

**TOPICS IN EMERGING FINANCIAL MARKETS
PROFESSOR J. P. MEI**

APAAC INC.



WE MAKE *YOUR* RISK *OURS...*TM

FINAL PROJECT

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EXECUTIVE SUMMARY

The objective of this case is to highlight the viability of introducing a factoring services company (referred to as APAAC Inc.) in the Northwest and Central regions of the Russian Federation that would target the transportation and purchase order financing lines of services.

Firstly, we will explore the various macroeconomic, political, social and legal factors; challenges and current characteristics that are essential to understand the objectives and opportunities of APAAC Inc. when entering this market.

In terms of the political environment, we discuss Russia's transition from the time of disintegration of the Soviet Union till date. We also give a brief overview of the current political structure and the corresponding risks and obstacles faced by corporations (domestic and foreign) in Russia today. The discussion on social conditions aims at highlighting the needs and requirements for credit services in such a potentially viable but structurally handicapped environment. In addition, it is necessary to explore the cultural dimensions according to Hofstede's theory, in order to facilitate a better understanding of the target market, and general environment. Furthermore, we discuss the legal framework that addresses, in particular, the regulations of banks, credit organizations and debt related transactions. Additionally we look at the *Civil Code* provisions and the federal law on *Banks and Banking Operations*.

Secondly, regarding APAAC Inc.'s business economics, we examined the history of factoring and its functioning, including the advantages and disadvantages for the firms due to using these services. This is followed by a summary of Russia's credit markets. In order to give a better overview, we also introduced the specifics of factoring in another emerging market, namely India. We conducted a detailed analysis of the present factoring services market in Russia, highlighting the demand and supply (competitors) analysis and the characteristics of entering the current market.

This business proposal will be of special interest to students as it explores the overall opportunity for APAAC Inc. and presents the readers with a detailed description of deal economics. Moreover, this section also addresses the specific challenges of the business model such as collection, contract enforcement issues and competition, to name just a few. To show our positive outlook and belief in this business opportunity, we have also discussed the potential expansion of the credit services offered by APAAC Inc. to include the possible introduction of a store credit card division.

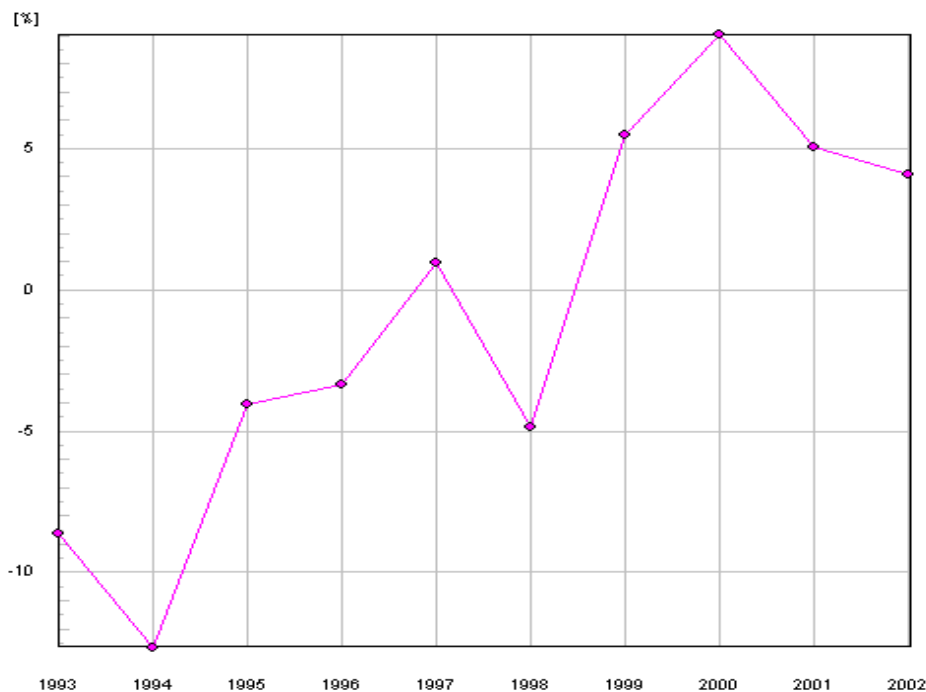
Finally, we have generated a series of spreadsheets that illustrate our business model in a more quantitative manner to better emphasize the financial practicality of APAAC Inc. Our projected income statement includes essential assumptions and data to provide a clearer understanding of the mechanics involved in our fiscal forecasts. Furthermore, we have included calculations for the cost of capital relevant to our business model. We have also conducted a discounted cash flow and sensitivity analysis of APAAC Inc. in order to approximate its potential long term value.

For the interest of fellow and future Emerging Market scholars, we have highlighted various aspects and points in the case that are relevant to class discussions. It is our objective and goal, that by the end of this case, the reader not only assesses the economic profitability and social benefit of this business, but also realizes the entrepreneurial potential of Russia.

MACROECONOMIC OUTLOOK

Following the collapse of the Soviet Union in 1991, the new Russian state has experienced a severe social and economic shock in the form of hyperinflation, production downfall (according to a Nobel laureate Joseph Stiglitz, current GDP level in Russia still remains almost 30% below where it was in 1990) and a disintegration of a state owned banking system.

More than 10 years since those dramatic events Russia is showing positive growth and recovery signs. The real GDP fluctuations from 1993 to 2002 are depicted on the graph below:



Although since 1993 Russia's GDP lost approximately 2.9% on annualized basis (it dropped from \$542 bln. in 1991 to \$350 bln. 2002 – World Bank), during the last four years GDP is recovering at a substantial rate. At the same time, inflation rate has dropped from an average of 350% to 12% in 2002. However, according to International Monetary Fund statistics 30% of Russia's GDP is made up of the proceeds generated by oil exports. Furthermore, the budget of the Russian Federation heavily depends on the global oil prices. The legislators set the budget in such a way that if the oil prices on URALS stay above \$18 per barrel, then the budget will have a surplus; if the price fluctuates between \$12 and \$18 per barrel then Russia would have to resort to foreign borrowing to meet its budgetary obligations and, in a worst case scenario when the price falls below \$12, Russia will have to default on domestic and possibly foreign debt.

The second largest contributor to the GDP is the gas industry, and "Gazprom", the world's largest gas company is the most significant taxpayer within Russia. The European Union is the largest

importer of the Russian gas. Further, due to the increasing trend of utilizing more environmentally friendly technologies in Europe, European gas market is expected to grow at a steady rate. Since gas prices are less volatile than oil, the budgetary income from this source is relatively stable.

“Russia does not have roads, it only has directions.” One of the biggest impediments to the economic development is Russia’s virtually non-existent inter-city highway infrastructure. It limits trade and labor mobility all over the country. On the other hand, Russian railroad system (87,157 km) provides efficient and low-cost means of transportation. Utility infrastructure is falling apart and is in desperate need of repair and replacement. Telecommunications and cellular phone services are one of the fastest growing market (since 2000 there are 2.5m active users) segments that develops communications infrastructure. Internet penetration is currently at a relatively low level with only around 3.5 million active users.

The improved economic conditions as well as sensible and stable government policy coupled with continued structural reforms led to an increased confidence among foreign investors. This improvement is reflected in the recent increase in FDI level. Although FDI has been below \$2 billion for the last 10 years, recently foreign investments have been boosted by a number of significant deals increasing the FDI by more than 38%. The most prominent ones include:

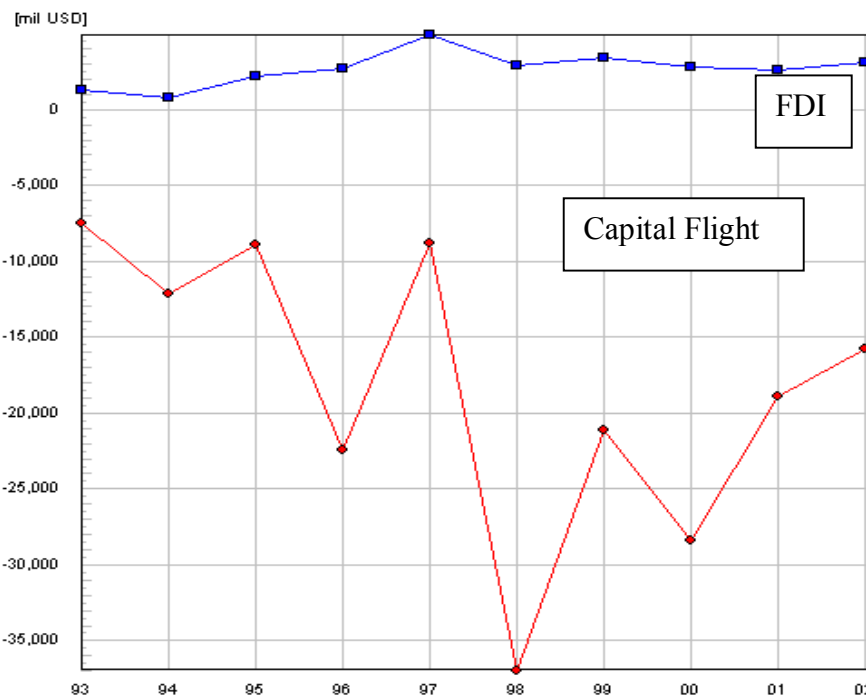
- Ford opening an assembly plant near St. Petersburg
- BMW establishing a production facility in Kaliningrad
- A network of Coca Cola bottling factories all over Russia
- Citibank opened several retail branches in Moscow and intends to expand into the regions
- GM’s joint venture with VAZ to produce a new Russian-American SUV model (Chevy Niva)
- In a landmark deal last week BP agreed to invest \$6.75 bln. into Alfa Group’s oil holdings which will give BP partial ownership of TNK (a Russian oil company with the largest oil reserves) and Sidanko.

