Understanding Localization in Russia

Including

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Introduction

With the Ruble dropping to a record low at the start of 2016, Russia is currently in a deep economic crisis. Foreign investors have taken note of this, with the automotive industry a prime example of an industry that has seen decreased foreign interest. That said, over the past year we have also seen major new foreign production sites in Russia, such as the German harvester producer CLAAS in Krasnodar or the German-Japanese producer of machine tools DMG Mori in Ulyanovsk.

We have also seen some existing Western production sites in Russia beginning to develop export capabilities, allowing them to compete with Chinese competitors in African and Arabian markets. This is possible thanks to strict cost management and the significant Ruble shortfall. Localization in Russia is a project for the long-term, and one that is worth consideration. As Russia’s economic crisis unfolds, investors should not be completely inactive – the time should be used to prepare for the country’s next consumer spending boom.

In this issue of Russia Briefing, we discuss the advantages of localization in Russia for foreign companies, and provide an analysis of Russia’s industrial parks and Special Economic Zones (SEZs). We also feature an article from the General Director of ZENTIS Russia on their experience of producing jam, marmalade and other sweets in the country.

We at SCHNEIDER GROUP can guide companies through the localization process with advice on tax, legal, accounting and IT/ERP matters. Additionally, we can set companies up in the relevant industrial zone, help establish their plant, and can offer interim-management in the intended areas for localization. These are just some examples of our services.

I wish you good luck with your localization project in Russia. Take the crisis as a chance!

Yours,

Ulf Schneider
Managing Partner
SCHNEIDER GROUP
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About SCHNEIDER GROUP

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We at SCHNEIDER GROUP provide our international clients with the back office services they need to expand their business into or within Russia, Kazakhstan, Belarus, Ukraine, Poland and Germany. Our services include market entry support, accounting outsourcing, tax consulting, import, ERP systems (1C, SAP and Microsoft Dynamics NAV) and support in legal matters with focus on migration, labor and corporate law.

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Russia’s Special Economic Zones, Infrastructure and Advantages
By Vladimir Kazakov, Market Research Director, SCHNEIDER GROUP, and Tikhon Evdokimov, Managing Partner, Navigator Consult

Case for localization
Every economic crisis provides opportunities. The current crisis in Russia is a result of several factors, such as the weak Ruble, low oil prices and, not least, Western sanctions on Russia. At the same time, however, Russia is still an attractive market with tens of millions of consumers. While no one can predict when the current economic situation will improve or when consumers will be prepared to spend more, those who stayed in the market and those who entered it during the crisis will certainly be in a better position in the future. They will see that their calculated risk will pay off.

What this crisis reveals is a need to rethink existing operating models of doing business in Russia, and an opportunity to use the situation to a company’s own advantage.

The vast majority of businesses working with Russia are importers. They are represented either by distributors or representative offices. Recent geopolitical and economic developments make this model unsustainable, principally because:

- The foreign exchange market has recently been volatile
- The population’s purchasing power to pay for goods and services in euros has diminished
- Brands have to fight for customer loyalty where many cheaper alternatives are available
- Competition from Asian substitutes has increased.

Western companies face hard choices: quit Russia, or stay in/enter the Russian market. Leaving aside those who quit, let’s focus on those who stay/enter and how they can plan their business strategy. They believe that being in Russia is critical for their European presence and are strongly considering localizing their manufacturing footprint. But is the moment right?

<table>
<thead>
<tr>
<th>Pros</th>
<th>Cons</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lower entry costs resulting from the devaluation of the Ruble, including decreasing wages, prices for real estate, equipment and advertising</td>
<td>Extremely difficult to sell this step to the Board/owners</td>
</tr>
<tr>
<td>Potential for export to third markets, e.g. inside the Eurasian Economic Union</td>
<td>Recession and decline in purchasing power and domestic demand</td>
</tr>
<tr>
<td>Import substitution at public tenders</td>
<td>Sanctions: possible supply problems from abroad</td>
</tr>
<tr>
<td>State preferences for start of localization</td>
<td>Price volatility due to currency exchange rate fluctuations</td>
</tr>
<tr>
<td>During a recession, investors are incentivized to enter the market</td>
<td>Local suppliers need modernization</td>
</tr>
<tr>
<td>Opportunity to develop supplier base</td>
<td>Low productivity</td>
</tr>
<tr>
<td>Significant local human capital resources</td>
<td></td>
</tr>
<tr>
<td>Lower operational costs</td>
<td></td>
</tr>
<tr>
<td>Unique opportunity to become first in your own niche</td>
<td></td>
</tr>
</tbody>
</table>
When planning localization of manufacturing, most businesses consider either a "brownfield" or "greenfield" option. Each approach has its own pros and cons, but many will not be aware of a better alternative: Special Economic Zones.

This alternative route has the major benefits of a brownfield project (i.e., higher speed of entry and available infrastructure) as well as those of a greenfield project (i.e., flexibility of site selection, efficient site layout, investment incentives). In addition, Special Economic Zones offer the following benefits to investors:

- Significant fiscal gains (low or no taxes)
- Federal guarantees for fixed rules of the game until 2054
- Free customs zone (0 import duties & taxes)
- Cheap land
- One window approach for dealing with formalities
- No minimum investment threshold.

### What Special Economic Zones Exist in Russia?

In 2005, the Federal Law on Special Economic Zones was adopted in Russia. It provided a legal framework for developing a network of Special Economic Zones (SEZ). An SEZ is an area in Russia with a special legal status and economic benefits designed to bring Russian and foreign companies into priority sectors of the Russian economy. SEZs are formed under a federal program overseen by the Russian Ministry for Economic Development. The state management company AO Special Economic Zones (AO SEZ) manages the majority of federal SEZs and is responsible for recruiting and assisting resident companies.

