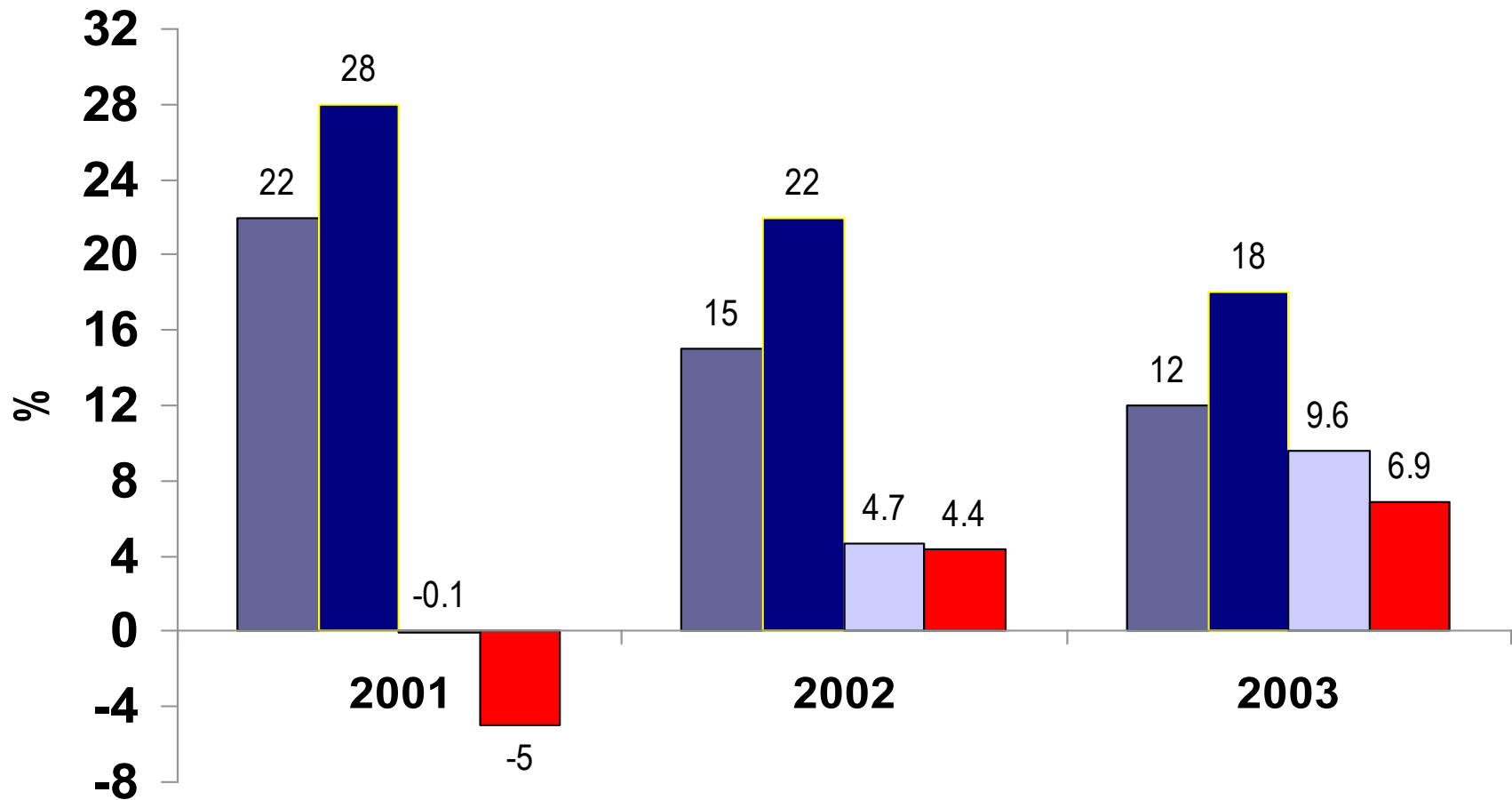# The Russian IT Market: Analysis and Review

2nd US-Russia ICT Roundtable
February 20, 2003
San Mateo, California

Contents

- **Russia Rises While the Tech World Falls**

- **Today's Russia -- Points of Attraction**

- **Russian IT Market by Segment**

- **Drivers and Barriers for Russian IT**

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Russia rises while the Tech world falls –
01-02 global IT spending was down, while Russia grew 20%+

IT Spending Growth (%)


Legend: Russia (IDC), Russia (EY), Worldwide (IDC), US (IDC)

Data:
- 2001: Russia (IDC) 22, Russia (EY) 28, US (IDC) -5, Worldwide (IDC) -0.1
- 2002: Russia (IDC) 15, Russia (EY) 22, Worldwide (IDC) 4.7, US (IDC) 4.4
- 2003: Russia (IDC) 12, Russia (EY) 18, Worldwide (IDC) 9.6, US (IDC) 6.9