A great deal of success, especially since the year 2000, resulted from a combination of higher world oil prices and the real exchange rate depreciation following the August 1998 default and devaluation (which presumably gave a boost to domestic production). The further inflation decline that we witnessed could be expected, following the immediate inflationary shock stemming from the devaluation of August 1998.

Foreign currency earnings are projected to remain strong, and the IMF has advised the Central Bank of Russia to sterilize its foreign exchange intervention in order to contain inflationary risks and

thus prevent any economic downturns. Labor costs in Russia are considerably low right now at around 0.75 cents an hour; and nearly 71 % of the population is in the work force (EIU), resulting in an increase in GDP per head from \$1167 in 1993 to \$2147 in 2001 and an increase in private consumption per head from \$534 in 1993 to \$1093 in 2001. In addition the unemployment rate decreased from 12 % in 1998 to nearly 7.8 % in 2001.

Currently, Russia needs to implement strong structural reforms in order to sustain its success and bolster continued growth. Russia seems to be aiming to rebuild its foreign reserves to a level necessary to instill confidence in the ability to handle sudden shifts in its balance of payments, without using trade or exchange restrictions. The success of this policy depends heavily upon two assumptions: 1) FDI will increase, 2) capital outflows will decline, 3) oil prices will remain around \$23 per barrel. The relationship between capital outflows and FDI is illustrated below:



Of special interest to our project is the state of Russian banking system and the financial industry as a whole. With combined assets of little more than 12 percent of Deutsche Bank, Russia's banking sector is very small. It is highly concentrated, with very few banks holding the bulk of all deposits and dominating lending and with many banks too small to engage in lending or deposit taking. Many banks are created by large companies in order to facilitate their own transactions and investments. Additionally, there is a large number of small and highly-specialized banks that are created by various enterprises to perform a limited number of specifically tailored financial services. Bank lending remains tied to the structures of Russia's financial-industrial groups, with intra-group

credits accounting for an estimated 43% of total credit, and the government or leading domestic companies continue to run the largest banks. Less than 40% of Russian banks' loan portfolios consist of credits extended for a year or more (World Bank, 2001).

Nevertheless, by 2002 the banking sector has reached the same level of capitalization as it had in 1998. Presently, the banks are exploring new types of services including factoring among others. The main player on Russian market is NIKoil Financial Corporation followed by Zerich Bank and a number of small private financial firms. For the most part these banks finance trade transactions (detail market analysis will follow in the next report)

According to emerging market data, studies have shown that a high correlation exists between economic freedom and growth. Russia tried to project a considerable level of economic freedom when it made its gargantuan effort to shed its communist past and approach the free market economy ideal, but it was not as successful as planned and Russia faced severe downturns in production and its overall economic condition. But for the last 5 years, with the combination of opening up the economy by the new administration and favorable market conditions (rise in oil prices), Russia seems to have shown a significant rise in its GDP levels from - 5 % in 1998 to + 9% in 2001 and GDP is currently growing at 5 %. This reaction in the economy supports the key characteristic of emerging markets that was stated above. Another notable attribute of an emerging market is its reaction to the privatization of SOE's. Prior to 1992, most of the companies in Russia were state owned and extremely inefficient. Around this time, the government decided to privatize a majority of its businesses in an effort to boost efficiency and for other political reasons, but this was highly unstructured and was mainly given to domestic investors, thus not resulting in a great overall benefit. As stated above, FDI increased by nearly 38% and, this was attributed to the increased consciousness and effort of the government to boost the economy, higher oil prices, depreciation in the real exchange rate and increased confidence of foreign investors, which can be supplemented by the recent investments by BP, BMW, Coca Cola, among others.

POLITICAL ENVIRONMENT

Yeltsin became the first president of the new Russian state after the disintegration of the Soviet Union in June 1991. He announced direct presidential rule and the dissolution of the CPD (Congress of People's Deputies) on September 21st 1993. In December of the same year the new Constitution was adopted and a new democratic parliament was elected.

The years 1998–1999 were characterized by political instability with many showdowns, rapid succession of cabinets of ministers and an obstructive Duma (lower house of parliament). Financial pressure forced a devaluation of the ruble and a default on the government's domestic and foreign debt after the collapse of its macroeconomic policies. Yeltsin was suffering from poor health and resigned on the eve of 2000 after securing the presidency for Vladimir Putin, former head of FSB (Federal Security Service). In his former career Putin also served on the team of a very prominent St. Petersburg mayor Anatoly Sobchak. Mr. Sobchak stood at the origin of numerous democratic social and economic reforms. He was well regarded by Western politicians and businessmen. Mr. Putin won with 53% of the votes in March 2000.

After September 11th, Putin opened a window of opportunity for a fundamental redefinition of East-West relations. He broke the long-standing foreign policy beliefs by allowing US troops to move into Central Asia. Past conflicts between China and Russia may be renewed as China grows more powerful and Russia has chosen its pro-western line of support. In May 2002 Russia signed a bilateral strategic arms reduction agreement with the US, and a Russia-NATO Council was created that gave Russia a permanent seat at NATO headquarters. This ensured closer cooperation between Russia and NATO on certain security issues, such as the fight against terrorism. Russia has dramatically changed its foreign policy principles under Putin from an Eastern to a Western direction. The foreign policy turnaround was controversial within Russia's military and security establishment, and many claimed that Putin's concessions to the West have gone unrewarded. However, others argue that Putin's pro-western line will see more substantial gains over time.

The Russian political system can be described as a strong presidency with a weak legislative and judiciary systems. Most small political parties are frail and poorly institutionalized. The new Kremlin-backed law, which raises the registration requirements for political parties, has forced mergers to secure political presence. According to this law, only political movements that have more than 10,000 members, with a minimum of 100 members in each of at least 50 of Russia's 89 regions can register as a political party. Unity (party supporting the Kremlin) and Fatherland-All Russia Movement merged into United Russia in February 2002 and became the strongest political force in the Duma. The

Communist Party (CPRF) consequently had to settle for second largest political party. During the Putin administration the CPRF has swayed between cooperating with the Kremlin and blocking government initiatives. However, the CPRF is not considered a threat to Putin or United Russia due to the divergence within the party and its aging support base. There are two liberal democratic parties (SPS and “Yabloko”) whose agenda's include full liberalization of the economy and promote “laissez-faire” policy. They also address such critical social and economic issues as the army reform, pension reform, land reform and RAO UES reform. However, these two parties cannot cooperate effectively and do not have a significant influence in terms of numbers. The political scene is predicted to remain relatively steady at least until 2008. It can be viewed as a cause of concern that political parties with few common interests are joining powers just to be able to have a say in the Duma. This can cause the parties to spend more time arguing within themselves rather than working together for a common goal.

The President, which serves a four-year term and is limited to two consecutive terms, has the power to appoint any position except that of a Prime Minister, a Central Bank Governor and a Chairman of the Constitutional Court. The Duma with 450 members needs a 2/3 majority to challenge the president. The Federation Council has 178 appointed representatives of regional governors and heads of regional assembly and has the power of veto. Putin set up the State Council as an advisory body designed to give regional governors direct access to the president, but it has few formal powers. The independence of the judiciary system was severely compromised under communism, and its authority is still weak. The president nominates Supreme Court judges, subject to the approval of the Federation Council.

A stable government is an important factor for successful business operations in any market. Political risk is the risk of unexpected political events in a host country affecting the value of investment. The risk of expropriation, disruption of business operations, protectionism, blocked funds and loss of intellectual property rights is lower under a stable government with an enforced judicial system, which has improved in Russia under Putin. After Vladimir Putin was elected President in 2000, the political climate in Russia is perceived to be as stable as it has ever been. For the first time in Russia's post-Soviet history, both houses of parliament are supportive to the president and his policies. Although it is criticized that Putin's success is through authoritarian means that have set back the democratic achievements from the Yeltsin era, it has made Russia more stable politically and overall has had beneficial consequences for the country. Putin earned the respect of most Russians, and will most likely win the presidential election next year.

