

## Russia IT and Telecom: investors are coming

Telecommunications and IT markets in Russia are experiencing a long-term boom and Western investors are coming, writes *Alexander Savchuk, General Director of Cominfo Consulting*.

### GENERAL OUTLOOK

2001 was marked by positive investment dynamics in the IT and telecoms industry. Investors took special interest in cellular communications and the Internet. The main emphasis was placed on expanding the variety of services based on these services. Total industry revenue in 2001 exceeded USD 6.5 billion.

In previous years, important government directives were prepared that defined development strategy for the next decade. Initially, the government approved the Concept of Telecom Services Market Development up to 2010. It was the first document in the industry that affirmed market relations in the sphere of telecommunications. The State Radio Frequencies Commission approved the Concept of Satellite Communication Development to 2010, while the State Telecommunications Commission approved the Concept of Cellular Mobile Communication Development in Russia to 2010. Another important government initiative was the establishment of the ambitious Federal programme called Electronic Russia 2002-2010.

In addition to these important strategic documents, a number of laws have been passed or will be passed in the near future. The new, more advanced draft Communications legislation is expected to replace current legislation later on this spring. The legislation regarding Electronic Digital Signature, passed in January 2002, sets the basis for e-commerce and e-banking in Russia. A number of more specific, technical regulations concerning telecommunications, such as the regulative directive on telematic services and the regulative directive concerning communications networks and data transmission, were passed recently by the Ministry of Communications. General legal developments, such as the introduction, from January 2002, of the Land Code, the new Labour Code and the new amendments to joint stock companies legislation, has significantly improved the investment climate in Russia, including the telecoms sector. However, we have to admit that the legal basis for business in the telecommunications industry is often inconsistent, lacks clarity and is not always compatible with its counterparts in Western countries. The problems of introducing usage-based pricing and interconnect payments between operators have not been solved yet. The pace of tariff reform is not in keeping with the transformations going on in the industry.

Incumbent (traditional) regional operators continue to yield their positions in the market. While they possess about 90% of the Russian communications infrastructure, they account for just a little over 45% of total revenue.

Although alternative operators own only between 7 and 8% of the infrastructure,

their share in the total revenue exceeded 50%, Their rates of revenue growth are considerably higher than those announced by regional companies and exceeds 100%. Such considerable growth can be attributed to the improved macroeconomic situation and to the booming cellular communication market where subscriber numbers doubled. Alternative companies are most active in the Moscow and St. Petersburg markets, where their share already amounts to between 75% and 80%. In several industrially developed affluent regions they also boast a considerable share of between 30 and 60%.

Large-scale projects to develop trunk networks will soon be completed. Client numbers are increasing rapidly, especially those who prefer in-lease data transmission network channels. Leading companies are Transtelecom (Railway Ministry), Gaztelecom and Gazcom (Gazprom), Svyaztrnsneft (Transneft - Oil transportation).

According to the Russian government's plans to restructure the country's natural monopolies, more than 70 Russian PSTN operators (regional operators) will be merged into seven inter-regional companies. The ultimate goal of consolidation is to make the Russian telecoms sector more efficient and attractive to investors. The state currently controls regional operators through its 75% stake in Svyazinvest, which is a 51% shareholder in virtually all of the regional operators.

To facilitate consolidation, a "core" regional operator in each of Russia's seven macro regions (usually the largest operator in the respective macro region) will issue additional shares that will subsequently be swapped for the shares of other local operators in the same macro regions.

Regional and alternative operators are not on an equal footing in fixed-line telephony. Regional operators who traditionally work in the area of telephone services also carry social burdens when servicing customers and they are limited in their network development budgets to the existing tariff level and system, of control.

Alternative companies, which have not experienced any pressure on the part of regulating authorities until recently, and which are oriented towards a highly profitable business sector, have developed modern networks and render high quality services. In 2001, in order to fill new consumer niches and to win promising new clients, alternative operators began providing fixed-line telephony services "bundled" with mobile communication and Internet services.

Four corporations are now considered the biggest market players: Moscow-based System Telecom, St. Petersburg TelecomInvest, the foreign Golden Telecom and Telenor, which is the strategic partner of Combella and VimpelCom.