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Russia – Points of Attraction (1) political and economic stability

President Vladimir Putin

- **More predictable** and pragmatic. Putin likely to be re-elected president in 2004

- Many expect Russian sovereign debt to be upgraded to investment grade after presidential elections

- Federal tax collection has almost doubled since 1998 as % of GDP

- **Repaying over US$ 10B foreign debt in 2003** presents little problem, with cash reserves over US$ 50B

President Putin's Approval Ratings
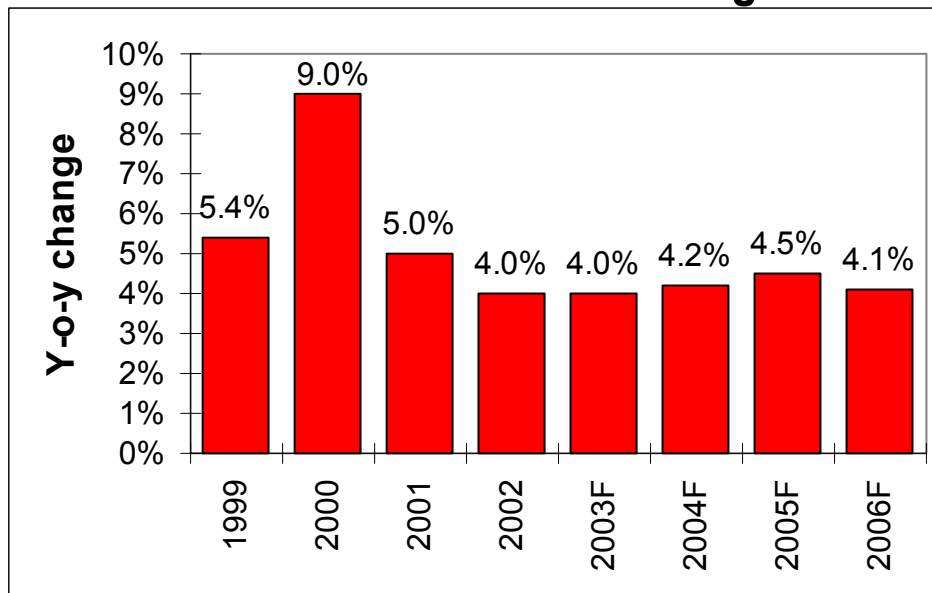
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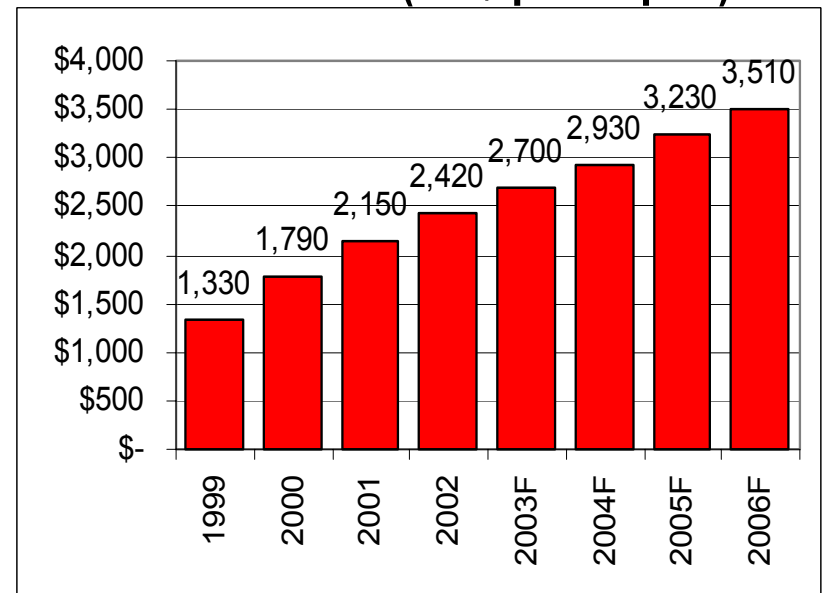*Quality In Everything We Do*
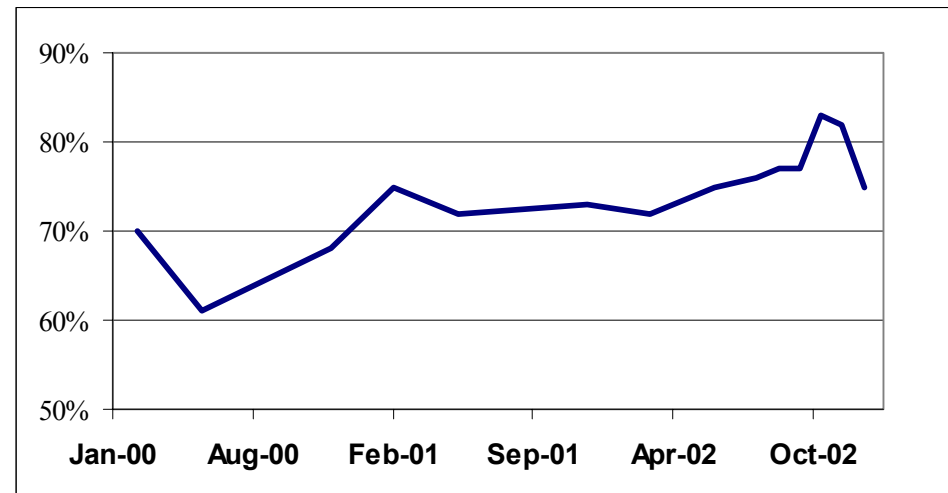
Russia – Points of Attraction (2) growing economy and buying power