There are four categories of federal SEZs in Russia by sector specialization:

<table>
<thead>
<tr>
<th>Preferences/taxes</th>
<th>Federal SEZ</th>
<th>Rest of Russia</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Industrial and production</td>
<td>High-tech and innovation</td>
</tr>
<tr>
<td>Corporate profits tax</td>
<td>2%</td>
<td>0% for 5 years</td>
</tr>
<tr>
<td>Federal budget</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Regional budget</td>
<td>0-13, 5%</td>
<td>0-13, 5%</td>
</tr>
<tr>
<td>Corporate assets tax (Property tax)</td>
<td>0% for 10 years</td>
<td>0% for 10 years</td>
</tr>
<tr>
<td>Land tax</td>
<td>0% for 5 years</td>
<td>0% for 5 years</td>
</tr>
<tr>
<td>Transport tax (rub/1 hp)</td>
<td>0 for 10 years</td>
<td>0 for 10 years</td>
</tr>
<tr>
<td>Insurance fee payment</td>
<td>14% till 2017 for residents involved in R&amp;D activities</td>
<td>14% till 2017</td>
</tr>
<tr>
<td>Free customs regime</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>Ready-to-use infrastructure</td>
<td>+</td>
<td>+</td>
</tr>
</tbody>
</table>

Source: Ministry for Economic Development of the Russian Federation
There are four federal Special Economic Zones of the industrial and production type in Russia and dozens of regional ones. Some are more successful than others. In any case, thorough research should be conducted before selecting a location. It is also important to understand whether your future plant should be located in a Federal or Regional Special Economic Zone.

A few rules of thumb to help your decision making process:

- If you want to own the land from the start, go for a regional SEZ (although the land is more expensive)
- If you want to start construction faster, go for a regional SEZ (you do not waste time getting a resident status by defending your case in the Ministry of Economic Development)
- If you want long term security of investments, fixed rules of the game, and full transparency in decision making, then go for a federal SEZ
- Talk to existing residents before picking an exact location

In closing, the Russian economy is in need of significant investment in technology modernization. Russia’s government launched a program of SEZs in 2005 which is now up and running. In addition, import substitution has become one of the key areas for Russia in the current economic environment. Authorities are providing further incentives such as special investment contracts. The time is right to seriously consider localization.

### Table: Special Economic Zones in Russia

<table>
<thead>
<tr>
<th>Type of zone</th>
<th>Operational (infrastructure complete and resident companies operate)</th>
<th>Forming (infrastructure under construction and resident companies operate)</th>
<th>Planned (pre-project and project work in progress)</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industrial and production</td>
<td>Automotive, metals, machine-building, chemicals, construction materials, consumer goods, etc.</td>
<td>Alabuga (Tatarstan), Lipetsk, Togliatti (Samara)</td>
<td>Kaluga, Moglino (Pskov), Titanium Valley (Sverdlovsk)</td>
<td>8</td>
</tr>
<tr>
<td>High-tech and innovation</td>
<td>Microelectronics, nanotech, IT, telecoms, biotechnologies, healthcare, pharma, nuclear, etc.</td>
<td>Dubna (Moscow), Zelenograd (Moscow), St Petersburg, Tomsk</td>
<td>Innopolis (Tatarstan)</td>
<td>5</td>
</tr>
<tr>
<td>Logistics</td>
<td>Aircraft, ports, logistics, shipping, repairs, etc.</td>
<td>Ulyanovsk-Vostochny</td>
<td>Murmansk, Sovetskaya Haven</td>
<td>3</td>
</tr>
<tr>
<td>Tourism and recreation</td>
<td>Biryuzovskaya Katun (Altai)</td>
<td>Baikal Haven (Buryatia), Gates of Baikal (Irkutsk), Altai Valley (Altai), Northern Caucasus Resorts (2 SEZs)*</td>
<td>Northern Caucasus Resorts (7 SEZs)*, Russky Island (Vladivostok)</td>
<td>14</td>
</tr>
</tbody>
</table>

*Total 8 10 12 30

*not operated by AO SEZ.
Special Economic Zone ‘Lipetsk’: Seeing is Believing

In order to combine the best parts of greenfield and brownfield localization options in Russia, our recommendation is to consider an SEZ model. Although there are more than 20 Federal SEZ in Russia, only a few are geared towards manufacturing needs.

Crucial to getting things done, especially in Russia, is the full support of local authorities and a clear understanding of the Western approach to investment. Based on many examples of our work with a number of foreign investors, it is evident that this requirement is fulfilled in SEZ ‘Lipetsk’:

- The federal and industrial SEZ ‘Lipetsk’ has been operating since 2007 and now hosts over 40 residents from more than 10 countries: the US, Belgium, Germany, Netherlands, Israel, Italy, Switzerland, Japan, China, Ukraine and Russia
- It is located near the M4 highway 400 km southeast of Moscow and can be reached by car within 4 hours, as well as by plane (4 flights a day, 45 minutes) or by train (6 hours)
- It has 16 operating plants, with further expansion plans announced
- Several existing residents (Bekaert, ABB, Honeywell, LanXESS, Yokohama) have confirmed that they received exceptional governmental support in setting up their greenfield manufacturing operation
- 2015 marked the arrival of 8 new residents who have already started construction work (e.g. Kemin Industries (USA), Honeywell (USA), ABB (Switzerland), Viessmann (DE), Ottevanger (NL), and PPG (USA)
- The regional governor, Mr. Oleg Korolev, has headed the local administration for more than 15 years, and was again elected for a new 4 year term in September 2014. The Lipetsk region is one of Russia’s most important due to its achieved economic growth, attraction of domestic and foreign investments and the purchasing power of the population
- Many regional achievements can be attributed to the Lipetsk SEZ, which is ranked as the #1 SEZ in Russia by the Ministry of Economic Development. It was also awarded #1 Position in Europe in its FDI ranking in 2014
- The Lipetsk SEZ governing company is headed by Mr. Ivan Koshelev, who managed to build a very strong and pro-business team of experts. Despite geo-political problems, the inflow of foreign greenfield investments has increased over the last two years and the first phase of the SEZ’s territory expansion is almost complete (size: 1100 ha). Lipetsk has also secured federal government approval to expand its territory to phase 3 (near the town of Elets in the Lipetsk region, an extra 1200 ha of land). All the necessary infrastructure of that phase will be built over 2016 and H1 2017, making this territory attractive only after 2016
- Significant tax benefits for residents:
  - Profit tax: 2% iso 20% from start of profit period for 10 years
  - Next 10 years = 7%
  - Further on = 15.5%
  - Property Tax: 0% iso 2.2 % for 10 years
• Land Tax: 0% iso 1.5% for 5 years
• Vehicle tax: 0 iso up to €4 per 1 hp for 10 years
• SEZ is run under the Federal control of the Ministry of Economic Development. This guarantees no change of the rules and preferences until 2054
• Free customs zone. This simplifies import procedures, lowers costs and reduces the distance with customs. A great asset, especially if you need to initially import a large amount of raw materials and finished goods for re-packing activities
• SEZ territory is fenced, secured with CCTV system and security personnel. SEZ has own fleet of maintenance cars, its territory is clean and well maintained.
• SEZ location is within 20’ minutes drive from Lipetsk city and 30 minutes’ from Lipetsk airport
• Integrity: SEZ Lipetsk is one of the few sites where Western business ethics are followed. A Code of Conduct is signed and followed by all Residents
• Option to use the SEZ HQ infrastructure:
  • Available offices, meeting rooms and canteen in, for example, the start-up phase
  • Well-equipped auditorium with 200 seats
  • Large rooms to invite customers
• There’s an Italian consulate on the premises which could simplify the procedure to send Russian employees to Europe/the Schengen zone.

Contact Details for Lipetsk:
Lipetsk, Gryazi District
Special Economic Zone Business centre
Phone: +7 (4742) 51-51-80
Fax: +7 (4742) 51-53-39
Email: info@sez.lipetsk.ru
Website: http://sezlipetsk.ru/
The Special Economic Zone in St. Petersburg

In accordance with the agreement between the Russian Federation and the government of St. Petersburg, the Special Economic Zone (SEZ) of the technology-innovation type in St. Petersburg will be active until 2025. The SEZ is located on 2 sites in the St. Petersburg territory: the “Noydorf” area (Strelna village, Petrodvorets district of St. Petersburg) and the “Novoorlovskaya” area (Primorsky district of St. Petersburg). The priorities of the SEZ are information technology and telecommunications, medical technology and pharmaceuticals, nanotechnology and precision instruments.

Currently, there are 36 residents in the St. Petersburg SEZ. At the same time, Noydorf and Novoorlovskaya land plots have been almost fully allocated. In connection to that, the process of Novoorlovskaya’s area expansion by 52.9 ha has been initiated.

In order to obtain SEZ resident status, a company has to submit an application and a business plan showing proposed activity in the SEZ, the size of the land plot required, the estimated volume of investments and capital investments, and the required power devices. Project applications are approved by the Supervisory Board of the SEZ in St. Petersburg and the Expert Board for the SEZ within the Ministry of Economic Development of Russia, following which the applying company acquires the status of a SEZ resident.

Residents get land on lease with fully finished engineering infrastructure, which allows the investor to enter the building site and start the implementation of the investment project as soon as possible. SEZ residents benefit from a reduced or abolished tax burden. Insurance premiums are therefore reduced from 34% to 14%; income tax is reduced from 20% to 13.5%; and the investor is exempt from property tax for 10 years, and land tax and vehicle tax for 5 years.

The free customs regime on the territory of the SEZ allows the investor to take advantage of Russia’s preferential customs regime, inter alia, to bring into the SEZ components, materials and production equipment with a zero customs rate. In addition, after the registration of ownership of the constructed property, the resident is able to redeem the land at a price of 25% of the cadastral value.
Analysis of Stupino Industrial Park

Stupino 1 Industrial Park has been created by a group of international industrial investors who have extensive experience of similar projects and are dedicated to the highest industrial quality standards.

The city of Stupino was chosen as the location for the newly created industrial park due to its history of domestic and foreign investment, and its unique industrial track record in post-Soviet times. The Stupino Municipal Administration and the Moscow Regional Government have also put a lot of effort into creating attractive and comfortable conditions for foreign and local investors. Currently, 15 international companies are present with production facilities in Stupino, among them Mars, Kimberley Klark, Campina, Atlas Concorde, Mapei, Caparol, Silgan and others.

Stupino 1 Industrial Park is conveniently located 80 km south of Moscow and is easily accessible on the M-4 highway from Moscow and Domodedovo International Airport.

Having started construction at the end of 2013, the Park finished the first phase of development in 2014 and now offers industrial land for built-to-suit projects for large international companies and SMEs. All utilities are in place, including electric power, gas, water supply and sewage. Optic fiber telecommunications, gated territory, security and access control systems are also immediately available for companies that start production in Stupino.

The Park’s management team also offers fast track solutions to companies that employ locally, including choice of land plot.

