

Russian Automotive Component Market

Why and where to invest



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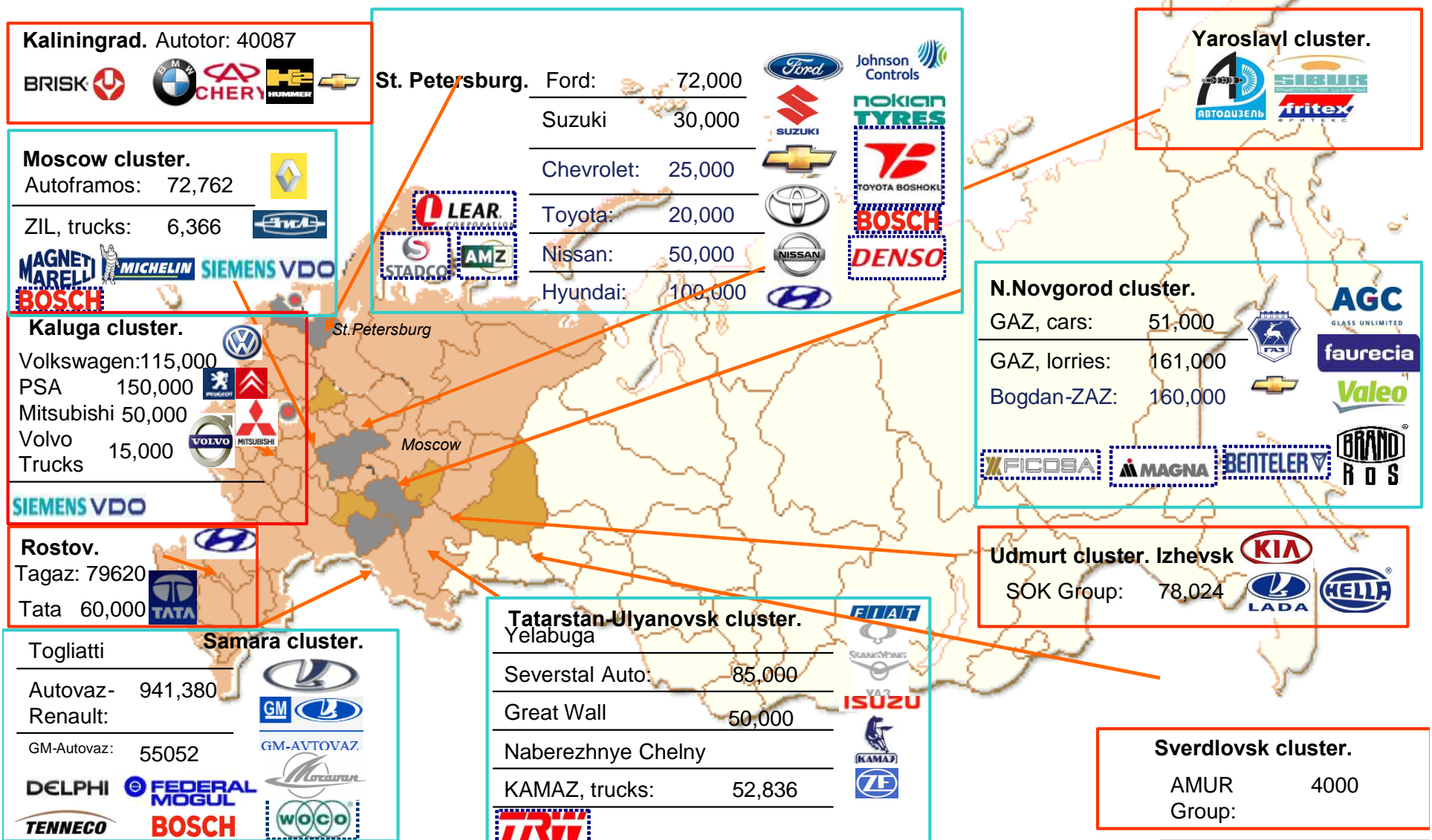
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Automotive market overview