- **Devaluation and investment catalyzed a growth** surge in 1999-2001.

- GDP/capita grew faster in USD terms. **Russian consumers enjoy increasing disposable income**, shown by PPP and other analyses.

Russian GDP Y-on-Y Change

Year	Y-o-y change
1999	5.4%
2000	9.0%
2001	5.0%
2002	4.0%
2003F	4.0%
2004F	4.2%
2005F	4.5%
2006F	4.1%

Russian GDP (US$ per capita)

| Year	US$ per capita
1999	1,330
2000	1,790
2001	2,150
2002	2,420
2003F	2,700
2004F	2,930
2005F	3,230
2006F	3,510

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Russia – Points of Attraction (3) structural reforms reducing risks

- **Tax reform** of 1998-2001 (with rates at 13% flat for individuals and 24% for businesses) **has led to a larger, more diversified tax base**

Russian Tax Collection (as % of GDP)
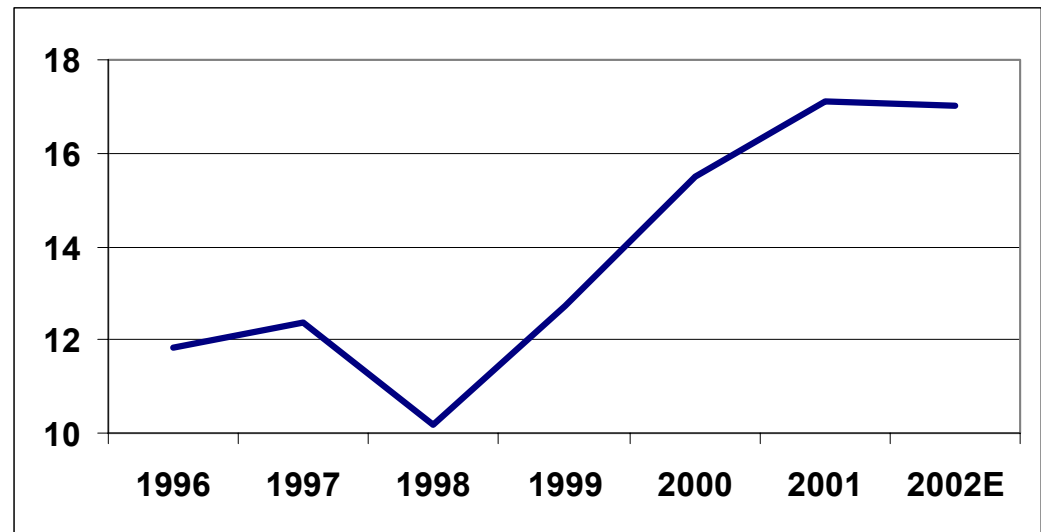
- **Land reform** has led to a wave of privatization transactions.
- **The banking system** is recovering due to a strong inflow of petrodollars into the country and gradual regulatory improvement.
- **Corporate governance** is slowly improving.
- **Other reforms** are announced or planned

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Russia – Points of Attraction (4) investor exit opportunities

- **IPOs have provided some exits** (per examples shown) in Russia, and will **gain importance over medium term.**

- **Trade sales have been the primary exit route** for investors. Examples:

  – *BP's recently announced its investment of US$ 6.75 billion for up to 50% of **TNK** (Truman Oil Co.)*

  – *Heineken bought stake in **Bravo** for up to US$ 400 million from private investors*