More information on the Stupino 1 Industrial Park is available at: www.industrialpark.org
Localization is not new in Russia. Car manufacturers and automotive component producers were among the first foreign brands to pioneer the local market. Renault, Nissan, Volkswagen, Toyota and Ford – to name but a few – have already established manufacturing sites. They first started with assembling cars from parts brought from abroad, then increased localization by finding local suppliers. Some were also bringing their overseas suppliers. Automotive clusters were built in several Russian regions to create production infrastructure. Manufacturers continue to localize by building plants to produce engines and other major parts. For example, in 2015, Volkswagen opened a plant to produce 150,000 engines annually. Similar success stories can be found in other sectors.

It may seem daunting to “smaller” businesses to localize their production. If it was difficult for the likes of Siemens, how can it be possible for these businesses to localize in this market? However, there are several examples of “smaller” companies localizing their production in Russia, which we discuss below.

DMG Mori
In autumn 2015, DMG Mori opened its new plant in the Zavolzhie Industrial Zone near Ulyanovsk, Russia. DMG Mori (formerly GILDEMEISTER), Ulyanovsk Regional Government and Ulyanovsk Region Development Corporation signed an investment agreement in 2011 and construction began in 2012.

The company first hired 25 employees and sent them on training to its subsidiary in Poland. In June 2014, the plant produced its first machines. They were originally built at the Ulyanovsk Nano-center, which is also located in this industrial zone. The plant produces CTX 310 ecoline turning machines, including DMC 635 V ecoline /DMC 1035 V ecoline vertical machining centers and DMU 50 ecoline universal milling machines. Total investments amounted to EUR 70 million.

The next step will be to place local orders for all sheet metal materials. Most of the mechanical machining will be done internally and many components will be sourced from local suppliers. Russian companies will also supply electrical parts, castings and other modules. DMG Mori admits that it will be difficult to find a Russian supplier for programming. However, they are already in discussions with the Bauman State University of Technology in Moscow. Production is currently 50% localized.

The most popular model is the CTX 310 ecoline machine which goes for RUB 7.3 million apiece. The plant offers a 36 month leasing program with a 30% prepayment.

The facility has the following parameters: land plot of 200,000 sq m, built-up area of 21,000 sq m, assembly workshop of 3,300 sq m, and production capacity of 1,200 machines annually on a one-shift working schedule.
Brano Group
Brano Group, an auto components manufacturer from the Czech Republic operating as Branoros in Russia, is launching a new production facility near Nizhny Novgorod. The company invested approximately EUR 6.5 million. Half of this amount was paid for a 12,000 sq m land plot and construction of a 3,500 sq m building to be used as an assembly workshop and warehouse. Another EUR 3 million was invested in new machines and equipment.

This new facility will produce seat frames for Nissan’s Tiida and Sentra models, and pedals for Skoda’s Yeti and Octavia Volkswagen’s Jetta. Production of car locks for GAZ and pedals for Ford’s Fiesta and EcoSport models is also on the agenda.

The facility is able to produce 12,000 seat frames for Nissan, 53,000 pedals for Volkswagen and Skoda, 65,000 pedals for Ford and 30,000 locks for GAZ. Branoros is looking to further expand its product range and is in discussions with UAZ and Avtovaz. In mid-2016, the company will start pressing all steel components in Russia, after which they will no longer be produced in the Czech Republic. This will be another step in further localizing production.

CLAAS
In October 2015, the first TUCANO harvester was produced in Krasnodar in Russia’s south, and the first batch of locally produced components was exported to Germany. This model was recognized as one of the ‘Top 100 Russian goods’.

The company began an extension of its existing production facility in 2013 to 45,000 sq m. After investing EUR 120 million, the company built a modern full-cycle production facility and launched production in 2015. The new facility’s capacity is 2,500 units per annum.

Parts and large assemblies are manufactured at the plant. The production cycle includes cutting, bending, welding and painting metal parts to final assembly. The company claims its level of localization is over 50% and it plans to localize its own production further and buy more from Russian suppliers. CLAAS wants to build harvesters which are 100% Russian.

On top of this, the company exported the first batch of components to its parent company in Germany. This was possible thanks to the high quality of equipment used in the factory.
Legal Requirements for Localization

by Helge Masannek, Group Director, Tax, Legal & Import, SCHNEIDER GROUP

When studying the figures of Russia’s import and export statistics, one of the country’s most serious economic problems becomes obvious: Russia’s exports consist mostly of raw materials and its imports, to a large extent, of processed goods, machinery and pharmaceuticals. The import dependency of Russia in most industry sectors amounts today to 70-90%. When the price for raw materials is high, this problem might not be so obvious and pressing. But at times, like today, when the prices of Russia’s major export goods are falling, it becomes a very serious problem. Motivated by high import duties, some Western companies have in the past invested in local production in Russia, particularly before the 2008 crisis. Following the crisis, however, new investments slowed down and never got back to the level as before 2008.

Government industrial policy

The Russian government has realized this problem and the Ministry of Industry has developed an ambitious import substitution plan for 18 industry sectors and 800 products aiming to reduce the import dependency to 50-60% in 2020 by implementing more than 2,000 localization projects. Furthermore, the government has tried recently to address this problem with the “carrot and stick” method: it excludes foreign suppliers from state tenders and offers incentives for companies that localize their production.

Well developed incentive programs had a significant impact in the past. One example is the automotive industry. By offering reduced customs duties on car components – some as low as 0% – through decree 166, in 2010 almost all large automotive corporations opened factories in Russia: Toyota, Nissan, Hyundai, Scania, MAN, BMW, Kia, Renault, VW, Skoda, Peugeot, Citroen, Fiat and Ford are only some of the brands that localized production. In order to be granted reduced customs duty, foreign manufacturers had to accept the obligation to localize 60% of production within six years, produce a minimum of 300,000 units per year within three years and localize 30% of engine production, as well as start local R&D activities. In 2014, the government issued decree 656 prohibiting state bodies to purchase vehicles and heavy equipment for public use produced outside the Eurasian Economic Union. Currently, only cars produced locally are allowed to take part in such state purchasing tenders. Locally assembled cars are still regarded as being produced locally, even if the components have been imported. But from 2018 on, the local content of such cars must be more than 60%. Pure assembly will not be enough.

