



THOMAS WHITE - GLOBAL INVESTING
CAPTURING VALUE WORLDWIDESM



Country Profile: Russia

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It has never been more important for you to understand what is occurring in the world beyond your country's borders. Whether you realize it or not, we are now all fellow citizens...Global Citizens.

The Thomas White organization was founded in 1992 with the goal of bringing the benefits of globalization to investors around the world. We believed that once investors understood that globalization was a positive force, they would also see the advantages of adding international equities to their portfolios. It only makes common sense that professional investors would begin searching the globe for the most attractive opportunities. Researching a wider universe of companies should improve long-term performance. Moreover, broad diversification typically lowers return volatility. Multinational corporations have been using this global strategy for years; why shouldn't investors do the same?

Now nearly two decades later, our firm growth and strong subsequent portfolio performance has confirmed our investment premise. Currently, Thomas White professionals are performing research and managing over one billion dollars in close to 50 countries. We believe one reason for our success is that the nationalities of these analysts are as globally diverse as our portfolios.

A handwritten signature in dark blue ink that reads "James S. White, Jr." The signature is written in a cursive, flowing style.

Russia: Rebounding from Recession



A testimony to Russia's remarkable transformation to a free market society, the RTS Stock Exchange supports an emerging economy with a market cap crossing the US \$1 trillion mark.

Avast nation replete with diversities, Russia geographically spans the breadth of the two continents of Asia and Europe. It is the largest country in the world in terms of its geographical area of more than 6.6 million sq. miles, and is almost twice the size of the U.S. While the population is 141 million, the population density in the country is 25% of that of the U.S., amongst the lowest in the world. A country with extreme climatic conditions, difficult terrain, and spread over 10 time zones, Russia boasts of abundant mineral resources, especially oil, natural gas, and coal reserves. It is the world's largest oil producer and the second largest exporter after the OPEC. The city of Moscow is clearly the political, economic, and financial center of Russia, accounting for over 50% of the country's credit institutions and foreign direct investment in 2007.

A journey from communism to democracy

The largest republic of the erstwhile Soviet Union, Russia has also been witness to

contrasting political structures. As a part of the Soviet Union, it experienced an authoritarian one-party communist regime from 1917-1990. Under its rule, critical decisions related to production, consumption, and distribution were centrally planned and enforced. The period also marked the genesis and build-up of the Cold War, characterized by the rivalry between the U.S. and the former Soviet Union, the two superpowers who battled each other on numerous turfs, whether it be ideological, political, economic, technological, industrial, or military.

The stand-off intensified during 1945-91, and though there was no direct military confrontation between the U.S. and the Soviet Union, it led to the creation of an increasingly polarized world. The Soviet Bloc, consisting mainly of communist nations in Eastern Europe, was pitted against the Western and Southern European nations which owed allegiance to the U.S.-propagated capitalistic ideology. While Joseph Stalin, who assumed power as the communist leader of Russia in 1922, rapidly transformed the Soviet Union into an industrial powerhouse, his policies were inward-oriented, and led to increasing isolation of Russia from the rest of the world.

Russians warm up to the world

The regime of Mikhail Gorbachev during 1985-90 is considered to be a groundbreaking one, marking the end of an era of isolation. At this time, the country experienced a visible paradigm shift. The cold war with the U.S. started thawing during this period. Gorbachev propagated the principles of *glasnost* and *perestroika* (openness and restructuring), encouraged private enterprise, as well as economic reforms. He initiated the process of the country's integration with the world. The opening of the first Soviet McDonald's outlet in Moscow in 1989 was one of the first outward signs of Russia's changing attitude to the western world.

Russia and the World	
Nominal GDP	\$1.231 trillion
GDP Rank	12/193
Per Capita GNI	\$9,340
Per Capita GNI Rank	76/213
Population Rank	9/227
Geographical Area Rank	1/251
Global Competitiveness Rank	63/133
Economic Freedom Index Rank	143/179
Human Development Index Rank	71/182
Major Industries	Oil, Natural Gas, Retail, Manufacturing

However, while Gorbachev was proclaimed worldwide as the pioneer of change and a visionary, he became increasingly unpopular in the Soviet Union as Russians battled scarcity of food and other basic amenities. There were agitations and increasing demand for independence from the 15 republics of the USSR.

