wine in New Bottles?*”; [web page] www.russianamericanchamber.org/newsletter/new_russian_investment_law.html [Accessed May 2, 2002].

²⁰⁴ *Ibid.*

²⁰⁵ Ramilova A., *op. cit.*, p. 76.

²⁰⁶ Lebedev V. M., “Inostrannie investitsii v ekonomice Rossii – tendentsia razvitiia”, *Finansi*, #8, 2001, p. 11.

²⁰⁷ “*Russia: Country Overview*”; [web page] www.geocities.com/Eureka/Plaza/6580/tdart03k.html [Accessed July 14, 2002].

²⁰⁸ www.prosperitycapital.com/pdf/MonthlyJanFeb01.PDF

There are also some “specific” Russian problems. Richard Dean²⁰⁹ argues that success of foreign investor on the Russian market frequently depends on the quality of Russian partner. The partner must be honest, willing to learn from the foreign partner, share information with him, not to deal with organized crime. Having “political clout” may be helpful, but it is vastly over-rated (and often ephemeral) as many disappointed Western companies can confirm. Foreign investors must also appreciate how different the Russian business culture. Basic Western business values like communication, cooperation, transparency, efficiency, training, quality control are frequently missing in Russian business experience and must be taught patiently but persistently.²¹⁰

It is obvious that some progress has already been achieved already and there are positive movements. However, what was already done, is not in itself enough to guarantee an improvement in the investment climate and long-term revival of the economy. There are still many problems with financial systems, the high level of mistrust among businesses, and the protection of ownership rights.

²⁰⁹ Mr. Dean is now partner with Coudert Brothers. He founded Coudert Brothers’ Moscow office in 1988 and heads the firm’s Russia practice. Coudert Brothers was the first Western law firm to establish an office in Moscow.

²¹⁰ Richard N. Dean, “*Three Critical Ingredients for Success in Foreign Investment in Russia*” (June 6, 2002); [web page] www.russianamericanchamber.org/newsletter/new_russian_investment_law.html [Accessed May 2, 2002].

Chapter III

The case of Russian beer industry

1. Russian beer industry background

As we already mentioned, beer wasn't popular during Soviet times and was of quite a low quality. There was no competition in the market and thus no stimulus for the production of beer according to world standards. As far as imported beer is concerned, it wasn't widely distributed because of the restrictions in the Soviet trade policy.

Moreover, during the 1980's, Gorbachev announced the struggle with alcoholism (*suhoi zakon*) and limited the production of beer and restricted the production of vodka. As a result, beer almost disappeared from the market. In the 1992-1996 the production of beer remained low because of severe economic policy of the state. The excises were high: up to 40% and beer production even decreased.²¹¹ From 1990 to 1996, the Russian beer consumption fell from 23 liters to less than 7 liters per capita. In 1998, Russia reached the same level of beer consumption which it recorded in 1990.²¹²

The first beer of the new quality appeared on the market in 1993, when Baltika started to produce beer with foreign equipment. In 1997, the Russian beer industry started to grow. The excises were reduced and competition appeared in the market. After the 1998 crises, imported beer became expensive for consumers and Russians shifted to domestically brewed beer. Production of beer increased with 28% during this year. In 1999 the growth was already 33%.²¹³

It is interesting to note that in the early 1990's, imported beer flooded the Russian market. It quickly became popular and was associated with the western way of life. However, Russians now tend to prefer domestic brands. According to estimates by the Central European Economic Review, today only 7 percent of the population

²¹¹ “*Investizionnii potentsial Rossii na rinke pivovarennoi produkcii*”; [web page] www.beerunion.ru [Accessed May 10, 2002].

²¹² “*Industry overview: Brewers*”; [web page] www.corporateinformation.com/rusector/Food.html [Accessed June 3, 2002].

²¹³ Sergey Minko, “*Russian Beer: Trade and Investment Opportunities for American Companies*”; [web page] www.bisnis.doc.gov [Accessed May 5, 2002].

consumes imported beer. Khazbiev says the share of foreign brands on Russia's market dropped from 10-15 percent before the August 1998 crisis to 1-2 percent today.²¹⁴

Another factor stimulating the growth in the Russian brewing industry was the Federation Council veto of a draft law passed by the Duma equating beer with strong alcoholic beverages. The passage of this law would have seen a sharp increase in excise on beer. Sources close to the industry told *The Russia Journal* the beer companies managed to persuade the upper house not to increase the tax burden on the brewing industry until per capita beer consumption reached 50 liters annually.²¹⁵

In addition there is a strong tendency in Russia to support domestic producers appeared. Saint-Petersburg governor Vladimir Yakovlev, for instance launched the program "Made in Saint-Petersburg" to encourage consumers to switch from imported products to locally manufactured goods.²¹⁶

Beer consumption in Russia has also been growing by a constant 15% per year over the past 3 years. The fact that the consumption is growing at a slower rate than production shows that Russian-produced beer is replacing imported beer, specialists from Ernst & Young argue.²¹⁷ However, according to statistical research on consumer behavior in the northwest region of Russia, the Saint-Petersburg beer consumers indicated a high satisfaction with imported beer. The local breweries "Baltika" and "Stepan Razin" shared only second place.²¹⁸

Russia is now one of the prospective and most attractive beer markets in the world. It has captured more than 4.8% of world beer market.²¹⁹ Even the fall of GDP after the 1998 crises did not influence the tendency of growth in the Russian beer industry. Beer in Russia nowadays pushes out strong alcoholic drinks for the consumption market. "If people had more money to buy softer alcoholic drinks they

²¹⁴ Stepan Zotov, "Beer consumption now outpaces that of vodka"; [web page] www.russianjournal.com [Accessed May 10, 2002].

²¹⁵ *Ibid.*

²¹⁶ "Vladimir Yakovlev casts his vote for Petersburg-area producers", *The Russian Journal* (September 9, 2000), No. 35 (78); [web page] www.russianjournal.com [Accessed May 5, 2002].

²¹⁷ "An Eye on Russia", Monthly review (October 2001); [web page] www.ey.com [Accessed May 20, 2002].

²¹⁸ Janna Agasiava, "Statistical research on consumer behavior in the northwest region Of Russia"; [web page] www.bisnis.doc.gov [Accessed May 5, 2002].

²¹⁹ "Investizionnii potentsial Rossii na rinke pivovarennoi produkcii"; [web page] www.beerunion.ru [Accessed May 10, 2002].

would buy less hard liquor and the proportion would change," Mamontov said, adding that the so-called "southern" model of alcohol consumption, in which people give preference to wine and beer over harder liquors, could eventually take over in Russia.²²⁰

The growth is supposed to continue because in Russia consumption of beer per capita is still less than in other countries with similar social conditions.²²¹

Consumption of beer per capita in 1999

Country	Consumption (litters)
Czech Republic	162.7
Ireland	156.6
Belgium	98.2
Netherlands	84.8
Poland	52.3
Russia	29.7

The source: The Union of Russia's Brewers.

Specialists from the Union Of Russia's Brewers also argue that consumption of beer will reach 57-63 litters per capita in 2007.²²² Viacheslav Mamontov, the executive secretariat of the Union says that consumption can increase even to about 70 liters per capita over the next ten years.²²³ Alexei Krivoshapko, an analyst at the United Financial Group in Moscow, agrees that the consumption of beer must increase at least to 60 liters per capita.²²⁴ According to Bravo's commercial director Evgeny Truhin the growth in 2002 will be 18-20%.²²⁵

On the other hand, there are researchers who argue that the market will stop to grow and that is why it is too late for foreign investors to come into the market. However, Sergey Minko, for example, believes that until Russian beer consumption reaches 100 liter per capita, investments in the beer industry offer a relatively fast payback to investments.²²⁶ That is why Russian beer market still have an ability to

²²⁰ Vladimir Kozlov, "Beer consumption in Russian has almost tripled last five years", *The Russian Journal* (December 21, 2001), No. 50 (143); [web page] www.russianjournal.com [Accessed May 20, 2002].

²²¹ *Ibid.*

²²² *Investizionnii potentsial Rossii na rinke pivovarennoi produkcii*"; [web page] www.beerunion.ru [Accessed May 10, 2002].

²²³ Vladimir Kozlov, *op. cit.*

²²⁴ *Ibid.*

²²⁵ Ekaterina Ignatova, *op. cit.*, p. 74.

²²⁶ Sergey Minko, "Russian Beer: Trade and Investment Opportunities for American Companies"; [web page] www.bisnis.doc.gov [Accessed May 20, 2002].

attract more and more investors. The forecasts about decrease in beer consumption were not justified, at least in 2001 the growth was 21%.²²⁷

During the last five years, foreign investors invested over USD 2 billions into the Russian beer market. From the mid-1990's BBH, Sun-Interbrew, SAB and Efes bought and reconstructed more than 20 breweries in Russia, installing modern machinery. In comparison almost all of the 296 Russian breweries are still worse for wear.²²⁸

The big companies have over the past five years made significant investments into production. Now they are primary investing into their distribution networks. The companies that can create more efficient countrywide networks, are likely to be the winners.²²⁹ BBH, for example, is going to invest USD150 millions in Russian beer industry during 2002. They already own 7 breweries in Russia and are going to expand production on their old factories and will buy a new one. Baltika is going to expand its production with 11% and is going to built a new factory in Samara for future exports of beer to China. Baltika accounts for 60% of all beer exported from Russia. Baltika's net profit from exports amounted to USD 17 million.²³⁰ Russian Ochakovo opened a new plant in Krasnodar in 2001, and is going to invest in it in order to increase production. SUN-Intrebrew is going to increase production on "Klinskiy" brewery, this year they will invest USD 50 millions in it. Hasbiev argues that after all of the mentioned investments there will be more beer than can be consumed by the Russian market. And it is difficult to be successful in the market having only one factory. He gives an example that SAB (Zolotaiya Bochka) and Efes (Stariy Melnik) which have only one factory each have been having losses for the last three years.²³¹

Saint-Petersburg is regarded as Russia's beer capital. According to Stuart, breweries represent three of the top 10 investments in the city.²³² Even after 1998 crisis,

²²⁷ Ekaterina Ignatova, "Pivnie hroniki", *Dengi* (July 11, 2001, No. 44 (348).

²²⁸ *Ibid.*

²²⁹ "An Eye on Russia", Monthly review (October 2001); [web page] www.ey.com [Accessed May 20, 2002].

²³⁰ "Baltika Brewery Acknowledged as Best Russian Exporter in 2001"; [web page] <http://www.rosbalt.com/2002/07/01/49528.html> [Accessed May 14, 2002].

²³¹ Aleksey Hasbiev, "Pivnaia dvuhhodovka" (Expert #6, February 12, 2002); [web site] http://www.sostav.ru/index/info_base/product/text_stat.shtml?prod120202 [Accessed June5, 2002].

²³² Stuart, "Europeans have strong presence at Saint-Petersburg beer auction exhibition", April, 1999; [web page] www.bisnis.doc.gov [Accessed May 18, 2002].

these companies continued to enjoy a steady growth in demand, as we mentioned already. The entry of the new brewery Bravo International into an already competitive market is a good evidence to prove this.²³³ Since privatization, most of the consolidation in the Russian beer industry has been carried out through the acquisition of the existing breweries and investment in their renovation. However, the stock of good acquisition targets among medium-sized independent breweries now appears to be nearing exhaustion. New entrants are forced to consider more expensive approaches. These could include buying into existing holdings and starting their own greenfield projects, which are difficult because of various legislative hurdles. Big buyers, on the other hand, are unwilling to pay more for what they still view as Russia's unstable political and economic environment.²³⁴

So, the main trends in the beer market are:

- Intensifying competition and acquisition of smaller breweries by larger ones, or mergers;
- Shift to locally supplied ingredients and packaging materials;
- Increase of draft beer production;
- Decrease of beer importation;
- Licensing of foreign beer brands for production by Russian breweries; and
- Improvement of beer distribution channels.²³⁵

However, there is one more but very important trend on the Russian market – increasing demand for premium beer. The financial crisis has changed the pattern of beer production. Immediately after it, small breweries drastically increased production of inexpensive beer of low quality. Now, as the economy is stabilizing, the demand for premium Russian beer is growing. The sales of well-known brands Bochkaryev in St. Petersburg and Zolotaya Bochka in Moscow increased.²³⁶ Danish brewer Carlsberg announced that it is going also to produce its flagship brand of lager in Russia.

²³³ *Ibid.*

²³⁴ “An Eye on Russia”, Monthly review (October 2001); [web page] www.ey.com [Accessed May 20, 2002].

²³⁵ Sergey Minko, *op.cit.*

²³⁶ *Ibid.*

Especially if we assume that the breweries, rushing to supply Russian's apparently unquenchable thirst for beer, have begun to saturate the market, it becomes obvious that major breweries are starting to think about their future consumers and about their share in the premium beer market. There are also a number of factors which influence the shift. Ramm-Smith of BBH said he believes that the "quality consciousness" of Russian consumers has definitely increased – after 10 years of drinking quality beer (relative to Soviet beer) the population is becoming increasingly discerning in its choices. He also said that there was a definite link between the increased demand for premium beer and the relative improvement in the Russian economy. "But there is a third reason," Ramm-Smith added. "The spending on marketing in the top segment of the market is greater than the combined spending on all of the other segments. There has been a really intensive marketing campaign."²³⁷

Already in 2001 Tinkov, the owner of mini-brewery Tinkoff in Saint-Petersburg said that the consumer market is growing at 25% and if one is not making sales now, will never do it. "We have increased prices three times recently, and demand is continuing to soar", he said.²³⁸

However Heineken's officials argue that in Russian there are only few companies which can produce premium beer. And particularly this segment of the Russian market is their main goal.²³⁹ It is important to note that the biggest section of consumers is still oriented on the low prices beer. It can be explained by the difference in income level in Russian big cities and regions. For example, in some regions the consumption of beer is 17-20 liter per capita.²⁴⁰ According to some researchers this situation won't change soon.²⁴¹ As for the brewers, it is more profitable for them to produce premium beer, because the excises are the same for cheap Zigulevskoe and more expensive Bochkarev, for instance.