  – *Nestle Waters bought a stake in **Saint Springs** from private equity funds*

BEE LINE CELLULAR COMMUNICATIONS Vimpel Communications	Golden Telecom
IPO Level 3 ADR US$ 110,000,000 Senior Convertible Notes, Level 3 ADR US$ 170,000,000 Share Issue to Private Investor US$ 50,000,000 *1996* NYSE Listed	IPO including Purchase by Strategic Investors US$ 135,800,000 Share Issue to Private Investor US$ 15,000,000 *1999* NASDAQ Listed
MTS GSM	bp
IPO Level 3 ADS US$ 350,000,000 *2000* NYSE Listed	Acquisition of up to 50% of TNK Shares US$ 6,750,000,000 *2003* (Announced)

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Russian ICT Market – almost US$ 20 bln by 2005

(Figures in US $ Millions)

2001 Revenue

6,007   5,021

391   760   374

2005 Revenue

7,231   9,228

800   1,637   831
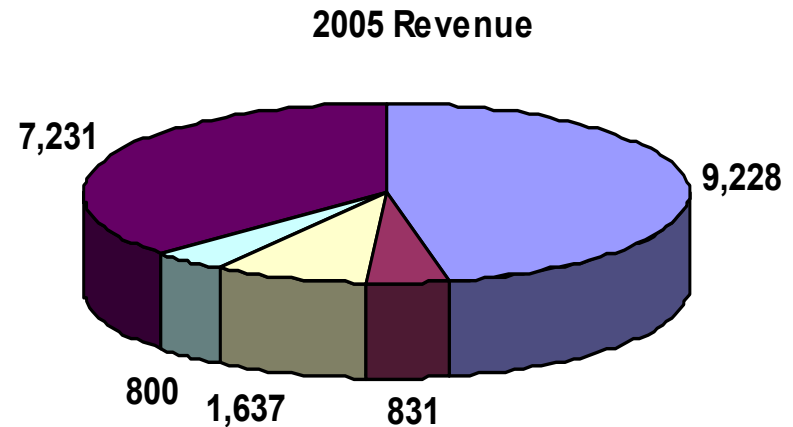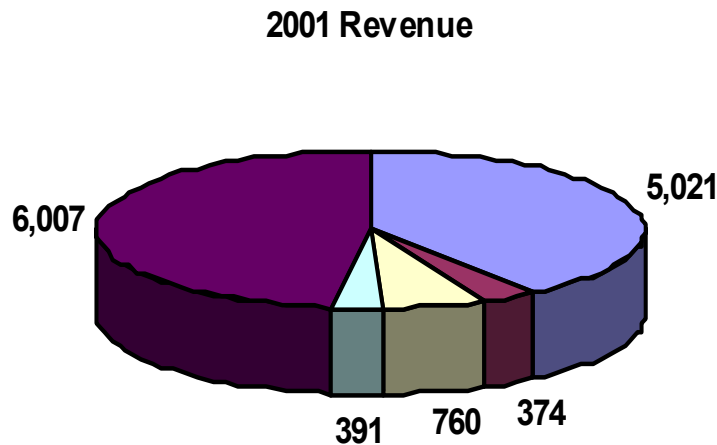
Segment CAGR (2002-2005)	ICT HW 16%	Software 22%	IT Services 21%	Data comm. services 20%	Voice telecom 5%

- **Mobile Subscribers / Penetration:** **~20 million / 14%** (current)
- **Personal Computers / Penetration:** **~12 million / 8.4%** (at Jan 2003)

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Russia – ICT hardware: growth across all segments

- Growing amid global slowdown.

- Corporate clients lead demand, but regions and retail will drive future growth.

- Growth could slow with price pressures.

- 12 million mobile handsets sold in 2002

Hardware Market '00-'05E (US $ millions)

Legend:
- End-user telecom equipment
- Peripherals
- Other (incl. PDAs) hardware
- Servers
- PC

