



# R Investment in Russia

## - the Finnish experience

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**T**he Russian Federation, since its renaissance as a market economy in the early 90s, has presented itself to the west both as a most tempting and as a most intimidating object for trade and investment. Since 1991, Russia has attracted a multitude of investors, having been a market of lucrative profits and, in some unfortunate cases, of losses, activities within the region to a good extent constituting a trade-off between risk and reward.

Finland can claim a competitive edge over its European rivals, having always enjoyed a special relationship with Russia, by virtue of the long common history of the two countries and, of course, Finland's presence in the immediate vicinity of Russia (St Petersburg lying only approx. 330km away from the Finnish capital). The Soviet Union and, for the last decade, the Russian Federation have always been significant trade partners to Finland and, indeed, Finnish companies in several fields can claim to be forerunners to other

western companies.

Recent successes among Finnish companies include Fazer Bakeries Ltd which currently controls approximately one third of St Petersburg bread markets and Nokian Tyres Plc, a car tyre manufacturer which is a market leader in volume in winter tyres within the Russian markets, while being a brand leader as well. Other lines of business that have gained a strong foothold in Russia include fields such as logistics, ICT, forest industry and building and construction.

### Investment in real estate

Due to the recent significant changes in the Russian investment environment in relation to real estate, causing this line of business to currently be of particular interest to investors, the development in this field deserves a closer examination.

Among Finnish companies in the real estate field, YIT Plc, specialising in apartment buildings, is aiming for a market share of 10 percent within St Petersburg this year. Other major developers, such as SRV Group Plc, Lemcon Ltd and Peab Seicon Ltd have also become well established in the market. Requirements for new retail outlets, related logistics centres, hotels and offices, needed for the growing businesses, provide continuing attraction to investors.

Manoeuvring in the field of real estate is, however, a major challenge to a western investor, due to factors such as non-transparency of the markets, issues related to title, ambiguities in the legislation, the complex and stiff bureaucratic system and the all-pervading cultural differences. These are, as such, typical features in all emerging economies, and teaming up with good and experienced partners and advisors is imperative in order to minimise the risks involved.

Obtaining of real estate by foreign natural or legal persons has, as such, been made a great deal easier by the recent land reform - the new Land Code of 2001 harmonises legal rules relating to acquisition and use of land which earlier were segmented and difficult to apply, opening up many opportunities for

investment in the future. Foreign persons and legal entities may now own land practically within the whole territory of the Russian Federation, subject to certain restrictions in specific cases. Leasing, however, still remains the most common form of exercising rights to land.

The Land Code, however, contains areas that leave room for interpretation. For example, owners of real estate, including foreign ones, now have a prerogative right to purchase land plots under buildings owned by them, at a price mandated by the Land Code, but it seems that due to lack of clarity in the Code, the state or the municipality in question may, in most cases, have a discretion to determine that the land should be leased instead. The Code also contains a number of discrepancies with existing laws and places reliance upon administrative implementation which may be problematic, since there is an element of unpredictability in the activities of Russian authorities. Due to the complex bureaucratic system which substantially precludes the foreign investor from obtaining insight into the operations of the real estate sector, it is still advisable for a western investor to act in close collaboration with Russian partners who understand the procedure and are well connected to the authorities.

### Importance of proper due diligence

Purchase of real estate or of a company in Russia calls for a thorough due diligence which should include, inter alia, a careful search of the ownership history of the real estate or the company in question, its current ownership structure, and, in case of real estate, the status of the land (due diligence is required, in relation to land, to determine factors such as possible third party interests resulting from prior land use and privatisation or other agreements). The requirement for title insurance, which is available in Russia, should also be considered in relation to real estate acquisitions. In Russia, establishing these facts in a reliable manner may be a far more complex operation than in most western countries.

The complexity of the situation regarding land rights also has to be taken into consideration in planning the ownership structure of the real estate to be purchased: a foreign company wishing to buy a building or a plot of land, in order to avoid the complexities of acquiring rights to land, in practice has to arrange its ownership through a Russian company already possessing valid land rights. A Russian company is in a better position to apply for the necessary infrastructure (gas, electricity, water, sewage etc) as well as for a change of status of the land from agricultural to industrial, residential or other use. Correspondingly, in selling the building or the plot of land forward, a sale of shares will be a considerably simpler transaction than a separate sale of the building and a transfer of the land rights (or a mere transfer of the land rights).

### Cultural differences affecting due diligence

The necessities and requirements for a thorough due diligence are confronted by cultural differences and affected by the unfamiliarity with well-established western commercial practices on the part of the actors in the young Russian market economy, as a result of which the expectations of both parties in relation to the process of due diligence as well as in relation to its outcome may vary considerably. Indeed, the concept of (legal) due diligence was only introduced to the Russian business world with the start of the economic reforms.

There may, by way of an example, be differences as to expectations in relation to speed of closure, as a result of which sellers may be reluctant to allow prospective buyers exclusivity for a long enough period to enable comprehensive due diligence.

On the other hand, the requirement of due diligence is further emphasised by the fact that in many cases, there is reluctance on the part of sellers to incorporate warranties, potential lease guarantees, assignments of contractors' warranties etc, into sales agreements. Further, purchase price expectations may remain at the level of the initial offer, despite findings made in due diligence (due diligence is sometimes seen by sellers as a mere formality, without substantial consequence). Determining the purchase price may be difficult to start with, due to the novelty of the land market and market economy in general and the factual absence of a genuine mergers and acquisitions and land market as such. Many sellers are valuing their properties on the basis of other recent transactions, rather than their true value.

### Minimising the risks

The rules of the game in the Russian mergers and acquisitions and real estate markets are in the process of being formed. While it is to be expected that with passage of time, the Russian and western practices will meet halfway and commercial customs and traditions satisfactory to both parties will evolve, a present day western investor will have to use the currently available tools to minimise its risks in Russia.

More security in acting in Russian markets may currently be obtained through large-scale projects with major strategic partners. Aligning the projects in question with the priorities of local government and community can pave the way considerably, and contacts at least at local government level throughout the project are highly recommendable. Directing the activities through a publicly traded company will naturally afford the

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investment a far stronger position than a choice of a private company (although, in connection with purchase of real estate through a special purpose vehicle company, as described above, the use of a private limited liability company will be more expedient in view of the time taken by the share transfer). In addition, having the right investment and legal advisors is imperative in any investment activity in the present day Russia.

For Finnish companies, their strong technical know-how, combined with a profound understanding of the market, together with a realistic appreciation of the risks involved and willingness to take adequate steps to control them, constitute a winning combination. Finnish companies of a wide variety of fields are entering the Russian markets and those already established in the market have the confidence to continue further expanding their Russian activities. ■

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