Russia's risk rating as per February 2003 is Ba2 (Moody's) and BB (S&P). The political risk element is lower (55) than the overall assessment (58).

Impenetrable bureaucracy and numerous obstacles and barriers that result from this “thick red tape” are part of the notorious Soviet heritage that impedes market development. American Chamber of Commerce in Russia published a list of issues that a Western investor should consider before embarking on a business venture in Russia. A Western capital investor should be especially aware of “the pressure exerted by organized crime directly in the form of extortion as well as indirectly in the form of distortions of the market”. This simply means that anybody who is eager to make money in Russia and stay alive at the same time must be willing to obtain some kind of “protective cover”. This “protective cover” can be provided in three basic forms. A company (depending on its size and significance) can acquire a guarantee of security and protection from government officials, from private protection agencies or from the mafia directly. In essence all three of the ways have one thing in common: a company that wants to stay in business must pay an unofficial specific “security tax”.

It is impossible to calculate exactly how much money companies lose in paying the “security tax”. However, it is possible to estimate the losses to GDP that result from overcoming bureaucratic barriers, such as numerous registrations, licensing, compulsory inspections and unofficial service fees. Economists from Moscow State University have computed that approximately \$7.7 billion are lost annually to overcoming different bureaucratic barriers. The opportunity cost for companies to cut through the red tape in order to operate by the written law is so high that they are forced to break and evade the rules and to work semi-legally.

The main administrative barriers that companies encounter can be broken up into three categories. First, there are barriers related to enterprise registration (creation). Second group of barriers includes product and activity licensing. Finally, the third group is comprised of barriers that are created by constant obligatory inspections.

All these administrative barriers to entrepreneurship obstruct entry into business. There is not much emphasis put on establishing barriers to exit business. So, those companies who by fair means or foul manage to overcome the barriers to entry have very few restrictions that will force them to stay in business and make it difficult to flee when something goes wrong.

Putin’s accomplishments

- Economic growth
- Declining inflation
- Foreign debt repayment
- Unification of federal and regional laws
- Tax reform
- Judiciary reform
- Labor law reform
- Land reform
- Social security reform
- Exclusion from FATF “black list”

Challenges ahead

- Reduction of dependency of Russian economy on the export of natural resources
- War in Chechnya
- Threats of terrorist attacks and civil disturbances
- Further development of the middle class

How to deal with political and business risk

1. Negotiate the environment through an investment agreement.
2. In case of a dispute the arbitration procedure should be held in a third country
3. Purchase political risk insurance
4. Structure foreign operations
 - Limit the scope of technology transfer
 - Limit dependence on any single partner
 - Enlist local partners
 - Plan for disaster recovery
 - Borrow on the local market
5. Work closely with law enforcement agencies in order to mitigate criminal risk

Although some parts of the course were not directly relevant to APAAC Inc., we were able to concentrate on other aspects in further detail. For example, repatriation and foreign exchange risk exposure did not apply to us as this would be a new venture firm located in Russia, with complete control in domestic hands and all transactions in Rubles. Political risk and effects on overall economy is however extremely important for our case. Investigating the Russian social norms and patterns, and way of doing business is also a subject of great importance; especially as corruption is an issue of immense concern.

International investors seek speculation in foreign markets as a means of increasing portfolio return and diversify away risk. From the perspective of a well diversified international investor, country risk is a good thing. For APAAC, political and country risk is non-diversifiable, and we stress this issue in our case.

SOCIAL CONDITION

Since the beginning of the transition from an authoritarian state into a deregulated, capitalist oriented economy based on democratic principles in 1991, Russia's output, real wages and labor productivity have fallen steadily. At the same time, inequality has increased – over the 1991-1998 period. The Gini coefficient¹ increased from .26 to .45, which means that more people were receiving a smaller share of country's wealth. Currently, unemployment is estimated at 12%. Poverty has increased from approximately 10% of the population in the late 1980s to a consumption-based poverty rate of 37.7% in the first quarter of 1999. This includes a jump to 23.8% in 1998, reflecting the impact of the financial crisis in August of 1998. The rural population has a higher prevalence of poverty than the urban population by approximately 10%. However, since 73% of Russia's population lives in cities, two-thirds of the poor are urban residents. According to the Congressional Information Service, 30.9% of the national population in 1994 lived below the national poverty line. The non-income dimension of poverty in Russia such as increased alcoholism and general insecurity have increased as well over the last decade. The majority of the poor are workers with unpaid wages, as well as the unemployed; in addition, poverty is high among certain groups of pensioners and families with several children. These preceding conditions increase the vulnerability and long term social implications of Russia's rising middle class, lower-middle class, and overall population.

The developments of the new private sector, privatization, elimination of price control, and significant reduction in subsidies have had consequences in the increasing income differentiation. The communist regime was unsuccessful in building a new market system. Interestingly, the income inequality in countries which adopted faster and more radical reforms (Eastern European countries except for Belarus and Ukraine) is lower than in Russia. Certainly, over-regulation, trade protectionism, tax exemptions, and subsidies have not only increased the wealth differentiation but also lead to more social conflicts. According to publication, "Russian Economic Trends Monthly," the income distribution in Russia in the years of 1993 and 1996 follows:

¹ A standard measure of inequality, ranging between 0 (perfect equality in the sense that each quintile in the income distribution has the same share of total income) to 1.

Yr		Gini Index	Lowest 10%	Lowest 20%	Second 20%	Third 20%	Fourth 20%	Highest 20%	Highest 10%
1993	d	30.5	...	7.4	12.7	17.8	24.3	37.8	...
1993	b	31.0	3.0	7.4	12.6	17.7	24.2	38.2	22.2
1996	b	5.5	10.2	15.0	22.4	46.9	...

b=distribution of per capita income

d= based on net household income

According to the Transparency International's 2000 Corruption Perceptions Index, Russia scored a 2.1 on a scale of 1 (highly corrupt) to 10 (highly clean). Corruption remains deeply rooted in the Russian economy and public administration. However, the government started a battle against corruption with an effective reform agenda that focuses on merit based awards and corruption resistant structures. In this light, the country hopes to become more competitive internationally and stimulate a better investment climate for Russians and foreigners. These measures aim at reducing administrative barriers, restructuring the public administration, strengthening corporate governance, introduction of IAS to strengthen the accounting systems and promote competition. In addition to the administrative reform, the government in the past year has been working on legislation that addresses corruption and restrictions to the business environment. This encompasses the easing of registration and licensing procedures required of enterprises, which in turn lowers business costs. Additionally, Duma through active Anticorruption Commission and the Chamber of Accounts is focusing more on public sector governance and fighting corruption. In 1999 the Corruption Diagnostic Study was established by the CAS to allow the Government to utilize more of its efforts to address corruption. However, many problems still remain. Firstly, these reforms need to be implemented at the federal and regional levels. Secondly, the public needs to be convinced that these results translate into more cost effective and less corrupt services. Finally, a well functioning and supportive court system is vital for further implementation of reforms.

Culture as defined by **Hofstede's** four dimensions has a tremendous effect on the economic structure and development in Russia. These dimensions are:

- Power distance
- Individualism
- Uncertainty avoidance
- Masculinity/Femininity

Russia scored 95 on the power distance scale. This is a very high result which means that the respect and dependency on the authorities is high. These are resemblances of the Soviet and Tsar époques, which impede the development of a free entrepreneurial society. The next important criterion is uncertainty avoidance where Russia received 90. This is a worrisome sign for the society as a whole because this means that people are less willing to take risks in an entrepreneurial environment. Therefore, services aimed at reducing business risk (such as factoring) should be in high demand.

According to Russian Statistical Committee, approximately \$80bn (Russian budget 2002 is only around \$50bn) in savings are held outside the financial system. This is due to the low level of trust by an average Russian to the financial institutions. Through out the early 90's Russians have been burned many times by banks going bankrupt, numerous financial pyramids (MMM), hyperinflation and a series of monetary pseudo-reforms. It is of a paramount importance for the future economic development to rebuild confidence of the population in financial institutions.

Legal framework of the Russian Federation pertaining to the regulation of banks, other credit organizations and debt related transactions.