²³⁷ Michael Heath, "Danish Brewer Carlsberg says it may start producing its flagship brand of lager in Russia starting later this year", *The Russian Journal* (No.23 (116), June 15, 2001); [web page] www.russianjournal.com [Accessed May 15, 2002].

²³⁸ *Ibid.*

²³⁹ Interview with Jan van de Merbel, Heineken's investor's relations specialist. June 25, 2002, Amsterdam, The Netherlands.

²⁴⁰ Ekaterina Ignatova, *op. cit.*, p.73.

²⁴¹ "Spros na pivo"; [web page] <http://www.tmn.ru/~soyus/pivo.htm> [Accessed May 16, 2002].

2. Government regulation of the Russian beer industry

State regulation was an important factor for developing the Russian beer industry. During the early 1990's, the taxation of beer production was 70-80% from revenues. In addition beer production was treated the same way as alcoholic drinks. Moreover as there was no clear tax legislation on breweries taxation they were frequently taxed by local authorities.²⁴²

During 1998-2000, the state regulation of beer industry was reduced and the results quickly appeared. If, for example, excise on the beer in 1996-97 was 40%, in 1998 it was reduced to 15%. An important step was also the exclusion of beer from the alcoholic commodities and thus cancellation of the special marking rules for beer.²⁴³ All these measures let brewers to increase capital recovery factor.

In 1993-95, 50-80% of all imported beer was passed through different kinds of privilege channels in order to reduce customs duties. Such channels were National Sport Fund and Moscow Patriarchy, for instance. Holsten and Bavaria were the main brands of privilege entry.²⁴⁴ Of course, it led to criminalization of the industry.

Last year the Federation Council vetoed a draft law passed by the Duma equating beer with strong alcoholic beverages. Russian beer producers managed to persuade the Duma deputies not to increase the tax burden on beer until annual beer consumption rate per capita reaches 50 liters. Specialists believe that this will attract foreign investment to help renew aging production equipment at breweries.²⁴⁵

Gennady Seleznev, Russian Duma's speaker said that it is important to support the beer industry on a legislative level.²⁴⁶ In order to do this, a group of directors of largest beer and non-alcoholic producers had in March 1999 promoted a working group in the Duma. The main idea of forming this group has be to assist Russian breweries on legislative level. They are lobbying for laws that would provide stable excise taxes and

²⁴² *Ibid.*

²⁴³ *Ibid.*

²⁴⁴ Ekaterina Ignatova, "Pivnie hroniki", *Dengi* (July 11, 2001, No. 44 (348), p.72.

²⁴⁵ Sergey Minko, *op. cit.*

²⁴⁶ "Imperia piva"; [web page] www.samara.ru/paper/41/2483/36190 [Accessed May 28, 2002].

lower import tariffs on imported ingredients for beer production. Sergey Nigkoev, Deputy Chairman of the Committee on Agrarian Questions, lead the group.²⁴⁷

One more example of State intervention into the industry could be the “attack” of the State Sanitary Supervision (*gossanepidnadzor*) and its head Gennady Onishenko. He proposed to once more treat beer as a strong alcoholic drink and to prohibit the advertisement of the beer on television.²⁴⁸ Brewers tried made their best to prevent it: they attracted cultural leaders and pop-stars. It took longer than two hours for the head of Health Ministry Shevchenko to make Onishenko to cancel his proposals.

Among the most recent regulations we would mention the amendments to the law “On advertisement” which were accepted by the Duma in April 2002, which are aimed at changing the advertisement rules for beer and mixed drinks. The brewers were in panic. First of all they eliminated Sun-Interbrew from the Union of Russia’s Brewers, because their advertisement was directed on teenagers. It is important to note that advertisement is very important for beer marketing. For example, Heineken’ officials are sure that their success depends to a large extent on their marketing know-how.²⁴⁹ Advertisement budgets of beer companies are very high: Bravo, for example has USD 31.6 millions only for its brand Bochkarev.²⁵⁰ According to the new amendments it is actually possible to prohibit any advertisement of beer.

As an example of the beer industry’s lobby in the Duma we should mention the draft “On the Fundamentals of State Regulation of Industrial Production and turnover beer in Russian Federation”. The draft included the definition of beer, governmental powers in the field of beer industry, its support of it, the rights and duties of brewers.²⁵¹ However, the draft is only introduced to the Duma.

It is important to note that the Duma is now considering some amendments to the law “On excises”. According to them excises will be increased dramatically on the beer, tobacco and gasoline, the estimated increase would be up to 25%.²⁵² Of course it

²⁴⁷ Sergey Minko, *op.cit.*

²⁴⁸ Ekaterina Ignatova, *op. cit.*, p.73.

²⁴⁹ Interview with Jan van de Merbel, Heineken’s investors relations specialist. June 25, 2002, Amsterdam, The Netherlands.

²⁵⁰ Dmitry Dobrov and Timur Borduk, “Pivo s zenzuroi”, *Dengi* (April 24, 2002), No. 15-16, p. 28.

²⁵¹ www.beerunion.ru [Accessed May 9, 2002].

²⁵² “Rossiskie pivovari predskazivaut volnu razorenii sredi otechestvennih proizvoditelei” (June 13, 2002); [web page] www.lenta.ru [Accessed June 13, 2002].

would be a serious problem for Russian brewers, which argue that it is the “vodka” lobby. The fact proves that producers of vodka started to worry about the tendencies on the Russian market. Viacheslav Mamontov, the head of Union of Russia’s of Brewers argues that adoption of these amendments would lead to the bankruptcy of small breweries and a decrease in beer production.²⁵³

Sashin, the head of economic and industry committee of Saint-Petersburg Administration, argues that the main barrier for investors in Russia is customs. For example, investors have to pay for the equipment they are importing and are thus placed in an uncompetitive position with domestic producers.²⁵⁴

Of course, the government regulations can influence the tendencies in the beer industry quite a bit: changes in taxation, advertisement rules and rules of trade form the cornerstone thereof. However, the players on the Russian beer market are very big and rich and they already have some practice of lobbying their laws. We should not forget that the beer capital of Russia is Saint-Petersburg and the Russian President is a good friend of the city.

3. Situation on Bravo and Baltika before the investment/privatization

Baltika brewery was built according to the “Gipropisheprom-2” project as one of the factories of “Lenpivo”-Leningrad’s association of beer and drinks industries. It previously consisted of 6 breweries which were poorly organized and could not produce high quality beer. The production on the old factory had to be stopped and reconstruction was urgently needed.

In 1978 the construction of the new factory began and in 1990 “Baltika Brewery” appeared. In November 1990 it already produced 27 thousands liters of beer. At this time it produced famous in USSR “Zigulevskoe”, “Rizskoe”, “Admiralteiskoe”, and “Prazdnichnoe”.²⁵⁵

Bravo Holding Limited is a Cyprus company, organized as a limited liability

²⁵³ *Ibid.*

²⁵⁴ <http://www.et.dux.ru/arts/et-289-art-28.html> [Accessed May 20, 2002].

²⁵⁵ www.baltika.ru [Accessed June 13, 2002].

company, according to Cyprus legislation. In 1993 it formed a closed joint stock company (*zakritoe akzionernoe obshestvo*) in Saint-Petersburg, Russia. Lately it was reorganized to “Bravo International”. The owners were Magnus Torsteinsson and Thor Bjorgolfsson – two businessmen from Iceland (the last, is now a consul of Iceland in Russia). From the beginning Bravo International was producing only mixed drinks in Saint - Petersburg. They produced the first bottle of beer only in 1998 with the financial support from Capital International Global Emerging Market Private Fund, which distributed its shares on the western markets, and bank credits.²⁵⁶ There were involved USD 100 millions in organization of beer production on Bravo. Around USD 50 millions were invested by shareholders; the International Financial Corporation together with syndicated European banks gave USD 40 millions, Sberbank gave USD 10 million credit. A Syndicated loan was made by Raiffeisen Zentralbank Osterreich AG.²⁵⁷ The loan was given for seven years and the interest rate was not divulged. Thus the shares of the company were distributed among the Capital International Fund and Iceland businessmen. They owned 45% each. Other 10% were owned by managers of the company.²⁵⁸

Bravo became the fastest growing brewery in Russia, however it stands only in 9th place in the list of the biggest Russian breweries. After three years of doing business they gained a 17% market share in the Saint-Petersburg region.²⁵⁹ 1600 people were employed at the factory. It is true that Bravo shows a major tempo of growing, however their revenues are not very big: according to the “Expert- 200” rating their sales in 2000 were only 2.3 billion rubles (Baltika had four times more). And capital recovery factor was quite low – 8.2%.

Bravo International produces four brands: Ohta, Botchkarev, Oblomov and the Lowenbrau brand which is brewed under license. In 2001 Bravo sold 2.5 million hectoliters beer and 400000 hectoliters mixed drinks. For 2002 they expect a beer volume to 4 million hectoliters.²⁶⁰ It is interesting to note that Production facility is not very important for Heineken, as Jan van de Merbel argues. He is sure that even on small

²⁵⁶ Aleksey Hasbiev, *op. cit.*

²⁵⁷ “Bravo narashivaet moshnosty”; [web page] www.beerunion.ru [Accessed April 4, 2002].

²⁵⁸ www.slavutich.lg.ua/aboutbbh/ [Accessed June 12, 2002].

²⁵⁹ Press release, “Heineken gains a foothold by acquiring Bravo International” (Amsterdam, February 1, 2002); [web page] www.heineken.corp.co.../ [Accessed May 20, 2002].

²⁶⁰ www.botchkarev.ru/eng/ [Accessed June 5, 2002].

factory, you can reach a high enough level of production. The most important elements are quality and the development of brands.

Actually, Bravo became famous in Russia for its brand “Bochkarev”, which was well developed. There are 7 kinds of “Bochkarev”: “Svetloe”, “Temnoe”, “Krepkoe”, “Osoboe”, “Marochnoe”, “Bochkovoe”, “Pshenichnoe” and “Bezalkogolnoe”. Bochkarev is No.2 beer brand in Russia and No.1 beer brand in the local premium segment, according to Merrill Lynch report.

They built new plant, bought new machines from the German company “KHS mashinen”. They build a big nice office in Saint-Petersburg, they had a lot of advertisement all across, actively took part in different contest and festivals. Everything was going fine, but the owners decided to sell the factory.

3.1. Conclusion

We have two absolutely different companies. One is the Soviet organized type, which was poor developed, had no marketing policy, modern equipment. Which appeared when nobody cared about beer or its quality in fact. It was, like almost all in Russia, just one part of the planned system. On the other hand, we have Bravo, which appeared much later, when the market was already developed and had big producers in it and thus competition. The previous management developed brands, policy of the company. Bravo already had connections with suppliers and consumers, all kinds of licenses. It had its own place on the Russian beer market. And the situation on the market is absolutely different. We can classify it as a successful company, since they started so late and still managed to push apart other producers.

4. Change of ownership

Why did Bravo’s previous owners decide to sell the factory? Maybe it is not difficult to enter the market, but to operate in it? Lawyers from Bravo think that the reason is that the beer industry required constant investments all the time, and they did not have sufficient funds.²⁶¹ It is difficult to agree with this point of view, because you

²⁶¹ Interview with Tatiana Odabashian Bravo’s lawyer, made by Zolotareva Olga. Saint-Petersburg, June 3, 2002.

can borrow money, issue bonds, take credit. It seems it is not a justifiable reason for selling the company. Last year Bravo managed to borrow from Douche Bank, ABN Amro Bank, Dresden Bank, Petrovskiy Bank quite successfully. All this money was put into the production process. According to Heineken's officials they really decided to start new business in Russia. It is something related to pharmaceutical business. "These guys are risky ones, real entrepreneurs"- Jan van de Merbel argues.²⁶²

Maybe they sold Bravo, because the price really was very good and the company was not so good, or it happened because of some risks, they realized for their money? Maybe the reason is the obstacles created by the Russian sanitary inspection? Then we can say that Government, first, in a way helped to make shift from vodka to beer, stimulating beer industry, and then, with the case of the draft legislation proposed by Onishenko create obstacles. "It is the effect of life, what can we do?"- Jan van de Merbel points.²⁶³ We would remember, that we have now in the market Sun-Intrebrew, SAB, Anhausen Bush, Miller, Heineken and for all of them, with their financial possibilities and lobbies, this sanitary Gennady Onishenko is nothing. Andrey Bushev argues that in the beer industry, as well as in economy of the country as whole, the repetition aspect plays its role.²⁶⁴ The industry very quickly developed and now a period of calmness must come. "That is why the owners decided to sell the company now in order to earn good profit", Bushev argues.

So, in the end of 2001 year, beginning of 2002, Bravo invited the world known financial company Merrill Lynch to provide an expert analysis of the company and to help them to find a buyer.²⁶⁵ They "checked" the company according to the "Due diligence" program.

The term "Due Diligence" is used to describe a process of acquiring objective and reliable information on a person or company prior to a specific event. Often the information is customized to ensure that it meets the client's needs.²⁶⁶ It helps to take informed decisions and to avoid culpability or negligence. In our case, the type Due

²⁶² Interview with Jan van de Merbel, Heineken's investors relations specialist. June 25, 2002, Amsterdam, The Netherlands.

²⁶³ *Ibid.*

²⁶⁴ Telephone interview from Saint-Petersburg with Andrey Bushev, Vena Brewery's senior lawyer, July 5, 2002.

