

**Testimony of
Patricia M. Cloherty
Chairman and Chief Executive Officer
The U.S. Russia Investment Fund
before the Committee on Foreign Relations
United States Senate
June 21, 2005**

Chairman Lugar, Senator Biden, and Members of this Committee, I appreciate the opportunity to testify today regarding The U.S. Russia Investment Fund, known as "TUSRIF" since its inception in 1995, though it is now managed by Delta Private Equity Partners, a private management company. Many observers believe that TUSRIF may be the most successful foreign assistance program in Russia since the Soviet Union ceased to exist in 1991.

I also want to compliment your staff, particularly Ken Myers and Ken Myers III, for their assistance and advice over the past ten years, and you, Senator Lugar, for your video keynote address at our tenth anniversary meeting in Moscow last September. The Russian audience deeply appreciated your words of encouragement to them as they go about the difficult task of re-building their economy, their society and their polity.

Like our elder enterprise fund sibling in Poland, TUSRIF's mission was -- and is -- to assist the new Russian Federation in its transition from a centrally-planned command economy to a market economy, not by giving away grants, but by making investments in entrepreneurial companies. We started with a board of directors of men and women who serve pro

bono, men and women who have made money during their careers owing to opportunities afforded them in the U.S. economy. Now they want, quite simply, to "give back" to their country by assisting Russia in a way that the U.S. Government ("USG") cannot.

About Us

TUSRIF was formed in 1995 with the USG as its sole financial sponsor, but under private management. TUSRIF's mission was to promote the development of a free market economy in Russia by providing investment capital -- equity and debt -- to emerging, potentially high-growth entrepreneurial companies. This was to be combined with technical assistance to management teams seeking to grow productive, transparent and valuable companies. Once such a program was established and working well, TUSRIF's Board of Directors was to form a privately financed successor fund to continue the investment program. Finally, the Board was to propose to the USG a plan for future use of the capital re-flows from TUSRIF's successful investments that would seek to further accelerate entrepreneurship and economic growth in Russia.

TUSRIF now has invested about \$300 million in 44 Russian companies, the most recent of which were made together with Delta Russia Fund, the privately financed successor fund that held its final closing last month with approximately \$120 million in committed capital. That fund has backed another half dozen companies already.

2004 was a watershed year. In that year, TUSRIF accomplished its mission. It ended its investment cycle and moved into the cycle of realizing returns through sales of its investment positions. Additionally, it

formed Delta Russia Fund, the private successor fund. The Board then organized a Legacy Committee and began planning for what it would propose to do with the proceeds from the sale of its investments.

So what exactly have we done?

We have backed new companies. We have launched new industries. We have introduced the art of equity investing in Russia and trained young Russians in that art. And, through exits, we have brought high quality international investors into the Russian market.

DeltaBank, a commercial bank we founded in 2000, pioneered in credit cards, which, while common in the West, are new to Russia. In 2004, TUSRIF sold its interest in DeltaBank to GE Consumer Finance, the global financial unit of the General Electric Company, for 4.37 times book value. This was the third highest multiple for a sale of a financial institution in the world for that year.

We were pleased that a company such as GE paid \$100 million, over four times book value, for a credit card business that began with a USG grant.

Second example . . . We formed DeltaCredit, a pioneer in residential mortgages and Russia's first mortgage bank, in 2001, to provide residential mortgages to Russia's emerging middle class. Like credit cards, mortgages never existed before in Russia. Now, with nearly 50 percent market share, the company is growing at 100 percent annually and is poised to remain a

leading player in Russia's expanding mortgage market for the foreseeable future. DeltaCredit established a residential mortgage origination network of 15 Russian and foreign banks. In 2004, Standard & Poor's Rating Services rated the bank stable, reflecting the improved capitalization and diversification of its funding base.

We also have been active in media investments. In February 2005, TUSRIF sold its stake in CTC Media, a television network, to Fidelity Investments, a leading European mutual fund. The sale of CTC Media at four times its original cost is TUSRIF's sixth successful sale of a company from its private equity portfolio, and it is the second deal with a large international strategic investor in the 15 months through December 31, 2004.