The main laws that regulate banking operations include the following:

- Civil Code
- Federal Law on “Banks and Banking Operations”
- Federal Law on “Financial Securities Markets”

Civil Code Provisions

For the purposes of the factoring business, we are in particular concerned with Chapters 24, 25 and 43 of the Civil Code. Chapters 24 and 25 specifically address the following issues:

- Transferring of creditors' rights to third parties
- Terms, conditions and requirements to the right transfers
- Responsibility of the initial creditor to the third party that acquires the rights to the debt
- Responsibility for the breach of obligations by any party

Chapter 43 deals particularly with factoring transactions. It outlines the framework of such transactions by identifying the relevant parties, their rights and obligations. It clearly defines the parties to the transaction and identifies the legal relationship between them. The parties and their rights are:

- “Financial Agent” – (the buyer of debt) must be either a bank, non-banking credit organization, or a commercial organization (as defined by the Civil Code and the Fed. Law on “Banks and Banking Operations”) and must possess a proper license issued by the Central Bank (details are addressed by the Fed. Law on “Banks and Banking Operations”); “Financial Agent” has the right to subsequently transfer its rights to the debt in question only if this right is stated in the original contract with the “Client”.
- “Client” – (initial creditor) is responsible for the validity of the debt and its compliance with federal and regional laws. The “Client” is responsible for the recourse of unpaid debt only if it is stated in the contract with the “Financial Agent”.
- “Debtor” – its obligation to the “Financial Agent” is identical to its obligation to the “Client” (original obligation). If the “Client” and the “Debtor” have agreed to limit or even prohibit the transfer of the rights to the debt to a third party (“Financial Agent”), the “Client” can still undertake legally binding transactions with the debt in question. In such a case, only the “Client” (not the “Financial Agent”) will be responsible to the “Debtor” for the breach of the original debt contract.

The Civil Code propositions seem to be in line with the Western standards. However, the implementation of the legal framework in a specific deal may be hindered by the overall weakness in law enforcement and by the unreliable judiciary system. Good connections and established working relationships with the law enforcement officials, such as the Prosecutor’s Office, “FSB” (Federal Security Service), and Ministry of Internal Affairs (the Police), will enable to minimize the risk associated with debt collection.

Federal Law on *Banks and Banking Operations* provisions

Credit organizations including banks and non-banking credit organizations have to be registered with the Central Bank of Russian Federation. Bank of Russia issues a license to an aforementioned organization which is required for this organization to perform any banking activity. In order to get the license from the Central Bank an organization has to prepare the documents specified in Article 14 of the Federal Law on “Banks and Banking Operations.”

In addition, the federal tax of 1% of paid-in capital is levied for the license. The Central Bank has to process the application within 6 months and notify the applicant of its decision. Furthermore, a credit organization has to receive an approval from the Central Bank whenever it is trying to expand its financing by selling its assets to foreign based companies or individuals.

The future securitization of the accounts receivables collected by the Firm will be governed by the federal law on “Financial Securities Markets” which provides detailed clauses on the topic.

The legal framework is present and intact; allowing establishment of the Firm. The challenges to the business would arise from the weak enforcement of law in Russia as well as the restrictions on foreign capital. Corruption among government officials is another issue to be considered. In order to mitigate risks due to the weakness of enforcement agencies the Firm will carefully pre-screen proposed business partnerships employing a variety of legal methods. Additionally, through the further securitization of the debt the firm will transfer a part of the risk to the future holders. In order to account for the aforementioned risks we will use conservative approach to the calculation of cash flows as well as the discount rate.

FACTORING

Factoring dates back in time, and its origin was in Mesopotamia 4000 years ago. The Mesopotamians first developed writing, put structure into business code and government regulation, and came up with the concept of factoring².

During the Roman Empire, when the Pilgrims landed at Plymouth Rock in 1620, they were 'up to their muskets' in debt, and had to work out a deal with the factors back in England and provided furs, fish and timber as a way of satisfying their obligations to those debts. In Colonial America, factoring agents vouched for credit worthiness of local businessmen, so that British companies would ship goods and equipment to start up business in the New World.

Prior to the 1930's, factoring in the US occurred primarily in the textile and garment industries, as those industries were direct descendants of the colonial economy. After the war, factors saw the potential to bring factoring to other forms of invoice-based business and the expansion began.

Today, factors exist in all shapes and sizes, as divisions of large financial institutions or as private factors that sprung up in record numbers as interest rates rose to new heights between 1960 and 1980. Factoring became a natural source of financing for many small businesses. Factoring should be considered a short-term solution to cash flows problems created by starting a company, lack of assets, no credit, rapid growth and seasonal demands³

How factoring works

Factoring is essentially a management (financial) service designed to help firms better manage their receivables; it is, in fact, a way of offloading a firm's receivables and credit management onto someone else – in this case a factoring agency or the factor.

Factoring involves the outright sale of the receivables of a firm by another firm specializing in the management of trade credit, called the factor. Under a typical agreement, a factor collects the accounts on the due dates, effects payments to its client firm on these days (irrespective of whether the payment has been received or not) and also assumes the credit risks associated with the collection of the accounts. For rendering these services, the factor charges a fee which is usually expressed as a percentage of the total value of receivables. The complete package of factoring includes:

² www.randomfundinggroup.com/factoring_history.htm

³ 'Looking into the cash factor', The Orange County Register, 07/08/1996

- Sales Ledger Administration: - for a service fee, the factor provides its client firm a professional expertise in accounting and maintaining of sales ledger and for collection of receivables.
- Finance: - the factor advances up to a reasonable percentage of outstanding receivables that have been purchased, say about 80% immediately, and the balance minus commission on maturity. Thus, the factor acts as a source of short-term funds.
- Risk Control: - the factor having developed a high level of expertise in credit appraisal reduces the risk or loss through bad debts.

Depending upon the requirements of the clients, the terms of the factoring contract vary, but broadly speaking, factoring services can be classified:

- Non-Recourse Factoring: - where the factor cannot call upon its client-firm whose debts it has purchased to make good the loss in case of default in payment due to financial distress. However, the factor can insist on payment from its client if a part of the receivables turns bad for any reason other than financial insolvency.
- Recourse Financing: - allows the factoring firm to insist upon the firm whose receivables it has purchased to make good any receivables that prove to be bad and unrealistic. However, the risk of bad debts is not transferred to the factor.

Factoring involves two types of costs:

- Factoring Commission: - represents the compensation to the factor for the administrative services provided and the credit risk borne. The commission charged is usually 2-4% of the face value of the receivables factored, with the rate depending upon the various forms of service and whether it is with or without recourse.
- Interest on fund advances: - are charged by the factor to firms drawing the same against uncollected and non-due receivables. It is roughly near the interest rate charged by banks for overdrafts.

As the cost of factoring varies, and the margins they have to work are extremely low, the strategy of factors must be to carve a niche in the services segment, namely in receivables management, and generate revenues by way of commission, rather than concentrating on lending and financing activities where the margins are slim.

Advantages of Factoring

- 1) Firms have added attraction of a ready source of short term funds. Such a form of finance improves the cash flow and is invaluable as it leads to a higher level of activity resulting in increased profitability.
- 2) By transferring the tedious and troublesome chore of sales accounting and administration, management now has more time for planning, running, exploiting and improving the business. A further reduction in overheads is brought about by the factor's administration of the sales ledger and the improved cash flows because of the quicker payments by the customers result in interest savings, contributing towards overall cost savings.

Disadvantages of Factoring

- 1) Factoring might prove more expensive than in-house management of receivables, especially for large firms that might have access to similar sources of funds, and have a well organized credit and receivable management department, as the factors themselves.
- 2) Factoring is perceived as an expensive form of financing and also as a financing option of the last resort. This likely has a harmful effect on the creditworthiness of the company in the market.

The increase in international trade has created a substantial market for international factoring. Increased international trade increases a company's exposure to currency risk, transport risk, country risk, including political and economic stability and foreign legal concerns, as well as debtor risk and trade terms which can extend to 180 days⁴. In 1996 the factoring industry got a black eye when police identified the suspect in the shooting death of Fountain Valley jogger as an agent for a factoring company in Huntington Beach⁵.

⁴ 'Australia's Westpac Bank Offers International Factoring Service', Dow Jones Interactive, 08/23/1998

⁵ 'Looking into the cash factor', The Orange County Register, 07/08/1996

RUSSIAN CREDIT MARKET

History

Commercial banking emerged in Russia in the late 1980s, when the first non-state banks were formed under the 1988 law on cooperatives. As a result of negligent regulation and licensing, Russia had more than 2,500 banks by 1994. The defense and devaluation of the Ruble (1997—1998) forced many banks to bankruptcy despite the support of the RCB, by mid 2002 Russia had just under 2,000 registered banks and credit organizations.

Players

Russia's banking sector is highly concentrated and dominated by state-controlled institutions, that is Sberbank (the former Soviet savings bank) and Vneshtorgbank (the Soviet-era foreign trade bank). Other banks are relatively small and only a small handful of private banks have enough capital to call themselves banks. Sberbank holds more than 70% of all retail deposits, and also dominates the corporate lending market although the quality of its loan portfolio is a source of concern. Other players include Alfa-Bank, Avtobank, Bank of Moscow and Rosbank.