The pharmaceutical industry is heavily affected by localization pressure from the government. The Pharma 2020 strategy, adopted already in 2009, specifies the goal to localize production of 90% of all drugs considered as “strategically important pharmaceuticals” and “life-important pharmaceuticals”. This list contains 601 drugs. With
regard to other drugs not on the list, the goal is to localize production of 50% of such pharmaceuticals. Due to this program and the threat of being excluded from financially interesting state tenders for hospitals, almost all major pharmaceutical corporations started evaluating localization of production in Russia.

In this context a question arises: what is required for localization? Is the repacking of imported pills sufficient? Do the active pharmaceutical ingredients need to be produced locally? Or does even the research and development of new drugs need to be localized? By the end of 2015, the government decree 1289 was enacted and implemented tough localization requirements for the pharmaceutical industry, as already envisaged by the Pharma 2020 strategy: if there are two domestic suppliers in the Eurasian Economic Union of “life-important pharmaceuticals” available, foreign products must be excluded from the respective tender. With regard to the question of the required degree of localization, the decree allows until the end of 2016 the repacking of imported drugs in Russia in order to not be banned from tenders. But from 2017, such repacking will no longer be sufficient and further production localization is required. Apart from the risk of being banned from tenders foreign suppliers are faced with an automatic price reduction of their offer of 15% if they win a tender.

Apart from the auto, heavy equipment and pharmaceutical industries, the light industry is currently affected by restrictions to public tenders. According to degree 7901, foreign-made goods (textiles) are excluded from public tenders.

Incentives for localization

But what about incentives? The legislative basis for incentives for localization are the federal laws no. 488 “On industrial policy in force since July 1, 2015 and the government decree no. 708 as of July 16, 2015 “On special investment contracts for selected industries”. According to this decree, an investor intending to localize production can conclude a special investment contract that might provide for different incentives. Unfortunately, the incentives need to be negotiated and will be provided on a case-by-case basis. Among the most interesting incentives is the possibility to be granted the status of a “sole supplier” for state procurement. Furthermore, such special investment contracts can provide for specific rules for the “country of origin”, i.e. specific conditions that need to be met in order for the goods to be produced are accepted as goods “made in Russia”.

Criteria for local products

If no special investment contract is concluded, or it does not provide for specific rules with regard to the country of origin, the requirements for products to be accepted as local products are specified in decree no. 719 as July 17, 2015, and the CIS Agreement as of November 20, 2009. The decree 719 describes criteria for specific industry sectors like the heavy machines industry, automotive industry or electrical engineering and electric power industry. If the decree 719 does not cover a specific industry or product, the CIS Agreement applies.

The criteria for local products differ widely for each industry and product. There is no general approach, so criteria needs to be checked in each individual case. Criteria might be the percentage of share of the cost of foreign raw material and components in the price of the final product, performance of certain production operations in Russia, and the availability of after sales services in the Eurasian Economic Union. Furthermore, the requirements might increase every year. For example, for motor cars in 2015 the performance of seven specific operations were sufficient, in 2016 a minimum of nine operations are required and from 2017 onwards eleven operations must be performed in Russia in order that a car be accepted as a local car.

Localization should be on the agenda of each company with a significant business presence in Russia. Localization might be unavoidable, if the business partners are state bodies, agencies or companies controlled by the Russian state. The requirements of how deep the local production needs to be should be checked in each individual case. But it should also be noted that products from the Eurasian Economic Union are often accepted as local products, so that localization in Belarus or Kazakhstan might be considered to meet the new requirements.
Conducting a Due Diligence Investigation Prior to Purchasing a Production Facility

Alexander Koepcke, Director, SCHNEIDER GROUP

When considering the acquisition of a company, it is of utmost importance to analyze the risks you might face. These risks can be summarized in a risk catalogue. The information compiled in this catalogue will be helpful in defining the required scope of due diligence, which can be seen as the thorough investigation of the target business prior to its acquisition in order to make the right decision based on quality information.

The main aspects considered when performing due diligence investigations of the target company include:

• Evaluation of the company as an object of investment
• Review of the company’s accounting, tax accounting and reporting
• Legal due diligence
• Assessment of internal controls over the company’s operations and assets
• Assessment of environmental risks

Each due diligence investigation of production facilities reveals certain areas for consideration. For the purpose of this article, we refer to a recent due diligence investigation of a Siberian plant following the request of a Western European company.

Access to the facility

This the first issue we encountered, as it was highly restricted. Getting access for non-employees could easily take two weeks. The reason for such restrictions could be harmful production conditions, as well as protection of intellectual property (in case of innovative and unique technologies). Delays should be foreseen prior to visiting the site, especially if the potential buyer intends to make a decision in a short space of time.

Harmful working conditions cause additional risks

Working conditions in some of the facilities were harmful. In such cases the company is obliged to provide a special assessment of the employees’ work places. If such an assessment is not performed, risks of liability for labor code violations arise. In case of accidents the company and the general director could encounter significant penalties and could even be held liable for criminal prosecution. If harmful conditions are confirmed, the company is obliged to make additional payments to employees and provide certain benefits, such as additional vacation days. Harmful working conditions must be stated in additional agreements to the employees’ labor contracts.