We support young, talented, dynamic, ethical and inspiring entrepreneurs, and we go to great lengths to stimulate entrepreneurship broadly. There are entrepreneurs such as Andrey Korkunov, a former rocket scientist who started his chocolate manufacturing company with his own money and has built the leading confectionary firm in Russia today. We have visited his manufacturing plant, seen his state-of-the-art quality control processes, met his employees, and, of course, tasted his products. When he accepted his Entrepreneur of the Year award in Russia last year, Andrey said that he wanted to "make life sweeter" for his country. He is doing this by creating jobs and generating wealth for his employees and for his community.

Olga Sloutsker is another example. Told that she could never succeed, she did anyway. Olga built a remarkable company: a chain of health and

fitness centers that grew to employ hundreds of people and literally reshaped the nation's approach to health and fitness.

We have come to know these entrepreneurs and hundreds like them since we founded The U.S. Russia Center for Entrepreneurship (the "Center") in 2001. Since then, the Center has become the leading entrepreneurial support organization in Russia today. Its novel combination of education, training, policy analysis, networking events and research and publications is driving an entirely new and effective culture of entrepreneurship in Russia. It truly is the centerpiece of TUSRIF's legacy to Russia, as contemplated in the original foreign policy objectives of TUSRIF.

Moreover, the success of our Center has become a model for innovative, "bottom-up" economic development elsewhere, including in countries of Central and Eastern Europe, North Africa and the Middle East. The State Department and USAID now are using our training modules in other geographies, much to our satisfaction.

The future of Russia's non-natural resource economy is dependent in great measure on these Russian entrepreneurs who are effecting economic reform, promoting financial transparency and good governance, and creating opportunity for themselves, for their employees and for their communities.

Russia's Economy

Russia's growth is attracting investors. Its GDP grew 7.1 percent, and industrial output increased steadily in 2004, spurred by increased domestic

investment and an upturn in private consumption. Macroeconomic factors - including currency stabilization, tax reform, controlled inflation, an expanding service sector and increasing exports -- contributed to political and economic stability in Russia during this period. The cumulative effect of these positive trends resulted in an upgrading of Russia's sovereign credit ratings, with Fitch Ratings raising Russia to investment grade BBB- in November 2004.

The budget surplus and public finances in general held steady, the trade balance rose significantly, and currency reserves at the beginning of 2004 exceeded US\$77 billion, a record figure for the entire post-Soviet period. Sovereign debt decreased to 33 percent of GDP, and the government maintained a stable repayment record. The Russian stock market again came out among the top performing markets worldwide. In 2003, the Russian stock market grew by nearly 60 percent, which made Russia sixth among the world's capital markets in terms of capitalization growth. Public confidence in the national banking system and the ruble began to grow, and the role of the dollar in the Russian economy shrank.

It is argued that Russia's economy is too dependent upon oil exports. In fact, with an oil market precariously balanced between a slowly growing supply and surging demand, the price effect of marginal barrels is exacerbated. It is possible that by pumping fewer barrels, Russia could make more dollars.

On the macro side, the budget of the Russian Federation is in good shape. It is on track for a 6.5% surplus; foreign reserves are approximately twice the total sovereign debt load; after prepaying the IMF, the government is now prepaying the Paris Club; the trade surplus is increasing; and the

reserve fund, now at almost twice its intended target of 500 billion rubles, has not been raided, despite many attempts. The greatest fear is ruble overvaluation such as occurred in the 1990s. Inflation is predicted to hold reasonably well at about 7% this year. The real (CPI-deflated) effective exchange rate is currently 6% below that of July 1998, despite the build-up of Russian reserves. Real incomes are increasing rapidly: the average Russian income increased by 12% last year. But with steady revaluation of the currency, and wages continuing to grow, a major improvement in economic efficiency has become imperative.

Given these positive developments, growth expectations in 2005 are being revised down somewhat, to about 6%. Notable, however, is that these are downward ratchets based on a conservative oil price scenario, and that every year since 2000, GDP growth has exceeded expectations. Furthermore, Russia is increasingly integrated into the European economies that are growing more slowly. For example, GDP growth in the reform-friendly Eastern European countries of Hungary, the Czech Republic, and Poland, is likely to fall to less than half of Russia's levels this year.

Inflation in Russia continues to exceed forecasts, so the government's reiterated CPI target for 2005 of 8.5% appears unattainable. Inflation reasonably can be expected to continue at about 2004's 11.7%. Given the need for a massive increase in charges from previously government-provided services, in energy prices, as well as creation of liquidity from purchase of hard currency inflows and the continued strong growth of the Russian economy, even attaining non-accelerating inflation will be a major accomplishment.