Major and developing automotive clusters in Russia



----- existing clusters, ----- developing clusters

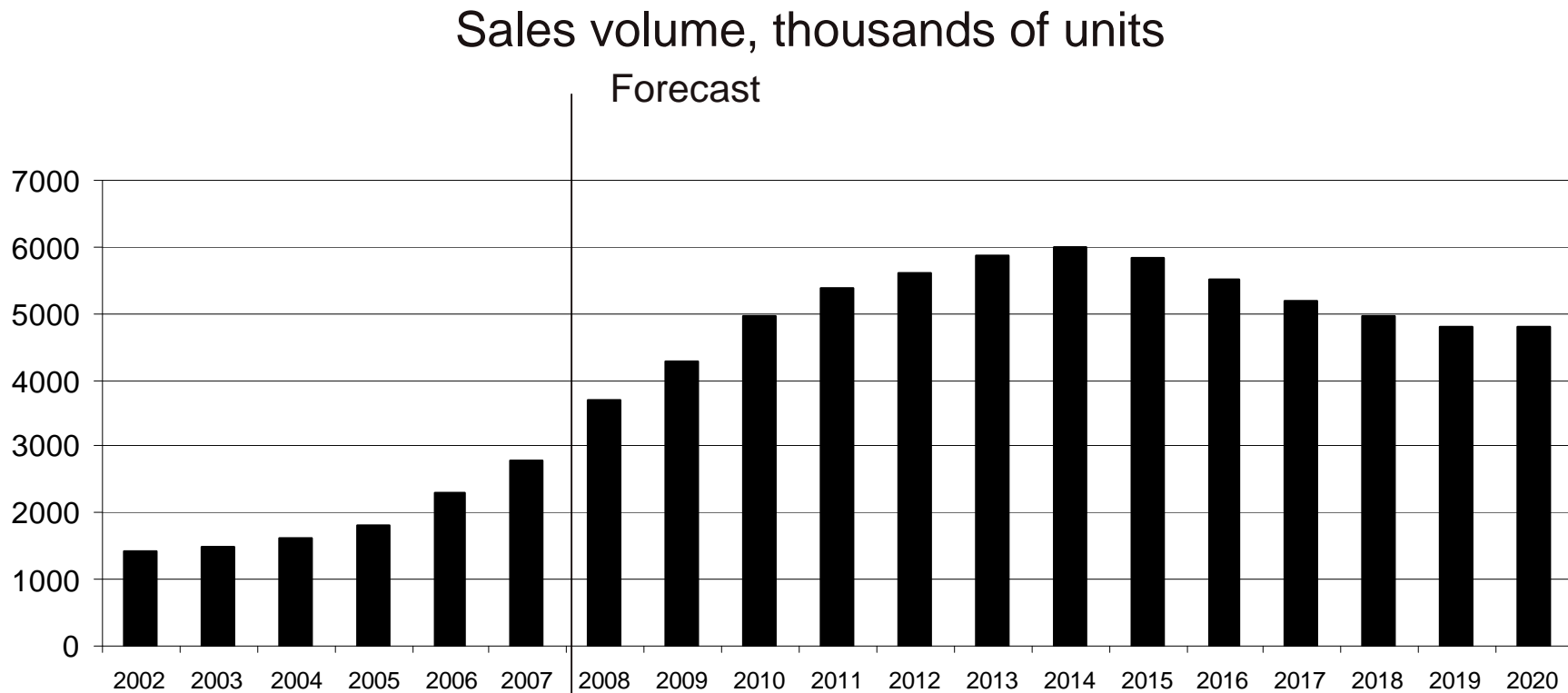
2007 car sales in Russia

| Car category | Thousand units | | | US dollars, billions | | |
|-----------------------------|----------------|-------------|---------------|----------------------|-------------|---------------|
| | 2007 | 2006 | Variation (%) | 2007 | 2006 | Variation (%) |
| Russian brands | 765 | 800 | -5% | \$6.5 | \$5.8 | 12% |
| Russian-made foreign brands | 440 | 280 | 57% | \$6.7 | \$4.4 | 52% |
| New car imports | 1205* | 720 | 67% | \$34.1 | \$18.2 | 87% |
| Used car imports | 380 | 260 | 46% | \$6.1 | \$3.6 | 69% |
| Total | 2790 | 2060 | 35% | 53.4 | 32.0 | 67% |

Sources: Goskomstat, GTK, ASM Holding, AEB, PwC estimates

*GTK mentions much larger figures for import of new cars – up to 1.4 mln.; we are trying to understand the reason behind the difference

There is no consensus on how the Russian market will develop over the medium term. However, according to one optimistic scenario of the development of the Russian economy, sales volumes could reach to as much as 6 million units per annum*