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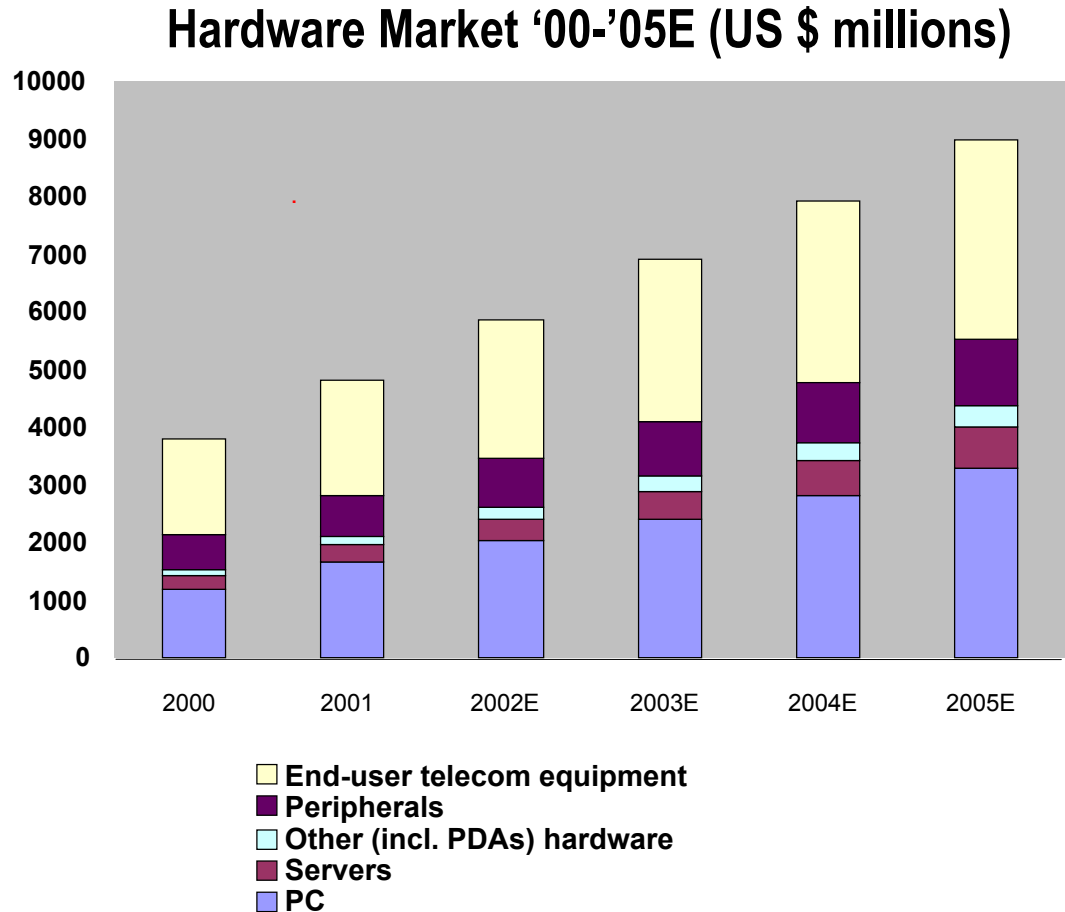
Russia – Software: small but large upside potential

- Up 80% p.a. last two years

- Russian companies are now investing into enterprise solutions

- Successful domestic products, and some exported
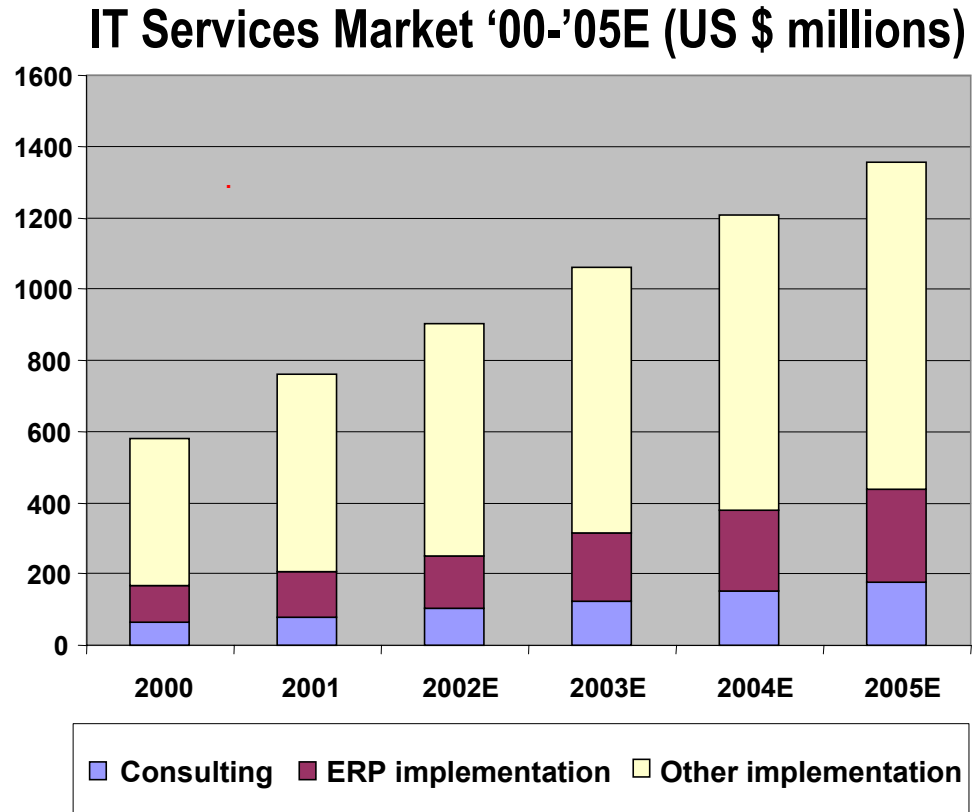
Software Market '00-'05E (US $ millions)