²⁶⁵ "Heineken" kupil "Bochkareva", *Financial Times* (February 5, 2002); [web page] <http://www.inopressa.ru/details.htm?id=7001> [Accessed April 20, 2002].

²⁶⁶ www.nationalfraud.com [Accessed June 5, 2002].

Diligence information that is important to us is Basic Personnel (verifications, refreshing personnel files, credentials) and Mergers and Acquisitions. The information is obtained through different sources and interpreted by highly skilled investigative stuff.

They gathered and systemized information about the company, analyzed conditions of the machineries, risks, trade marks, actives, previous judicial disputes of the company, made financial analyze. They drew a conclusion on the cost of Bravo. Attention was mainly paid to country risks, because everything is in order with Bravo by itself, Odabashian argues.²⁶⁷

Merrill Lynch negotiated with potential investors and consulted both parties. However all parties kept silence about these negotiations, even Heineken. When the talks about the sale of Bravo appeared in summer 2001, Thor Bjorgolfsson said that he is not going to sell the Russian business.²⁶⁸ Bravo's competitors, at this stage, doubted the attractiveness of this company and were saying that it is just self-advertisement. And these talks in the press were only needed in order to give them more softer conditions in negotiation with the credit organizations.²⁶⁹

It is well known that rumors can play a big role in especially financial markets. For instance, in December 2001 there was information in the press that Interbrew is going to buy SAB. Interbrew said that it is really possible, however this project is only on its initial stage. After this Intrebrew made an official statement that all this information is incorrect and was imagined by an unknown author. On the day of the publication SAB's shares of SAB increased with 8%.²⁷⁰

Among the contenders for buying the company were: Heineken, South Africa Brewery, Sun Inter Brew. The Merrill Lynch report was send to all the companies together with their offer. After getting acquainted with the documents the companies send their counteroffers. The conditions of Heineken's proposal were most appropriate for Bravo, that is why they choose it. And in December 2002, the deal was concluded.

²⁶⁷ Interview with Tatiana Odabashian Bravo's lawyer, made by Zolotareva Olga. Saint-Petersburg, June 3, 2002.

²⁶⁸ "Gazeta nashla pokupatelia Bravo", *Vedomosty*, (December 18, 2001).

²⁶⁹ *Ibid.*

²⁷⁰ *Ibid.*

The documents in their totality were prepared by Dutch lawyers. It is clear why “previous owners” of Baltika decided to “sell” the company. As we already mentioned the situation in the Russian beer industry was quite difficult in the early 1990’s and Baltika, like many others, was privatized. The factory was reorganized into OAO Baltika (Join Stock Company). 28 legal entities and more than 2000 private persons became shareholders of the company. The share capital of Baltika equals RR120.572.800. It is divided on 107.087.200 ordinary and 13.485.600 privileged shares. The control package (75%) is holed by Baltic Beverages Holding AB. The remaining 25% of shares are held by the management and employees of the company. This is a good financial stimulus for them.²⁷¹

4.1 Conclusion

Privatization of Baltika was governed by the government, so, investors faced all this problems with unclear legislation, risks, briberies. The selling of Bravo was done by its previous owners. The information about the future of the company is usually kept secret, like in our case. Bravo’s owners realized that in order to sell their company well they have use international practices and consultants. The involvement of Merrill Lynch, shows that in Russia mergers and acquisitions practices are quite developed and constitute world’s standards. It is It is interesting to note that according to Dan & Bradstreet – Nord any “due diligence” done in Russia are made in the interest of the Russian firm. That is why they worked out their own program rating system which helps to estimate the risks of doing business with a company. However in hundred of the lead companies of Saint-Petersburg, Bravo International took 42nd place, while the year before nobody paid attention to it.²⁷² It proves the report results of Merrill Lynch on Bravo International.

5. Investors background

BBH was established by Scandinavian beer companies specifically for investment into the former USSR territory. Participants during the first stages were: the

²⁷¹ <http://www.slavutich.lg.ua/aboutbbh/> [Accessed June 12, 2002].

²⁷² “Shestero iz “zolotoi” sotni” [web page] http://www.courier-media.spb.ru/42/dist7_news.html [Accessed May 20, 2002].

Swedish firm PRIPPS, the Finish HARTWALL GROUP and the Norway RINGNES²⁷³. BBH is a Swedish registered company located in Stockholm.

It is interesting to note that BBH acquired first only 43.5 percent of shares in Baltika. Two years later, BBH had increased its stake to 75 percent. The company installed new equipment at the brewery, making Baltika the first Russian beer manufacturer to produce large quantities of quality beer with a long shelf life. The move quickly made the brewery Russia's market leader.²⁷⁴

The main strategy of BBH, according to its CEO report is acquiring majority interests in local breweries with local brands and management. After acquisition they improved the technology, producing beer of western quality and developing personnel.²⁷⁵

BBH very quickly became a leader in the Russian beer industry. In order to achieve that, they have invested USD 3.4 billion since 1991 in Eastern European breweries. From 2000 onwards they started to invest in existing breweries to expand capacity and improve quality of the beer. The new strategy is aimed at new acquisitions secure geographical coverage in the most highly populated areas (currently there are as Samara and Khabarovsk. The consumption of beer is very low in these regions and it will give them a possibility to import beer to China).²⁷⁶ BBH also holds a large proportion of "Vena" and other Russian breweries. Nowadays BBH controls 33% of the Russian beer market.

Heineken N. V. is the most internationally known brewer in the world. Its brands are sold in more than 170 countries and the company owns over 110 breweries in more than 50 countries. In 2000 net turnover amounted to EUR 8.1 billion and net profit to EUR 621 million. Heineken employs over 40.000 people. Heineken's family holds 56% of Heineken Holding N.V. and 50% of Heineken N.V. other shares are in a free float.

²⁷³ http://beer.spbnews.ru/baltica_history.html [Accessed June 12, 2002].

²⁷⁴ Dmitry Dobrov, "Who owns Russia: Food, beverages and cigarettes"; [web page] www.russianjournal.com [Accessed June 10, 2000].

²⁷⁵ <http://reports.huginonline.com/hugin/759374.pdf> [Accessed June 12, 2002].

²⁷⁶ "An Eye on Russia", Ernst & Young (CIS), Monthly review. October 2001 Limited; [web page] www.ey.com [Accessed June 10, 2002].

Heineken takes 3rd place in the world on beer production. It is known as one of the richest and “slowest” in the beer world market. Vice president of “Baltika” - Russian biggest beer company Adam Tlehurst, argues that Heineken in itself is not satisfied with its strategy development department. It does not give enough attention to international beer markets, not buying beer factories.²⁷⁷ However Heineken considers its position as an “excellent sustainable financial performance achieved by marketing of strong local and international brands with the emphasis on the Heineken brand and through a carefully selected combination of broad and segment leadership positions”.²⁷⁸

The British beer company Bass Brewers can serve as an example. Dutch started negotiations with them, but the Belgium giant Interbrew intervened and quickly bought it. As a result, Heineken, which in 2000 only was in the second place in the world after Anheuser Bush, was pushed by Interebrew to the third place. Trying to return to its previous position, Heineken was going to buy Australian beer company Foster’s Brewing Group for the USD 7.9 billion.

According to the beer business specialist of the UFG Bank Aleksey Krivoschapko, their slowness leads to more expenses for them. Heineken usually comes last on the emergency markets and pays more than others.²⁷⁹ It was the same in Spain, Poland, and maybe in Russia? On the other hand, maybe Heineken’s “carefully selected combination” seems “slow” to its competitors?

However Heineken’s brands were in the top ten international brands in 2001. They produce 18.6 million hectoliters of beer. To compare, the closet competitor Carlsberg produces only 8.9 millions hectoliters.²⁸⁰

Jan van de Merbel does not agree with Krivoschapko: “We can not work everywhere in one moment” – he said. On the other hand, Heineken is better developed on other markets, where the competitors are weaker. Yes, one can enter market, so what? One can enter the market and lose money then. There must be a good return.

²⁷⁷ Aleksey Hasbiev, *op. cit.*

²⁷⁸ “Heineken gains a foothold in Russia by acquiring Bravo International”, Heineken’s NV press release, Amsterdam, February 1, 2002.

²⁷⁹ *Ibid.*

²⁸⁰ Investor Relations Presentation, Heineken N.V. and Heineken Holding N.V., June, 2002.

Price considerations are also important. If the price of the factory is too high, Heineken will never buy it.²⁸¹

Heineken's strategy is to combine the power of local and international brands. But its strategy includes other two items: a carefully selected combination of broad and segment leadership positions, and a focus on cost structure.²⁸²

However, Heineken is sometimes "too careful", for instance during 1993-96 they agreed with Carlsberg not to behave "aggressively" in the each other countries. The European Commission is still deciding whether to penalize them or not. The penalty can be 10% of the annual turnover of the companies.²⁸³

While all of the biggest beer companies – Sun-Interbrew²⁸⁴, SAB, BBH and Efes were already on the market, Heineken just began to pay attention to the Russian beer market, while the others already had invested USD 2 billion into the Russian beer market. Hans-Kristian Jacobsen, EBRD specialist, argues that this money "made a miracle". Russia was a big empty market with old - fashioned factories and beer that nobody wanted to drink anymore. It was cool to drink imported beer, and the cans became decorations in many Russian kitchens. Investors bought factories ones and built new ones, bringing new machines, equipment and technologies.

The motives for entering the market coming were obvious: the Russian beer market was annually growing by 30%. In 1999 the four western firms together with "Ochakovo" controlled almost three quarters of the Russian beer market. However it was still not too late to come on the market without huge expenses. May be Heineken could build a new factory or modernize an old one this time and produce domestic brands like many others.

²⁸¹ Interview with Jan van de Merbel, Heineken's investor's relations specialist. June 25, 2002, Amsterdam, The Netherlands.

²⁸² Investor Relations Presentation, Heineken N.V. and Heineken Holding N.V., June, 2002.

²⁸³ "Carlsberg and Heineken can be punished by European commission"; [web page] <http://www.slavutich.lg.ua/aboutbbh/> [Accessed May 29, 2002].

²⁸⁴ Interbrew, a Belgian beer company, and Sun Group, the biggest beer producers in Russia after Baltika, formed the Sun-Interbrew joint venture, which took over nine breweries in Russia and Ukraine. Analysts coined it "the biggest merger in the history of the Russian beer industry." The union was logical — Sun lacked the money to carry out reconstruction of its six breweries, while the Belgians had come to the Russian market too late, and managed to buy only one production facility, the Posar brewery in Omsk, and sign an agreement to buy the Klinsky brewery.

5.1. Conclusion

Both companies are without doubts international. They both combine international and domestic brands. However BBH was among the first investors on Russian market and played a great role in its development. Moreover BBH was especially organized for investing into former USSR countries. We conclude that they have some know-how of doing business in this territory. Maybe it helped them to enter the market earlier. Heineken is working all over the world and have much more money. Both companies prefer to work with domestic management. For transitions it is clear, that foreigners face some problems with doing business in their business environment, traditions, customs and thus prefer to work with Russian management in our case.

6. Entry choice considerations

BBH was one of the first investors to enter the Russian beer market. Heineken arrived much later. What are the reasons determining the time and the mode of entry? Why do some companies prefer to acquire a company in the target state, some to open a new one, for example? There are different factors which influence a firm's choice. "Entry choice" or "entry mode" makes possible the entry of a company's products, technology, human skills, management or other resources into a foreign country.²⁸⁵ The determining of the entry mode is one of the most important decisions facing managers, because success of a company depends on the right choice.

The most important issues underlines the choice are levels of control, dissemination of risk, resource commitment, and the flexibility that each mode possesses.²⁸⁶ These all refer to the company which is going to enter the market. We can also add know-how, product differentiation and the international experience of a firm. However, there are some local factors also such as country risk, government policies, and socio-cultural distance, which means similarity in businesses, industrial practices, language, and education level. Socio-cultural distance discourages investment because

²⁸⁵ Driscoll, M. and Paliwoda, S, "Dimensionalizing International Market Entry Mode Choice", *Journal of Marketing Management*, 1997, 13, p. 58.

²⁸⁶ Anderson, E. and Gatignon, H, "Modes of Entry: A Transaction Cost Analyses and Propositions", *Journal of International Business Studies*, Fall 1986, pp. 1-26.

of the difficulties involved in transferring marketing, technology, and human resources to socio-culturally different markets.²⁸⁷ It was found to have significant influence on a firm's choice. Country risk refers to unpredictability in the social, political and economic environment of the host country.

Driscoll and Paliwoda provide a very clear systematization of possible entry modes and their determinants.²⁸⁸ They identify three modes: investment; contractual and export modes, differentiated by four dimensions: control, dissemination risk, resource commitment and flexibility.

The first is export, when the firm manufactured products in its home country and then export it the host market. High risk countries are more likely to be entered through the export mode, for example. A company is quite flexible in this case; however the level of control is low, of course, as well as dissemination risk and resource commitment. The second is contractual, which includes licensing and franchising. The last one is investment, which may be made through acquisition, mergers or Greenfield projects. Acquisitions allow firms to enter the market quickly and gain access to an already developed network. The investment mode can be characterized by a high level of control and resource commitment, but low levels of dissemination risk and flexibility. It is obvious that the most important aspects of choice considerations are resource commitment, control and dissemination risk.

Moving to underlying dimensions of mode choice, let's start from control. The value of control gives a firm an opportunity to respond accurately to the need of the market and to respond to the moving of competitors. Actually different entry modes imply different levels of control. It is clear that investments give high control, and exports can be characterized by a low level of control.

The dissemination of risk is the possibility that the firm specific advantages will be expropriated by a counterparty. For some companies this question is very important, that is why preventing a leakage of information can be an important element in the company's strategy. Hill and Kim argues that the greater risk of dissemination of

²⁸⁷ Driscoll, M. and Paliwoda, S. op. cit., p. 73.