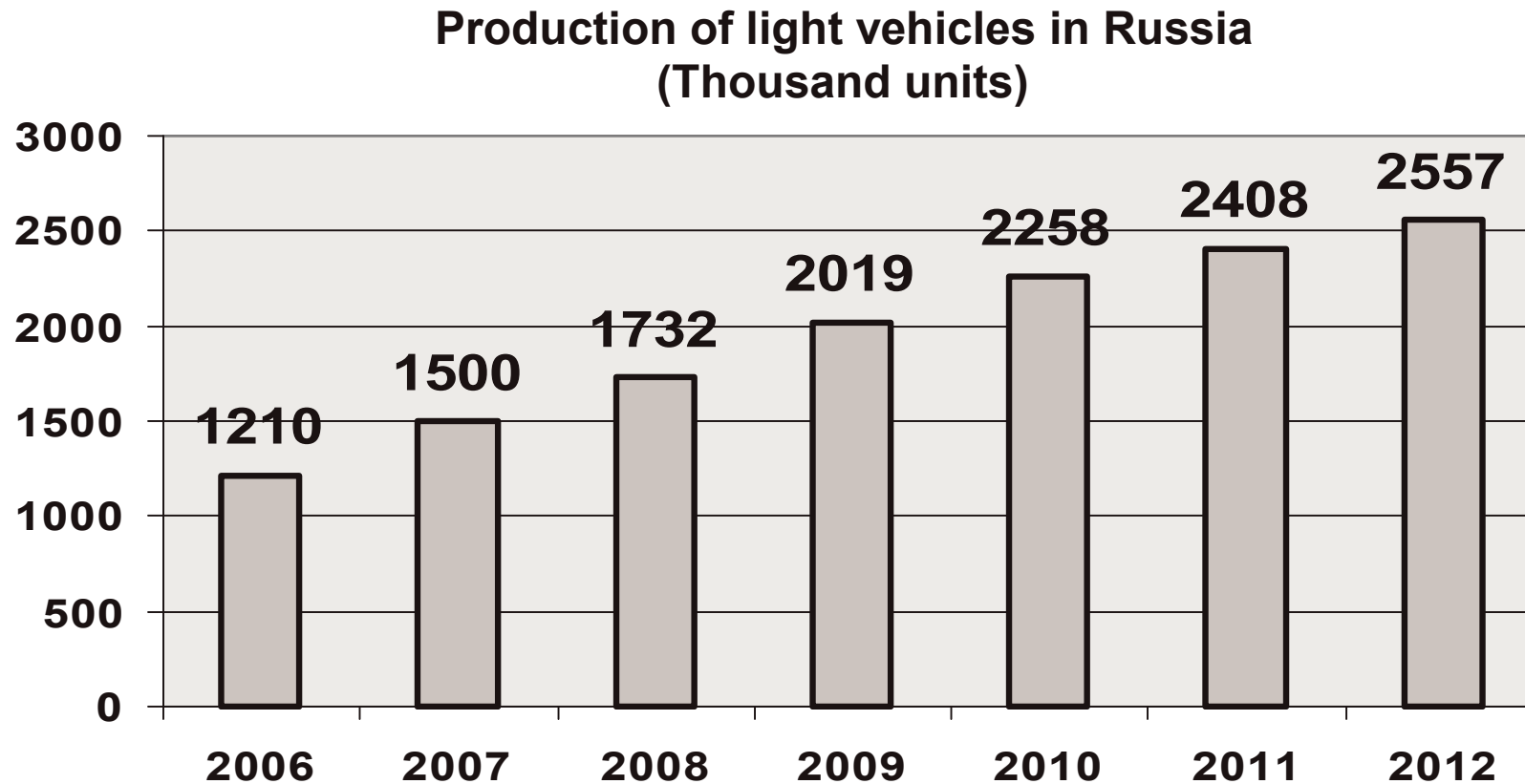


Source: PwC estimates

* For further discussion of possible scenarios for the development of the market see "Some thoughts on the future of the Russian car market", Stanley Root, February 2008

What would such sales growth mean for domestic car production?

Assuming no major unexpected political or economic developments within the next 5 years domestic production of light vehicles could double



Sources: AUTOFACTS

PricewaterhouseCoopers

Russian automotive/component markets

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What would such sale growth mean for car parc development?

Just as foreign brands have captured the market for the new car sales, so in time foreign brands will capture the entire car parc

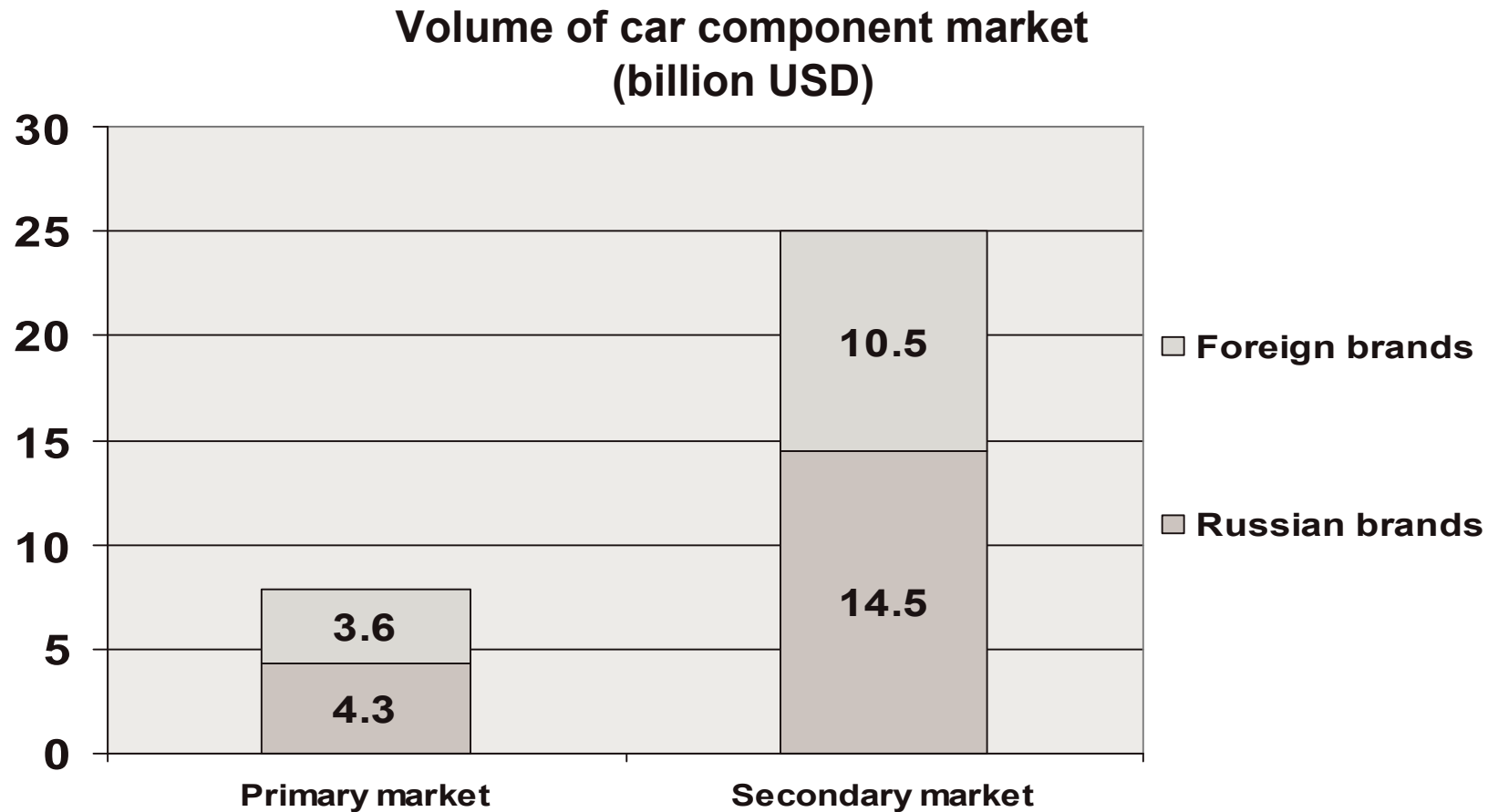


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Component market overview

Russian car component market in 2007

The current breakdown in USD between primary and secondary auto component market in Russia is estimated to be 24% and 76% respectively*