Large operators are capable of making bulk investments into the creation of nationwide backbones and integrated networks. Successfully developing their regional activities, telecommunications holdings are becoming tough competitors for regional operators, especially in the cellular telephony sector. It is most likely that local cellular companies will either enter into a partnership relationship with any of the corporations in

the near future or cease to exist since they will be unable to stand up to till's new competition. A new trend in the telecoms market is investment of domestic capital. Alfa Group last year invested several million dollars into VimpelCom and its regional cellular projects. Oil company YUKOS bought all Russian telecom assets from the US Andrew Corporation, a good example of exit strategy for foreign investors.

Most of the alternative operators are private companies. Shares in regional operators are traded on stock exchanges. Shares in Russian regional operators are becoming a more attractive investment alternative as the consolidation process draws to a close and additional hikes in local tariffs are expected. The Russian equity market is bullish, so regional operators are set to benefit from an inflow of foreign capital. Investing in regional operators should be viewed as a long-term bet on the positive outcome of sector restructuring and tariff reform, hi addition, it is likely that the government will relinquish control over the sector and allow strategic investors to take significant stakes in interregional operators. Among prospective strategic investors could be foreign telecommunications operators, as well as Russian financial-industrial groups.

## TARIFF POLICY

The Russian federal authorities regulate local and domestic long-distance tariffs. The regulatory tariff-setting body is the Anti-Monopoly Ministry of the Russian Federation. Growth of revenue for regional operators will primarily come from an expected increase in local rates, which are significantly lower than in Eastern and Central European countries.

In 1999 the Ministry of Communications changed its pricing policy. If in 1996 the rates covered only 46 % of the cost of local communications services and in 1999 they were below cost, currently approximately half of the operators provide services at prices above cost and on average rates are at the 99-100 % level with respect, to costs. Commercial entities pay 20% more for long-distance services than residential customers and state entities pay 50 % less than commercial. Fixed fees vary. For example, residential customers in Moscow are now paying a fixed monthly fee of RUB80 (USD 2,6) per month. An installation fee is approximately RUB3000 (USD100).

In the long-term, the rates for international telecommunications for private and state companies are set to even out. In 2002 the Anti-Monopoly Ministry plans to base its pricing policy on a combination of economically justified costs and profitability. At the end of 2001, the Anti-Monopoly Ministry approved a significant increase in the residential local rates of operators across the country Residential local rates in Russia were increased by a total of about 40% in 2001, in comparison with an 18.6% increase in inflation. In 2002 it is planning to increase local rates by an additional 30-35%.

The Anti-Monopoly Ministry is planning to change its policy towards alternative companies. It proposes to include companies, which offer traditional telephone communication services and have a capacity of 10-30,000 lines, in a register of natural monopolies. So far alternative operators from 12 regions of Russia have been included in

this register in addition to 200 traditional operators.

Such measures may have a negative impact upon alternative operators, which are only now starting to offer communications services to the population, since they will have to lower their tariffs below profitability level. Nevertheless, it is planned to finish the transition to two categories of local communication tariffs (for households and businesses) and to prepare the transition to a single interregional tariff for all categories of users.

Consequently, tariff reform is lagging behind the other transformations going on in the industry. Coupled with a small share of new services offered by regional operators, this results in low per line revenues, which yield dozens of times less than those of operators in the developing Eastern European markets.

## THE MOBILE COMMUNICATIONS MARKET

According to statistics, cellular communications are currently booming in Russia. The subscriber base doubled during 2001 (3.4 million subscribers at the end of 2000 and 7.84 million at the end of 2001). In March 2002 there were already about 9 million subscribers in Russia. The total number of mobile telephone subscribers in the Moscow region reached 4.3 million and exceeded the number of fixed communications subscribers.

The regional client base is also growing. Currently Russia is in second place among the countries of Eastern Europe in terms of the absolute number of subscribers, however the level of cellular communications penetration is extremely low and totals only 5.3 % (in Poland, for example it is 25 %). In Moscow this indicator is much higher (about 40%). Overall a rates decrease is taking place. MTS has the largest share of Russia's mobile market with 34%, followed by VimpelCom with 26%, and Northwest GSM with 10% (as of March 2002).

