

STUDYING TRANSITION

FOREIGN INVESTORS IN THE RUSSIAN CORPORATE SECTOR: QUANTITATIVE AND QUALITATIVE EVIDENCE

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The paper is based on the study implemented within the framework of the project "Insiders, Outsiders and Good Corporate Governance in Transitional Economies: the Cases of Russia and Bulgaria".¹ Under the project, 20 in-depth interviews were conducted in mid-2003 with top-managers of open (publicly traded) joint-stock companies in six Russian regions (Moscow city, Moscow region, Novgorod the Great, Novosibirsk, Krasnoyarsk, and Ekaterinburg). The interviews brought important new data. In particular, they gave opportunity for qualitative study of foreign investors' role in the Russian corporate sector and of their demand for good corporate governance. Additionally, we used both official statistics and formalized surveys data for quantitative illustrations.

Foreign Investment as Viewed by Statistics and Companies' Surveys

The Russian State Statistics Committee (Goskomstat)² has registered growth in foreign investment in the Russian economy over the last years: in 2002, they doubled against the 1999 volume (the lowest post-crisis level). Direct foreign investment declined by 7%, while investment in equity rose by 50%. As for portfolio investment in stock and shares in Russian enterprises, although its volume has formally increased 4.5-fold

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² Maeroeconomic data on foreign investment see in (Goskomstat, 2003a, pp. 22-24); (Goskomstat, 2003b, pp.164-165, 331-333).

in recent three years, they amounted to only 1.4% of total volume of foreign investment in 2002.

The share of direct foreign investment accounted for about 20% of total foreign investment in Russian economy in 2002-2003 (including a 7-8% share of investment in equity, and a less than 7% share of credits received from overseas co-owners). The major 'consumers' of direct investments were industry and trade (up to 3/4 of all direct investment). More than a fourth of all entities with foreign participation belong to the industrial sector and another third, to retail trade and public catering.

Structure of foreign investment by country of origin shows that three off-shore countries (Cyprus, Luxemburg, the Virgin Islands) accounted for a fourth of total new foreign investment in 2002 and for almost 30% in the first half of 2003. The share of these three countries in the accumulated total of foreign investment exceeded one fifth by the end of June 2003. According to the majority of experts, it may be called 'quasi-foreign' investment (return of Russian capital that earlier flew abroad). As a rule, off-shore firms are affiliated to management and owners of the Russian companies obtaining the investment.

An annual (since 1998) structural survey conducted by Goskomstat at about 27,000 large and medium-sized industrial enterprises is the most representative study. The available survey results (Table 1) are relevant not only to joint-stock companies, but also to other legal forms (partnerships). Structure of authorized capital can be calculated on a weight basis by size, so that average structure of capital of industrial enterprises is biased towards capital structure of larger enterprises. Changes over two years show that the share of all levels of government is on the decline, and the share of non-financial commercial entities is on the rise. At the same time, the share of foreign investors and founders has noticeably increased. But in fact, really foreign capital and capital of Russian origin that has come back from off-shores may be combined in the statistical survey data.

According to the structural surveys' data, foreign participation in authorized capital of companies has been growing in Russia in recent

years, and concentration of foreign capital is rising. For instance, by the end of 2001, average share of foreign individuals and juridical persons in authorized capital of large and medium-sized enterprises has reached 10%. At the enterprises where foreigners are among shareholders or founders, this share is over 47% (Goskomstat, 2002, pp.98-99).

In addition, we may consider the results of formalized surveys implemented by independent expert organizations. After the 1998 crisis, special surveys of corporate ownership structure were conducted by the Higher School of Economics (HSE) in 1999 and 2002, by the Bureau of Economic Analysis (BEA) in 2000, by the Russian Economic Barometer (REB) in 1999, 2001 and 2003, and by several other institutions. Results of these surveys reflect different periods, and their sampling is not always representative. The data demonstrate (Table 2) declining shares of the state and ordinary workers against the background of growing shares of managers and outsiders, mostly representing non-financial enterprises. The role of foreign shareholders, as well as financial institutions, remains insignificant (about 2-4%). However, we have to point out that in these cases, the respondents were speaking about stakes of genuine foreign partners.