*Sources: AutoStat

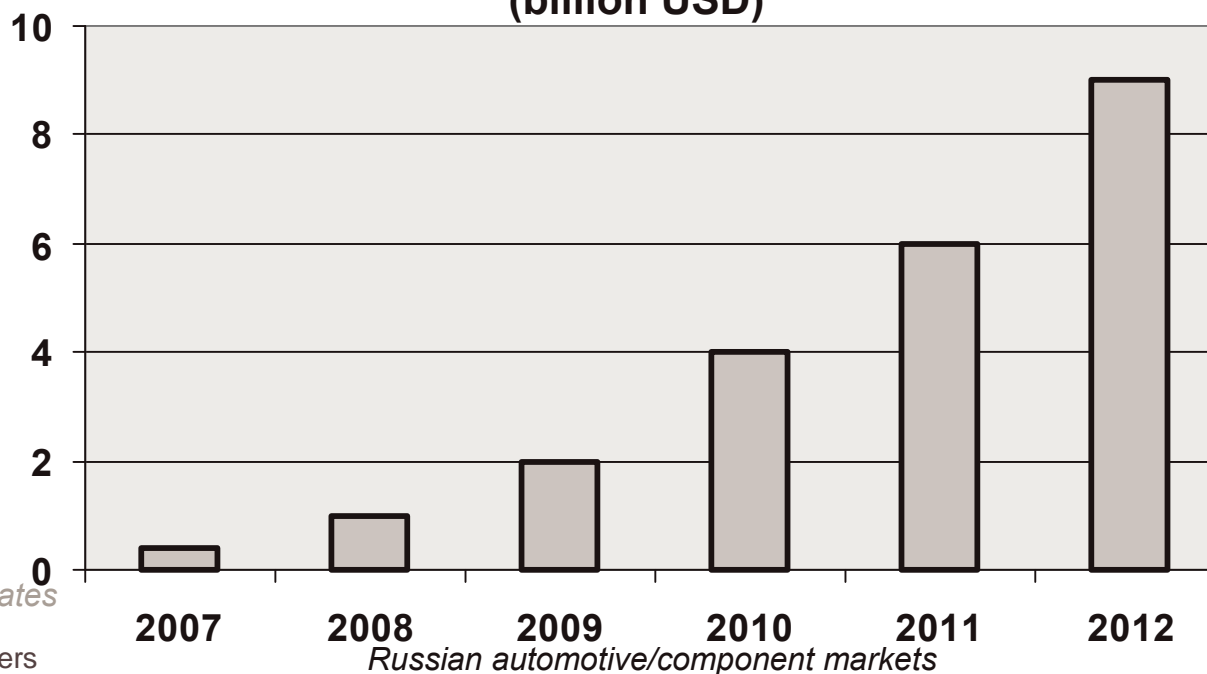
Primary market: potential of auto component production for Russian-made foreign brands

- 440 000 Russian-made foreign brands were produced in Russia in 2007
- The value of auto components produced within Russia for the assembly of Russian-made foreign brands in 2007 was a mere 360 mln. USD, because the majority of components are imported
- Many foreign OEMs signed an investment agreement with the Economics Ministry and agreed to reduce the monetary value of their imported components by a third within seven years

Assuming that:

- The volume of production of Russian-made foreign brands exceeds 2 mln. by 2012
- Average price of a car will be approximately 25 000 USD, 60% of the cost is auto components and at least 30% of components are produced locally
- Then the primary market demand for foreign quality auto components could reach or exceed 10 bln. USD. over the period

Primary market: production of auto component for Russian-made foreign brands (billion USD)



Sources: PwC estimates

PricewaterhouseCoopers

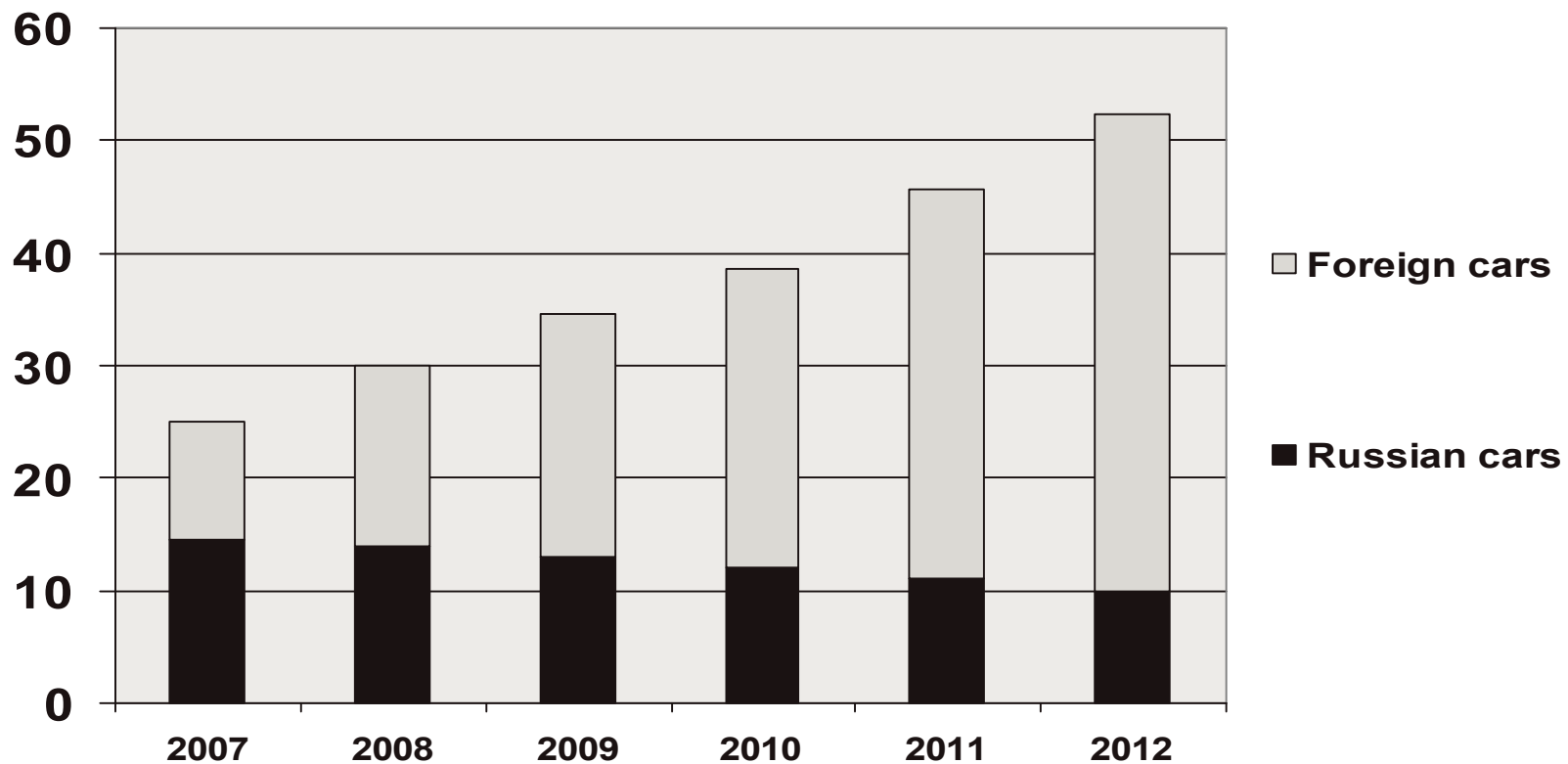
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Dynamics of the secondary market for car components