Main problems

Russia's banking sector fails to fulfill its main function to act as financial intermediate, channeling household savings into industrial investments. Although corporate loans outstanding rose from 11% of GDP in 2000 to 15% in 2001, banks were only estimated to finance 3% of total investment in 2001. Assigning creditworthiness in the enterprise sector is considered extremely difficult due to lack of transparency. The legal framework is creating insecurity for creditors, and there is also the issue of lack of capital as most Russians prefer to keep their money outside the banking sector. Additionally, the banks are not willing to expand their credit card services to the middle class income families. The Russian banks solely provide their credit cards to "very important customers", a.k.a. people who have extended connections and good relationship with the active management. This situation is difficult to change, since in order to provide potential customers with credit cards; firstly, the tax system has to change, so the people would reveal their actual income; secondly, they should deposit their money into the banking system (currently Russians have around \$80billion "under pillow" reserves), and finally the collection agencies should emerge. In order for the proper collection agencies to be established, the legislators have to provide the nation with the effective and enforceable privacy laws. Nevertheless, providing customers with consumer credit can be an extremely lucrative business as mentioned later on in the report under our expansion possibilities.

FACTORING IN ANOTHER EMERGING MARKET: INDIA

We considered it essential to include another emerging market and the status of our desired business in it, as it gives the reader an idea about the problems, environment, solutions, and essentially creates a benchmark to understanding the basic characteristics of factoring in emerging markets. In spite of the various differences between the Russian and Indian credit markets, we believed the overall goal, nature and structure of companies entering such markets and the logistics of factoring would follow similar patterns.

In the 1980's, India was witness to a virtual deregulation of its capital market, giving birth to a number of innovative financial instruments and schemes was born. The policy of the power-that-be helped in the development of the money market and capital market movers tried to transplant successful schemes of the west. However, despite all of their efforts over the years, the small-scale sector was unable to recover its dues from the medium and large industries particularly in the public sector, and thus the small-scale units faced a liquidity bind because of their inability to collect dues. Available market data revealed that funds locked up in book debts were increasing at a faster rate than growth in sales turnover or inventory buildups. Clearly, factoring was the only remedy available.

While the worldwide factoring turnover was nearly \$ 500 billion (1998), the factoring market in India is relatively non-existent with only a few small players, although the market demand is estimated to be around a \$ 1 billion (according to a State Bank of India report). In India, factoring is considered as a source of short-term financing and is viewed purely as a financing function – as a source of funds to fill the void of bank financing for receivables for small-scale and other industries. This often leads to a catch 22 situation and in launching of factoring services in India; the thrust should be on the twin areas of receivables management and credit appraisals, especially since the small scale sector lacks these sophisticated skills.

Recent government efforts have tried to maintain a thrust of the continuing momentum of economic reforms that have been announced in the Union budget, as well as the Credit Policy (such as tax breaks for exporters and importers, terms of trade etc.). During the year, the Reserve Bank of India (RBI) has tried to boost liquidity and reduce the cost of funds to banks, by reducing bank rates, cutting CRR's and reducing the repo rate. It further announced the reduction of interest rates on export financing and rationalizing the former. In light of this news, several agencies have boosted export financing and also tightened their provisions, so as to better

support and help the core of Indian exports, the small and medium scale business sector; such as the following: -

The Export Import Bank of India (Exim Bank), a pioneer in the forfaiting business in India and having detailed knowledge of the Indian market, recently announced a tie up with Westdeutsche Landesbank Girozentrale (WestLB), Germany's 4th largest banking group, to offer factoring and forfaiting services to Indian exporters. This would be a logical step as structured trade financing is still in its infant stage in India. WestLB is a major international player in the business of factoring and forfaiting and other trade finance projects. In addition to the above, the International Finance Corporation (IFC) has evinced interest in taking up a stake in the venture, aiming at around 25%, with WestLB having 40% and Exim Bank having 35%. A relatively small initial equity base is planned, along with the commitment of other financially strong equity holders to provide lines of control at competitive prices when required and also give the new firm adequate financial leverage. With the setting up of this organization, it will no longer be necessary for Indian exporters to approach foreign institutions for their financing needs. The setting up of a new multi-product company offering export factoring and forfaiting under one umbrella will be particularly beneficial to small and medium enterprise (SME) exporters, who are the backbone of the country's exports.

Thus in lieu of the recent rise in international trade movements and in an effort to capitalize on the market, several key players in the Indian market, such as the Exim Bank, the State Bank of India and other financial agencies have stepped on the pedal to bolster their efforts and plans towards factoring and financing. Of course, we have to keep in mind that the presence of an efficient and strong legal system is the single most important factor in fostering the growth and success of factoring, and factoring as it is becoming clear, can only thrive in conjunction with a favorable legal framework and judicial support – which India, along with Russia, still needs to perfect!

FACTORING SERVICE MARKET IN RUSSIA

Demand Analysis

The Russian banking system does not meet the nation's capital and credit needs, but a company doing business in Russia can find satisfactory banking services. The reason for complication is Russia's slow recovery from its 1998 financial crisis, which crippled many of the largest banks. Since 1995, the total number of banks declined from approximately 2,600 to 1,320; of these, barely 300 survive. During the ruble's devaluation, the assets of Russia's banks shrank from \$88.7 billion to \$34.4 billion, a rate of more than 60 percent. By spring 2000, banks in the country experienced moderate improvement as their capital increased 2.8 times over the previous year. Nonetheless, capitalization of the banking system remains at 75 percent of the pre-crisis level. The problem partly results from limited government action to restructure Russia's banks after the crisis. The Agency for Restructuring Credit Organizations (ARCO) is responsible for providing supervision and temporary financial assistance to insolvent banks, but its resources are inadequate. To date, ARCO has attempted to restructure two large banks and about 15 small ones. After the 1998 crisis, the Central Bank of Russia (CBR) proposed changes to the banking system, but no new legislation or institutions have appeared to improve the shortcomings of the banking system.

The Russian economy has shown some strength as it has recovered from the 1998 crisis. Real growth in the economy has spurred some lending by financial institutions; it has also led to domestic and foreign investment. Russian banks have recently become more active in equipment financing, providing such services as factoring and leasing. A number of western investment banks and venture funds which scaled back their Russian operations after the 1998 crisis have reactivated their lending. Additionally, the European Bank for Reconstruction and Development (EBRD) has financing programs that provide more opportunities for traders and investors. The use of limited recourse project financing remains disadvantaged by several factors: the immaturity of commercial legislation, contract enforcement, asset title, rights of debt and equity holders, and contractor performance requirements.

Companies new to exporting to Russia usually insist on advance payment for goods and services. In fact, this is the normal procedure for most transactions in Russia. Russian banks issue letters of credit only when the Russian buyer can deposit the requisite funds ahead of time. Prior to the 1998 financial crisis, western banks would accept letters of credit only on that basis; today, very few western banks accept Russian letters of credit under any circumstance. Once a

U.S. firm has established a strong relationship with a Russian trading partner, it may consider extending short-term credit as a way to bolster sales volume. This is usually done with caution and only after careful evaluation and establishment of successful payments

For some large transactions, advance payment from a Russian buyer may be impractical. In such cases financing may be provided by a bank, export credit agency or venture fund. In cases when leasing is appropriate, exporters insist on payment of three to four months upon delivery date.

As many as twenty Russian banks now offer factoring services. However, the volume and value of transactions using this technique have yet to attain levels which are either profitable or self-sustaining. Given chronic liquidity problems in the Russian economy, international leasing may become an important alternative to export sales. Currently, less than five percent of imported equipment is leased. Equipment for the aviation, energy, transportation, pharmaceutical, forestry and fishing industries, which may be too expensive for Russian customers to purchase, is often leased.

Because of low liquidity throughout the Russian economy, a high proportion of transactions are conducted on a non-cash basis (barter and promissory notes). At one time, such barter transactions were estimated to account for 70 or 80 percent of economic activity. Although difficult to measure, there is evidence that the use of barter is declining rapidly. While barter can be more complex than cash transactions, U.S. firms do not dismiss them, because they can be profitable and help a company win market share.

Russian companies or government entities often offer ruble-denominated *veksels* (promissory notes) in lieu of cash. While some reliable companies issue *veksels*, other firms with no credit history, or worse, also issue them. U.S. companies do not accept promissory notes as direct payment. However, it may be worthwhile for them to rely on Russian banks or "*veksel* brokers" as intermediaries who will accept the final risk of the promissory notes to ensure that the U.S. exporter is paid in cash.

APAAC is addressing a customer need in the current Russian market. Fluctuations in general economy will impact the factoring business as there will be less activity in certain sectors. It is difficult to make comparisons as this service is not yet offered in the Russian market. We have, however, through thorough analysis researched how this form of business has exploded in other parts of the world, and have concluded that there exists a market and a large part of capturing this market is to move fast. Entering any market, and emerging markets in

particular, entails some level of risk, but we aim to reduce this through extensive upfront market research. The nature of our business is also beneficial as it has low entry and exit costs, and requires low working capital.

