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## *How Decisions on Investing in Russia are made by German firms?*

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### **Abstract**

In the paper we have clarified how the German multinational (MNE) and small and medium sized enterprises (SME) appraise and perform their foreign direct investments in Russia. Our analysis was supported by a survey of German firms running their business in Russia which was made in the period from April to July 2008. In the survey we also asked about the problems and barriers which German companies face when they invest in Russia. Finally, we have presented how the ‘typical’ investment decision process is run in German firms that are going to Russia. German firms start up their operations in Russia by establishing a subsidiary (~80%). All information related to the investment decision is collected mainly internally (~80%). 66% of firms appraise foreign investment using the Discounted Cash Flow technique which incorporates principally macroeconomic factors, such as the expected inflation rate (~70%) and the GDP growth (86%). Institutional factors describing a country’s level of corruption, the quality of governance or economic policy and economic structure risks are generally ignored. One sixth of firms use these indicators only. The expansion is often financed by the parent company (43%) or by German home banks and their Russian subsidiaries. The main obstacles while investing are the weak and changing legislation, frequent tax inspections, complex tax system and corruption. Undeveloped transport infrastructure belongs to the significant barrier as well. However, such factors as language, domestic competition or limited access to the strategic important industries are considered as minor hurdles. Besides this, profit repatriation restrictions are assessed as a moderate problem. In two thirds of cases the expected return on investment has been achieved or even beaten. The key reasons for the failure of investment are overoptimistic market expectations, unsatisfactory qualifications of the domestic personnel, unreliability of business partners and non-accurate market research.

Key Words: Investment Climate, FDI, Germany, Russia.

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## **1. Introduction**

In the paper we have clarified how the German multinational (MNE) and small and medium sized enterprises (SME) appraise and perform their foreign direct investments in Russia. Our analysis was supported by a survey of German firms running their business in Russia, which was made in the period from April to July 2008. In the survey we also asked about the problems and barriers which German firms face when they invest in Russia. The questionnaires were sent out mainly to the members of the German-Russian Foreign Trade Union (Deutsch-Russische Auslandshandelskammer) and the East Committee of the German Economy (Ostauschuss der Deutschen Wirtschaft). The response rate amounted to around 20%. Four firms said that they had not yet started up in Russia. One company had sold its Russian entity to a private-equity firm. Four companies were not able to answer precisely due to the lack of time.

Our paper is structured as follows. In the first chapter we analyze how German firms evaluate and perform investments in Russia. The second part is devoted to the analysis of problems and obstacles that German firms have when investing in Russia. In conclusion we presented how the ‘typical’ investment decision process is run in German firms that are going to Russia.

## **2. Evaluation of investments**

The expansion to new markets can be one of the suitable strategic options available for a growing company. In terms of the ‘eclectic paradigm’ two kinds of resources motivate a decision of a company to go abroad: ‘ownership’ advantages (company-specific assets that are costly to produce but easy to transfer across national boundaries e.g. R&D, technical and managerial know-how) and host-country ‘locational’ advantages (factors that make it profitable to operate abroad e.g. market size, lower foreign labour costs, government investment incentives and subsidies). Thus, at any given point of time, the level and composite of a firm’s foreign activity reflects its strategic response to the ownership specificity (O), locational (L) advantages and to the opportunities open to the firm to internalize (I) the market for its ownership advantages (Dunning, 1993).

There is a wide variety of possible ways of starting foreign activity, ranging from exporting to establishing wholly-owned subsidiaries or strategic alliances (licenses, franchises, joint venture) which differ in terms of the commitment of the investor’s own resources and the risk it is willing to accept and the need to control foreign operations (Douglas and Craig, 1983). FDI as an entry strategy is chosen by larger firms that have greater international experience, in

regions that are perceived to have high potential (Agarwal and Ramaswami, 1992). It may take the form of wholly or partially-owned subsidiaries or joint ventures. As can be seen from our survey, 7% of German firms started up the Russian business in the form of joint ventures, 79% - established a wholly-owned or partially-owned subsidiary. Joint venture entry mode would be preferred when cultural distance is large between the host and the home countries (Agarwal, 1994). The probability for forming joint venture is positively related with the level of host country welfare, the level of host government restrictions and level of competition in the host country (Gomes-Casseres, 1990). As the German and Russian cultures are quite similar, the level of competition on the Russian market is still often not so intensive and the Russian governmental restrictions are not so tight, the result of our survey (only a 7% share of joint ventures in entry modes) is in the line with the theoretical background.