Because of the dramatic increase of foreign brands in car parc we expect to see a related strong growth in the secondary market for foreign brand components

Volume of secondary car component market (billion USD)



Sources: AutoStat, PwC estimates

Perspectives for the Russian automotive component market

- Because of strong growth of Russian car market and car parc as a whole and because in particular of the tremendous success of foreign brands
- We expect significant increase in demand for foreign brand auto components in Russian both in primary and secondary market.
- Consequently there could be significant opportunities for investment in the Russian automotive sector.
- The question is “Where?”.

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Site selection factors

Some factors to be considered when choosing a location in Russia*

- Availability of qualified work force and wage rates
- Legal issues – managing your risks
- Infrastructure (telecommunication, utilities, etc.)
- Federal and regional tax regime
- Custom duties
- Corruption and fraud risk
- Ease of dealing with local bureaucracy (probably the single most important factor)

**For a broader discussion of the issues of investment in the CEE region see series of PwC publications "Eastern Influx"
<http://www.pwc.com/extweb/pwcpublishations.nsf/docid/5272B7569A7EAE4F85257279006605B3>*

Availability of qualified workforce. Regional unemployment rates

- A key consideration for any investment is availability of local qualified workforce. We are witnessing a rise in competition for labour in certain clusters as foreign investments increase. Indeed we have recently seen the first ever industrial action in the automotive industry – a good indicator of relative shortage of labour supply.
- One guide as to the level of competition for labour in the region is the local unemployment rate*.

Regional unemployment rates in 2006

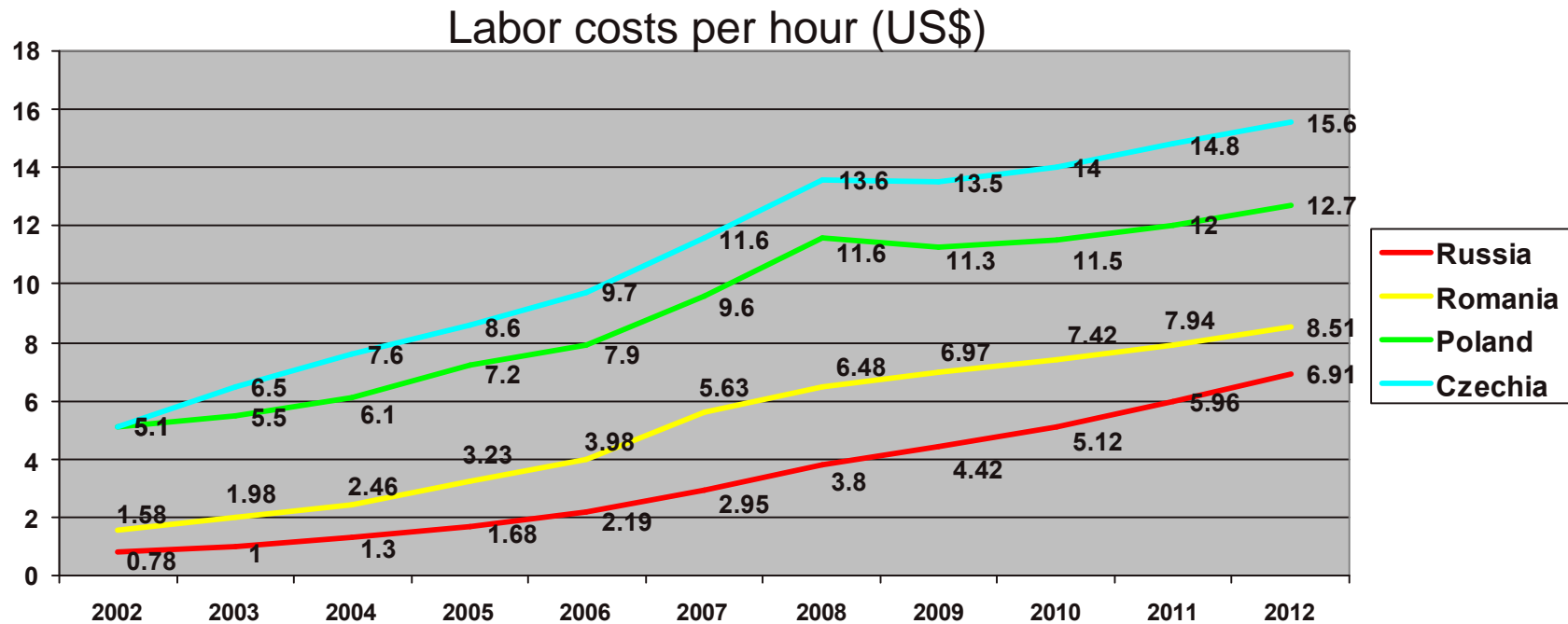
| | |
|---------------------------|------|
| Moscow | 1,6% |
| Moscow region | 3% |
| St-Petersburg | 2,4% |
| Leningrad region | 5,9% |
| Kaliningrad region | 4,5% |
| Novgorod region | 5,3% |
| Rostov region | 8% |
| Samara region | 4,3% |
| Sverdlovsk region | 7% |
| The Republic of Tatarstan | 5.6% |
| Udmurt Republic | 8,4% |
| Ulyanovsk region | 6,9% |
| Yaroslavl region | 3% |