Overdependence on a few client companies

The target company produces highly specific products at the request of several client companies, and has even opened production facilities on the territory of these customers. There is a significant dependency on these customers that might
enable them to dictate disadvantageous terms of agreements. In this particular case we noticed:

- Delay of payments of two months from customers
- Restricted terms of product delivery
- Full responsibility of the target company for damage (e.g. caused by fire or accidents), even on the territory of the customer.

Lack of inventory-taking is a red flag

The absence of inventory-taking created the following risks:

- Lack of reliable information about the value of the company’s assets
- Shortages of assets or damaged assets

Company assets could be overstated in financial reports, or a part of the stock may require devaluation. The lack of inventory-taking may also be a sign of weak internal controls.

Fraud risk

Fraud risk was also assessed. We conducted, among others, security checks of company officials and the main contractors to assess compliance in dealing with third parties.

These are only some specific issues that might come up. Taking them into account, potential buyers should carefully determine the scope of due diligence required with the help of their service provider.
Options for tax registration

Generally, a foreign company in Russia may choose between the establishment of a subsidiary (a Russian legal entity in the form of a Limited Liability company or a Joint Stock Company), or a subdivision of a foreign company.

If a company’s plans are not connected with IPO, it is advisable to register an LLC in Russia as it is easier from the corporate law perspective. From a tax point of view there is essentially no difference between LLCs and JSCs.

Please note that the obligation for registration generally exists, even in cases where no taxes should be paid in Russia. If a foreign legal entity performs activities in Russian territory, it is obliged to register with the Russian tax authorities within 30 calendar days starting from the beginning of those activities, regardless of whether its activity has constituted a permanent establishment or not.

1.1 Financing

Financing a Russian subsidiary requires additional actions from the shareholders. In accordance with Russia’s laws on JSCs and LLCs, if the equity of the company is less than its charter capital at the end of the third financial year after its registration, the company should be liquidated or the shareholders should provide its subsidiary the additional funds for the improvement of the situation.

In practice, the most widespread options of financing are the following:

1. Increase of the charter capital
2. Contribution in equity
3. Granting a loan

However, the decision on the financing option should be taken considering the particular circumstances. For example, the granting of a loan may have a negative impact on the structure of the balance sheet while increasing the charter capital and contribution in equity. At the same time, the granting of a loan allows a simple back payment of money.

In comparison to a Russian legal entity, a subdivision of a foreign company may be easily financed by its Head Office. The money transfer within a legal entity is not connected with any restrictions. The money transferred to the Head office by its Russian subdivision is not subject to withholding tax.

1.2 Cost Transfer

As the “cost sharing” concept does not exist in Russia, the pure transfer of expenses to the Russian subsidiary is not possible. However, if a parent company actually renders the services to its subsidiary, the respective service agreement may be concluded. In practice, tax authorities check such expenses very carefully. Tax risks may be reduced if the company provides very detailed documentation justifying the services rendered (time sheets, reports containing the results of...
services rendered, etc.). Importantly, companies should consider whether a third party would pay for such services under similar circumstances.

The transfer of cost between the Head office and its Russian subdivision is generally allowed if a Double Tax Treaty (DTT) between Russia and the respective contracting state contains such provisions. It's important to note that the tax authorities thoroughly review these costs in order to determine whether the costs are actually attributable to the Russian permanent establishment and whether they adhere to the arm's length principle.

1.3 Carrying on the activities in different regions of Russia

When a company has many projects in different Russian regions, it should be registered with the relevant tax authorities in all places where the projects are located. The registration of a subdivision of a Russian company is easier in comparison to the registration of a subdivision of a foreign company.

However, in some cases, it might be reasonable to carry on activities through a subdivision of a foreign company. For example, when the DTT concluded between Russia and the respective state defines special time frames for constitution of a permanent establishment for building sites. Currently, the terms of such DTTs deviate between 12 and 24 months for the most part.

Holding structure

Foreign companies in Russia should be aware of other advantages and disadvantages which might be granted by a respective DTT. For example, the DTT concluded with Germany allows the unlimited deduction of the advertising expenses for profit tax purposes – an important point for trading companies.

Special Economic Zones (SEZ)

If a foreign company intends to organize the production of goods in Russia, it should consider that, in some regions of Russia, there are special economic zones which provide different tax advantages for their residents.

As a rule, such advantages include exemption from profit and property tax during the first 5 years. However, the exemption is granted only in regard to transactions performed in the SEZ.

Additionally, certain SEZs offer companies the possibility of participating in different investment projects that provide tax advantages.

Transfer pricing regulations

Starting in 2012, Russia adopted new transfer pricing regulations which align very closely to the OECD model. In accordance with transfer pricing regulations, all cross-border transactions with related parties are subject to transfer pricing control. This means that the tax authorities may check the controlled transactions in order to define whether the prices applied in the transaction comply with the arm’s length principle.

All companies which carry out controlled transactions are obliged to submit the transfer pricing notification before May 20 of the year following the reporting year. The transfer pricing notification is a kind of tax declaration, but it does not contain the justification of prices applied in controlled transactions. Such information should be included in the transfer pricing documentation, which is submitted to tax authorities upon request.

Foreign companies should take into account that Russian transfer pricing regulations do not foresee any special provisions at the "startup" phase. Therefore, if a new established company incurs operating losses, it is very probable that the profit tax should be adjusted from the transfer pricing perspective. No corresponding adjustments for transactions with foreign related parties are allowed.

Therefore, it is advisable to obtain the general understanding about the price in advance and operate an appropriate margin level in the Russian market.
The Substitution of Import and Localization

By Yanina Tokadi, Head of Import Department, SCHNEIDER GROUP

The prevailing task of the Ministry of Industry is to facilitate local production. Tax benefits and other forms of support are meant for local manufacturers.