Legend: System infrastructure | Development & Deployment Tools | Applications
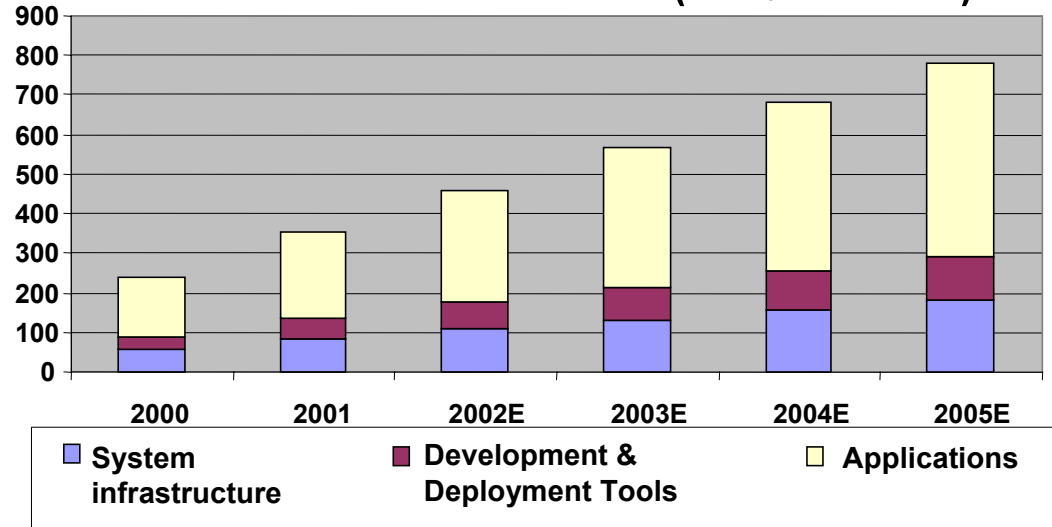
International Piracy Rates

Country	2000	2001
Vietnam	97%	94%
China	94%	92%
Indonesia	89%	88%
Ukraine/Other CIS	89%	87%
Russia	88%	87%
Lebanon	83%	79%
World average	37%	40%

- Piracy a problem (~85%) but less than China and improving with legislation (on patents and trademarks) and enforcement (e.g. new arbitration procedural code)

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Russia – IT Services: the key channel still maturing

- About 30% of the IT services revenue are estimated to stem from consulting and ERP implementation.

- Remainder is broadly hardware installation and maintenance.

- Service revenues are difficult to measure (rigorous surveys needed)

- Revenues are primarily project-based, with annuity work (e.g. outsourcing) rising slowly

IT Services Market '00-'05E (US $ millions)

Legend: ■ Consulting ■ ERP implementation ☐ Other implementation
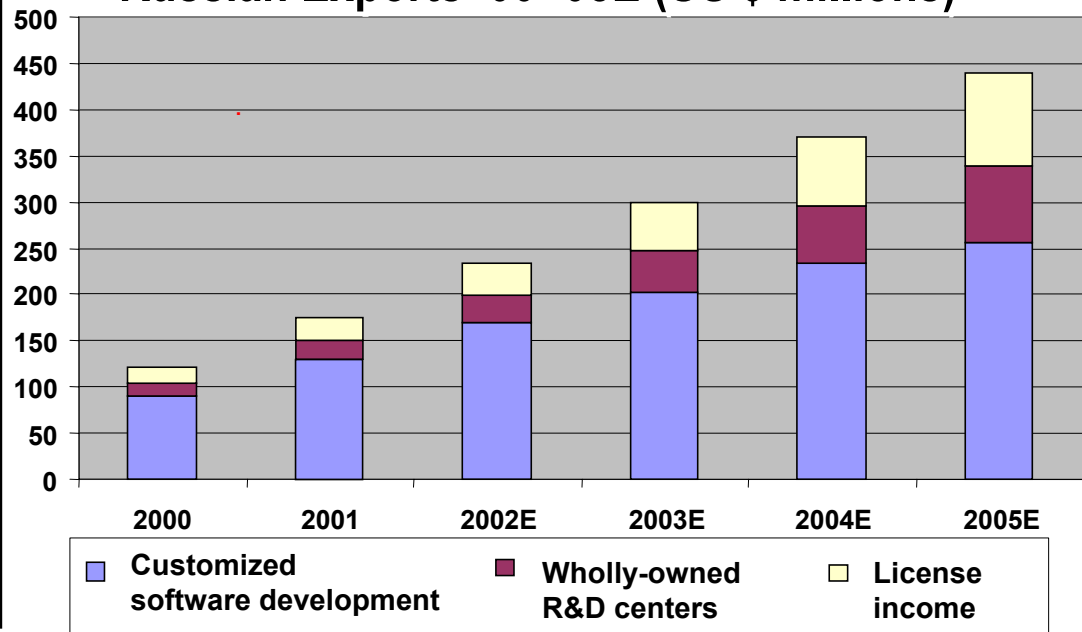
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Russia – IT exports: on the rise but under-leveraged