... and a New Era is ushered in

Democracy made its first entry into Russia in 1991 when the Soviet Union disbanded itself into numerous independent states called the Commonwealth of Independent States (CIS). In that year, Boris Yeltsin emerged as the first democratically elected President of Russia.

The early 1990s were characterized by an austerity regime, which caused prices to skyrocket, while a severe credit crunch devastated many industries in Russia, triggering a virtual depression in the country. The reforms also wreaked havoc on the living standards of the populace, who were now deprived of the Soviet-era state subsidies. However, Yeltsin's promise to discard some unpopular economic reforms, and boost welfare spending, helped him regain a second term as President in 1996.

However, political and economic debacles continued to engulf the ailing President, especially Russia's debt default in 1998 and the ensuing financial crisis. Yeltsin eventually resigned in December 1999 in a surprise move, nominating Vladimir Putin as the acting President, who then went on to win the Presidential elections in 2000. Putin was subsequently re-elected for a second term in 2004. As per the Russian constitution, Presidential elections were held in March 2008, and Dmitry Medvedev, Putin's trusted aide and nominee, enjoyed a landslide victory. He is the reigning



The *Matryoshka*, or nesting doll, originated in Moscow over 100 years ago, and remains an endearing symbol of Russian culture.

President, while Putin continues to wield power by assuming the role of Prime Minister.

A Cultural Assortment

While Russians constitute about 80% of the population, and Christianity is the predominant religion, Russia still maintains an ethnically diverse character. The affluent Moscow region contributes to one third of the country's output. The vast expanse of North Russia, Siberia, and the Far-East is home to over 60 ethnic groups, many of whom lead a primitive lifestyle with hunting, cattle breeding, and fishing as their main occupations. Siberia, which constitutes 75% of the Russian landmass, accounts for just 23% of the Russian population owing to its treacherous terrain and severe winters. Three out of four Siberians live in urban areas, while the rest practice herding, farming, and hunting in isolated or nomadic settlements.

Demographic Changes Reflect Transition Traumas

Since the collapse of the Soviet Union, Russia has experienced a decline in its population growth rate. The life expectancy is the lowest among industrialized nations and Western European countries. This is especially true of male life expectancy which is 59 years, the lowest even within the CIS region. In contrast, most Western European countries like France, Germany, Italy, and the U.K., boast of an average male life expectancy of 76 years. Shockingly, Russia on an average expects only 42.1% of its male population to survive up to 65 years of age. The socio-economic turmoil in the 1990s, labor market restructuring, and loss of social provision have manifested themselves in psychosocial stress and alcoholism. This has resulted in a higher incidence of cardiovascular ailments. Such mortality trends pose a challenge to the socio-economic development of the country.

However, on a positive note, the country touts a 99% adult literacy rate, which is quite aligned and comparable to the developed world. Coupled with a newfound standard of living that is impressive, the country fairs reasonably well in human development, ranking 67 out of 177 countries in the world. Russia prides itself for having more higher education graduates than any other country in Europe.

Engine of Growth



Despite efforts to diversify, the oil and natural gas industry continues to drive Russia's economy.

A country that derives its economic strength substantially from its natural resources, especially oil and petroleum products, Russia has been successfully riding the high oil price wave since the onset of the decade. Moreover, Russia surpassed Saudi Arabia in oil exports recently for the first time since the Soviet Union's collapse. Over 70% of Russian crude oil production is exported, while the remaining 30% is refined locally.

The country houses the world's largest natural gas company, which stands tall as an icon representing Russia's proud position as a global energy business leader. Owner of the world's largest natural gas reserves and natural gas transmission system, exporting to 32 countries worldwide, the company's share in global natural gas production is 20%. Moreover, the largest privately owned oil and natural gas company in the world by proved reserves of oil and the second largest in terms of proved hydrocarbon reserves is also based in Russia.

This firm has its business spread across 30 countries, and also retails petroleum products in 22 countries. The country also touts the world's largest pipeline system spanning over 31,000 miles, owned by a state-run oil company.