Scandinavian investors are the most active in the mobile market. Telenor has a 27% stake in VimpelCom. Sonic Duo, a GSM 900/1800 mobile operator in the Moscow area and part of the nationwide MegaFon project is another example. The company was established in 2000 by Sonera (35%) and Russian company CT-Mobile (65%), a subsidiary of investment company LV- Finance.

Advanced CDMA cellular communications were rapidly developing in 2001. Despite the actions of authorities, which selected the GSM standard prevailing in Europe as the basis for telecommunication systems development in Russia, the CDMA network subscriber base grew by over 2.5 times year-on-year in 2001. As of 31 December 2001 the number of CDMA network subscribers (IS-95) exceeded 204,000. In 2001 the share of CDMA (IS-95) networks in the Russian cellular communications market in terms of the number of subscribers was 2.6 %. 16 communications networks in 18 regions of the Russian Federation were built using CDMA technology.

In 2001 key cellular players began their expansion into the regions. MTS ([www.mts.ru](http://www.mts.ru)), VimpelCom (Bee-Line brand name) and Telecominvest (MegaFon brand, [www.megaфонmoskow.ru](http://www.megaфонmoskow.ru)) will become the national mobile cellular operator by integrating their regional networks into a single unified network, developing standardised tariffs and deploying intergrated nationwide customer service and billing systems.

VimpelCom has launched GSM 900/1800 networks in 50 Russian regions over the past six months. MTS holds licenses to provide GSM services in 46 regions of the Russian Federation, covering 56% of the population). MegaFon is a nationwide project initiated by Sonera, Telia, Telecominvest and CT-Mobile with a view to combining regional GSM mobile operators into a unified network. The MegaFon operators hold licenses for the largest coverage area in Russia; currently the project embraces 68 regions of the Russian Federation with a population of 122 million, or 80% of the country's population. The number of MegaFon network subscribers amounts to more than 900,000.

Foreign players have similar plans. For example, the U.S. telecommunications holding MCT Corp., which controls cellular service providers is operating in the CIS under the Indigo brand name. As of late 2001, Indigo had a consolidated subscriber base of 583,000. The company is pursuing an aggressive development strategy, requiring investments of USD 800 million in 2003 and 2005. Indigo's licenses cover about half of Russia and MCT intends to increase its national licensed area to 75% by acquiring small local operators. As part of its strategy, MCT aims to phase out outdated AMPS analogue equipment, which is primarily used by Indigo operators, replacing it with GSM standard digital infrastructure.

Another example is an agreement between Swedish Tele2 and Millicom International Cellular (MIC) group, based in Luxembourg, to sell MIC's Russian cellular telephony assets to Tele2 for approximately USD 80 million. MIC controls 12 regional mobile operators, operating under AMPS/TDMA standard, as well as owning 20% of the Moscow Cellular Network (NMT standard). According to Ministry of Communication regulations, the DAMPS' standard will only continue until the year 2010, Last year the Ministry decided to award these operators GSM-1800 licenses and this is the main reason for Tele2's purchase of the promising assets.

All leaders invest in new technologies, the creation of added value mobile services and thirdgeneration mobile networks. For example, Sonic Duo and Ericsson have successfully completed the first stage of testing for the UMTS trial system supplied by Ericsson in the contest of the project to establish the UMTS trial system fragment in Moscow. VimpelCom and MTS successfully use WAP and GPRS services.

## THE INTERNET AND IP TELEPHONY

The Internet services sector is growing very rapidly and is one of the most attractive businesses for investors. According to Cominfo Consulting estimates, the total volume of the Internet services market (access, hosting, advertising, e-commerce, IP telephony etc.) was USD 350-380 million in 2001.

Over the last 5 years the maximum audience (all those who accessed the Internet at least once) grew by 80% - 200% annually. The average annual "core" (those who regularly use the Internet) growth between 1997 and 2001 was 54 %. In 2001 the "core" accounted for 40% of maximum users. In 2001 the maximum number of users was 11 million and the 'core' was 4.2 million. In 2002 we expect these figures to be 12.5 million and 5.8 million respectively. Nevertheless, the level of penetration will still not exceed 3%.