14% of German MNE and SME entered the Russian market through merger and acquisition (M&A) transactions, double as much as established sales representatives.

When a strategic decision on investing abroad has been made, firms begin to gather information relevant to investment appraisal. Near 80% of investors gain information through the internal market research, 36% contact the Deutsch-Russische Auslandshandelskammer. The table below indicates that the average satisfaction with the internal market research was even higher than with that made by an external provider. The least satisfaction was received from the Association of German industries (2.7).

Table 1. Ways of information collection and satisfaction level

<b>Way of information collection</b>	<b>% of usage</b>	<b>Satisfaction level</b>
Internally	80%	3.8
Outsourcing to a Big Four company	21%	3.0
Outsourcing to a German tax and legal advisor (Roedl&Partner, Burkhardt)	21%	3.7
Association of German industries (BDI)	21%	2.7
German-Russian Foreign Trade Union (AHK)	36%	2.8

Note: satisfaction level scale: 1 – not satisfied, 5 – very satisfied.

The most popular investment appraisal technique among German firms is the Discounted Cash Flow approach. Two thirds of firms use this tool. This corresponds to the conclusion of a survey by Horvath and Partners Management Consulting (2006) which states that more than 80% of German companies appraise investments with the help of the Discounted Cash Flows

technique or Free Cash Flows technique (Hofmann et al., 2006). Strategic management tools, such as the BCG matrix were the next most important investment evaluation practice, ranked by 17%. One half emphasized the strategic importance of the Russian market as the reason for the expansion to Russia.

Using the DCF assumes the estimation of future cash inflows and outflows in the parent's currency (e.g. EURO) and discounting them by the appropriate cost of equity from the parent's perspective. Country, industry and company-specific risks should be accounted for in the relevant cash flows or in the discounting rate. For instance, corruption implies extra costs for a firm in the form of bribes, but it may also be cost-reducing, given that bribing leads to advantages, such as a preferential tax treatment, reduced costs for licenses and permits or a faster handling of bureaucratic procedures (Hakkala, 2005). The recommended treatment for allowance for country specific risks is that all factors affecting the amount of future cash flows are reflected in the expected values and associated probability distributions of the cash flows to be discounted. Uncertainties about cash flows arising from country specific risks should be captured in the forecast of Russian roubles cash flows (Armitage, 2005).

Country specific risks can be assessed through a number of aggregate indicators composed by international organisations, such as the World Bank and Transparency International. In our survey, the investors were asked for to indicate whether they account for the following measures:

- CPI – Transparency International Corruption Perceptions Index ranks countries in terms of the degree to which corruption is perceived to exist among public officials and politicians. It is a composite index, a poll of polls, drawing on corruption-related data from expert and business surveys carried out by a variety of independent and reputable institutions;
- CRS – Economic Intelligence Unit Country Risk Service measures political, economic policy and economic structure risks as well as currency, sovereign debt and banking sector. It is designed for commercial bankers, institutional investors and corporate executives who invest in both emerging and developed markets;
- KKM - World Bank Kaufmann-Kraay-Mastruzzi Worldwide Governance Indicator measures the quality of governance and captures six key dimensions of governance (Voice & Accountability, Political Stability and Lack of Violence, Government Effectiveness, Regulatory Quality, Rule of Law, and Control of Corruption) for the period between 1996 and present. It is based on approximately 40 data sources produced by over 30 organizations worldwide.

Our underlying assumption was that investment climate indicators might affect 'foreign risk premium'. As proposed by Dymrza (1972), investors might construct a composite risk

factor reflecting the country investment climate risks based on uncertainty of cash flows and then use this factor to discount forecast cash flows. The survey states that only one of six firms (16%) involve investment climate indicators when they appraise investment; more than half of firms is not familiar with them at all. This result may be due to the fact that firms are not aware of the logic behind these indices. In other words, how can the value 'four' of CPI Index ranging from 'one' to 'ten' be interpreted in terms of the 'foreign risk premium' or incremental cash outflows? What does the increase in the CPI from 'four' to 'five' mean? Should the discount rate be decreased accordingly? There is no commonly recognized methodology to solve this problem. That is why it is highly probable that political and regulatory risks are accounted for intuitively or emotionally by decision making person. Emotions are intimately linked to personal experience, foreign market and language experience, personal interests. Emotions can (and sometimes do) influence the perception of investment climate indicators or economic measures determining the final investment decision. An example is the valuation of a country risk indicator such as CPI which is nominally the same for all decisions makers. Its interpretation depends on the emotion of an individual decision maker. What the one decision maker who is familiar with the country and its specific business practices and language will consider as the moderate level of corruption, might be evaluated 'very high' by another (van de Laar & de Neuboorg, 2006).