Changing of the Guard in the Private Sector

The positive changes in Russia's regulatory and tax frameworks complement the transformation occurring within many Russian businesses themselves. The 1998 fiscal crisis shook out many weak links in the economic chain. Surviving companies are for the most part those with coherent strategic visions, rational business plans and professional management. The crisis ultimately produced a new generation of strong young entrepreneurs dedicated to building new industries rather than investing or speculating in old ones. These entrepreneurs develop their businesses from a clean slate, avoiding the financial baggage and practices left over from the Soviet era and the years prior to 1998.

Russian enterprises today generally are focused on corporate value-building, realizing that in a competitive business environment, the critical imperative is satisfying customers. Such companies increasingly understand that, in order to keep investment flowing, internationally accepted principles of accounting, due diligence and shareholder rights must be adhered to, and that performance in a manner consistent with business plans is required.

Another remarkable development has been a dramatic "reverse diaspora." Talented young Russians who left Russia to attend universities and to work in Western Europe, the United States or Japan in the wake of the events of 1991 and 1998, are returning, bringing their educations and newly-honed skills with them. They are joining the entrepreneurs who stayed. Together, they are forming a new class of sophisticated business managers.

Happily for me, these are the kind of young women and men who make up

my investment team at TUSRIF. They, in turn, make their training and experience available for the new managerial elite. It forms a dynamic that makes identifying and partnering with innovative, responsible Russian management teams increasingly possible, a process that is starkly different from the chaotic and speculative bets of the mid-1990s.

Here's an example from our own staff: Kirill Dmitriev. Born in Kiev in 1975, he came to the U.S. in 1992. He is an honors graduate of Stanford University, a Baker Scholar at the Harvard Business School, and has worked for Goldman Sachs in its investment banking division and for McKinsey & Company in Los Angeles, Moscow, and Prague. Prior to joining us, Kirill was Deputy General Director of Information Business Systems (IBS) in Moscow, Russia's leading IT services company. Now he is a partner with me and others like him in Moscow. At the age of 30, he is comfortable in two cultures and two languages as well as the language of finance, and is poised to be an international leader in private equity.

The reverse diaspora serves to enrich the highly-educated managerial base that it re-joins.

Improving Liquidity for Investors

In private equity, which is TUSRIF's business, liquidity is key. Heretofore limited in Russia, the ability of investors to secure liquidity at appreciated values has improved apace with the growth of quality companies. The June 2000 Nasdaq IPO of Mobile TeleSystems, one of Moscow's two largest cellular service providers, as well as its rival Vimpelcom's earlier ADR float on the NYSE, exemplify one path to liquidity for investors. In February 2002, Russian food giant Wimm-Bill-Dann repeated these earlier successes with an IPO of American Depository Receipts (ADRs) on the New

York Stock Exchange (NYSE). Furthermore, in April 2002, RosBusinessConsulting achieved a successful IPO on the Moscow Interbank Currency Exchange, and Seventh Continent, a Moscow-based supermarket chain, went public with an IPO on the Russian stock exchange in November, 2004. TUSRIF's successful exits over the last two years from investments as described earlier further demonstrate increased opportunities for liquidity in the Russian market -- in this case, in the private market. Over the next several years, we expect increased demand from both capital market participants and strategic investors to buy into fast-growing local companies with Western-style management and robust transparency.

In fact, the number of IPOs on the Russian stock market in the last 18 months exceeded all of those for the past eight years. This is significant. None of those companies even existed in Soviet times. They are diversified, in technology, retailing, and steel. Forty percent of the demand for shares is from Russian citizens. The companies offering shares accept the need for transparency, but, as important, are placing their confidence in the future. They are toning down the emerging markets standard practice of "grab now, because there is no tomorrow."

Three other factors are enhancing financial liquidity. Western strategic investors are seeking to acquire a foothold in the expanding Russian market. Russian groups are diversifying and expanding regionally. And there is a growing interest among mid-market companies in tapping public securities markets through IPOs, both in Russia and abroad, to raise capital to fuel their growth. The Fund's fifteen successful exits from investments in the last three years demonstrate that investing in well-managed growth businesses can generate strong returns.