Over 70% of Internet users come from the private sector and mainly connect using dial-up. At the same time the Internet access market is far from being saturated and is very fragmented: in Russia there are several hundred ISPs, mainly small ones. However, the process of consolidation and business integration could be observed recently and is particularly active in large cities. Currently Moscow and St. Petersburg account for about 70% of the entire Internet services market. However, the share of regional markets is rapidly growing due to the growth of per capita income (an average regional user already spends as much as 10 dollars per month on the Internet) and the creation of regional trunk networks. The growing PC fleet in Russia, which, according to experts, reached 8 million in 2001, also influences the growth of the Internet services market. The average connection rates are currently at USD 0.7-1.0 /hour. The total capacity of Russian international ISP channels increased dramatically from 5 Mb in 1996 to 4.5 Gb in 2002.

The data storage services sector (hosting, colocation, etc.) is actively growing. For example, Cable&Wireless created two large data centres in Moscow. Broadband wireless Internet access and metropolitan area networks are promising sectors for investments.

E-commerce in Russia is only just starting. The B2C sector prevails both in terms of the number of companies and in terms of volume. In 2000 B2B turnover was USD 42 million (26%), B2C USD 122 million (74%). In 2001 the figures were USD 100 million (31%) and USD 218 million (69%) respectively. For 2002 our experts forecast B2B of USD 189 million (37%), B2C of USD 317 (63%) and in 2004 USD 464 million (43%) and USD 615 million (57%).

According to Cominfo Consulting estimates, as of the beginning of 2002, the Russian market of IP-telephony services is USD 65-80 million. In 2001 the volume of IP traffic totalled 250 -300 million minutes, i.e. 8-10% of all outgoing international, and long-distance traffic in Russia. Over 400 licenses to provide IP-telephone services as an independent telematic activity were issued to Russian companies. Currently 80 communications operators provide IP-telephony services, however the seven largest companies account for over 50 % of the market: Tario Trading, RGC, ZOND Holding, O.S.S., Sitek, Incomtel and Elvis Telecom. The interest of foreign IP-operators in the Russian market is confirmed by the fact that the number of companies providing services to Russian users is growing. Companies from Europe, Canada, USA, Israel and Singapore are actively working in Russia, Roaming, of the largest IP operators covers the entire world.

## THE IT MARKET

The volume of the Russian information technologies market grew by approximately 25 % in 2001 as compared to 2000 and exceeded USD 3 billion. The Russian IT-market, compared with the declining western markets, is largely growing due to the relative self-sufficiency of the national economy, the growth of IT expenditure in most companies and a high demand for comprehensive business support information systems.

Computer equipment, systems integration and information security services are the development development leaders. Properly re-allocation is close to completion in most industries and financial and production management efficiency is becoming more important. A growing number of companies are aiming to rebuild their businesses to western standards, including corporate management, logistics and budgeting systems. The ERP and SCM solutions market is actively growing. The market of CRM systems has started to develop.

The creation of the Computer and Information Technologies Companies Association in Russia was a natural result of market development. It reflects the position of a State, which prefers to engage not with separate representatives of the business, but rather with professional entities that are more effective in lobbying their interests. Another example is the creation of the National Software Developers Association (NSDA). Experts estimate the offshore programming market will reach 100-120 million in 2002.

In 2001 the Russian IT market saw a consolidation of forces as well as new development. Business integration and the formation of two poles representing large companies formed through the merger of several companies and small companies taking over the orders of large ones will take place soon in the field of systems integration. There will be no medium-size companies since departments in large companies will replace them.

In 2002 integration will affect not only the systems integration market. The new conglomerates will comprise systems integrators, distributors and computer assembly etc. Most probably, these structures will be rebuilt on a 'holding company' principle. The industries that actively consume IT services are the fuel and energy industries, metallurgy, banking and financial sector, government, retail and wholesale networks.

The growth of the Russian hi-tech and telecom industry is also confirmed by the stock market dynamics of the leading Russian technological companies that have placed their securities on the American stock market. VimpelCom, Rostelecom and MTS stock trades on NYSE and Golden Telecom on NASDAQ.

## TO SUMMARISE...

The modernisation of the Russian high-tech sector has resulted in strong growth and is attracting Western capital. Investors are positive. There is momentum, and the trend is upward. Government policy, including regulation and tariff issues, has become more stable and transparent. Businessmen who are planning to invest may consider a variety of ways in which to enter the markets. It is important that different options are available to harvest the investments including corporate finance and stock market instruments.