Source: Russian Service of Labour and Employment

**Unemployment rates have been constantly declining in recent years.*

Wage rates

- According to the Russian statistical state bureau the average monthly wage for 2007 was 13500 RUR (530 USD) . However there is significant inflation pressure and wages have increased by 27% by comparison with 2006.
- According to UN forecast Russia is expected to experience a significant decline (15%) in its working age population between 2005 and 2050, which could further add long-term inflation pressure to wage rates.
- Nevertheless Russia appears to offer a competitive advantage in wage rates compared to its neighbours over the medium term.



Source: Economist Intelligence Unit

Regional wage rates variations

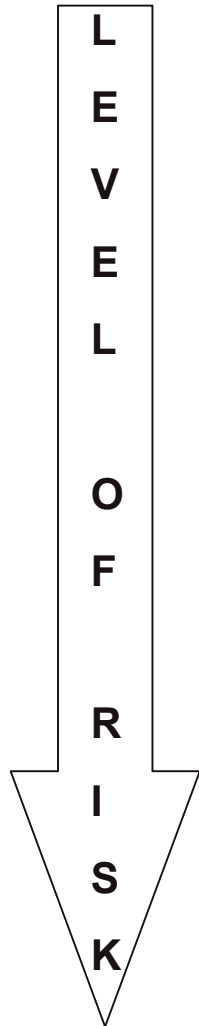
Assuming Moscow salaries are taken as 100%, regional coefficients for average employee wages vary as follows:

| | |
|-------------------|-----|
| North-West Region | 65% |
| Central Russia | 69% |
| South region | 40% |
| Volga region | 45% |
| the Urals | 74% |
| Siberia | 53% |
| Far East | 73% |

Source: Russian statistical state bureau

Measuring the risk of initial investment

There are many options for establishing an investment in the Russian automotive industry, each with its own level of risk:



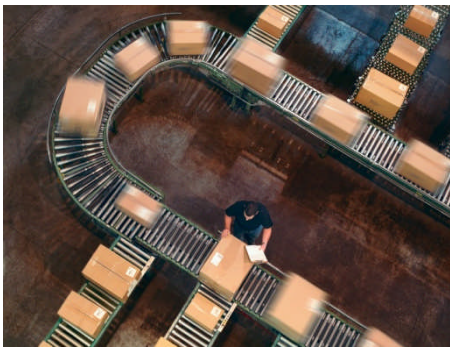
- Supplying sub-assemblies for final assembly by a Russian manufacturer in Russia
- Entering into a Royalty agreement involving the provision of know-how to a Russian manufacturer which would in turn manufacture the particular products
- Setting up a small assembly operation in an industrial park
- Setting up a joint venture with a Russian partner
- Setting up a greenfield factory in a Special Economic Zone
- Buying a Russian company
- Setting up a greenfield plant somewhere else

Russian Infrastructure

- **Russian infrastructure is in urgent need of modernization.**
- Russia's **road capacity** is less than one-seventh of that of Canada.
- Roads account for **only 9%** of country's land freight transportation, compared with 36% in US and 68% in Germany.
- The Russian **rail network** is the 2nd -largest in the world, with 85,500 km of track, but much of the rail stock is old and in need to replacement, e.g. depreciation level of freight cars is 86%, electric locomotives – 73%, railway infrastructure – 52%.
- Russia has 351 **airports**. 24 airports, identified by the Ministry of Transport as priority investment projects. But still most connections go through Moscow.
- Russia has among the highest levels of **port cargo** turnover of any country (300-500mnt/year turnover) similar to Italy and the Netherlands. The logistical chain is already stretched and there is an urgent need to invest in logistic centers.
- On the positive side, Russia has high **telephone penetration** with 31 fixed-line phones per 100 citizens and more than 100% mobile density. Russia has more than 31 millions **personal computers** and about 35 millions **internet** users.
- **The Russian government has plans to invest significant amounts in the development of the infrastructure over the medium term.**

Source: Renaissance Capital

Taxes – some key issues for potential investors



- Tax planning for capital investment
- Compliance with VAT regulations and in particular proper documentation
- Transfer pricing/customs valuation
- Treatment of discounts/bonuses
- Profit repatriation
- Tax implications for financing the investment
- Tax on warranty services, return of goods
- Tax treatment of over/under shipment of goods
- Tax accounting policy
- **NB There are some regional tax concessions which are good to have – but it is wise not to let the profitability of the investment rely on these**