²⁸⁸ *Ibid.*, p. 59.

the firm's knowledge assets, the more likely it is that the firm will serve foreign markets through investment entry modes such as wholly owned subsidiaries.²⁸⁹ Licensing, for instance, creates high dissemination risk.

The resource commitment refers to the financial, physical and human resources that a firm need to enter a foreign market. It is closely linked to asset risk expropriation and currency risk, because it depends on the volume of the resources a company brings to the foreign market. It is obvious that in order to open a subsidiary one has to transfer equipment, people – this is much easier, from that point of view, if you are dealing with licensing, for instance.

One more dimension is flexibility. It is an ability of a firm to change entry modes quickly and with minimal costs, depending on circumstances. In order to maintain flexibility, a company must organize its formalization properly and control its resource commitments. It will help to adapt to changing circumstances. It is important to note, that circumstances can change in a manner in which it will worsen the company's situation as well as favors a greater presence. Accordingly, the most flexible entry mode is exports.

Driscoll and Paliwoda argue that socio-cultural distance, tacit know-how and product differentiation – are found to significantly influence separate choice dimensions²⁹⁰.

Early movers, by their mere presence, provide a strong example to other investors that operations in such an environment are feasible. These are especially important to states which just opened their borders and want to attract investors.

Rojec, for example argues that the choice of FDI modes generally falls into two main categories, either greenfield or acquisition. He proves that “in principle, no modality is better or worse than others; all modalities depend on individual intentions

²⁸⁹ Driscoll, M. and Paliwoda, S, “Dimensionalizing International Market Entry Mode Choice”, *Journal of Marketing Management*, 1997, 13, p. 66, citing Hill, C. and Chan Kim, W, “Searching for a Dynamic Theory of the Choice of International Entry Mode”, *Strategic Management Journal*, 9, pp. 93-104.

²⁹⁰ *Ibid.*

and circumstances”.²⁹¹ However, an investor should be aware that the choice of entry modes in many ways influences the success or failure of the venture.

In the case of the greenfield FDI project, the option is between either a wholly-owned subsidiary or a joint venture. A wholly-owned subsidiary occurs when a foreign organization establishes a local firm that is 100 percent owned and controlled by it. Joint venture is a cooperative effort between two or more organizations, which are participating beyond a mere investment in the decision making activities.²⁹²

In the acquisition mode there are four main alternatives: joint venture acquisition, equity increase, share acquisition, or asset acquisition.²⁹³ The research made by Robert Pye, who analyzed a number of firms in Eastern Europe, proves that there is almost equal distribution between the use of both greenfield and acquisition modes. It is interesting that, according to his analysis, there is a trend of foreign organization increasing their shareholding positions over time from minority and equal positions towards majority and full control. The trend shows that investors are careful. They do not tend to invest huge amounts immediately. On the other hand, investors were cheated by the same possibilities in Russia, for instance, when because of increasing shareholding positions of Russian counterparty, an investor lose its voting power.

Specialists argue that the acquisition modes of FDI are used to accelerate the process of establishing the local operations in countries where the level of stability is viewed as being more positive.²⁹⁴ The acquisition mode was used by Heineken, so can it be a proof that a certain level of stability in Russia is already established. Moreover, it is much easier to acquire an ongoing business, than to start a new business. Domestic managers have a deeper knowledge of local markets, familiar with suppliers and customers.

²⁹¹ Rojec, M., Jermakovich, W.W., “*Foreign Acquisition Strategies in the Central European Privatization Process*”, Working paper, Center for International Cooperation and Development, Ljubljana, Slovenia, 1995.

²⁹² “Foreign Direct Investment in Central Europe: Experience of Major Western Investors”, *European Management Journal*, Vol. 16, No.4, August 1998, p. 385.

²⁹³ For the definitions see: “Foreign Direct Investment in Central Europe: Experience of Major Western Investors”, *European Management Journal*, Vol. 16, No.4, August 1998, pp. 385-386.

²⁹⁴ “Foreign Direct Investment in Central Europe: Experience of Major Western Investors”, *European Management Journal*, Vol. 16, No.4, August 1998, p. 388.

But why did Heineken buy the factory in Saint-Petersburg and not in one of the Baltic republics which are only five minutes by bike? One of the reasons for companies to invest abroad, is the location advantage.²⁹⁵ Location advantage explains the factors which reduce the cost of organizing production in a host country relative to the cost of exporting the product from the home country of the investor. Bravo was attractive, because of the Russian beer market, first of all, because of its brands, modern machinery, and location of near growing consumers markets. The most important feature of location advantage, in our case, is demand. Demand conditions in a market can have a big impact on the entry mode chosen, because it is clear that FDI will be preferred only when the cost of serving a market through exports exceeds the cost of production in the foreign market.²⁹⁶

According to J. Paliwoda, government policies and regulations, size of the firm, and corporate policies also influence the choice of an investor.²⁹⁷ Talking about government policies we have to mention intellectual property, transfer pricing, labor, competition, trade and investment policies. As to location factors, they are determined by market attractiveness, socio-cultural distance and country risk.

There are factors, which refers specifically to a firm that is going to enter the market. It can be know-how and experience or strategic considerations. Experience includes experience of managers, and thus of the firm. If a company is working with international markets, like Heineken, for example, it is easy for them to enter one more market. The experience can be also relevant to one particular market. The provision in the contract between Heineken and Bravo's previous owners prohibit them to use money received for building a new brewery in Saint-Petersburg, because Heineken know that they can easily do it, and become their competitors. International experience helps to reduce different risks and increases the likelihood of the firm to use investment entry mode and choosing an acquisition than a joint venture, for example.

It is interesting to note that according to Driscoll, the nature of the company's know-how can be tacit. It means that companies hardly can determine it in the contract. It is some special knowledge which is difficult to even explain or put into words.

²⁹⁵ "Law and the regulation of foreign direct investment: the experience of central and eastern Europe", [web page] www.lexis-nexis.com [Accessed March 18, 1999].

²⁹⁶ Driscoll, M. and Paliwoda, S, *op. cit.*, p. 73.

²⁹⁷ Paliwoda J. and Ryans J., ed., *International Marketing Reader* (London, 1995), p.21.

Actually this reason is called among the basic determinants of FDI, namely, the possession of firm-specific advantages in certain areas. The difficulties and costs involved in transferring tacit know-how provide incentive to use investment mode, of course.

Imperfections in goods, economies of scale and government intervention are reasons which encourage firms to invest directly. Product differentiation, pricing, discrimination in access to capital and restrictions on market entry make FDI a preferred strategy to other forms of entry.²⁹⁸

Political and economic conditions are the main determinants of market entry choice in our opinion. Political and economical instability increases the risk of asset expropriation and nationalization. In Russia, political and economic chaos, conflict with Chechnya, bureaucratic business climate serve to discourage foreign investments.²⁹⁹ Contractual arrangements are frequently breached and it is difficult to enforce against a counterparty. That is why Poliwoda concludes that the primary option available for Russia is exporting. However, time is moving and changes are visible. The new Russian President and legal reforms lead to the replacement of political risk by commercial risks as the major concern for exporters

Poliwoda also argues that in Eastern Europe the dividing lines between acquisition, privatization and joint ventures are becoming blurred. Acquisitions lead to privatization, and joint ventures can lead to eventual acquisition.

Why did Heineken buy Bravo? If they wanted to come into the Russian market why they didn't built new factory? Baltika's factory director, Bolloyev said that it takes too much time from building a factory to the appearance of the first beer bottle of beer. It can take 3 to 4 years. And it was a great deal for Heineken because everything was working already. Bravo's lawyer Odabashian takes the same point of view. Dutch counterparty basically also agrees with beforementioned.

²⁹⁸ Driscoll, M. and Paliwoda, S, "Dimensionalizing International Market Entry Mode Choice", *Journal of Marketing Management*, 1997, 13, p. 70, citing Hymer, S., 'The International Operations of National Firms: A Study of Direct Foreign Investments', *Doctoral Dissertation*, Massachusetts Institute of Technology, 1976.

²⁹⁹ Paliwoda J. and Ryans J., ed., *International Marketing Reader* (London, 1995), p.26.

According to Jan van de Merbel, Heineken was discussing some other possible target breweries. First they were going to work together with Wimm Bill Dann (WBD) in Russia. WBD already has some experience in the Russian beer market. They acquired a controlling stake in Nizhny Novgorod brewery “Volga”. WBD also bought shares in the “Pivindustria Primorya” and “Moskvoretsky” brewery. All three companies were united to form the TsEPKO holding.³⁰⁰ Heineken was looking for other opportunities to enter Russian market. The biggest problem for entering and operating on Russian market is organized crime, Jan van de Merbel argues. Heineken do not want to deal with it. This was among the reasons of why Heineken choose Bravo. It seems separated form the criminalized Russian beer industry.

Vitaly Maslov gives an interesting example of how a Turkish beer producer entered Russian beer market.³⁰¹ The construction of “Kniaz Rurik” brewery started in 1993 in Moscow and the huge amounts of budget money were invested in it. Azerbarzany Aga-Ragim Dgafarov became a director of the newly building brewery. A considerable amount of invested money went the “wrong way”. And “by chance”, almost at the end of the construction, Efes Beverages appeared, which after investing a small amount in order to complete construction and obtained 90% of the brewery. He concludes that Russians are drinking Russian beer, produced by Russian brewers in Russia, but all revenues go to foreigners. “Is it insulting?”, Maslov asks.³⁰²

6.1. Conclusion

We agree with Rojec that “in principle, no modality is better or worse than others; all modalities depend on individual intentions and circumstances”.³⁰³ On the one hand, Heineken has international experience and it already acquired breweries all over the world and it must be easier for them to acquire one more. BBH was one of the first movers into the Russian market and can serve as an example for other investors, that it is possible to enter the market and to do business in it. However, they took a big risk. Heineken is much more careful.

³⁰⁰ Dmitry Dobrov, “Who owns Russia: Food, beverages and sigarets”, *The Russian Journal* (No. 42(135), October 10, 2001); [web page] www.russianjournal.com [Accessed May 2, 2002].

³⁰¹ Vitaly Maslov, “Ch’e pivo p’em?”, *Vladimirskiy Rubez* (March 13, 2001); [web page] <http://zavtra.ru/cgi/veil/data/zavtra/01/380/53.html> [Accessed June 27, 2002].

³⁰² *Ibid.*

³⁰³ Rojec, M., Jermakovich, W.W., *op. cit.*

According to Jan van de Merbel, Heineken did not want to privatize just any old Russian brewery because of contradictive legislation governing privatization in Russia. “The legal system was a mess”, he argues. First, Heineken was thinking about privatizing a beer company in Russia. But it was impossible to understand who is the actual owner of the factory, who can decide on privatization issues and sign an agreement. Legislation was and still is changed every day. One day the special committee was deciding, the next the municipality, the next day Moscow takes all powers. So you can privatize the factory, but next day they would say that it wasn’t legal and boot you out. “It was too risky to privatize anything in Russian”, Jan van de Merbel argues.³⁰⁴ For example, according to State Privatization Program the governments of subjects of the Federation decide on access of foreign investors into the privatization process of oil and gas objects. After the auction they send information about the investor to the Russian government and to Federal Security Service (FSS). Taking the FSS report into consideration government decided on the legality of the privatization. However, this provision contradicts with the Law “On Privatization of State and Municipal enterprises in Russian Federation”, which stated that the determination of the privatization procedure must be governed by The State Committee for the Management of State Property (*goskomimushestvo*).³⁰⁵

Heineken chose the acquisition mode. This mode is basically used in countries where the level of stability is viewed as being more positive.³⁰⁶ However, before that Heineken was trying all other modes, in order to get some knowledge about the market. First, they were exporting its products to Russia. After Alfred Heineken came to the conclusion that beer was not a local or regional product but that beer can travel, Heineken realized that exports is the first step, so as to built brand name awareness and the quality image.³⁰⁷ Exports also allow the firm to acquire all the information about local market situation. Only then exports are followed by a licensing contract, local brewery acquisition or establishing of a new brewery. Of course the route that can be chosen depend on local market circumstances, such as import restrictions and required investments.

³⁰⁴ Interview with Jan van de Merbel, Heineken’s investors relations specialist. June 25, 2002, Amsterdam, The Netherlands

³⁰⁵ Nasonov J., “Uchastie Inostrannogo Kapitala v Privatizazii gosudarstvennih predpriatii”, *Zakonnost’*, #1, 1998, p. 31.

³⁰⁶ “Foreign Direct Investment in Central Europe: Experience of Major Western Investors”, *European Management Journal*, Vol. 16, No.4, August 1998, p. 388.

³⁰⁷ “The history of Heineken”; [web page] www.heinekencorp.com [Accessed June 4, 2002].

After exporting for a while, according to Aleksey Hasbiev, Heineken as well as Holsten, Miller, Staropramen, Lowenbrau started to look for beer factories who want to produce their brands on a licensed basis. If Holsten, Miller and Staropramen were produced at SAB's factory in Kaluga and Lowenbrau on the Bravo International in Saint-Petersburg, nobody wanted to produce Heineken, though they were negotiating with Ochakovo, SAB, Efes. So it was the last opportunity to get into Russian market - to buy a modern brewery for a much too expensive price, Hasbiev argues.³⁰⁸

Robert Pye argues there is a trend of foreign organizations increasing their shareholding positions over time from minority and equal positions towards majority and full control. It was the same was with Baltika, when BBH first bought a part of shares and then increased it to 75%.

We conclude that in the Russian beer industry the most important determinants of the entry choice are time considerations, location advantages as well demand, attractiveness of equipment levels and brands of the domestic company.