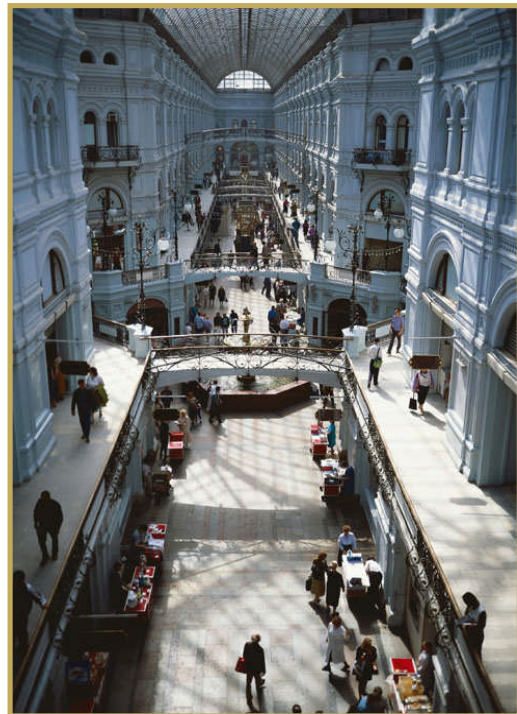
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About half of the country's exports are comprised of crude oil and natural gas. The natural resources sector also appropriates most of the FDI inflows coming into the country. At present, the integration of the Russia into the global economy is thus largely leveraged by oil, natural gas, and mineral resources.

...And some new sectors on the block

Apart from the dominant oil and natural gas industry, construction, retail, banking, and manufacturing are a few other emerging sectors in the country. Russia's exuberant consumerism, fueled by surging oil prices, had boosted the retail sector, until the financial crisis changed the scenario. Modern retail has been growing at about 13% a year in Russia and also increasingly spreading to tier-two and three cities. Moreover, the country's modern retail food sector is expected to increase its share in the overall Russian grocery market in the next two years. It is interesting to note that even the older population of Russia now overwhelmingly prefers modern retailing formats to traditional stores. While domestic retailers lead the way, global retailers are also benefiting from the retail boom. Critical growth drivers for the economy include Services, which contribute 56% of the economy's output, and Manufacturing, which makes up 38% of the GDP.

The retail industry, which includes automotive and household goods repairs, received the highest FDI inflows in 2008. However, the sector has trailed the manufacturing industry in recent times. Despite a rapidly shrinking economy, manufacturing has recorded growth, an encouraging sign. Real estate, retail, finance, and construction are the other prospective emerging sectors in the world's tenth biggest economy. As such, it is not surprising that Russia has been identified as an economy with high FDI potential.



As retail comes of age in the country, global retailers are making a beeline for Russia. Elaborate and expansive malls are sprouting up in support of this booming market.

Economy: Recovery Trails BRIC countries

After the tumultuous transition years from communism to capitalism spanning the 1990s, the Russian economy has been on a steady growth path since the onset of the 21st century, barring the recessionary phase during the latter half of 2008.

The eight years between 1998 and 2006 have virtually been witness to an economic miracle, as Russian GDP expanded by an unprecedented 57.6%, while real income of the population grew by 65%. Poverty rates were cut by half and regional disparities toned down to a degree. The inflation rate, which was as high as 47% in 1996 declined to 9.6% by 2006. High-energy prices, robust domestic demand, large foreign inflows, and macroeconomic reform enabled the economy to clock an impressive growth. Economic growth averaged above 6% between 2001 and 2008, touching a high of 8.1% in 2007. However, the turmoil which engulfed the global financial system in 2008 sent Russia into its first recession in a decade, marked by a collapse of its stock markets, a massive flight of capital, and the loss of one-third of the value of the ruble. Growth remained stagnant, while consumer and investment demand came to a grinding halt across all regions of Russia. The largely oil-dependent economy crushed under the impact of tumbling oil prices, which sunk to abysmally low levels as most major economies went into a recession. What made Russia particularly vulnerable to the crisis was its overt reliance on the oil and natural gas sector and a narrow industrial base.

The Kremlin responded by announcing stimulus packages worth over US \$200 billion. The Russian government's unprecedented policy response focused mainly on supporting the financial sector and enterprises. The oil reserve fund built up during the boom years helped the government pump in money into key sectors of the economy, notwithstanding the mounting fiscal deficit. The gradual recovery in oil prices also helped the country limp back to normalcy.