However, the share of foreign investment in total fixed capital investment in the early 2000's was falling: from 6.6% in 1999 (record high over the reform years) to 4.1% in 2002. The data of sample surveys of industrial joint-stock companies conducted in the late 1990's - early 2000's by HSE and BEA show that the share of foreign investment in fixed assets has always been negligible (about 1-1.5%).

Foreign Investors' Participation in Capital of Joint-stock Companies: Evidence of Interviews

Findings of our in-depth interviews do not contradict either to macroeconomic trends or to surveys' results and explain the mechanism and consequences of foreigners' participation in activities of Russian enterprises (see Table 3 for details).

The sample includes six objects with direct participation of foreign investors in their capital. They are a joint Russian-Greek venture with 50:50 stock capital distribution between two legal entities, the Russian party being a large oil refinery. Five other joint-stock companies present a variety of minority and medium shareholders, which added up to a solid participation in two of the cases. Besides, three more case stories are joint subsidiary companies with US and Germany participation in their capital (with 50:50 capital stock distribution) in groups of companies, established in course of restructuring of privatized enterprises.

Foreign investors' participation clearly declares itself in integrated business entities: members of groups, subsidiaries or groups of companies. Only one company of all those with foreign participation is independent, its shares were being purchased by a business group at the date of the interview. All surveyed business groups had foreign investors of some or other type.

Two major contrasting types of foreign participation in the equity of Russian joint-stock companies can be observed.

The first type is a strategic investor participating in individual businesses (projects), which are promising to turn out goods to be sold in domestic or foreign markets. A foreign investor is an individual or legal entity representing private non-financial capital. This is a major shareholder in a joint venture generally owning no less than 50% of shares.

Generally speaking, there were cases in this country when foreign investors surely secured themselves controlling stakes (for example, "Nestle" has bought more than 90% of shares in the stock of a chocolate producer "Rossiya", which is an open (publicly traded) corporation; some foreign investors have also built new plants).

Foreign shareholders participate in capital of deliberately organized joint ventures (subsidiaries or spin-offs, of joint-stock and other forms of business organization). This type of investment is the least risky for foreigners and, more than that, spares them the trouble of sharing the

"Soviet heritage" of privatized joint-stock companies in their relations with regional and local authorities. It gives them the opportunity to focus on the most promising business lines, utilizing the best labor and other resources of their Russian partner. This type is also suitable for their Russian partner, because it rules out foreign interference in control over the business as a whole.

The prevailing pattern of ownership is parity (50:50) with the Russian partner, which, on the one hand, gives no legitimate advantages to either of the shareholders and on the other, prevents them from opportunistic behavior that could ruin the business. Such patterns of ownership are based on mutual trust between the partners, which typically represent medium-scale businesses.³ The foreign partners' interests confine to making profits, steady progress of the business and, possibly, expansion of their participation in it (for example, there is a case story of a business group, which, in the long run, may be eventually sold to the foreign partner by its Russian owner).

The interview also evidenced the existence of smaller strategic investors (there is a single case of an enterprise with 12% of equity owned by an individual, and 9% by a US company). They support sales of enterprise products in order to develop their core business lines, using stable business contacts with the management, i.e. the owners of the enterprise.

The second type of participation is a variety of minority shareholders ranging from the smallest to those holding 5-10% blocks of shares. They may represent institutional and other portfolio investors or firms affiliated to the management of their main companies (such "quasi-foreign" firms most probably have their stakes in the stock of three Russian corporations in our sample). Reasons of minority shareholders to

³ A similar scheme was used in the major deal of 2003, which was merger of British Petroleum and the Tyumen Oil Joint-Stock Company (TNK). Notice that according to our interviews, parity ownership is the base of two new joint ventures.

participate in the stock are to get dividend income and to gain on growing market value of the companies.

Foreign Shareholders' Role in Joint Businesses

Foreign shareholders' role in firm's operations is manifold and varies according to their status. First of all, there is a number of cases when minority investors do not participate in economic activity and decision-making. This is true for institutional investors of listed companies, not to mention affiliated firms.

Interestingly, far from all joint-stock companies with strategic foreign participation make direct investments in fixed assets. Moreover, this is more typical of initial stage of a joint venture. Participation of foreign partners is more visible in decision making, including invitation of foreign managers, development of production and engineering capabilities, marketing and sales activities, export promotion in particular.