We agree with Poliwoda that political and economic considerations are the main determinants of market entry. However, he concludes that the primary option available for Russia is to export. We are sure that exporting is something of in the past. The new Russian President and legal reforms lead to the replacement of political risk by commercial risks as the major concern for exporters.

So, there are plusses as well as minuses of every form of legal entity, making it important for foreign investors to have different possibilities to organize their business, in order to choose one, which fits their point of view the best in every particular case and can serve as achievement of their purposes.³⁰⁹

7. Choice of legal entity form

While investing in foreign production the degree of partnership established,

³⁰⁸ Aleksey Hasbiev, "Pivnaia dvuhhodovka", (Expert #6, February 12, 2002); [web page].

http://www.sostav.ru/index/info_base/product/text_stat.shtml?prod120202 [Accessed June5, 2002].

³⁰⁹ Musin V. A., "Pravovie voprosi inostrannih investitsii v SSSR", *Pravovedenie*, No. 4, 1991, p. 21.

becomes an important issue, because of the power of control that a greater ownership share brings with it. Profits received and transfer pricing depends on it. On the other hand, sharing ownership with domestic partners helps reduce market uncertainty. Thus, depending on firm's characteristics and industry conditions, different ownership structures occur.³¹⁰ However, this question is not frequently examined in literature.

According to Hennart joint foreign-domestic ownership can achieve the advantage of economies of scale and diversifying risk; overcoming entry barriers into new markets; pooling of complementary bids of knowledge; allaying xenophobic reactions when entering a foreign market.³¹¹

Louri in his work argues that the optimal ownership share can be defined as full, majority and minority. The considerations are derived by maximizing the profits a company can expect to receive from foreign investment, after having taken into account transaction and other cost considerations. Companies choosing full ownership are found to be mainly influenced by the resource intensity of the industry and firm-specific variables. Geographical and cultural distance plays a negative role, while invested capital and expected profits have a strong positive effect. Majority ownership is negatively affected by the capital intensity of the industry, underlying the desire to share ownership when a large and risky project is involved. Minority ownership is preferred when the capital requirements are large, uncertainty due to oligopolistic conditions are high. In this case leverage is heavily used.

Foreign investors can adopt a number of different forms of business representation in Russia. These include Russian legal entities of representative offices and branches of foreign legal entities. According to Russian legislation foreign legal entity or individual may set up a Russian legal entity or purchase the shares of an existing legal entity. It could be:

- joint-stock company;
- limited liability company;
- full partnership;

³¹⁰ Louri H., and others, "*Foreign Investment and Ownership Structure: An Empirical Analysis*", Kluwer Academic Publishes; [web page] www.kluweronline.com [Accessed June 20, 2002].

³¹¹ Hennart, J.-F., "A Transaction Costs Theory of Equity Joint Ventures", *Strategic Management Journal* 9, 361-374.

- limited partnership.³¹²

As we already mentioned, Baltika is organized as a joint-stock company. According to Article 97 of the Russian Civil code, a joint-stock company is a company whose charter capital is divided into a number of shares of stock. The participants in a joint-stock company are not liable for its obligations and bear the risk of losses connected to the activity of the company within the limits of the value of shares of stock. A joint-stock can be “closed” or “open”. The shares of the opened joint-stock company are freely transferable. Stockholders of a closed joint-stock company have the preferential right to purchase shares of stock by other stockholders of this company. Therefore the transfer of shares is restricted. On the one hand, joint-stock company opens an opportunity for additional capital, which could be easily attracted. From the other, in such a legal entity as a partnership, entrepreneurs are safeguarded from double taxation, which could become a problem for joint-stocks with the absence of double tax treaties, for instance.

The main reason for choosing joint-stock as a legal form for Baltika is, of course, privatization. During it the shares were issued and sold. There are many benefits from this form of legal entity, like the possibility of obtaining additional investments more easily, if the shares of the company are liquid enough the company can be confident to international lenders and attract funds more easily. But on the other hand you are never sure about other side of the shareholders, first of all in the decision making process, then the treatment of minorities. The problem with takeovers also arises. The takeover wave in the Russian beer industry has in our mind just started. Tver brewery “Afanasii-Pivo” can serve as a good example. When the Aton company, specializing in Mergers and Acquisitions, started to buy the shares of the company, the management thought that they did it in order to invest money into Afanasii-Pivo in future. When they realized that it was hostile takeover, it was already too late to undertake any defensive measures.³¹³

The limited liability form was used by Bravo’s owners in order to enter the Russian market. It is easier to organize and to control it. The authorized capital of such a

³¹² The Civil Code of the Russian Federation, art. 69, 82, 87, 95.

³¹³ “Ataka na Afanasii-Pivo”; [web page] www.karavan.tver.ru/html/n460/article2.php3 [Accessed July 15, 2002].

legal entity may be of a minimum size. The minimum charter capital of a limited liability company is 100 times the monthly minimum wage.

It is interesting that Bravo Holding was organized under Cyprus legislation. Such a scheme is usually used by the companies which are receiving dividends from the Russian company and if there is no tax relieve on it or no tax treaty between states. Because the withholding tax rate for dividends for the Cyprus company is zero related it helps to reduce the tax burden.

We should mention the practice which was quite popular in Russia, when foreigners were entering into joint ventures with Russians, because they believed in their knowledge of business environment, culture and so on, and were providing capital and technology. After some time, Russians started manipulating with shares, issuing additional ones, and foreigners usually were lived without their money, or voting power in a company.

Talking about legal entities forms, we should mention state registration of the legal entities. Because only after registration, they obtain all their rights and duties. The first problem is the amounts needed in Russia for registration, minimum capital requirements were determined in national currency. However, especially in the early 1990's, the inflation was huge and it created the possibility to get the status of the foreign investments entity, with minimum foreign participation. For instance in Ukraine, these amounts were determined in hard currencies which was a safeguard against this kind of cheating.³¹⁴ The already mentioned Presidential Decree "On improvement of the work with foreign investments" (1993), which gave companies with foreign participation 3 years grandfathering provision can serve as a good example. Of course, recommendations to do business through foreign registered companies or companies with foreign participation, in order to ensure yourself from possible tax pressure, immediately appeared in the press, for example.³¹⁵

In order to register a company with foreign participation in Russia one needs to present a number of documents, approved by different state bodies. This process is quite expensive and foreign investors are of course interested in "one stop shop"

³¹⁴ Boguslavskiy, M. M., *op. cit.*, p.38.

³¹⁵ "Sovmestnie predpriatia vitianuli schastlivii bilet", *Kommersant*, No. 192, 1993.

registration.³¹⁶ In addition it is not absolutely clear which state body is supposed to register enterprises with foreign participation, and legislation, determining the procedure, frequently changes.³¹⁷ The governor of Saint-Petersburg Jakovlev, for example, argues that the registration procedure is the great obstacle for foreign investors.³¹⁸ In order to register enterprises with foreign participation of more than 100 thousands rubles, one need to go to the Registration Palate in Moscow. What if an investor is going to do business in Magadan or Vladivostok, for example?

7.1. Conclusion

The choice of legal form directly depends on the countries investment climate. Participation of foreigners in joint-stock companies shows the degree of their trust to reforms and environment in the country. However there are other determinants such as the company's strategy, financial possibilities, transaction and other cost considerations. This is why the choice of legal entity form depends on a various reasons. It is important to note that all legal entities forms have advantages and disadvantages. The major determinants are the level of control, the possibility to get additional investment, the decision making process and tax issues. This is why investors must have a choice in which form to organize their business. Appropriate legislation on the issue is of great importance. It appears that in Russian the choice of legal form may depend on other factors linked to this or that form. Such factors could be state registration, for example. Unclear and frequently changed legislation, bribery and other obstacles can be serious determinants of an investor's choice.

8. The deal

On February 4, 2002 Heineken announced that it bought Bravo and it was going to pay USD 400 million for its purchase. Heineken was going to pay in installments, and only USD 100-150 million would be paid immediately. In Heineken's press release, Manel Vrijenhoek said that they are going to pay the amount until the end

³¹⁶ Lebedev V. M., "Inostarnnie investizii v ekonomike Rossii – tendenzii razvitiia", *Finansi*, No.8, 2001, p. 14.

³¹⁷ Semeusov V., "Registracia predpriatii s inostrannimi investiziami", *Rossiiskaia Ustuzia*, No. 5, 2001, p. 13.

³¹⁸ Zakupen' T., "Pravovie Aspekti Registracii Uridicheskikh Liz s Inostrannimi investiziami", *Hoziaistvo i pravo*, No. 2, 2001, p. 100.

of 2002 and finance this acquisition from it “available resources”³¹⁹. It helped them to get only starting positions in the Russian market. As we already mentioned, Jan van de Merbel said that there were no problems with transferring funds. Russian banks did everything quickly and on a good level.³²⁰

8.1. Compromises

When we asked Bravo’s lawyers if there were any compromises, they were surprised: “Of course not”. In their mind Heineken paid a good price for all hardships and risks they would suffer starting a new company in Russia. Bravo is an already well-known company in Russia, its brands are popular, they have good machines, good specialists, and connections in the market. It is a good deal for Heineken, Odabashian argues.³²¹

When we asked Jan van de Merbel about negotiations and possible compromises and difficulties during it, he said that there were almost no negotiations: “We received their offer, and sent our counter offer. On their part everything was prepared by Merrill Lynch. We also invited some advisors”.

However, Heineken insisted on inserting a specific point in the contract. It is provision that the previous owners cannot use the money for building a new brewery in Saint-Petersburg region, because it is very easy for them, they have experience, and so on. It proves that Heineken, nevertheless, is afraid of something, the competition or know – how, of previous owners, in this case.

8.2. Price

There were many talks in the press about the price of the deal. USD 400 millions: was it too much and what did Heineken paid for this amount? Some say that it is too much for a Russian company. Odabashian argues that the amount is

³¹⁹ Press release, “*Heineken gains a foothold by acquiring Bravo International*” (Amsterdam, February 1, 2002); [web page] www.heineken.corp.co.../ [Accessed June 4, 2002].

³²⁰ Interview with Jan van de Merbel, Heineken’s investors relations specialist. June 25, 2002, Amsterdam, The Netherlands.

³²¹ Interview with Tatiana Odabashian Bravo’s lawyer, made by Zolotareva Olga. Saint-Petersburg, June 3, 2002.

appropriate.³²² Bravo is well developed, has its own position in the markets, its brands are known to the citizens. Aleksey Krivoschapko from United Financial Group (UFG) argues that the amount of the deal is fair.³²³

It is important to note that in fact, the amount of the deal is only USD350 million and other USD 50 million are conditional. It will be paid if Bravo reaches 4 million hectolitres production, and the margin of profitability is on the same level.³²⁴ Heineken paid cash using their available resources.

However, Hasbiev reached the conclusion that whatever Heineken representatives say, the amount for a middle class factory with USD 50 million debts and with quite a low recovery factor, is too much. Jan van de Merbel in turn said: “Bravo is big enough to be grown up in future with Heineken support. The most important is productivity, and then distribution, marketing and branding”.³²⁵

Hasbiev also does not agree with Taimuraz Bolloyev (Baltika’s director), which argues that for this amount one can build 4 breweries in Russia, and this money was paid for production development and trade marks marketing which need time, since Heineken missed the development of Russian beer industry in the 1990’s. He argues that it is nevertheless too late for Heineken to come in the Russian market. The growth of the market becomes slower. According to “Business Analitika”, year the growth will be decrease for the next year by 3.5-4 % annually and in 2005 Russian market will stop growing. Maybe Hasbiev is right that it is too late, but he does not say a word about the entry risks and difficulties, which the early entrants faced.

However, Jan van de Merbel is sure that the market is not divided or full. “It is not mature yet”, he said³²⁶. And what is most important to Heineken, is that there is now a shift towards high quality beer, premium beer like Heinekens brands, for instance. So, Heineken does not care about the size of the market they will get, the most important element to them is profitability. Premium beer is a bit expensive and there is not too

³²² *Ibid.*

³²³ “Pravilnoe pivo ot Heineken], *Vremia novostey*, February 4, 2002).

³²⁴ Interview with Jan van de Merbel, Heineken’s investors relations specialist. June 25, 2002, Amsterdam, The Netherlands.

³²⁵ *Ibid.*

³²⁶ *Ibid.*

many of this kind of beer in Russia, so they hope to take this part of the market, and earn good profit. Most of the contenders, as well as Heineken, were interested in Bravo's brands in particular. It is important to note that in Russia not enough attention is paid to incorporeal assets. In western companies intellectual property usually takes 35% of the market price of a company.³²⁷ In Russia there is still no definition of so called "brand". Basically, in Russia, brand is equalized to trade marks. However, a trade mark becomes a "brand" only when it is used with other incorporeal assets, which determine the quality of the goods and their reputation on the market.³²⁸

8.3. Accounting

Before acquiring Bravo, Heineken's specialists also did a "due diligence" on some Russian breweries, they were thinking of buying. But they did not even show "bad debts" provisions in their financial records. It is important to note that Heineken pays a great deal of attention to the situation on the beer markets all over the world. In order to do it they attract specialists from different analytical and investment analyses companies. However, such companies usually face problems with Russian accounting standards.³²⁹

One of the major differences of Russian accounting from international practice lies in understanding of the term "accounting". In Russia it has the primary meaning of booking and the secondary meaning of reporting. Therefore Russian accounting rules extensively cover rather bookkeeping procedures, rather than financial reporting rules.³³⁰

EBRD and other international bodies active in the Russian corporate environment, strongly recommend the introduction of international accounting standards (IAS) in Russia.³³¹ They argue that the government must replace Russian Accounting Standards with a full IAS.

³²⁷ Tatiana Samoilova, "Ozenite moi brand", *Russkii fokus* (October 1, 2001); [web page] www.economiks.ru/info/articles/art99.htm [Accessed July 18, 2002].