CORPORATE, INTERBANK AND PERSONAL LOANS

(Total Loans in Million Rubles)

	Personal Loans	Corporate Loans	Loans to Banks
12/31/2000	34,555	507,383	44,757
12/31/2001	78,446	822,120	68,156
11/30/2002	120,056	1,032,845	101,236

* Sourced from the Bulletin of Banking Statistics (pp.74): Central Bank of the Russian Federation.

AVERAGE WEIGHTED INTEREST RATES ON CORPORATE & PERSONAL LOANS IN RUBLES

(%)

	Interest Rates on Personal Loans in Rubles			Interest Rates on Corporate Loans in Rubles		
	By all maturity	Up to 30 days	More than 30days	By all maturity	Up to 30 days	More than 30days
2001 January	22.6	23.6	18.6	18.6	16.9	12.6
2002 January	21.4	22.3	18.9	17.8	15.6	13.7

* Sourced from the Bulletin of Banking Statistics (pp.74): Central Bank of the Russian Federation.

Overdue Account Payable of Organizations

The amount of the overdue account payable at the end of October 2002 equaled approximately 1466.6 billion Rubles or 89.5% by the corresponding period of the year 2001.

ACCOUNT AND INDUSTRIAL STRUCTURE OF THE OVERDUE ACCOUNT PAYABLE

	October 2002 (billion Rubles)	In % by		Referred to as of October 2002, in % by	
		Oct. 2001	Sept. 2002	Oct. 2000	Sept. 2001
Overdue Account Payable	1466.6	89.5	99.2	100.9	98.1
Including: Industry Production	685.6	83.3	98.6	96.7	98.7
In % by the overdue A/P	46.7				
Construction	123.9	98	99.6	103.5	102.0
In % by the overdue A/P	8.5				
Agriculture	163.3	99	100.6	115.4	100.6
In % by the overdue A/P	11.1				
Transportation	130.8	73.6	98.3	118.3	95.6
In % by the overdue A/P	8.9				
Communication	4.2	103.9	100.7	115.9	99.0
In % by the overdue A/P	.3				
Trade & Public Catering	128.4	100.7	100.8	101.4	89.9
In % by the overdue A/P	8.8				
Wholesale trade of technical goods	17.7	153.9	107.2	96.9	98.2
In % by the overdue A/P	1.2				
Housing & Communal Services	160.7	101.0	98.4	103.6	99.1
In % by the overdue A/P	11.0				
Tourism	.1	108.9	101.7	17.1	71.0
In % by the overdue A/P	.01				
Other Activities	51.9	116.2	100.5	72.1	98.1
In % by the overdue A/P	3.5				

As of the end of October 2002 the share of the overdue account payable in the total volume of the account payable reduced by 1.1 point and now equals 29.7%.

CREDIT ORGANIZATIONS

(At the beginning of year)

	2001	2002
Number of credit organizations registered in Russian Federation	2126	2003
(including functioning credit organizations)	1311	1319
Number of affiliates of functioning credit organizations registered in Russian Federation	3793	3433
Registered starting capital of functioning credit organizations (billion Rubles)	207.4	261
Number of credit organizations with licenses giving the right on:		
Involvement of deposits of population	1239	1223
Operations in foreign exchange	764	810
General licenses	244	262
Operations with precious metals	163	171
Number of functioning credit organizations with foreign participation in starting capital	130	125
Of which:		
With 100 % of foreign sharing	22	23
With foreign share from 50 %up to 100 %	11	12

* Data collected from the Central Bank of the Russian Federation.

CREDITS, LENDED TO ENTERPRISES, ORGANIZATIONS, BANKS AND INDIVIDUALS

(At the beginning of quarter, billion Rubles)

2001	Credits Total 1)	To enterprises and organizations 2)	To banks 3)	To individuals 4)
I Quarter	956.3	763.3	104.7	44.7
II Quarter	1067.5	808.1	154.5	60.1
III Quarter	1181.1	894.5	163.0	72.3
IV Quarter	1322.6	1034.8	149.8	84.5
2002				
I Quarter	1467.5	1191.5	129.9	94.7

- 1) Data of the Central Bank of the Russian Federation, including credits to foreign countries.
- 2) Excluding credits to non-resident legal entities.
- 3) Excluding deposits and other funds deposited with the banks.
- 4) Including credits to individuals – private entrepreneurs and non-residents.

Supplier / Competitor Analysis

Limited choices and difficult tradeoffs confront companies choosing a bank in Russia. Companies can choose from three types of banks: a foreign-owned subsidiary, a state-owned Russian bank (newcomers to the commercial field), or a variety of Russian private commercial banks. Most foreign businesses prefer to deal with foreign-owned banks because they are more stable and generally offer better quality service. Until recently, these banks concentrated their activity in highly profitable financial markets and were not interested in commercial banking. However, strong demand has drawn them into diversifying their services to include foreign trade transactions and commercial banking. Many foreign banks now provide regular commercial services including accounts, transfers, currency exchange, credit, documentary operations, letters of credit, and trade financing. Unfortunately, the lack of nationwide branches makes these services largely unavailable to customers operating outside the major metropolitan centers of Moscow and St. Petersburg.

Some state financial institutions are taking on the role of commercial banks and project an image of stability and prestige. Sberbank is the largest such institution in Russia because it was the savings bank for Soviet citizens. Following the August 1998 crisis, it received individual accounts transferred from banks liquidated by the government. Therefore, Sberbank has an unmatched nationwide network of 50 branches and over 2000 outlets handling millions of private and commercial accounts. Sberbank is rapidly increasing its commercial loan portfolio but must prove that it can develop the organizational and management skills to successfully operate as a commercial bank.

Vneshtorgbank is another state bank. Originally founded to facilitate international trade, it is almost wholly owned by the Russian Central Bank. Since the crisis, it has focused on retail and corporate clients. Vneshtorgbank survived the 1998 crisis in by minimizing speculative trading in GKO's (short-term federal obligations) on which the government defaulted. As one of the few institutions which met its obligations after August 1998, it has since gained 7,300 new corporate and 7,100 new retail clients.

Russian Private Commercial Banks consist of other viable Russian banks include emerging service-oriented banks and large banks owned by financial-industrial groups. The 1998 crisis severely impacted the major Russian banks, closing about 15 of the largest and leaving others in a weakened state and in need of reorganization.

The most aggressive component of the Russian banking system is a group of new banks which grew larger following the 1998 crisis. These banks survived because they avoided speculation in GKO's and because they offer professional services. These banks are likely to remain customer oriented and to find creative solutions to Russia's business complexities. A potential weakness is their limited capacity to provide services comparable to those of large international banks. Furthermore, they lack nationwide coverage. Ten of the leading banks are:

- | | |
|--------------------------|--------------------|
| 1) Gazprom Bank | 6) Mosbusinessbank |
| 2) National Reserve Bank | 7) Mezhprombank |
| 3) Sobinbank | 8) Avtobank |
| 4) MDM Bank | 9) Rosbank |
| 5) Bank of Moscow | 10) Alfa-Bank |

Barriers to Entry

Factoring is a rather new civil law issue in Russia, which ever day becomes more and more significant. Enterprises which transfer their financial requests to banks or other credit specialized organizations to receive delivered goods paid ahead of schedule, achieve the maximization of financial turnover. However, there are not many regulations which would protect either party who engages in factoring, which is mainly due to the fact that laws are created based on transitions in the market and individual legal proceedings.

Corruption is perceived to be wide-spread and deeply rooted in Russia. It cuts across the country's economic development agenda and therefore is a serious obstacle to Russia's economic development. It undermines economic management, public sector administration in the interest of the nation, and financial management. It is a central issue for creating a law-based environment for private sector development and growth.

The influence and effectiveness of bribes are one of the major impediments for business development. In simple terms, in order to accomplish or achieve a task, the cost of the bribe in many times is the fastest and most cost efficient method. However, this requires the support of heavy capital. Last year, as reported corporations in Russia allocated an estimate total of 60 billion dollars towards bribes. Laws and regulations have been passed to address corruption and bribery, but in reality not much as been enforced. Additionally, investor protection agencies are weak in Russia, although they do exist to build confidence for foreign investors. Reforms and discussions are always in progression, but these organizations have long-term goals.

Additionally, business connections and relationships with local officials and the local administration evidently allows for companies to progress faster and do so in a less costly manner. However, a lack of strong connections can only create potential obstacles for companies to overcome.