Reasonably enough, almost all enterprises with foreign investment are dynamic exporters, selling from 13% to 90% of their products to developed countries. The main attraction for foreigners are makers of unique machinery as well as integrated steel makers. Presence of foreign partners gives extra competitive advantages to Russian companies (state-of-the-art production and managerial techniques, promotion techniques in particular, as well as positive corporate image) both abroad and on the domestic market.

Companies with and without foreign participation look not much different in current assessments of intensity of competition. However, companies with foreign participation point out increasing competition more often and name foreign manufacturers as their major competitors on the domestic market. At the same time, these companies are characterized by having better condition of equipment and technologies (by the way, the interviews show that these particular respondents are more critical about their own businesses) and being more active in their

investment policies, although there is no much difference in rates of growth in their output in recent years.

Foreign Shareholders' Attitude to Legal Institutions

Interests of the two contrasting types of foreign shareholders, strategic and minority ones (the latter are mostly institutional investors), are different, and they result in different attitudes to legal institutions.

Major strategic investors secure a certain safety net against opportunistic behavior of their partners, threats of takeover and encroachments on their ownership rights (including attacks of authorities) by maintaining trustworthy relations with their Russian partners, by establishing parity ownership and direct participation in decision making, in appointment of and control over executive management. These procedures substitute for formal legal institutions.

Foreign co-owners of companies are interested in appropriately regulated relations between owners and executive management, in proper procedures for expansion of their participation in capital as well as for withdrawal. In this aspect, they are in no way different from any Russian dominating owners.

As for minority shareholders, their presence is typical mainly of companies listed on the stock market. Investors can require procedures for protection of minority shareholders in case of reorganizations of companies (takeovers, mergers) and in the election of their boards of directors. Moreover, foreign minority shareholders' participation is generally carried out either through their representatives in boards of directors or by appointment of independent directors, including foreign citizens. Another way of control (as shown in one of our interviews with a large steel maker) is thorough examination of the company's performance data. In such cases, the shareholders demand that financial disclosure should be prepared and submitted under international standards.

Notice that few cases of difference of interests between minority and major shareholders, as well as of corporate conflicts, have been

registered mainly in public companies with foreign minority shareholders.⁴ The reasons for split-ups observed in the survey are incompatible approaches of minority and major shareholders to dividend payments, and disagreement over restructuring of business. But dominant Russian and minority foreign shareholders agree in their approach to the increase of their company's market value (and to its positive image, respectively). This provides ground for negotiations and for making agreements, as well as for willingness to prevent an open conflict.

By our respondents' opinion, the best way to resolve corporate disputes is negotiations. Going to courts or associations is mentioned as a main or second-best way (mostly, in companies with foreign minority investors) in less than in a half of responses. At the same time, orientation towards resolution of conflicts in courts may be related to the scale of business and to its belonging to an integrated business group.

So, strategic foreign investors are oriented towards reliance on informal procedures for protection of property rights (although they are keeping legitimate procedures in view). In most cases, the area of potential conflicts and demand for protection of minority shareholders' interests is limited to foreign investors of companies listed on stock exchanges.

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⁴ Excluding one case of a unique enterprise with a large stake of the government, individual cases of divergence of interests and/or conflict in companies without foreign participation are typical of enterprises where ownership concentration is not yet comotete it is also the case when them is a threat of *capture*

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Table 1

Breakdown of Equity Capital of Large and Medium Industrial Enterprises at the End of Each Year (% of equity capital)

Shareholders or founders	1999	2001	Change over two years, in percent agepoints
Public authorities - total, including:	18.5	13.5	-5.0
- Federal government	10.4	6.6	-3.8
- Government of unit of Federation	7.3	5.1	-2.2
- Local administration	0.8	1.8	+ 1.0
Non-financial institutions	41.6	65.2	+ 23.6
Financial institutions	3.2	6.1	+ 2.9
Non-profit organizations	4.3	1.8	-2.5
Individuals	20.1	13.4	-6.7
For reference: contributions by foreign legal entities and individuals*	6.6 (40.3)	10.0(47.2)	+3.4 (+6.9)

* *In brackets enterprises with foreign interest*

Source: Author's calculations based on released statistical data (Goskomstat, 2002, pp. 81, 98-99); (Goskomstat, 2000, p.72).