³²⁸ *Ibid.*

³²⁹ Interview with Jan van de Merbel, Heineken's investors relations specialist. June 25, 2002, Amsterdam, The Netherlands.

³³⁰ "Doing business in the Russian Federation", PricewaterhouseCoopers, February 1, 2000, p. 17.

³³¹ "The Investment Environment in the Russian Federation: Law, Policies and Institutions", OECD (May, 2000), p. 12.

However, it is impossible to ensure high quality reporting without strong accounting profession and incentives. Accounting never played an important role during the Soviet times. Actually it was basically used for statistical purposes and was underdeveloped. That is why so much attention must be paid to developing of the accounting profession in Russia. It is important to note that it is one of the main working fields of the Russian Government.³³² As an example can serve the draft of Law “On Accountancy”.

According to Russian legislation, joint-stock companies must publish their financial reports. The situation is different for limited liability companies, such as Bravo. We were asking for Bravo’s annual report, however, at first its officials were refusing to release it. As major Russian companies, they realized that for investors it is of great importance to have an idea about company’s accounting: it gives the possibility to compare it results with branches in another countries to at least understand how the company is doing. Major Russian companies such as Baltika, for example, prepare its annual reports according to US GAAP.

According to PricewaterhouseCoopers, accounting has become noticeably less tax-driven over the last few years. Accounting procedures tend to become more harmonized with IAS, but, still has a long way to go.³³³

8.4. Conclusion

One of the difficulties the investor faces in transition, is pricing. First of all, there are many different points of view on the price of the deal. The main price determinants are: market conditions, consumption, country determinants and, of course, the factory by itself. In recent years, the most important issue turned out to be brands of the company. In our case we mentioned that in Russia there is no definition of “brand” and it is not considered during acquisitions of Russian enterprises. Of course, in Russian accounting principles there is no term such as “goodwill”, thus it is quite difficult to understand the real value of a company. However investors want to know what it is they are buying, so they can evaluate the price properly. It is important to note that there is a

³³² “*Investizionnii klimat v Rossiiskoi Federazii I meri po ego uluchsheniu*”, Department of investment policy of the Ministry of Economic Development of the Russian Federation; [web page] www.gov.ru [Accessed June 12, 2002].

³³³ “*Doing business in the Russian Federation*”, PricewaterhouseCoopers, February 1, 2000, p. 17.

clear tendency to accept either IAS or US GAAP for Russian big companies. The problem must be solved at the governmental level, however the companies, which are looking at attracting foreign investors already realized this need.

It is important to note that the price paid for the company was the biggest amount paid in the history of the Russian beer industry. It proves the attractiveness of the industry and the level of competition surrounding it.

International consulting and law firms play a major role in Russia. All “serious” transactions are governed by invited specialists. Investors usually do not work directly with potential company’s lawyers. Investors prefer to attract all kinds of specialists in order to determine the situation of a country by itself, in industry and, in particular, the company. Especially outside one of the large Russian cities the local authorities are unaccustomed to deal with anything other than Russian enterprises, that is why professional assistance for foreign investors is also needed in dealing with state bodies.

However, the tendencies of recent years look much more democratic and civilized. As first, foreign investors could not get access to more-less attractive enterprises during privatization; corruption and insiders were the main elements of old system.

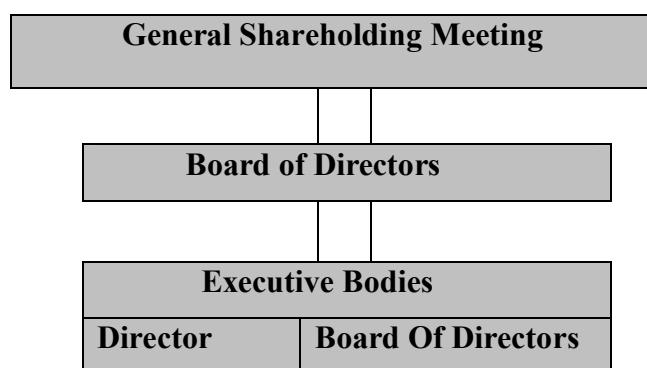
9. Situation on the companies after the acquisition/privatization

9.1. Corporate governance

From the very beginning the managers of Bravo International were Russian. After the acquisition there were no changes in employees, neither in the management board. It is important to note, that specialists from Merrill Lynch had interviews with all of the top management of Bravo. They were evaluating their skills, experience and were satisfied with their knowledge. In fact, the success of a company usually depend on the team, maybe that is why nothing was changed. Moreover, Heineken officials said that they were satisfied with the current management and at most they would send certain personnel to Amsterdam for stages and courses. Jan van de Merbel said that they would not change the current management, before next year. He also pointed out that “they did

a good job”. Merbel said that they prefer to work with Russian personnel and in future it will also be basically Russian. It corresponds with Heineken’s strategy to combine “international” and “domestic”. However, they recruited a new financial director, in order to control the financial flows money and were going to send a marketing specialist to the Saint-Petersburg office.

Talking about corporate governance it is important to mention the structure of the company. Baltika’s corporate structure, for example, is organized as following:



The current director of Baltika is Taimuraz Bolloyev. He was a nominee in the “Best Manager” category of the “Corporate governance in Russia – 2001” program, organized by Investor Protection Association.³³⁴ He is considered as one of the best Russian managers. It is important to note, that BBH as a whole, usually gives an opportunity for its managers from all countries to develop the strategy of the company and to manage it by themselves.³³⁵

With reference to BBH, its shares were divided between Hartwall and Carlsberg Breweries of Denmark. However, the takeover made by the leading British brewer Scottish & Newcastle changed the situation. They bought 50 percent of the BBH shares in a USD 1.8 billion stock purchase.³³⁶ The takeover placed Scottish & Newcastle behind Heineken as the second largest brewer in Europe and gives it three of the top 10 European brands: Baltika, Kronenbourg and Foster’s.

³³⁴“Investors named the winners of the program “Corporate Governance in Russia - 2001»; [web page] <http://www.hermitagefund.com/governance/sbe> [Accessed June 10, 2002].

³³⁵ <http://www.slavutich.lg.ua/aboutbbh/> [Accessed June 20, 2002].

³³⁶Claire Bigg, “Baltika gets new foreign partner”; [web page] <http://www.russiajournal.com/weekly/article.shtml?ad=5794> [Accessed June 10, 2002].

Scottish & Newcastle officials said their main interest in acquiring the Hartwall share was to gain access to the fast-growing Russian beer market. Baltika views the takeover as a move likely to secure its position as Russia's No. 1 brewer.

The other 50 percent of Baltic Beverages Holding is owned by a fierce rival of Scottish & Newcastle – Carlsberg Breweries of Denmark, as already was mentioned, which raises questions as to how the two partners will now get along. According to Carlsberg officials, the company was not informed about the deal. The deal also surprised Baltika officials. "The half that currently belongs to Carlsberg has had a number of owners, but the half that belonged to Hartwall has remained very stable since 1993"- they said. It is interesting, how they are going to govern the company now.

Tlekhurai, Baltika's vice president dismissed suggestions that the takeover could bring changes within Baltika, displaying solid confidence in the fate of Russia's leading brewing business: "As a rule, one avoids touching the goose that lays the golden eggs. And we are definitely this goose right now".³³⁷ It is interesting to add that according to Tlekhurai, "Scottish & Newcastle" was pushed to buy the shares by Heineken, which bought Bravo.³³⁸

9.2. Economic policy

It seems that the most interesting question for Russian experts. is one about the Bravo's and Heineken's brands and their future. The major question was if Heineken will produce its own brands in Russia. Bravo's officials argued that they will.³³⁹ However, Odabashian pointed that, Bravo has many brands, they produce also a number of low alcoholic drinks, and Ohota's taste and quality, for instance, is almost like Heineken's. They called this type of beer "street beer" (*ulichnoe pivo*). "Heineken must be happy to get so many new brands, having only his own, almost identical to Russian one, before"- Odabashian argues.

³³⁷ *Ibid.*

³³⁸ "BBH uvelichila svou dolu v ustavnom kapitale "Baltiki"; [web page] <http://www.slavutich.lg.ua/aboutbbh/> [Accessed June 17, 2002].

³³⁹ Interview with Tatiana Odabashian Bravo's lawyer, made by Zolotareva Olga. Saint-Petersburg, June 3, 2002.

Asking about the question of identity of Heineken and Ohota we make Jan van de Merbel to laugh. “Of course not!”- was the answer.³⁴⁰ First, it depends on consumers tastes and market territory. Heineken it is an international brand and one cannot compare it with any domestic brand. Most important of all is that “Ohota” is not even a premium beer.. According to the Merrill Lynch report it is mid price beer. Heineken has a better image, that is why people are ready to pay more. Quality is different also. Marketing plays a major role here. Merbel gave an example of Nike and Coke. “They have the same strategy. I am sure that is every country you can find almost the same quality of products, but you see what their massive advertisement and high quality marketing are doing! May be in Russia one can produce the beer of the same quality but they will never develop and advertise the brands as we can”.³⁴¹

Heineken as a global brand has many benefits. Firstly, they can use common brand building tools, shared pool of commercials. Secondly, they have economies of scale and knowledge which can be used for other brands. However, the resent case of Arthur Andersen proves that there also some deficiencies: if something goes wrong brand suffers all over the world.

Manel Vrijenhoek mentioned that Heineken has been exporting to Russian since the 1980's and now they have the possibility to brew Heineken locally. It is in response to the very high Russian import duties. But he also remembered that the brands of Bravo are “well-positioned local mainstream brands”. Does this mean that they are going to save the production of “Bochkarev”, “Ohota” and to start producing Heineken locally? On the other hand, import duties alone can not be a reason for changing a company's tactic. If you look at the case of Western-brand cigarettes manufactured in Russia, they are generally half the price of imported cigarettes. But many people still prefer to pay more for an imported brand," said Eric van der Ven, Heineken's export manager for Russia.³⁴²

However, import duties in Russia are too high. Imported Heineken costs 3 times as Russian premium beer. That is why it was basically sold in expensive clubs and

³⁴⁰ After asking this question during the interview in Amsterdam, we found out that Bravo put an advertisement on a job hunting web site, that they are looking for a lawyer. May be the person who thinks like this was fired?

³⁴¹ Interview with Jan van de Merbel, Heineken's investors relations specialist. June 25, 2002, Amsterdam, The Netherlands.

³⁴² Michael Heath, *op. cit.*

hotels. Heineken did not even spend much on advertisement in a mass market. But what will the case now be with its exports? The United States is the only country to which Heineken is only export and they are not going to buy a factory there. Heineken was developed there as “The beer which is imported from Europe, only good quality” for many years already. So, consumers know it only in this way, and they are not going to change it.³⁴³ In all other countries Heineken was first exported and then produced domestically.

Viktor Piatko is sure that if Heineken will produce its brands it will not do it now, but much later.³⁴⁴ He also pointed out that all of the main Bravo’s brands will be produced, except “Oblomov”, because they could not register this trade mark.³⁴⁵ It is not also clear what will be the situation with licensed production of Lowenbrau. It seems that its production is important to Heineken as well.

We agree with Aleksey Hasbiev that it looks strange that Heineken is going to strengthen its position in the Russian market and not change the policy of Bravo’s brewery. Especially according to Jan - Fransua van Boksmeer, a member of Heineken’s executive committee, Russian Heineken will appear in the market next year already³⁴⁶. This announcement finally cleared Heineken’s future plans. It is important to note that in the Russian market “Bochkarev” is important as a national brand. Heineken is well known all over the world, it will become popular in Russia, Jan van de Merbel argues.

Any changes in production is of course closely linked to the factory’s equipment. Talking about Bravo’s equipment, Heinekens specialists agree that they are of a good quality level and quite modern. However, Heineken is going to install new tanks, because the production of Heineken needs different technology. Water is also a big problem in Russia, that is why they are going to do something with, so called, “waste water treatment”. Heineken is going to bring some special equipment in order to clean water.

³⁴³ Interview with Jan van de Merbel, Heineken’s investors relations specialist. June 25, 2002, Amsterdam, The Netherlands.

³⁴⁴ Hasbiev, *op. cit.*

³⁴⁵ Region inform (February 5, 2002); [web page] <http://www.whisky.ru/article.htm?id=1397&idref=1> [Accessed June 6, 2002].

³⁴⁶ Anna Sherbakova, “Heineken ne ispugala zena “Bravo”, [web page] www.beerunion.ru [Accessed March 2002].

Jan van de Merbel is sure that Heineken will quickly obtain its market segment with its own Heineken's brands. Especially in Russia, it is quite easy to market brands. The reason lies in television. In Russia there is the unique possibility to quickly develop brands, because there are channels which work in the all territory of Russian Federation. (ORT, ROSSIA). In the US you can not find such channels which are being watched by the whole country, that is why one has to spend money on boards, for example.

The main competitors of Bochkarev brand in Russian premium local beer segment, according to Merrill Lynch report are Stary Melnik (Efes), Zlotaya Bochka (SAB), Baltika (Carlsberg) and Nevskoe (Carlsberg).³⁴⁷

The trade mark "Baltika" appeared in 1992. It is now the most popular beer brand in Russia, which includes 10 kinds of beer. In 2001 the brand was advertised as the "Russian famous beer". "Baltika" brand holds more than 12 % of the Russian beer market. According to the Gallup Media agency, in 2000 Baltika became the most recognized Russian beer trade mark – it is known by 58 % of consumers. In this year Baltika was honored for the second time as "national trade mark" as the most popular Russian beer brand.³⁴⁸

In 2001 Baltika sold 1.4 milliard liters of beer and took 22.5% of the Russian beer market. Its revenue increased with 66.7%.³⁴⁹ It became the biggest brewery in Russia and Eastern Europe. Baltika produces 15% of all Russian beer. According to the Financial Times, Baltika takes 45th position in the biggest Eastern Europe companies rating. It is the only company from the food and brewery sector on the list.³⁵⁰

Before building the malt plant in Saint-Petersburg, specialist said that one of the main secrets of Baltika's success were imported ingredients: malt and German hop.³⁵¹ The big achievement was Baltika's quality system according to international standard ISO 9001-94. The company was also honored by Russian government for its quality achievements.