- Niche packaged software (e.g., OCR, anti-virus, gaming, others)
- Offshore programming, leveraging science-intensive strengths, has been growing at a significant pace. For ease of measurement, we include onshore R&D centers of foreign companies (e.g. Intel, Motorola).

IL-2 Sturmovik – declared "... the best World War II flight simulator" by PC Gamer

Russian Exports '00-'05E (US $ millions)

	Customized software development	Wholly-owned R&D centers	License income

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Russian Software – several world-class players with global sales and higher margin business models…

- **2nd largest global optical character recognition (OCR)** software producer, with a 10-20% share in certain European markets

- **Top 10 global seller of anti-virus** software. Seeks 5% of global US$ 2 billion antivirus market

- No. 1 accounting software company. Dominant gaming developer and producer.

- Leading developer of web and wireless low bandwidth integrated rich media 3D simulation products for large industrial applications.

- Supplies algorithmic technology to Texas Instruments for its DSP 5000 series

- IBS provided the software and funding for this content services company

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… and the list could be greatly expanded by addressing barriers on the domestic software industry

Despite export growth in recent years and as projected, the Russian software product industry has potential to rise further and faster

Software Exports '00-'05E (US $ millions)
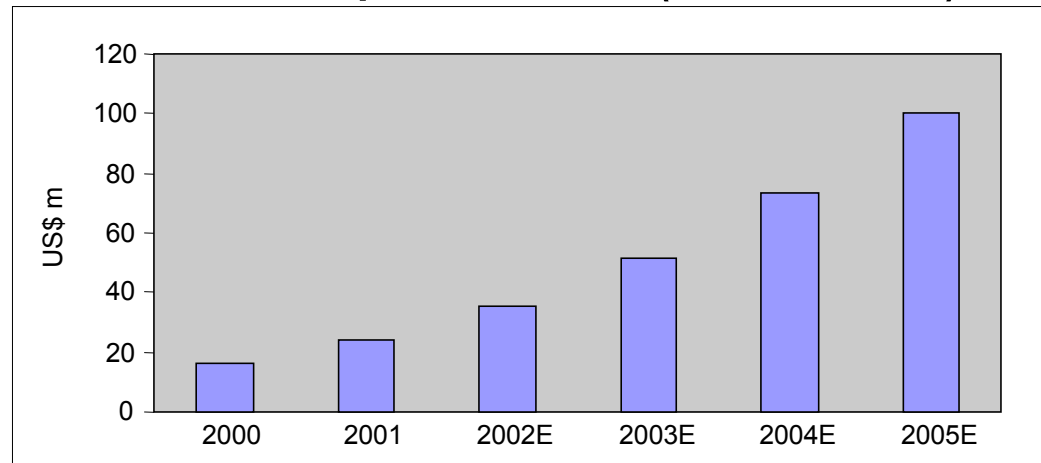
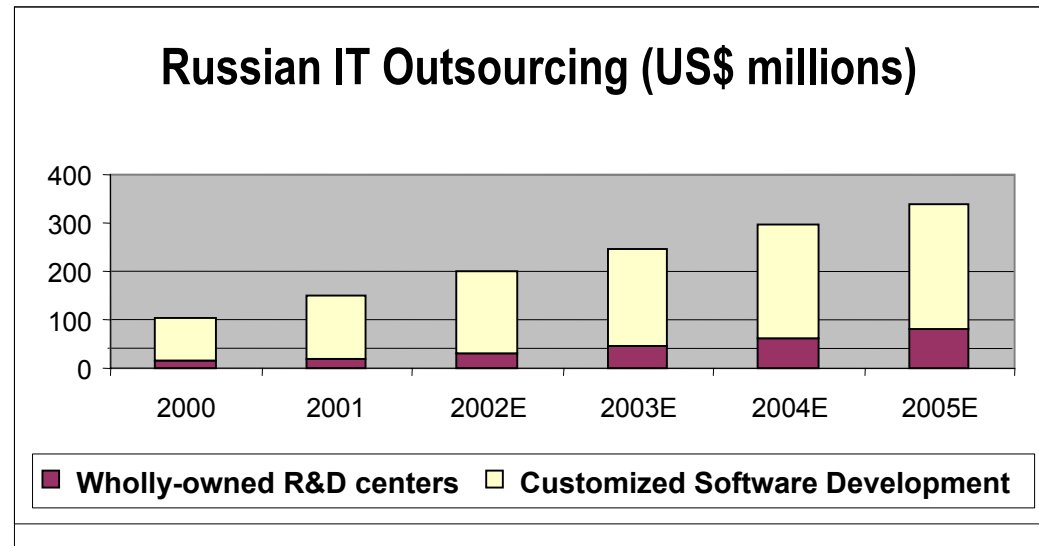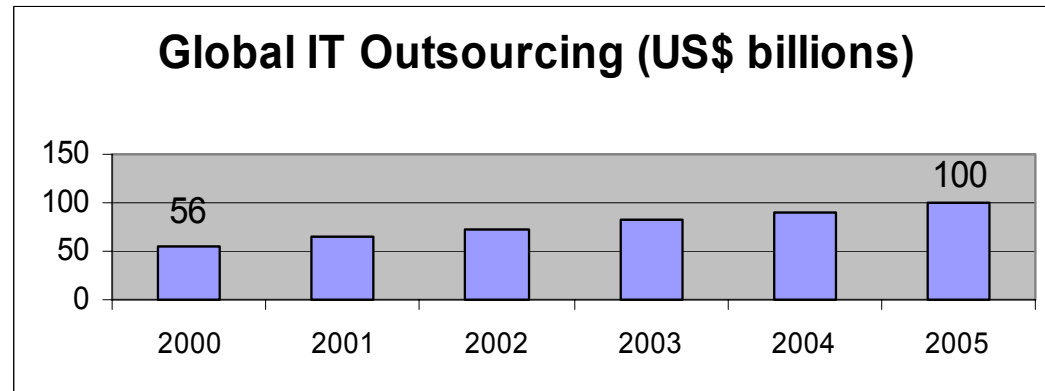**Barriers on Growth of Russian Software Product Companies:**
- piracy
- lack of early-stage funding
- lack of qualified management
- lack of sales and marketing orientation
- lack of global network