Hence, it is not fully evident how German firms react and allow for political and regulatory risks. A possible scenario was analyzed by Leonhardt (2003), who tested the sovereign risk theory of FDI presented in (Schnitzer & Mueller, 2001) and used his survey of 380 German firms that invested in transition economies from 1989 to 2000 to prove that if political risks measured by the State Capture Index rise, the investor will decrease its ownership share in the FDI to protect itself against the possible expropriation via taxes by the host country government (Schnitzer, Mueller, 2001).

In the contrast to the institutional indicators, the host country's macroeconomic measures are appreciated. We were interested specifically in the six indicators of the macroeconomic environment: expected growth of GDP, inflation rate, creditworthiness, unemployment rate, exchange rate and country's external indebtedness. We found that over 90% of firms keep at least one of the above indicators in mind at investment evaluation (86% - GDP, 71% - inflation rate; chart 1). It has been expected because these indicators influence forecast cash flows and the rate of discount more directly. The creditworthiness of the host country impacts on a foreign risk premium. The inflation rate devaluates the real interest rate. The rising external debt ratio of a country induces companies to anticipate future tax liabilities to service the debt (Ghura and Goodwin, 2000). Fluctuating exchange rate can affect the foreign investment profitability estimated from the parent's point of view. Besides the influence on the future cash flows, such

indicators as the expected growth of GDP, inflation and exchange rate might partially determine a foreign risk premium as assumed by the macrofactor model (Elton, Gruber and Mei (1994)). We are, however, of the opinion that the expected inflation rate and the country rating as measured by S&P, Fitch or Moody’s are usually the only factors reflected in the discount rate applied. All other country’s macroeconomic conditions are captured in the forecast cash inflows and outflows. Whereas in measuring political and similar risks the investors rely on the ‘emotional’ evaluation by investment decision maker rather than on aggregate indicators developed by international institutions.

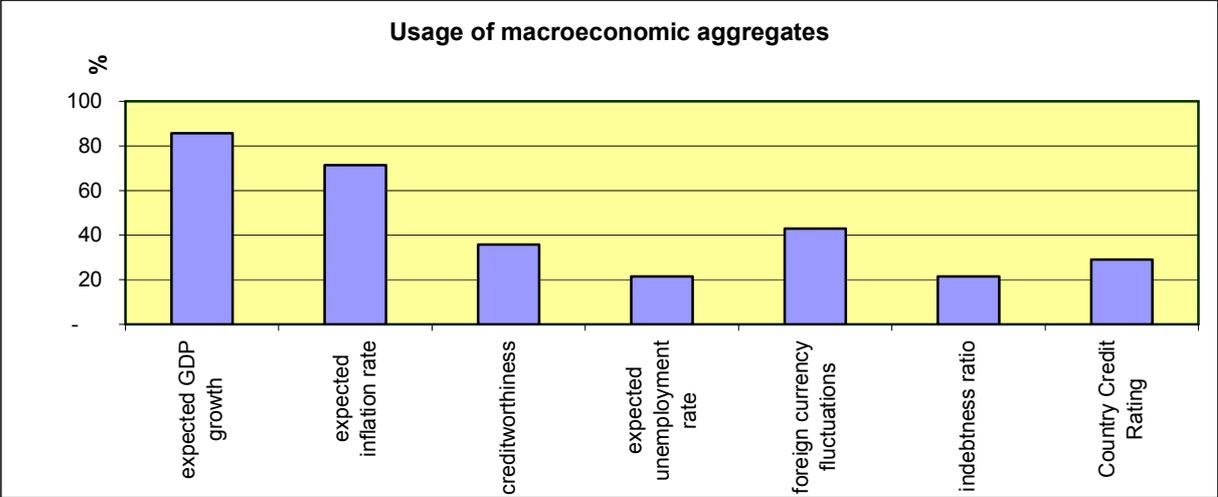


Chart 1. Usage of macroeconomic aggregates by German firms at appraising FDI in Russia

Firms that pointed out the usage of DCF or NPV were asked to state the time horizon in which future cash flows are usually planned. Answers were divided equally: one half forecasted cash flows for the period from one to five years; the other one – for the period from five to ten years. It is worth mentioning that under the International Financial Reporting Standards (IAS 36) for the purposes of the test on goodwill impairment<sup>2</sup> it is required to forecast relevant cash flows for the period up to five years.