Alternative Solutions to Cash Flow Problems

There are not many alternative solutions to cash flow problems besides bank financing and trade financing, which makes this difficult for many growing businesses. Case in point, logistics or transportation companies claim that trucks are their major assets, but since there is a high rate of depreciation on these assets banks are reluctant to extend loans to these companies. On the other hand, in reference to individual or trade loans such as in the merchandising industry financing can only easily be obtained if there is an existing sales contract between the supplier and buyer or strong business relationship. The greater majority of loans are administered from banks or corporations; and personal loans are highly selective. For these preceding reasons of limited alternative solutions to cash flow problems, many companies have turned to factoring services, which is evident from the high growth rate of the industry.

Exit Strategies

The most feasible and primary strategy that APAAC Inc. is considering for the future is the possibility of being integrated into a larger financial institution (like NIKoil or Citibank) by selling off its business. In a worst case scenario, if this strategy is impossible to execute, we will consider selling our client base to other interested firms at a premium, followed by a complete liquidation of all our accounts receivables and other marketable assets and securities. However, in response to our constant belief and trust in our business model, we predict the likelihood of our primary strategy to be much higher and realistic.

THE OPPORTUNITY

Based on the analysis of the transportation industry in the North-western and Central regions of Russia and the interviews with the insiders of the industry, we believe that it provides a prospective opportunity for the factoring services. Transportation companies of all sizes are faced with the issue of collecting money for their services. Their clients, faced with cash flow problems themselves, prefer to delay payments and have a 30-day (industry standard) time window to pay the transportation company's invoice. After interviewing industry insiders we discovered that very few trucking companies agree to take on accounts receivable even from trustworthy customers. Most of the time the drivers are instructed to stay on the client's premises until the bill is paid in cash. This kind of collection practice is detrimental to the operations of the transportation companies. The opportunity and real cost of having the drivers solve the collection issue is high and is measured in the lost revenue from the foregone trips and per diem expenses for the drivers.

Currently the transportation companies try to avoid having accounts receivable. As a matter of fact, the only kind of debt that these firms put on their books as accounts receivable is the debt that is deemed to be uncollectible. This situation with the monetary transactions and cash flows within the industry provides a great opportunity to capitalize on the *unrealized existing need* for factoring services. An owner of a trucking company in St. Petersburg told us that he would "be willing to take up to 85% of the amount that his clients owe him and not have to bother about the hassles of collecting". Presently, there is no market for factoring services in the transportation industry simply because nobody targets this industry. NIKoil, the largest factoring services provider, only works with the following industries: manufacturing, food products trade, production of alcohol beverages, pharmaceuticals, consumer chemicals, perfumes and cosmetics, office staples, electronic and day-to-day goods, metallurgy, lumber industry, toy producers, telecommunications and construction materials. By providing factoring services to trucking companies APAAC, Inc. will create the market for accounts receivable. As soon as the truck makes the delivery, the transportation company will take a receivable from the client and APAAC will make a discounted payment to the transportation company and purchase the rights to that receivable.

Transportation companies will serve as a foothold to enter a more lucrative trade industry. By serving the transportation industry APAAC will receive access to the buyers and sellers of the transported goods. This will open an opportunity to offer factoring *and* purchase order financing services for large trade transactions (See projections).

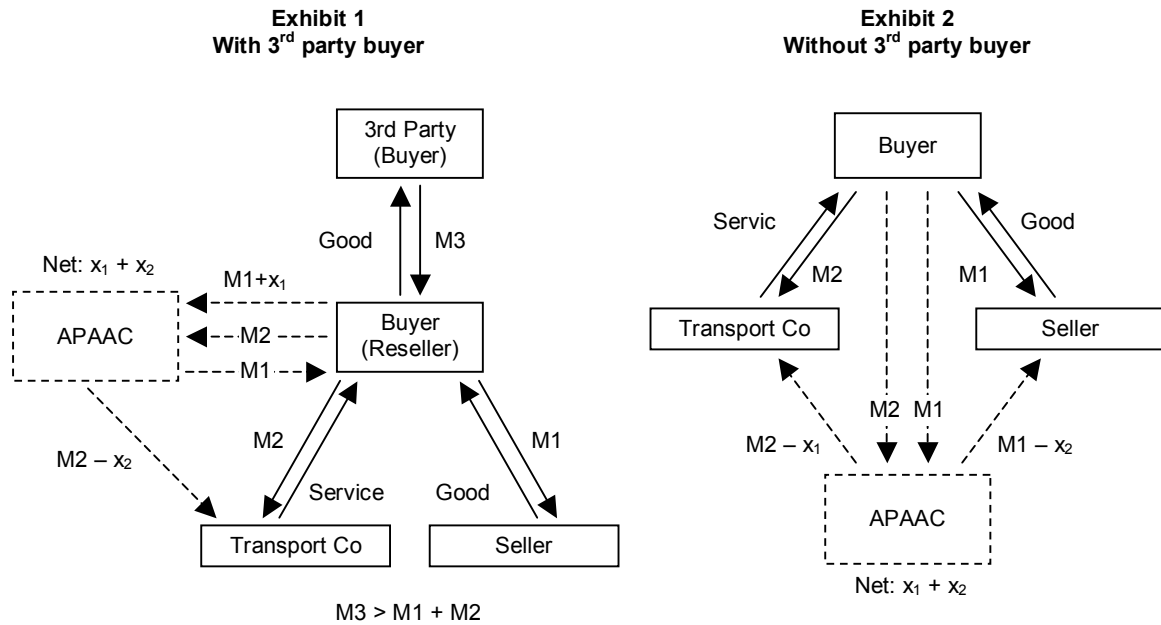
Deal economics

There are two main types of deals that we anticipate to get involved in. All of them include a simple factoring transaction with a transportation company (APAAC will pay the transportation company face amount of fees less discount = $M2-X$), which gives us the rights to the receivable from the “buyer” (assuming terms of the trade transaction are FOB). This gives us an opportunity to offer our services to the buyer or the seller of the goods.

In the first case (Exhibit 1), when the buyer is also a re-seller to a 3rd party and has a purchase order for the goods, APAAC will offer the buyer to finance the purchase of the goods from the seller with the purchase order from the 3rd party buyer as a collateral. In this case APAAC will be entitled to receive from the buyer the face amount of transportation fees ($M2$) as well as the cost of goods that the buyer owes to the seller plus a premium ($M1+X1$). APAAC will be repaid from the proceeds received by the buyer ($M3$). $M3$ will always be greater than $M1+M2$ because it includes the profit margin for the buyer/re-seller. The goods that the “buyer/re-seller sells to the 3rd party buyer” shall serve as a collateral (Article 488, Civil Code of RF), which will cover both the transportation fees and the cost of goods acquired from the seller. The buyer carries the risk of collecting cash from the 3rd party buyer. At the same time, the deal terms shall be structured in such a way that if the 3rd party buyer fails to sell the goods and pay the buyer/re-seller, then the title to those goods shall pass to APAAC.

In the second case (Exhibit 2), in addition to the factoring transaction with the transportation company, APAAC will offer factoring services to the seller of the goods. The transportation company will pass the right to receive payment for freight services from the buyer (assuming FOB terms) to APAAC. The seller will pass the right to receive payment from the buyer for the cost of goods. The goods again will serve as collateral; however, the transportation fees will not be collateralized. After establishing itself on the market APAAC will seek to find buyers and sellers (in international and domestic trade) and provide trade related financing directly (without serving the transportation companies)

Deal economics



It is important to acknowledge that very often the deals between the sellers, the buyers and the transportation companies will involve prepayments. Thus, APAAC Inc. will factor only the remaining part of the receivables. Therefore, only the pro rata share of the merchandise will be used as collateral in the factoring deals.

Business Risks

The management of APAAC Inc. has identified the following risks that the business will face:

- Collection and contract enforcement
- Forced litigation to prevent or recover losses
- Insufficient due diligence resulting in fraudulent actions towards APAAC Inc.
- Lack of transparency – shadow economy
- The impact of a possible financial crisis on trade (next significant election year is 2008)
- Unexpectedly large number of bad debts (more than 30%)
- Competition from existing players and new financial institutions
- Complications arising from corrupt practices of government officials with respect to licensing, registration and ongoing business operations

All efforts will be made to prevent the aforementioned risks. We intend to put a lot of emphasis on due diligence procedures. The due diligence department will be staffed with experienced

lawyers and former law enforcement officers with various backgrounds. We will work only with transportation companies that have membership in ASMAP (Association of International Auto Transporters). The guidelines for membership in ASMAP are strict. Only companies that have been in business for more than 2 years and meet certain capital requirements are admitted. This will weed out unreliable, young companies with no reputation. Proper due diligence, cooperation with law enforcement agencies, as well as collateralization of the factoring deals will allow APAAC to reduce the risk of unexpectedly large number of bad debts. It is also important to recognize that most of the companies in Russia are not operating transparently. We will have to incorporate this risk in our pricing strategy. This risk will be reduced as we begin to establish long-term trustworthy relationships with clients. At the same time, we will have a first mover advantage in offering factoring services to transportation companies. With respect to factoring trade receivables we intend to compete with the existing financial institutions based on price. We will also use our relationships with freight companies to gain business from the buyers and the sellers of merchandise.