³⁴⁷ Merrill Lynch report on Russian beer industry prepared for Heineken N. V.

³⁴⁸ Annual report, Baltika 2000.

³⁴⁹ www.beerunion.ru [Accessed June 13, 2002].

³⁵⁰ <http://propivo.ru/prof/producers/arihiv0701.html> [Accessed June 13, 2002].

³⁵¹ <http://www.baltika.r52.ru/index.phtml> [Accessed June 13, 2002].

Baltika likes to talk about the high quality of its beer: European standards and so on, however there are some specialists that say that the quality of Baltika's beer "could be higher". There were even some claims on its quality. Specialists from Baltika's quality department in a private discussion agree that quality of the beer is not good enough. For Baltika it is now more important to expand its capacity across Russia and to invest into new factories in new regions. This is why they are almost not working on the quality of the beer right now, because it also needs major investment.

The situation in the Russian beer market changes every year. Heineken's appearance on the market, with its financial possibilities, increased competition. Forecasting about future consumption made Baltika to spend more on marketing and advertisement. According to its annual report these expenses grew by in 2.3 times already in 2000 year, according to its annual report.

9.3. Conclusion

The changes introduced by investors are obvious. The changes at Baltika after its privatization, first of all concerned its corporate governance, of course, - it became a joint-stock company. The major changes were in its economic policy. Investors brought new technologies and know-how. Baltika started to develop its brands long ago and now they are well known in Russia. Moreover "Baltika" is considered as one of the most important brands for BBH. Investors are spending much more on the marketing of their products. They invest also into the industries which are close to beer production, as water treatment and malt production plants, for example.

After the acquisition of Bravo, almost nothing was changed at the company, except for the financial and marketing directors. It proves that investors prefer to work with Russian managers and specific of doing business in Russia is still an important issue. However, it is important to note that Russian managers are well educated and are real specialists in their field. The interview done by Merrill Lynch with Bravo's management proves this. Investors frequently trust Russian managers' knowledge and skills.

Bravo's brands are much younger than Baltika's. However they have got their place on the consumer market. Despite the fact that Bravo's equipment is modern,

Heineken is going to invest in its modernization. They also going to reconstruct pipes on the factory and improve other parts of production chain. For example, pipes for beer could not have sharp corners, it can influence the taste of the beer. It means that Heineken is bringing its know-how. And it is a good example of how investments, technology and know-how could be attracted not only to old-fashioned brewery in order to modernize it, for example, but on quite modern factory.

10. Investments and strategy of the investors

10.1. Investments

We mentioned already that in order to start the production of beer, Bravo International used syndicated loans from European banks. First Bravo's owners were investing in order to start production of mixed drinks in early 1990's and thereafter to produce beer. Now Heineken is going to invest in the factory at the end of 2002 in order to start production of the Heineken brand. This is already third investment program. In the beginning of 2003 Heineken's premium beer will appear on the Russian market.³⁵² Besides investment into machinery needed especially for beer production, Heineken's officials argue that water is a big problem in Russia as well, therefore they will start to do waste water treatment.³⁵³ Heineken will import special equipment in order to clean the water. We should mention that Heineken is dealing with research in this field and invest much in the development of technology for water treatment all over the world. Heineken also needs to install equipment to purify water before using it in beer production process. Moreover, they have some know-how, which they want to implement at the Bravo factory. It will require additional investments. "While we were analyzing some Russian breweries, we found out that almost all of them have difficulties with pasteurization and pipes",- Jan van de Merbel argues.

Talking about beer production and investment in the breweries, we should not forget about environmental issues. EBRD pays a great deal of attention to it, for instance. Before giving a loan to Baltika they did an environmental audit through independent consultants, which confirmed the company's compliance with Russian regulations related to environment, health and safety. The audit included a plant

³⁵² Interview with Jan van de Merbel, Heineken's investors relations specialist. June 25, 2002, Amsterdam, The Netherlands.

³⁵³ *Ibid.*

in Rostov, which was recently been acquired and upgraded. The reports also confirmed that Baltika's corporate practices in respect of environment, health and safety satisfy EU requirements to a large extent. The audit emphasized that only minor environmental investments were needed to be undertaken. They were determined in an Environmental Action Plan (EAP) and agreed with Baltika. The implementation of the EAP ensured that Baltika's operations reached full compliance with both national and EU requirements, including those related to waste-water quality.³⁵⁴

Baltika decided to produce only high quality beer, according to European standards and technology from the outset. Of course, in order to implement this one needs to find money. Solving this problem, Baltika's management designed the first program on investment reconstruction and development of the factory.³⁵⁵

The program suppose to work from 1993 to 1998 and was aimed to attract funding for new machinery in order to produce a high quality beer. The program ended before the deadline of November 1996. During the first investment program they built new machinery on the complete production chain, built water cleaning stations, changed all pipes on the factory, and computerized the total production system. According to its investment program, Baltika bought new brewery equipment from Huppmann and Ziemann for the amount of USD 15 millions. It was a huge achievement for a Russian company.

All this made "Baltika" the number one brewery in Russia, with advanced European equipment and the most powerful production possibility in Russia. It is important to note, that it was a big achievement for a Russian company, because the productivity in Russia even nowadays remains extremely low – several times lower than at American enterprises.³⁵⁶

From 1996 to 2000 Baltika developed 5 investment programs. From 1996 to 1999 investments were used to expand production possibilities of the main factory. In 2000 much was invested into quality improvement and expanding the distribution

³⁵⁴ *Ibid.*

³⁵⁵ www.baltika.ru [Accessed June 13, 2002].

³⁵⁶ Forecast Conference "*Russia on the Rise*"; [web page] www.amcham.ru/external/280202.html [Accessed June 20, 2002].

chain.³⁵⁷ The biggest amount of investment was in 1998 – USD 104.7 million. From 1996 annually they were growing at twice. From 1996 till 2000 Baltika attracted more than USD 350 million. The company has a system of project finance, which is developed annually and which is confirmed by the board of directors. For every project a specialist is appointed as project leader.

Soon Baltika decided to expand its production to the regions as well. They created their own holding structures. Baltika acquired the “Donskoe pivo” brewery in 1997 and the control package of shares of the “Tulskoe pivo” brewery in October 2000. Currently Baltika’s investment program aims to change the machinery in the factories and increase their production possibilities. After the acquisition, Baltika issued additional 11million shares in order to convert the shares of the acquired companies.³⁵⁸ According to its Annual report, Baltika invested more than USD 40 million during 2000 into the “Tulskoe pivo” brewery.

Since 1998, “Baltika” organized 16 representative offices in big Russian cities. This is why its old name OAO “*Pivovarenniy zavod “Baltika”*” became not real, and the company was renamed to OAO “*Pivovarennaia kompaniya “Baltika”*”.

Thus, Baltika first became a leader in attracting foreign investments and now it became an investor in itself, modernizing old factories and building new ones. According to Baltika’s Annual report, the main source of its investments is its profits. Baltika’s total amount of investments is 84% (USD 74.9 million). On the other side they have long term loans. In 2000 the company received USD 20 million from EBRD. The total amount of the loan is USD 40 million. It must be repaid by 2006. In 1999, Baltika also got a loan of USD 40 million from EBRD and participating commercial banks. The proceeds of the loan are suppose to complement the company’s internally generated cash flows, to enable Baltika to expand its production capacity and to develop its distribution network across Russia, as well as to strengthen its long-term working capital position.³⁵⁹ EBRD regarded Baltika as one of the best managed and most highly respected industrial companies in Russia.

³⁵⁷ Annual report, Baltika 2000.

³⁵⁸ <http://www.tabepha.ru/news/pz/pz-baltika/index.html> [Accessed June 10, 2002].

³⁵⁹ <http://www.ebrd.com/oper/projects/psd/psd1999/289jsc.htm> [Accessed June 5, 2002]

Baltika is working in Russia with Sberbank, Menatep Sankt-Peterburg, Dresden and Citybank. Baltika also has an account with ABN AMRO Bank. Baltika's policy is to borrow in rubles as well as in FOREX proportionally in order to reduce currency risks. It is important to note that Baltika has the highest credit rating among Russian companies.

Baltika together with French "Groupe Soufflet", opened the "Malt plant Soufflet-Saint-Petersburg" in 2000. The cost of project was USD 50 million. USD 35 million was invested by the French party, which holds 70% of shares. This project is extremely important to Baltika and to the Russian the beer industry as a whole. Most Russian breweries import malt from abroad. This is why they are exposed to currency and exchange rate risks and other difficulties. According to Baltika's annual report, one of the reasons for the increased expenses was the increased price of the malt from foreign suppliers, and the depreciation of the ruble (14%). For example, Heineken will import malt for its beer production from Poland and Bulgaria.³⁶⁰

At this stage, Baltika is gaining a comparative advantaged over its competitors in the Russian Market. The factory became the biggest malt producer in Russia. It can produce malt for 10% of the Russian beer market. 75% of its malt production will be bought by the company's breweries.

In October 2000 Balloyev met with the president of EBRD, Jan Lemier. He visited the Baltika brewery and said that he was proud to finance such a projects as a malt factory and the Baltika brewery.³⁶¹ He was interested in Baltika's future development program, the required investment, the situation in other fields of the Russian economy and investment needed for different sectors. Bolloyev said that the beer industry needs USD 100-200 million annually, however it depends on agriculture sector to a large extent, which is very poor in Russia. This is why investments in this field are extremely needed. EBRD was highly interested in the possibility of investing in the agriculture sector.

³⁶⁰ Interview with Jan van de Merbel, Heineken's investors relations specialist. June 25, 2002, Amsterdam, The Netherlands.

³⁶¹ <http://www.baltika.r52.ru/index.phtml> [Accessed June 13, 2002].

From 1993 to 2000, investments in the company were USD 347 million. Production of the company increased 38 times.³⁶² During 2001 USD150 million was invested in the company. According to Baltika's press release it was the largest investment since the formation of the company.³⁶³

10.2. Strategy

It is important that investors expand their investment projects to other fields of the economy on a continuous basis. As investors gain some knowledge of the market and the country with their first projects, it is important to prove to them that it is possible to operate in the market and earn profit. One should endeavor investors to remain in the country, even through improving the investor's strategy.

Alexsey Hasbiev, for example, argues that Heineken bought Bravo in order to change it for another brewery outside of Russia, maybe. Sun-Intrebrew, for instance, have no production facilities in Russia's North-West, this is why they were interested in Bravo International too. They also took part in Bravo's tender, but however lost because they proposed only USD 364 million.³⁶⁴ Intrebrew is the only company, which was ready to pay more than USD 400 million for Bravo International. Having the factory in Saint-Petersburg, they could produce their brand "Klinskoe", which is more profitable than "Bochkarev", Hasbiev argues. In return they could offer Heineken one of their breweries in Bulgaria, for instance, where their position is weaker than Heineken's. As a result of such a deal Heineken could increase its share in the Bulgarian market, instead of a small Russian market.³⁶⁵ We posed this question to Heineken's officials. "Nonsense!" was the reply. Jan van de Merbel remembered the talks about Heineken's slowness and said "if Sun-Intrebrew is ready to pay more now, who is slow then?"³⁶⁶

³⁶² www.baltika.ru [Accessed June 13, 2002].

³⁶³ <http://www.tabepha.ru/news/pz/pz-baltika/index.html> [Accessed June 5, 2002]

³⁶⁴ Aleksey Hasbiev, *op. cit.*

³⁶⁵ Krivoshapko, cited by Aleksey Hasbiev, "Pivnaia dvuhhodovka" (Expert #6, February 12, 2002); [web page] http://www.sostav.ru/index/info_base/product/text_stat.shtml?prod120202 [Accessed June 5, 2002].

³⁶⁶ Interview with Jan van de Merbel, Heineken's investors relations specialist. June 25, 2002, Amsterdam, The Netherlands.

It is interesting, that when Bravo started its tender, the *Sunday Telegraph* announced that SAB was the most likely buyer of Bravo. And without mentioning any sources they said that SAB proposed USD 500 million!³⁶⁷

On the one hand, it is obvious that Heineken came to Russia too late. But on the other hand, one should not forget about the financial possibilities of Heineken, which are higher than for many others in the Russian market.³⁶⁸ Moreover, some specialists argue that Heineken jumped onto the band wagon.³⁶⁹ In order to prove that, Heineken's officials remembered the story about the turtle and the rabbit, where the turtle turned out to be first. Heineken is doing business in many countries, and it can not operate everywhere at the same time, it depends on the company's priorities. They argue that they are going to stay in Russia and expand their businesses in the country.³⁷⁰

It not easy to study the investment climate from Amsterdam, it is better to see all, having one factory in Russia, maybe this is Heineken's case study? And it will give them the opportunity to expand across Russia in time, taking advantage of their experience with Bravo.

When Jan – Fransua Van Boksmeer was asked why they bought Bravo, he said that when one is coming in to new country one should go for the best. This was an explanation also to the question about building a new factory in Russia.³⁷¹ As we already mentioned, it took much time since Bravo was opened and the first bottle of beer appeared. Heineken of course would be not satisfied with such a pace, especially when all the specialists are arguing that the market will stop growing soon and Heineken has just no time.