Despite the stimulus programs, Russia was the worst-hit among BRIC nations by the global financial crisis, with the country's real GDP contracting 7.9 percent in 2009 compared to the rosy outlook for other members of the BRIC group. Depressed export demand, tight credit flow, declining investment, and reduced consumption kept economic activity subdued for a while. Output is not seen to reach the pre-crisis high at least for the next few years. To make matters worse, the banking sector is in dire straits with overdue loans expected to increase sharply, weakening capital adequacy. Despite the central bank lowering its interest rate several times, the banking industry remains structurally weak. To rev up the sector, the government set aside about \$16 billion to support bank recapitalization.

Another fallout of the crisis has been the onset of social tensions in the wake of soaring unemployment and unpaid wages. Unemployment skyrocketed to an eight-year high and dampened growth in real wages. The Russian government was quick to react, ordering regional representatives to tackle the issue. However, the World Bank estimates unemployment and poverty in Russia will remain high in the near term.

The Russian market has tracked oil prices since the middle of 2008. With a market capitalization crossing US \$1 trillion, the Russian Trading System (RTS) is considered the benchmark of the Russian market, reflecting one of the most dynamically developing emerging markets in the world. The blue chips in the Russian market are represented primarily by two sectors, Oil and Natural Gas, as well as Communications. A number of Russian stocks trade as ADRs on big Western European and American exchanges.

Interestingly, the Russian economy's recovery from the recession has been equally dramatic. The gradual improvement in oil prices, crucial to the economy, helped the country emerge from recession in the third quarter 2009 with a quarter-on-quarter growth rate of 0.6%. Helped by increased oil prices, Russia posted a growth rate of 4.1% in 2010. Significantly, Russia's total oil production touched 10.145 million barrels a day in 2010, the highest level since the break-up of the Soviet Union, thanks to the rising development of greenfield deposits. However, the growth story was interrupted by an unprecedented heat wave and drought, which destroyed much of the crops and slowed down the economic recovery. Needless to say, food prices rose by a whopping 12.9% in 2010, compared to a 6.1% increase in 2009. The rate of increase in food prices surpassed the consumer inflation rate of 8.8% recorded in 2010. The surging inflation in Russia caught the attention of the International Monetary Fund, which in December 2010 urged the country to focus on bringing down inflation. The IMF also cautioned that the country's economic recovery may remain subdued as the global recovery is uneven. Inflation pressures have forced the central bank to say that interest rates may have to be raised in the first quarter of 2011.



The Russian government's announcement of a \$32-billion privatization plan is the latest move to change investor perceptions about doing business in Russia.

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Business Climate

Russia was a favorite destination for FDI inflows until the onset of the financial crisis, when foreign investments were reduced to a trickle. However, the potential for future FDI inflows remains large, with the energy sector slated to draw foreign investors who want a piece of the country's huge natural resource pie.

However, the country's business environment is still a weak area, with government intervention in private enterprises being the norm rather than exception. Some foreign companies have run into problems with their

local partners, while the Russian administration has not hesitated to bully companies which seem to pose a threat to government-owned firms. In a 2009 study by World Economic Forum, Russia stood 114th out of 121 countries in terms of foreign trade. Despite the government slashing of corporate tax rates recently, Russia stands to lose competitiveness as foreign investment dries up. Lack of modern infrastructure is also hurting the country's business prospects.

The slowing domestic growth in the wake of Russia's unprecedented drought in the first half of 2010 also spurred a dramatic increase in capital flight from the country during the year. Foreign direct investment into Russia plunged 17.8% to \$8.2 billion during the first nine months of 2010. The Russian government, realizing the need to improve investor perceptions about doing business in the country, launched a second round of privatization of state-run assets in the second half of 2010. The proposed \$32-billion program involves the sale of the country's largest rail freight operator, as well as a stake in a state-owned oil producer, and minority stakes in two prominent government-owned banks. The revenues garnered from the sell-off will help the government bridge the country's widening budget deficit. Encouragingly, big-ticket M&A deals such as PepsiCo's acquisition of Russian dairy producer Wimm-Bill-Dann in December have helped allay investor concerns about the business environment in Russia.

Moving closer to enter WTO

The long-delayed question concerning Russia's entry into the World Trade Organization seems to be heading for a happy ending. Russia has now cleared two big hurdles that were hindering its entry into the elite club. WTO rules empower existing members to veto new applicants. In September 2010, Russia entered into a bilateral agreement with the United States which cleared the air on many issues. Following the U.S. nod, Russia clinched another deal with the European Union in December, which required Russia to withdraw export duties imposed on timber and to slash railway freight tariffs. These items aside, some multilateral issues also need to be sorted out in the coming months before Russia makes a formal entry sometime this year. Now that the WTO membership is becoming a reality, questions have been raised on how much Russia will actually benefit from the deal since oil and natural gas exports to the European Union are already exempt from tariffs. However, few would disagree that WTO membership would help Russia attract the foreign investments it desperately needs to modernize its oil and natural gas-dependent economy.