Financing expansion: basically there are two ways of financing of foreign activity: through the internal capital market or external borrowings. 43% of firms cite that their initial Russian investments were paid off by German parent companies. 21% of firms borrowed from German home banks or their Russian subsidiaries. Around one third of firms left this field blank. For the cash management services 30% of firms chose German home banks, 36% -

<sup>2</sup> Goodwill is arisen from the purchase of a share in a firm in case the cost of acquisition is more than the fair value of net assets bought. Goodwill is recognized as a non-current non-tangible asset and should be tested on impairment annually.

subsidiaries of German home banks, followed by Russian state-owned banks (14%) or banks with the foreign capital (14%).

### 3. Hurdles of investing in Russia

Usually firms going abroad seek full-ownership of FDI, no restrictions on profit repatriation or capital flow control, protection of technology spillovers and intellectual property rights, transparent tax, legal and court system as well as consecutive government policy. In Russia, firms face a complex web of legal rules and bureaucratic procedures, all of which have the potential to increase costs and risks. We have considered mainly four groups of country specific hurdles: political risks, tax system, legal system, infrastructure.

Companies were asked to rate each hurdle from ‘one’ (‘very significant hurdle’) to ‘five’ (‘no hurdle’).

The most important elements inherent to the political risk are profit repatriation restrictions and complete loss of the invested capital due to expropriation as nationalization. Unless foreign investors operate in Russia in the so called ‘strategic important industries’ where the access of foreign capital is limited, we assess the risk of expropriation or nationalization as negligible. So we asked to evaluate repatriation restrictions only. As expected, profit repatriation restrictions in Russia are the medium problem for German investors (mean - 3.6). As can be seen from the table two, they are more concerned with excessive permissions and licenses required to run the Russian business. Slow bureaucracy and non-transparent governance are really common hurdles that are pointed out by foreign and domestic investors. These shortages are aggravated by bad tax administration, frequent tax inspections (mean: 2.6), as well as non-stable legislation (mean: 2.8).

Table 2. Hurdles of investing in Russia

<b>Hurdle</b>	<b>Mean</b>	<b>Standard deviation</b>
Language	4.0	0.9
Limited access to strategic important industries	4.0	1.6
High level of competition	4.0	0.8
Profit repatriation restrictions	3.6	1.5
Excessive permissions and licenses	2.8	1.1
Lack of good transport infrastructure	2.8	1.8

Non-developed banking and payment system	3.8	1.6
Non-stable and permanent changing law system	2.8	1.1
Complex tax system	2.6	1.4
Excessive tax rates	3.1	1.8
Frequent tax inspections	2.6	1.5
Corruption	2.8	1.6

Note: level scale: 1 – very significant hurdle, 2 – significant, 3 - medium, 4 - minor, 5 – no hurdle.