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Russian software outsourcing – seeking its fair share (offshore and onshore) of the pie

Estimates of Russian offshore software development (OSD) revenues vary up to $300 million for '02. Difficult to measure given large number of small boutiques (<50 programmers).

Leading Russian OSD players include:

Global IT Outsourcing (US$ billions)

56					100
2000	2001	2002	2003	2004	2005

Russian IT Outsourcing (US$ millions)

2000	2001	2002E	2003E	2004E	2005E

■ Wholly-owned R&D centers □ Customized Software Development

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Russia cannot compete on price alone, so it adds value by leveraging scientific know-how and creativity

Russia can overcome China's cost advantages by… subcontracting to teams in regions where salaries are 50-70% less than in Moscow…

Country	Annual Salary (US$)
China	4,750
India	5,850
Russian Regions	5,900
Russia (average)	7,500
Moscow	10,000
United States	63,000

…and by **leveraging its skills advantage**.

Evaluation Criteria	India	Ireland	Russia	Singapore	Israel	Mexico	China	Philippines	Hungary	Malaysia
Labor Cost	A	D	A	C	D	B	A	A	B	B
Cultural Fit (incl. language)	B	A	B	B	A	C	B	C	C	C
Infrastructure (incl. tax & legal)	A	A	B	A	A	B	C	B	C	B
Skills & Training	A	B	A+	B	A	C	B	C	C	C
Intellectual Property Protection	B	A	C	A	A	B	D	C	B	C
Political Stability	C	A	B	A	D	A	B	B	A	B
Process Maturity	A+	A	B	B	A	B	C	C	C	C
Overall	+4	+3	+2	+2	+1	-1	-3	-3	-3	-4

* Sample scorecard based on qualitative assessment and subject to change

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Enhancing drivers / lowering barriers for Russian IT

- Address barriers on software industry noted on earlier slide

- Strengthen Russian IT <u>industry association</u> (APKIT)

- Strengthen <u>government leadership</u>

  - Proposal #1: Create an "Russian IT Ambassador" office to promote Russia to foreign customers/investors (as China and India did with Microsoft). IT Ambassador could fill role of foreign commercial service to assist smaller exporters

  - Proposal #2: Create the "Office of IT Policy" to work with industry to accelerate reforms (customs, IPR protection, etc.)

  - Look to international models, but find a Russian solution, e.g. an "IT Czar" could lead abroad and at home on proposals #1 and #2.

- Build more ties to the <u>Russian diaspora</u>

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