Seeking Better Ties with the Ukraine

Internal squabbles between Russia and some of the erstwhile Soviet republics have been the bane of the Russian energy sector. The country has had a long-running feud with Georgia, which escalated into a full-blown war in August 2008. The Georgia stand-off and the recurring disputes with the Ukraine have wielded a body blow to the country's business prospects, especially its

flagship oil and natural gas industry. Over 80% of Russia's Europe-bound natural gas is transported via the Ukraine. Adding fuel to the fire, the Ukraine threatened to raise the natural gas transit fee by 65 to 70%. To tide over the crisis, Russia has been promoting project Nord Stream, a new scheme which will bypass the troublesome regions, mainly the Ukraine.

In a significant development, Russia has been cozying up to the new political leadership in the Ukraine under Viktor Yanukovich. Under the terms of a deal inked by Medvedev and Yanukovich, Russia's state-run Gazprom agreed to a 30% cut in the price of natural gas supplied to the Ukraine and to increase investment in the country. Russia, in turn, would benefit from an increase in gas supplies and an extension of the lease for a Russian naval base stationed in an Ukrainian port. However, cracks soon surfaced in Russia-Ukraine links when Prime Minister Putin made an impromptu proposal that the Ukraine's state-run Naftogaz be merged with Gazprom. The implications of such a deal could be far-reaching: Firstly, it would be nothing short of a takeover of a Ukrainian company saddled with debt. Quite naturally, the European Union, which buys Russian gas through the Ukraine, would be troubled by the move. Finally, the Western world, which has been trying hard to woo the Ukraine away from Russia, would find the development detrimental to their interests in the region. Though the Ukraine has not responded positively to the merger proposal, Russian President Medvedev talked about the possibility of joint ventures or partnerships between companies in both countries. While Russia has always wanted control over the Ukraine's gas pipelines, the southern neighbor has been urging Russia to abandon the idea of a new pipeline which would bypass the Ukraine. Alternatively, the Ukraine has floated the idea of modernizing its pipelines with help from natural gas companies in Russia and Europe. However, the future of Russia's monopoly in natural gas is facing a serious threat. Europe is trying to ensure its energy security by diversifying the sources of supply with imported natural gas from Norway, Qatar, and Trinidad. Moreover, the European Union has started work on the Nabucco pipeline, which will connect Europe to natural gas-rich Central Asia via the Balkans, Turkey, and the Caucasus region, a move which has won the approval of the transit countries. Russia's production growth in coming years will depend much on the availability of viable export routes for the country's oil.

Resource nationalism seems to be the order of the day as far as the Russian oil and natural gas industry is concerned. Under Vladimir Putin, Russia brought more than half of its oil industry under state control. Foreign companies started investing in Russia's oil and natural gas sector in the 90s. However, frequent skirmishes and concerns about Russia's business environment have deterred Western and European companies from venturing into the country's oil and natural gas sector in recent years. State-run oil and natural gas firms still have an edge when it comes to competing with rival firms. Furthermore, taxes on oil exports and extraction are still high, which deter potential foreign competitors.

Overcoming Challenges Key to Success

Russia has to grapple with social issues of poverty and unemployment even as it emerges from the recession. While an increasing focus on diversifying the economy will help to ensure a sustainable and balanced growth, the country would do well to encourage small and medium enterprises. To leverage the great FDI inflow potential, the

investment climate should be enhanced and barriers to entry and exit should be

reduced. The banking system needs to be revamped, and the dominance of oil and natural gas monopolies should be checked to create a level playing field. High levels of corruption and poor infrastructure also impede the country's development. The largest country on earth can make the most of its geographical advantages and develop its human capital, and productivity could be improved. Fostering a free market economy, Russia has the ability to emerge stronger and unleash its full potential to ensure its place in a globalized world. 🌐



Moscow enjoys the distinction of being the largest city in Europe, ahead of London. As Russia emerges as one of the world's economic powers, the country's capital has become the cynosure of all eyes.

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