Heineken, as well as Baltika, is going to expand its sales across Russia, but it plans are still secret.³⁷² However, Heineken's main aim is only the premium beer segment. In order to expand, one needs to invest in distribution and logistics. There may

³⁶⁷ “Gazeta Sunday Telegraph: rossiiskuy pivovareny kompaniu Bravo International mozet kupit South African Breweries”; [web page] http://unipack.ru/r4_det.html?num=2152&file=arch [Accessed June 6, 2002].

³⁶⁸ *Ibid.*

³⁶⁹ Anna Sherbakova, “Heineken ne ispugala zena “Bravo”, [web page] www.beerunion.ru [Accessed March 2002].

³⁷⁰ *Ibid.*

³⁷¹ *Ibid.*

³⁷² *Ibid.*

be difficulties. The time when the Russian government prohibited to sell beer in the regions without special excise mark and did not issue the sufficient quantities thereof, can serve as an example. Bravo' production decreased and the company lost RR 120 million. Bravo was going to sue the Russian Government. However changes in the law abandoned the government's decision.³⁷³ We already mentioned other possible obstacles on behalf of the government such as sanitary and advertisement rules, for example.

It is interesting to note that apart from beer, Bravo is famous in Russia for its mixed drinks. Heineken and the founders of Bravo will jointly continue to develop Bravo's mixed drinks in a separate company, Heineken's press release says.³⁷⁴ Heineken owns 50% of this entity's shares, according to Jan van de Merbel. However, some argue that they have only 49% and the business will be controlled by the former owners. If this is true, it means that Heineken trust them with their investments. Maybe Heineken is sure about their connections and experience of doing business in Russia. Merbel argues that it is more difficult to enter the market of mixed drinks, competition is not very high in it and they are real experts in it, this is why they kept this business. "Actually, it is not our major, and we are dealing only with beer, but it was part of Bravo, so we had to buy half of shares. But it is not strategic for us", Jan van de Merbel argues.³⁷⁵

10.3. Conclusion

The production of beer is closely linked to agriculture and the supply of other related products such as cans and bottles, for example. Investors tend to avoid currency and other risks linked to the importing of ingredients, thus investing in domestic agriculture, for example. Investors are using their own fund as well as loans like Baltika. According to PricewaterhouseCoopers, the lion's share of all foreign investments in Russia, is channeled towards modernizing existing capacities and acquiring new fixed assets.³⁷⁶

³⁷³ "*Bravo narashivaet moshnosty*"; [web page] www.beerunion.ru [Accessed April 4, 2002].

³⁷⁴ www.heinekencorp.com [Accessed May 12, 2002].

³⁷⁵ Interview with Jan van de Merbel, Heineken's investors relations specialist. June 25, 2002, Amsterdam, The Netherlands.

³⁷⁶ "Doing business in the Russian Federation", PricewaterhouseCoopers, February, 2001, p. 5.

As we mentioned EBRD was interested in future investment programs with respect to Baltika. That is the possibility we were referring to when saying that an example of one industry can play a big role in development of the whole economy. Bolloyev, for instance can lobby for projects from other industries, because creditors trust and believe him. The President of EBRD and Bolloyev agreed to work together in future.³⁷⁷ However, we should also point out that the sector-to-sector capital flow in Russia is at a very low level, according to the report prepared by the Expert Institute and the American Chamber of Commerce in Russia.

Investors working in the Russian market basically use borrowed funds. Bravo and Baltika heavily depend on this leverage. However, Heineken used his own reserves for buying Bravo and investing in equipment upgrades. Nonetheless, most Russian companies must still rely on internal revenues as their primary source of investment capital, because of the weakness and underdevelopment of the financial markets. Together with the banking system, they continue to hinder capital flow between industries.

The first investment programs on companies and new equipment immediately made them the leaders of the Russian beer industry. The production as well as the quality increased and improved dramatically. There is a tendency that investors first improve quality - benefit consumers and then expand its production across the country. Baltika was the first example of the “new” Russian beer. However investments were needed in order to achieve that. Heineken will also invest in order to improve quality, however it is already at an improved level of quality, it is the premium beer segment. The first investments made by BBH benefited consumers with good quality beer and on the other hand supported the shift from vodka to beer, improving beer taste. Now the market is quite mature and Russian consumers are acquainted with different kinds of quality of beer. Together with other social factors there is a shift towards more expensive and high quality beer. Heineken is investing in order to start producing this particular kind of beer, and then also to expand its production across the regions. Therefore the main strategy is almost similar.

The investors brought technology and know-how to related industries also: water treatment, ecology and environmental issues, for example. Both companies pay a

³⁷⁷ <http://www.tabepha.ru/news/pz/pz-baltika/index.html> [Accesses June 12, 2002].

great deal of attention to it. The idea that multinationals bring only tainted productions to transitions and are looking for “pollution heavens”, is refuted by the considered companies.

We should mention that in Russia there are some difficulties with glass for beer production. If one, for example, wants to order beer from Baltika, he needs to change beer on empty bottles. It means that he first needs to find them. In order to do that you have to buy empty bottles from citizens and this relates to all kinds of problems arising with the organization of this procedure. In the Netherlands, for example, customers are just paying some additional money for bottles (*statiegeld*) and are repaid the original *statiegeld* when returning empty ones. The problem is quite critical in Russia, because during Soviet times there was little attention paid to tare and packaging, but now, on the basis of different marketing strategies, these issues became very urgent. We believe that investors operating in the Russian beer market are going to serve the problem and soon investments into the glass factories could be expected. It is one more example of how investments can pool into the Russian economy.

Conclusion

There is no doubt about the importance of FDI for developing countries: foreign investments bring higher wages, it is a major source of technology transfer, know-how and managerial skills. There is a direct link between FDI and domestic investments. The factors responsible for FDI level are on the whole the same as those depressing domestic investment. Thus progress in attracting FDI will help to increase domestic investments. All developing countries realized it and are trying to do as much as possible to attract investors. They adopt new legislation giving investors different guarantees. Investors are interested in making profit and are also interested in new markets for their investment. They are given all kinds of recommendations and advice with respect to developing countries.

We should mention that investors are careful entering the emerging markets. No one will just come and invest huge amounts. Heineken, for instance, tried all different kinds of market entry: exporting, looking for license production and only after obtaining some experience of doing business in Russia, acquired a brewery. BBH, first acquired a small stake of Baltika and then increased it. However, BBH as a first mover provided a strong example to other investors that operations in such an environment are feasible. It is especially important to states which just opened their borders and want to attract investors. Specialists argue that the acquisition modes of FDI are used to accelerate the process of establishing local operations in countries where the level of stability is viewed as being more positive.³⁷⁸ The acquisition mode was used by Heineken, so it proves that certain level of stability in Russia is already established. On the other hand, investors are still not using Greenfield projects, and this means that some difficulties remain. They prefer to acquire going concerns rather than starting new business, as well as to work with domestic managers, which have deeper knowledge of local markets, familiar with suppliers, customers and market specifics.

Modernizing the economy is Russia's strategic objective during this decade. Russia must reach its economic competitiveness on a global level and create conditions for long-term and stable growth. Of course, it requires the development of an appropriate official policy and the creation of good investment climate.

³⁷⁸ "Foreign Direct Investment in Central Europe: "Experience of Major Western Investors", *European Management Journal*, Vol. 16, No.4, August 1998, p. 388.

The Russian government did much to improve the investment climate in the country, however investors complain that much more should be done. Legislative reform is only the first step on the road to improving investor's perceptions of the investment climate in Russia. Real progress is possible only with proper enforcement. It requires an independent and qualified judicial system and enforcement apparatus. Thus, the task of improving the investment climate should not be seen as one of looking for resources that can be attracted to the Russian economy, but rather as one of removing the administrative and institutional barriers that are hampering investment processes. Investors argue that many structural reforms were either incomplete or delayed, frustrating hopes for a surge in restructuring and new investment within the enterprise sector. We agree with Kudina M. V. that attracting of foreign investments must be done together with reforming of the total economic system. In order to do it, the most important thing is to determine the factors, which can attract investors and then to improve them. It is furthermore important to have a clear idea of where the most significant obstacles, encountered by investors, lie.

In the thesis we showed what investors were expecting from the Russian government and what was done. In Russia, the progress in improving legislation governing economic, business and investment activity is becoming visible. For example, only a few years ago taxation in the Russian Federation was considered as the biggest obstacle to foreign investors. However, the measures accepted by the Russian government made investors change their attitude about the issue. Investors are satisfied with the new Russian Tax Code and reforms in the field. Good examples are corporate governance and accounting reforms also. It means that Russia is aware of the investor's needs and is working step by step in the right direction. The most important to the Russian government is to keep foreign investors needs in mind, however paying more attention to practice and not only give different kinds of guaranties and promises. It appears not to be enough. For example, on first glance, the crime level is not directly related to investment activities, however, it turns out to be one of the most important determinants of the investors' decision making process. Organized crime and corruption remain Russia's major problems. Organized crime concerns privatization, banks in Russia are organized as treasures for big criminalized corporations, crime is everywhere. This is why work must not only be done on specific legislation on foreign investment but on the total complex of legislation.

It is important to get in touch with investors during the reforms to be able to respond to their needs sooner. We should mention that investors are quite active as well. They are taking part in the “Independent Director” program, for example, in 2001 Independent Research Task Force (IRTF) appeared in the Russian market. The IRTF analyzes the “weakest” parts of Russian enterprises looking for foreign investments and the “tricks” of Russian counterparties in order to make recommendations to foreign investors. IRTF specialist, Aleksey Danilianz, argues that the difference in the world outlook of counterparties is a more serious obstacle than the crime level in Russia³⁷⁹. “Investors frequently think in the “Harvard” way about doing business in Russia, however, in Russia one’s own experience is more suitable than any tutorials”, he argues.

It is amazing that most scholars discuss the different problems with investment climates, loopholes in legislations, lacking elements of investment policies. “Russia has problems here and obstacles there”. And this crises... It changed the attitude of investors towards Russia, their confidence was lost. However, we would mention that in any factor one can find positive sides. For example, the devaluation of the ruble created a growth impulse for Russia’s domestic producers of import-substitution goods, primary in retail sectors like the food industry. It was a great push to domestic brewers, in particular.

Moreover, despite all the hardships and risks investors face, there are many reasons to invest in Russia. Especially for investment in the beer industry we would list the following: the huge consumer market, federal and regional authorities are trying to create a good investment environment, the workforce in Russia is highly educated and labor is relatively inexpensive; using modernized Russian factories, foreign investors may produce competitively priced goods for world markets. Thus, it appears that everything is not so bad. Investors, nevertheless, are coming and operating in the Russian Federation. The Russian beer industry is a good example of this. However, it is important to note that the higher the risk, the higher the return must be, this is why investors tend to invest in industries with the quickest return such as food industry and brewers, for example.

³⁷⁹ Jury Sune, *op. cit.*, p. 35.

The Russian food industry and brewers are very attractive to investors and it has already proved itself. The beer industry only developed once the foreign investors arrived. Our research shows that the foreign investments translated into consumer and state benefits. FDI was a precondition to improving the quality of Russian beer and together with the state's social policy, it influenced the consumption of beer in Russia. This is why consumers got excellent quality and a product more healthy than vodka, investors got their revenues, the state budget got its taxes. It means that success has been achieved on several scores. The Russian beer industry proves that Russia can attract foreign investments, investors can earn profit in Russia, and all parties can benefit from it.

The beer industry is a real example of how investment could be attracted to the Russian Federation. On the tenth anniversary of Baltika, president Putin said that he remember the time when Baltika became an example of attracting of foreign investments to Russia.³⁸⁰ Gennady Seleznev, speaker of the State Duma, agrees with President: "During 10 years of its work Baltika proved that the Russian economy is not only alive, but it can reach European level. I am very proud that we have such companies of European level as Baltika"- he said.³⁸¹

The success of Baltika proves that the rapid development of the beer industry can push the development of other Russian industries. It can serve as a very good example of attracting foreign investments. There are no doubts that investments did much in this case. The investments in Baltika, for example, were one of the biggest investments in the food sector of the Russian north-west. Investments increased production several times in a short period of time.³⁸² Investors brought with them new technology, improved quality, a new way of life. Baltika's beer of the improved quality was a turning point in the Russian beer industry history. It was an example of the effect of foreign investments and the preconditions for new investments.

In our work we showed that investors first tend to invest in machinery in order to improve quality, then in distribution, to expand across Russia and for future exports, as BBH. The most important thing, we have to mention, is the tendency of investors to

³⁸⁰ "Imperia piva", [web page] <http://www.samara.ru/paper/41/2483/36190> [Accessed June 5, 2002]

³⁸¹ *Ibid.*

³⁸² http://beer.spbnews.ru/baltica_history.html [Accessed June 5, 2002]

develop related industries. The example is Baltika with its malt plant and discussions with EBRD about possible investments in the agriculture field. One more is the question of glass and cans for beer production. In our mind, for Russia it is of great importance now to create linkages between the foreign dominated sectors and other areas of the economy, to create the inflow of investment in other industries.

Much has been said above, terms regarding the need to deal with crime, corruption, enforcement of contracts and judgments in dispute resolution so as to improve the investment climate for foreign investors.

Finally, we would mention the importance of Russia's accession to the World Trade Organization (WTO) for its ability to attract foreign investment. Harmonization with international economic policy practices and integration into a multilateral trading system would only benefit the country. Investors are also looking towards it. Jan van de Merbel, for example argues that because of the integration of The Netherlands into the world community and WTO, Holland has no cars and textile production, however the country succeeded in other industries, like brewers, for example. It is important to become a member of WTO and to integrate and specialize. Russia needs to develop industries where it has advantages. An example of quick recovery and successful policy is the Russian beer industry. We believe it will become a solid base for future democratic changes in the Russian Federation.

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³⁸³ All legislative acts were taken from Legal Data System "Garant".

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