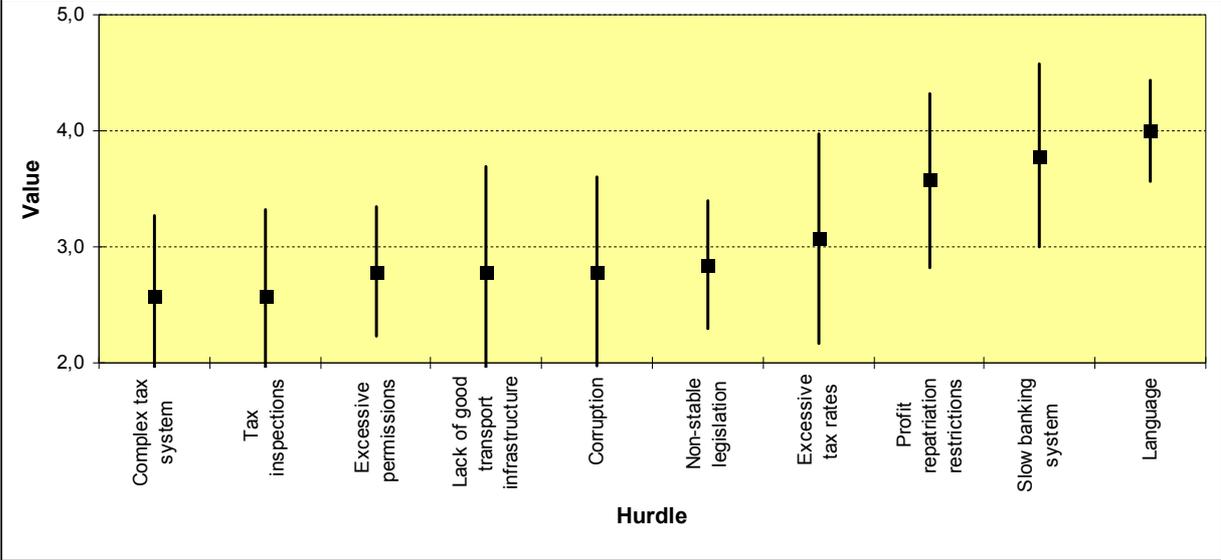


Chart 2. Ranking of hurdles of investing in Russia

Note: Square equals to the mean value of a hurdle; the difference between high and low values amounts to the standard deviation

Although the Russian language is the Slavonic one, language barrier is not a big problem. This is remarkable that the domestic competition is not the obstacle for investors as well. It demonstrates that companies from Germany have so valuable competitive advantages and advanced technologies which allow them to penetrate Russian markets successful, even if domestic competitors exist. In fact, in some industries, such as automobile construction, machine-building or petrochemical the technology gap is enormous. Accordingly, most Russian enterprises are not competitive.

Corruption is the element of the host country’s institutional environment that may act to deter FDI. As corruption is often treated as a tax, it should be incorporated into the FDI decision-making process, e.g. by inclusion in the forecast cash flows or respective discount rate. Corruption is considered as a medium hurdle by German investors. This figure can be understated as investors might be not fully honest in their answers. The scale of the obstacle is as long as for the non-stable legislation, excessive licensing and lack of the reliable transport infrastructure. Although in the academic literature Transparency International Corruption Perception Index is very popular, as it has been shown above, only 14% of firms take it into account in the course of the foreign investment evaluation. The effect of corruption is usually accounted for by provisions made for corruption related expenses on the basis of own previous experience or estimations.

Despite all hurdles German firms continue expanding their operations in Russia. From 2000 to 2005 the total German FDI in Russia increased 4.5 times to €6.8bn, while German export to Russia rose 2.6 times to €17.3bn (source: German Central Bank, Deutsche Bundesbank). Among the so called BRIC (Brazil, Russia, India, China) countries the level of German investments to the Russian economy is compared to Brazil, which is 2.5 times as much as to India and only by 40% less than to China. However, it is still low in comparison with the United States (30 times less) or neighboring West European countries (United Kingdom, France).

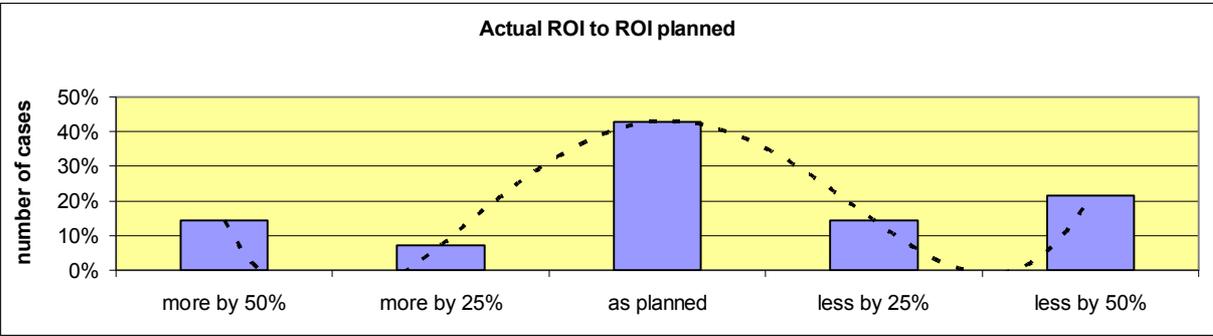


Chart 3. Distribution of German firms in accordance with the relation of the actual ROI to ROI planned