After evaluating the worthiness of industries and manufactures for government support, the Ministry of Industry came up with 18 industries including, but not limited to, Machinery, Shipbuilding, Automotive, Agriculture, Light industry, Pharmaceuticals and Medical Devices.

Devaluation of the Ruble helped manufacturers start production at the beginning of 2015. The Russian domestic textile manufacturer, Dargez, reported a sales increase of 40% in 2015, and the market share of domestic textile manufacturers is expected to grow from 20% to 40% in the near future.

The leading distributor and manufacturer of electric tools, Interskol, has recently launched a plant in Russia and they are now considering relocating another plant from China to Russia. RM Nanotech, a Russian manufacturer of industrial water filters, has been growing successfully due to the weakening Ruble.

While these industries are improving, the agricultural industry has benefited most of all. Food processing – such as the manufacturing of cheese – has grown by 40% in 2015. However, all manufacturers admit that benefits from the Ruble devaluation were neutralized by high loan rates. Loan interest rates surpass profitability of their businesses.

The policy of Import substitution and Localization does not necessarily mean a stop to foreign purchases. The development of domestic manufacturing requires Western Innovative technologies.

Russian manufacturers, such as Automakers, tend to subcontract local manufacturing of spare parts, but they still have to import high-tech equipment despite the rapidly rising prices in Ruble terms.

The joint venture of Sinara and Siemens produces the train car “Lastochka” for the Russian Railway. The project was supposed to achieve a 55% level of localization by the year 2015, 70% in 2016, and 80% in 2017. The Commission of the Eurasian Economic Union (EEU) exempted the company from import duties in 2013. The company has already launched production of simple components, but they continue to expand localization. As a result, they are requesting that the Ministry of Industry and Ministry of Economy prolong the period of exemption from import duties. Only under the condition that the import duties are cleared could the company accomplish the project and supply the cars in the defined time.

Confirming the Country of Origin

To comply with localization requirements, at least 50% of the end-product must be produced in Russia. This concerns not only the components, but the manufacturing processes also.
The Federal Law "On industrial policy" No. 488-FZ of 31.12.2014, effective from July, 2015, is aimed at developing local manufacturing in Russia. The investors may benefit from incentives offered to those who conclude "Special investment contracts".

The same Law states that domestic suppliers (not only Russian, but those originating from other EEU countries) shall prevail in the state procurement auctions. It actually puts limitations on purchasing foreign goods and supplies in such industries as automotive, heavy equipment, and consumer goods manufacturing, including textile, pharmaceuticals, medical equipment and devices.

Government Decree No. 708 as of July 16, 2015, "On special investment contracts for selected industries" (adopted under the general provisions of federal law no. 488-FZ) puts in certain obligations for the potential investor. They must erect new or upgrade existing production facilities. The proportion of components of local origin and manufacturing processes performed locally are stipulated in the Special Investment Contract.

The definition of the local product for the purpose of Russian state procurement is stated in the Decree of the Russian Government no. 719 dated 17.07.2015 and focuses on the Photonics, lighting industry, electrical engineering and electric power, heavy machinery, automotive and other industries.

For the industries not mentioned in the abovementioned Decree, the Criteria according to the CIS Agreement dated 20.11.2009 should be applied. The goods are considered to be of Russian origin if, in the process of fabrication, there was a change in the last four digits of the HS code. The list of raw materials and components which can be imported is limited. Also, the manufacturer is obliged to buy certain raw material and components in Russia. The maximum value of imported materials in the finished product is limited (Rule of Ad valorem share).

The manufactured goods need to get certified in terms of country of origin. The Certification of Origin in the so-called "ST-1" form can be obtained at the local Chamber of Commerce. The manufacturer needs to prepare the following documents to go with the application:

- Foundation documents
- Delivery agreement
- Import documents of the components imported for production purposes
- Manufacturer report on the nomenclature of the produced goods, raw materials and technical operations at the production.

**From Import to Export**

Set up of a local manufacturing site in Russia, or any other country of the EEU, can meet more than just local purchasing needs. The value of the Ruble is not likely to return to pre-2014 levels. Regarding the low cost of production, the manufacturer can export the finished goods to other countries. The benefits of the exporter in Russia are similar to those in Western countries; among them is the exemption of duties and VAT. The charged customs fee is minimal. The cost of transportation for Russian exports is lower than the cost for imports. The supplier must observe restrictions of export of goods of dual-use only when exporting equipment and technical devices. It might be necessary to obtain the permission from the Service of Export control (FSTEK).
When considering the options for localization in a foreign country (such as Russia), one of the first questions that a shareholder asks is whether or not there is an appropriate Project Leader to oversee the development of the company and fully implement the plan in a new environment.

Interim Manager for Setup

A common approach for companies entering a new market is to form a partnership with a consulting firm and outsource, for example, legal, tax and accounting matters. In Russia, there is also a relatively new trend; using an interim management service for the start-up period. There are two main options for structuring the interim manager’s position:

1. To appoint an individual as the General Director. This option remains the easiest, although there are some particularities.

   Firstly, a company must have a general director registered, but it is not possible for a foreigner (without a work permit) to register as general director due to Russian migration law. At the same time, the company must be registered before an application for a work permit can be submitted for the perspective foreign general director (and other foreign employees).

   Secondly, since 2015, it is possible to have two or more General Directors. This gives opportunities for segregation of duties between several directors, although since this is a relatively new possibility there is little practical experience with this dynamic as of yet.

2. To register a Management Company as the single executive body. In this case legal obligations are taken over by a service provider, and the client has a trustworthy partner with capital assets. The client can benefit from the infrastructure of the Management Company, including human resources. Usually, service providers have experts in different areas, such as accounting, legal and tax, customs, as well as market research.