However, we have little control or influence on the corruption and financial crisis risk. The only feasible ways to solve these problems is to take out insurance and deal with the corrupt officials directly (the way all other businesses deal with them).

Possible Expansion of Credit Services

We have also considered the possibility of expanding into the avenue of providing credit services to retailers and other department store outlets. This very much resembles store credit cards such as the Macy's card or The GAP card. Currently in the United States and other western countries, there are several large financial companies such as GE Capital and Fidelity that offer these similar services. In the case of department store chains such as Macy's and Bloomingdales, they have an in house system that is tied up with a major bank, regulating and running their own credit services. We have to keep in mind, that not everyone has such financial and managerial backing.

In general, even in the US, it is hard to find companies that offer these services to small scale retailers, and often, the retailers may approach their own bank directly to obtain similar services. Banks offer credit lines that depend on a company's bank balance and reputation with the bank. However, this does not have the same effect as a credit card company.

This is where financial services companies (what we intend to be) step in and provide help. They usually require their customers to have some sort of background (history in the market and credit history) and internal infrastructure in order to reduce risk and facilitate business. E.g. a corner Deli that has been in business for 30 years cannot issue store cards! Once the terms of the deal, such as commission and fees have been worked out, the store starts issuing these cards after detailed credit checks of applicants. The credit limit per card depends upon this credit score and the interest and willingness to pay. There are certain companies that just want to make money and thus charge exorbitant rates of interest, smart consumers will have to be aware of these loan sharks.

In terms of the Russian market, we intend to offer similar services to various establishments such as Passage, Piatorochka, and DLT in St. Petersburg and 7th Continent and Okhotniy Ryad in Moscow, which are all large and respectable food and clothing stores. We will first begin by offering them credit lines (short term only) for financing their purchase orders. These credit lines will have competitive rates of interest but relatively strict terms of trade in the beginning. Once a substantial business confidence is ascertained we shall ease the terms. The terms of credit will be revolving, but all dues will have to be cleared and completed within a year from purchase (This is the same for all store cards in the US). In certain cases, our interest rates might vary from institution to institution.

As time progresses and we establish our links and business further, we shall contemplate the possibility of issuing store cards to these various businesses. These cards shall only be issued to a select number of store customers who will be chosen after a thorough screening of their personal financial statements. We shall only undertake collection of a part of the amount (say 60%) and the rest of the risk will have to be shared by our client. This will allow us to minimize our personal risk of accumulating bad debts. Once the economy, financial and judicial stability in the country improves, we shall contemplate offering similar services (only short term credit lines) to smaller retailers.

At present, no one is offering such financial services (store cards) to retailers for in store purchases. Banks offer lines of credit, to large retailers and wholesalers, depending on company history and balance with the bank in question. On a larger scale, there are companies such as NIKoil who offer financing, but these are only for extremely large and stable monetary transactions with international concerns. Our aim is to develop the domestic market that at present lacks such services.

VALUATION

Among many valuation techniques we decided to use Discounted Cash Flow. Firstly, we believe that even though DCF does not account for the options embedded in the business it is still the best technique available to value a company. Secondly, for the purposes of our project we are trying to come up with an approximate valuation to which the adjustments will be made in the future, and DCF accounts for the main variables that will have to be adjusted later.

Since the comparables are not readily available in the Russian market, the valuation based on the comparable multiples is not applicable.

In order to calculate the appropriate discount rate we took the risk free rate (MinFin 30 Sovereign Eurobond) of 12.00% and added the risk premium of 8.00% that includes business risk as well as regulatory risks and fraudulent activities that the company can be subject to. Consequently, our discount rate is 20.00%.

Our Cash Flows equal to the Net Income due to the fact that firstly, APAAC Inc. is assumed to be an all-equity financed company (no interest expense), secondly, capital expenditure is close to zero due to the nature of the business, and thirdly, depreciation is not incurred due to the absence of capital assets. Non-cash working capital is assumed to stay stable in the short- and medium term. Terminal growth rate is approximated to be 10.00% based on the assumptions discussed earlier in this report. The value of the firm is estimated to \$17,424,979.

Furthermore, we conducted sensitivity analysis in order to observe the range of the valuations depending on pessimistic, expected and optimistic scenarios. The most probable value for APAAC Inc. based on this type of analysis is \$16,442,165

CONCLUSION

Having analyzed, researched and studied the Russian market and the feasibility of a company catering to the factoring needs within the transportation industry and purchase order financing segment; we find that there exists an opportunity to close the gap between the market need and lack of supply. Furthermore, we expect a rise in the demand for factoring services in Russia as the economy and trade continues to grow, in line with Russia becoming a stronger global player and accepting globalization in its entirety. Through our unique competitive strategy, we expect to target and capture a substantial share of the factoring market and hope to mould the pattern for carrying out business not just in our segment, but in the economy as a whole.

PRESS RELEASES AND OTHER CURRENT RELEVANT INFORMATION

Press Release Information (All the following publications were sourced from “Internet Securities, Inc”):

1) Timeline Set for Mandatory Switch to IAS (Moscow Times: 1/24/03):

Under this law, banks and publicly traded companies will be required to switch from Russian to International Accounting Standards starting in 2004. This will promote the investor confidence level and increase the transparency level in company’s financial statements.

2) MST World Bank Plans Major Probe into Russian Corruption: (Prime-TASS News Wire: 3/14/2001):

The World Bank is planning a project to research corruption in Russia. World Bank experts are working in 12 Russian regions and have contacted 50 heads of major enterprises and plan to reach two thousand.

3) Russian Entrepreneurs Spend \$33 Billion on Bribes: (WPS – Russian Business Monitor: 10/21/02):

Igor Lisinenko, Chair of the public organization Business Russia, states that 82% of Russian entrepreneurs are involved into corruption and spend up to \$33 billion on bribes a year. Lisinenko classified these organizations as medium to large sized businesses. These figures totaled a sum of approximately equal to one-fourth of the federal budget expenditures in 2002.

4) Mavrodi Found, But Where’s The Money? (Moscow News: 2/19/03):

The recent arrest of Sergei Mavrodi had settled the high hopes that investors would be able to get back their money after one of the country’s biggest investment scandals but court procedures must first follow.

5) Government to Raise Investment Attractiveness of Processing Industries (Info-Nova Press Digest: 2/21/03):

The Russian government has broadly approved a socio-economic development program for Russia drafted by the Economic Development and Trade Ministry; effective through 2005. If successful, Russia’s GDP will grow at 7-8% annually in 2007-2015.

6) Winning Investors’ Trust a Priority for Russia – Premier (BBC Monitoring: 5/14/01):

Winning investor trust is a key priority of the Russian government. The government is considering an investment agency, a body which would assist the adaptation of small and medium size businesses with Russia’s economic conditions. Additionally, the government will analyze the work of foreign banks in

Russia to learn from their experience. This will increase transparency of commercial banks and financial institutions in Russia through modernization and attractive incentives.

**7) IMP, OECD, UN and World Bank Experts Call for Better Statistics to Fight Poverty:
(International Monetary Fund: 11/19/99):**

Mr. Vladimir Sokolin, General Director of the Russian National Statistical Agency, described his country's 5-year program for statistical renewal, which is being financed with a \$30 million loan from the World Bank. The project is targeted at developing a new model of statistical system to build on experience and adopt new international statistical practices. The reform will restructure the entire informational space of Russia, including all types of statistical data collected and processed by the National Statistical office and other ministries and agencies.

SOURCES

- 1) Topics in Emerging Financial Markets – J. P. Mei (Course notes and slides)
- 2) NYU Virtual Business Library
- 3) Economic Intelligence Unit
- 4) IMF working papers (1999 – 2003)
- 5) EBRD report “Russian Federation – country investment profile” (1999, 2000, 2001)
- 6) Central Bank of Russian Federation
- 7) Goskomstat - State commission for Statistics
- 8) Russian Venture Capital Association (www.rvca.ru)
- 9) Ros Business Consulting (www.rbc.ru)
- 10) Vedomosti – Russian National Newspaper (www.vedomosti.ru)
- 11) Moscow Times (www.moscowtimes.com)
- 12) Moscow News (www.mn.ru)
- 13) Russian Legal Database – Garant (www.garant.ru)
- 14) Organization for Economic Cooperation and Development (www.oecd.com)
- 15) NIKoil (www.NIKoil.ru)
- 16) Internet Securities Inc. (<http://site.securities.com>)
- 17) ASCI Journal of Management (www.asci.org.in)
- 18) The Export-Import Bank of India (www.eximbankindia.com)
- 19) The Reserve Bank of India (www.rbi.org.in)
- 20) Series of interviews conducted with owners of “Gepard”, a trucking company in St. Petersburg, Russia