Table 2**Structure of Equity Capital of Industrial Joint-stock Companies,
According to Independent Survey Data (% of total)**

Shareholders	HSE-1 End of 1998	BEA Beginning of 2000	REB Beginning of 2003	HSE-2 End of 2001	ISEPD Beginning of 2002
Employees, including:	40.1	52.5	50	38.7	31
- managers	9.0	17.8	28'		9
- ordinary employees	31.1	34.7	22		22
Government, including:	8.4	5.7	4	8.7	28"
- federal level	4.6	3.1		3.3	
- regional and local level	3.8	2.6		5.4	
Outside shareholders,	51.5	41.8	45	52.6	41
- Russian non- financial	13.9	15.1	15	31.1""	22
- Russian banks, investment	13.1 (banks-1.3)	4.5	8 (banks-1)	0.8***	3 (banks - 2)
-foreign shareholders	3.7	2.9	2	4.6	2
- others (mainly individuals)	20.8	19.3	21	20.7** *	14

* including 3% of affiliated firms

** including 7% of other state-owned companies

*** these figures include foreign interest as well.

Source: Author's calculations based on primary or published survey data. HSE - 1, the survey of 318 joint-stock companies in Autumn 1999, more than 260 joint- stock companies responded; HSE-2, the data for 243 joint-stock sampling from RF Goskomstat structural survey (see details in (Dolgopyatova, 2003); BEA, the survey of 437 enterprises in Spring 2000, over 360 JSCs responded; REB, the survey in February, 2003, 102 JSCs responded (Aukutsionek et.al., 2003, p. 4); ISEPD (Institute for Social and Demographic Problems), the survey of defense industrial companies (Vitebskii, et.al., 2002, p. 36).

Table 3
Comparison of Businesses with and without Foreign Interest In
Equity (based on 20 in-depth interviews)

Business state and activities indicators	Enterprises or groups of companies	
	With foreign interest - 9	Without foreign interests - 11
Forms of foreign partner participation in business (types of joint business)	Subsidiaries-4; Minor strategic shareholders -1; Minor portfolio investors - 4	N/A
Type of business interviewed	Independent enterprises -1; Groups of companies - 5; Members of groups, subsidiaries - 4	Independent enterprises - 8; Members of groups, subsidiaries - 3
Exports, volume	Export-8 (13-90%); easy possibilities of export -1	Export (1-15%)-4; no export - 4; easy possibilities of export - 3
Condition of technology and equipment	Good - 3, medium - 6, bad-0	Good - 4, medium - 5, bad-2
Level of competition	Strong - 7, moderate - 2	Strong - 9, moderate - 2
Competition dynamics for the last 3 years	Increase-6, without changes - 3	Increase-4, without changes - 7
Competitors on domestic markets	Foreign only - 3, foreign and domestic - 3, domestic only - 3	Foreign only -1, foreigners and domestic - 6, domestic only - 4
Investment for the last 3 years	Regular-9	Regular - 6, irregular or no investments - 5
Divergence of interests between large and minor shareholders'	Yes - 4 (4) cases	Yes - 2 cases
Threat of capture'	Yes-1 (1)case	Yes - 4 cases
Regular dividend policy'	Yes-1 (1)	Yes-3

Table 3

Comparison of Businesses with and without Foreign Interest In Equity (based on 20 in-depth interviews) (continued)

Business state and activities indicators	Enterprises or groups of companies	
	With foreign interest - 9	Without foreign interests - 11
Dominating position in the Board of Directors*	Managers' - 4 (3) Groups' or owners' - 5 (3)	Managers' - 6 Groups' or owners' - 4, no data -1
Role of a Board of Directors in the company'	Nominal - 4 (2) Expert - 3 (2) Monitoring or decision-making - 2 (2)	Nominal - 7 Expert -1 Monitoring - 3
Corporate conflicts or green-mail'	Yes-3(3) cases	Yes - 2 cases
Preferable ways of settlement of corporate conflicts'	Negotiations - 7 (5), courts-6 (6), associations and unions -2 (2), no data -1	Negotiations-10, courts-3, associations and unions - 0

* *In brackets, for 6 businesses interviewed with direct foreign interests in a company's equity.*