The further expansion of the current activity of German firms depends partially on their being satisfied with previous Russian investments. To measure the satisfaction we were interested in: (a) whether an investment decision would be made if it were appraised at present; (b) whether the planned return on investment (ROI) had been achieved. 57% of firms stated that they would definitely take investment decision again. 28% of firms cited that they would probable invest in Russia. The rest of firms was not sure about their behavior. These 57% are

well correlated with the share of firms ROI of which was actually achieved or even beaten (64%: calculated as the sum of the first three bars on the chart 3). On the other hand, firms which did not come up to expectations (36%) were unsure of whether they would invest in Russia if they evaluated investment decision at present (36%: the sum of the last two bars).

Finally, we found out the reasons that, in the opinion of firms, are in charge of investors failing to fulfill their goals. The reasons have been ranging from ‘the overoptimistic expectations’ to ‘the indiscipline of the personnel’. On the chart 4 possible reasons are shown in the ascending order. As can be seen from the chart below, ‘the indiscipline of the personnel’ is the least relevant cause, whereas ‘the overoptimistic expectations’ of investors explain the failure of their goals the best way.

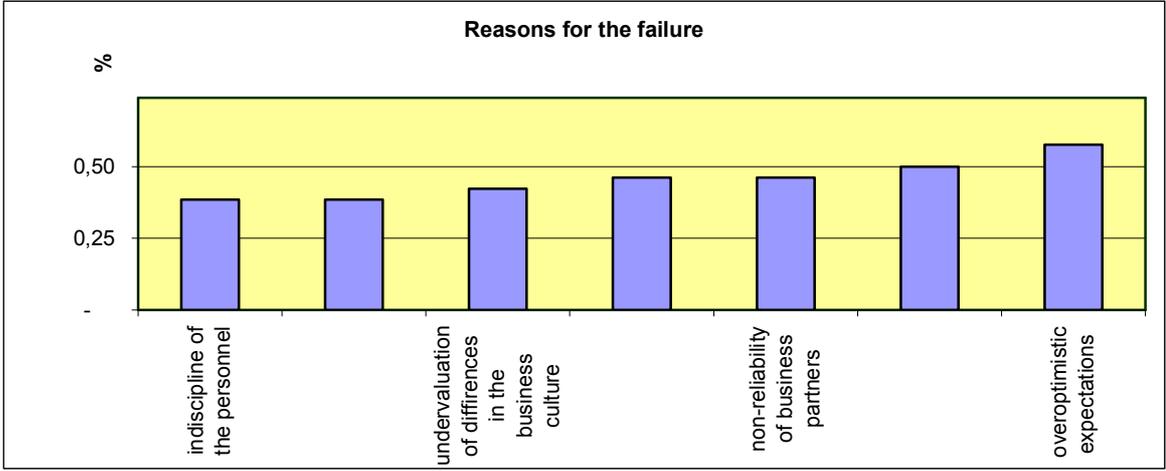


Chart 4. Reasons for the partial failure of investment goals

Note: 1 – the reason is high relevant; 0 – not relevant at all

**4. Conclusion**

Therefore a typical decision on investing in Russia can be presented as follows: German investors start up operations in Russia by establishing a wholly-owned or partially-owned subsidiary (~80%). All information relevant to the investment decision is collected mainly internally (~80%). A foreign investment is appraised by the Discounted Cash Flow technique by 66% of firms. Investment evaluation technique incorporates principally macroeconomic factors such as the expected inflation rate (~70%) and the GDP growth (86%). Institutional factors describing country’s level of corruption, the quality of governance or economic policy and economic structure risks are generally ignored. One sixth of firms use these indicators only when they make decision. The expansion is often financed by the parent company (43%) or by

German home banks and their Russian subsidiaries. German firms prefer home banks or their subsidiaries for the cash services as well. The main hurdles for investing are the weak and changing legislation, frequent tax inspections, complex tax system and corruption. Undeveloped transport infrastructure belongs to the main barriers as well. However, such factors as the language, domestic competition or limited access to the strategic important industries are considered as minor hurdles. Besides, profit repatriation restrictions are assessed as a moderate problem. In two thirds of cases the expected return on investment is achieved or even beaten. The key reasons for the failure of investment consist of overoptimistic market expectations, unsatisfactory qualifications of the domestic personnel, unreliability of business partners and inaccurate market research.

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