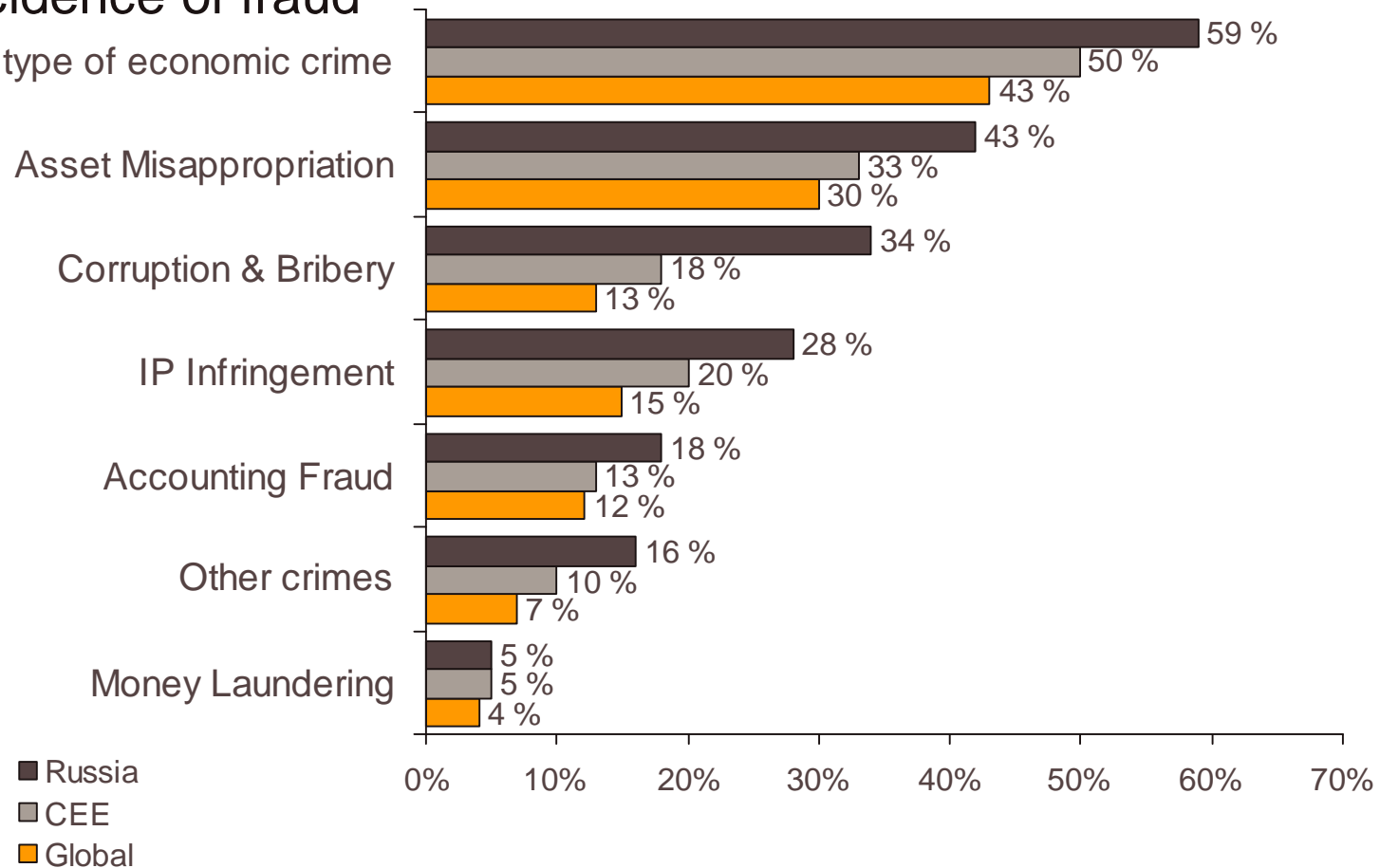
*For more details please see PwC publication “The Doing Business in the Russian Federation Guide”,
<http://www.pwc.com/extweb/pwcpublishations.nsf/docid/E70BAEC31B0C17D8802571FC005699D4>*

Corruption and fraud risk (1)

Along with tremendous growth opportunities that Russia presents there are also high levels of risk. Russia ranked poorly in recent PwC Global Economic Crime Survey.