A knowledgeable interim manager can offer certain advantages, such as sound experience in setting up production, industry know-how, deep knowledge of Russian regions, and contacts with local government bodies. In recent years Russia has developed different investment incentives promoting free trade zones and industrial parks. An experienced interim manager could advise on such matters, as well as other potential subsidies and benefits when localizing. The responsibilities of interim managers often include cooperation with government bodies, tax authorities, banks and customs offices. Many Russian regions also have so called Development Corporations that are there to attract foreign investors and to assist them during the start-up period, for example with communication with the state authorities and preparation of documentation to obtain permits.

by Alexander Koepcke, Director, SCHNEIDER GROUP
Project Management

When developing a localization project, it is important to appoint an engineering and project management company to take over the technical planning. This company will take part in the project development, take care of respective project documentation, and might assist in obtaining the necessary permits from the state authorities related to construction.

Furthermore, there are a lot of documents that companies must take care of relating to health and safety. These areas can be partly outsourced, but each production company in Russia must, in any case, have its own responsible employees. An experienced interim manager should have an overview of the above areas in mind and ensure that the company does not skip any essential processes.

Internal Documentation

Another important aspect is the set of internal documents to be prepared. This includes job descriptions, agreements on financial responsibility for assets, guidelines / internal regulations and orders. For instance, to sign an agreement on financial responsibility with a warehouse clerk is not sufficient to make that person liable for the inventory. A company must provide the appropriate conditions for this particular employee, i.e. the stock should be locked and the storekeeper (or several storekeepers working as a team) should have the keys, and other employees must not have access to the premises. Stock-taking must be conducted before putting agreements on financial responsibility in place.

In order to control the above points, there must be regular and open cooperation and communication between the headquarters’ management and local employees on site, and the plant should be visited regularly.

Accounting Issues

When starting business activities in Russia there are a lot of accounting issues to be considered. A reporting package in Russia is to be prepared mainly on a quarterly basis, whereas in Western practice it is required monthly. Compiling information for the reporting month in case of “early closing” might be difficult, as contractors are often slow to provide all the input documentation. A company must look for a Chief Accountant not only with extensive experience in Russian reporting but also with good experience in IFRS. From the very beginning it is advisable to develop an accounting policy that fits reasonably closely with IFRS.

While building an accounting team in Russia, the significant document flow accompanying each business transaction should be taken into account. For example, there are about 5-6 bookkeeping entries to be made to reflect the purchase of stationery and to expense it. Consequently, a whole team is needed along with the Chief Accountant to handle the document flow and corresponding bookkeeping entries. The number of staff needed depends on the volume of transactions occurring. In line with recent legislative changes, one of the first steps to consider is electronic document interchange with the state authorities and business partners (B2B EDI). This will help reduce document flow and increase efficiency.

In the early stages it is also highly advisable to set up accounting software adapted to both Russian standards and the management reporting requirements of headquarters. Whether a company decides on 1C, SAP or other ERP systems, additional IT tools and developments will often be required.

Financing processes must be worked out thoroughly if the company establishes a separate legal entity in Russia, as transactions between affiliated companies are closely controlled. In the area of settlements with a parent company, there are strict requirements regarding transfer pricing documentation. Moreover, a big part of the start-up process is tax planning, i.e. choosing the optimal approach to taxation, planning the volume of transactions and using possible tax optimization tools in accordance with the Tax Code.

Taking all the above into consideration, it is advisable to have a local service provider with a strong reputation and extensive local experience as a business partner to accompany your activities.
Experiences with Localization

Johannes Peter Schönhuber, General Director, OOO Zentis Russland

As everywhere in the world, one should consider to localize in a country only when being in a strong position. Especially in a country like Russia, where there is a lot in transition, you cannot plan and foresee everything. In the global political and economic environment, Russia had to find out that it is highly dependent on certain imports and this dependence can be a disadvantage. It is therefore understandable that Russia is trying to become independent. This is under the guise of “localization.” To protect local production, Russia has introduced counter-sanctions, which might not be abolished when the sanctions against Russia are eventually repealed.

This situation offers great opportunities. Due largely to low oil prices, the weak Ruble has weakened the Russian economy, but this can be used as an advantage. Office rents and plots are more affordable than ever. Many providers are keen to take on construction projects worth up to 20 million Euros. A year ago, this was quite different. On the government level, you can now get a lot of support. With the economy expected to improve somewhat in 2016, one could assume that investments will not suffer losses.

Despite these current benefits, one still has to pay attention to build their business plan based on a “normal” macro-economic environment.

When realizing a construction project in Russia in connection with localization, the following points should be considered:

- Companies should have an accurate idea of how the building project will look. This also needs to be provided to a Russian general contractor to adapt it according to Russia’s regulations and laws.
- Companies should employ a project engineering firm to supervise the general contractor to ensure they fulfill the contract.
- Begin construction only when authorized for the construction, including ports for electricity-gas-water, etc., are actually received.
- Analyze which tariff numbers or customs duties are applied and check that these are correct.
- Apply for the certification of the produced goods on time.

Despite these current benefits, one still has to pay attention to build their business plan based on a “normal” macro-economic environment.
Localization in Russia – too many questions?

One partner with the answers.

When localizing your production in Russia, you may have many questions. Our 500 experts have the answers to questions like:

“Is Kaluga still an option?”

“How can I be granted reduced customs duties?”

“Should my General Director know the governor?”

“Where to find an English speaking accountant with production knowledge in Samara?”

“Can I use the SAP logistic modules (SD, MM, PP/QM) also in Russia?”

“How much localization is needed to participate in government tenders?”

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