Actual incidence of fraud

At least one type of economic crime

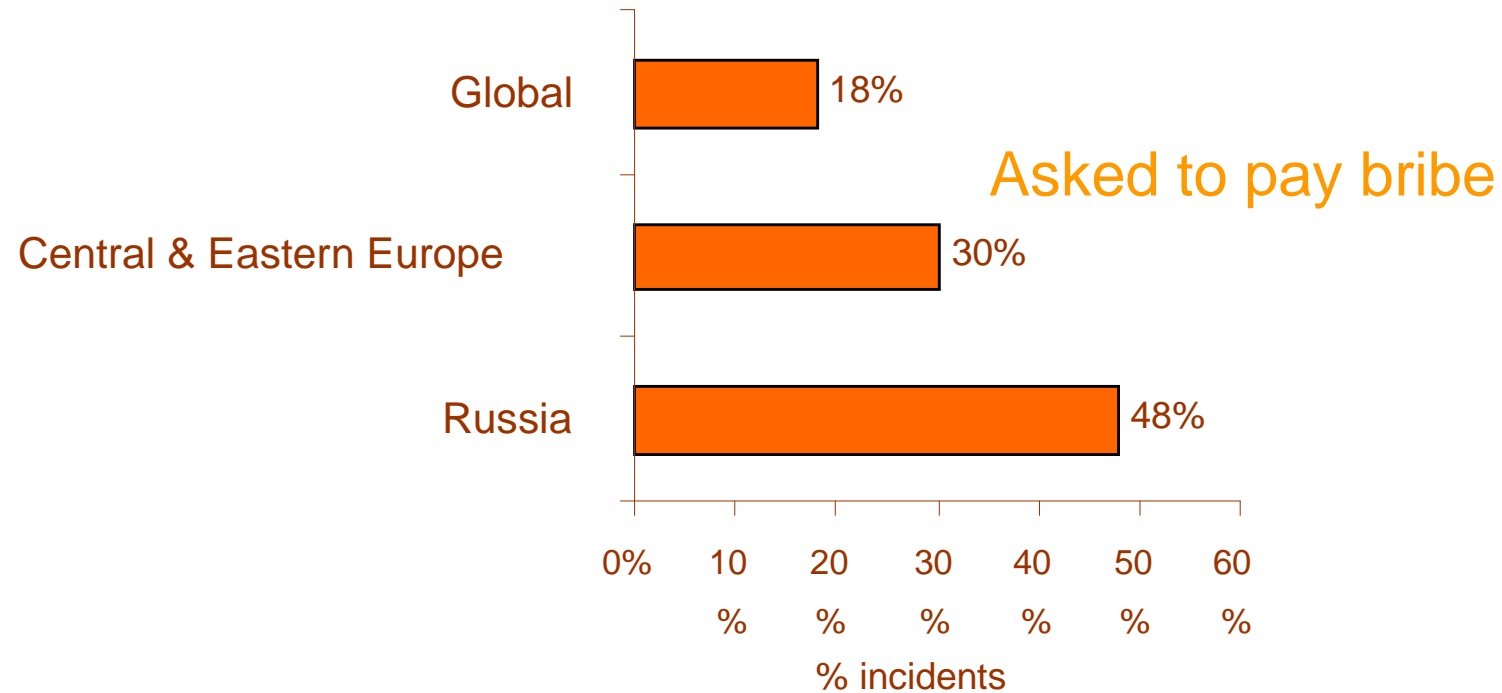


Source: PwC 4th biennial Global Economic Crime Survey

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Corruption and fraud risk (2)

Bribery is still more widespread in Russia, compared with the other regions.



Source: PwC 4th biennial Global Economic Crime Survey

Conclusions

1. Russian automotive component market offers significant opportunities, but competition for those opportunities is increasing.
2. Russia is a high reward but a high risk investment – investors should take great care with their due diligence and negotiations.
3. There are many factors to be considered, but, for larger investments, establishing good relationships with local bureaucracy is probably the single most important factor.
4. Different regions offer different opportunities*. To strengthen their position in negotiations investors should have alternatives available.

PwC is in process of producing Investment guides to automotive industry in these regions. The first has already been produced for Tatarstan.

Example of the Russian automotive cluster: Leningrad region



| Background | |
|---------------------------------------|-------------------------------|
| • Population | 1,637,000 |
| • Labor force | 934,105 |
| • No. of Universities (St.Petersburg) | >100 |
| • No. of technical/business schools | 160 |
| • No. of Students | 80,000 |
| • Intl Airport | Yes |
| • Unemployment rate | 6.1% |
| • Investment Rating | 3B1 by rating agency "Expert" |

| Main industries |
|---|
| • Heavy machinery and mechanical engineering, automotive, metals, chemicals, forestry, food |

| Major foreign investors: |
|---------------------------------|
| • Ford |
| • Caterpillar |
| • Toyota |
| • Nissan |
| • GM |
| • Suzuki |

| Authority co-operation | Labor | Logistics | Utility | Technoparks |
|---|---|---|--|---|
| <ul style="list-style-type: none"> • Treaty relations with Federal Government • Very formal | <ul style="list-style-type: none"> • About 25,000 engineers graduated in 2006 • 30,000 RUB per month – Blue collar • 85,000 RUB per month – White collar | <ul style="list-style-type: none"> • Proximity to Europe • Seaport • High quality of roads and railroads | <p>Electricity \$0,7 per kwh of electricity</p> <p>Water \$0,5 per m3 of water</p> | <ul style="list-style-type: none"> • Sosnovy Bor • Kolpino(logistic) • Sponda (industrial, logistic) |

SUMMARY
 Being very strong on most of criteria, St.Petersburg has recently seen many Multinationals (incl. many automotive) come to the region, which obliges new investors to compete for labor, government support and favorable plots

Example of the Russian automotive cluster: Kaluga region



Background:

- Population 1,000,000
- Labor force 545,005
- No. of Universities 16
- No. of technical/ business schools 31
- No. of Students 42,444
- Intl Airport No
- Unemployment rate 5.7%
- Investment Rating 3B1 (By Rating Agency "Expert")

City characteristics:

- Main Industry – heavy machinery and mechanical engineering, automotive, food, services, pulp & paper

Major foreign companies:

- Volkswagen
- Volvo Trucks
- Mitsubishi / Citroen
- Siemens
- Samsung

| Authority co-operation | Labor | Logistics | Utility | Technoparks |
|--|--|--|---|---|
| <ul style="list-style-type: none"> • Good level of loyalty • Personal relationships • Very busy | <ul style="list-style-type: none"> • One technical university • about 300 engineers graduated in 2006 • 25,000-30,000 RUB – Blue collar • 90,000-100,000 RUB – White collar • White collars from Moscow available | <ul style="list-style-type: none"> • Situated on federal highway Moscow-Kiev • Moscow region logistic facilities available | Connection to electricity network – 15,900 RUB per kWt/H \$0,7 per kwh of electricity \$0,5 per m3 of water | <ul style="list-style-type: none"> • Vorsino (70 km to Moscow, automotive) • Obninsk (Pharma) • Lemkon (Finnish) |

SUMMARY

Kaluga being located close to Moscow, having good and cheap labor resources and infrastructure provides good investment opportunities, though the authorities are proactive in cooperation mainly on large projects

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