Industries of Note

◆Consumer products and services

With a population of approximately 145 million and an area spanning 17.1 million square kilometers, Russia is potentially a vast consumer market as consumer confidence increases and incomes rise. Many segments of the consumer goods market are positioned to grow rapidly over the medium term, driven by steady growth in personal incomes. As purchasing power among Russia's various consumer segments has increased, a preference for domestically-produced items also has increased. Some foreign manufacturers have sought to become more competitive in the market by building "national" brands out of locally-produced Russian goods that have gained popularity among Russian consumers. Meanwhile, as incomes grow, some consumers have started to turn back to international brands, while keeping intact their positive attitude towards local brands.

Consumer spending increased 22.4 percent above its 2002 value and it is expected to continue to increase. Real income grew by 14.5 percent in 2003, compared with 10.1 percent in 2002. Real disposable income growth accelerated to a record 20.2 percent in the year to December.

◆Technology

Russia has a large talent pool of internationally-recognized scientists and engineers. Some 50 percent of the country's higher education students concentrate on science, mathematics and engineering, a higher percentage than in any country in the world. Russia's scientific and technological talent pool is a relatively untapped commercial asset in such rapidly-evolving fields as optical and laser technology, software, coatings and materials.

The Russian IT sector grew 23 percent to US\$6 billion in 2003, and is expected to grow to US\$10 billion by 2007. The market is expected to maintain a growth rate in excess of 20 percent per annum through 2005.

The growth is fueled by the need of large Russian industrial companies to enhance productivity using IT; by the emergence of rapidly-growing medium-size companies that rely on IT systems to manage growth; by an increasing number of foreign companies establishing operations in Russia and utilizing IT heavily; and by various levels of the Russian government which are retrofitting their processes with electronic solutions. The Russian government has launched a massive IT spending program, "Electronic Russia 2000-2010," that is expected to generate a total of over US\$2 billion in IT contracts. The program is aimed at eliminating the gap in IT use between Russia and more developed countries in an effort to increase transparency as well as productivity in Russian companies and state institutions.

The Russian IT market is strategically important for global technology players because of the significant growth potential it represents. Several global technology providers, such as Intel, Cisco, Microsoft, and Hewlett Packard, have undertaken extensive marketing efforts to grow the IT market in Russia and to capture market share.

◆Media

Some 300 million Russian speakers (about half of whom reside outside of Russia) constitute the fourth largest language group worldwide. As of 2003, 58.6 million Russian households (98.6 percent of general public) are equipped with TV sets. Russia is the largest television market in Europe by

number of TV households and has one of the highest TV usage rates in the world (over three hours a day on average). At the same time, pay-TV penetration is only 9.2 percent compared to 50 percent in Hungary and 29 percent in Poland. Broadcast media is still dominated by the state, but the private sector is growing fast, both in distribution of content and, in particular, in the development of original Russian programming. Five private broadcasters—NTV, STS, REN TV, TNT and TV3—now claim 36.2 percent of the national audience.

TV advertising, which commands some 47 percent of the total advertising market, has been growing at over 51 percent compound annual growth rate ("CAGR") from 2001 to 2004, having more than tripled to reach US\$1.4 billion in 2004. Still, in absolute terms, per capita TV advertising expenditures in Russia remain low at US\$9 compared to the Eastern European average of US\$17 and Western European of US\$47.

Consumer spending on movies grew 70 percent per annum during 2002-2003 to reach US\$190 million in 2003, up from US\$18 million in 1999. Nevertheless, per capita spending is US\$1.4 in Russia as compared to the US\$20-30 range in Western Europe and US\$35 in the U.S.

The Russian video games market is growing due to increasing personal computer and console sales. The market was approximately US\$120 million in 2003 and is expected to reach US\$200 million in 2005. The average game price is increasing, but it is still at a level of about US\$4 per licensed copy in comparison to the US\$20-60 range in the U.S. and the EU.

The magazine publishing market in Russia grew at 46 percent CAGR in 2001-2003 to reach US\$300 million in 2003. Deal activity in this area has

intensified recently, notably the acquisition by the Swiss group, Edipresse, of 52 percent of Kon-Liga Press (three Russian titles); the launch of Russian editions of National Geographic, Forbes and Glamour; the purchase of a 35 percent stake in the leading glossy magazines publisher, Independent Media, by Prof-Media group, which is controlled by Interros, a local pool of capital; and the buy-out by Hachette Filipacchi of a controlling stake in its Russian joint venture HFS.

◆Telecommunications

Russia's telecommunications infrastructure is positioned for significant growth as economic prosperity extends out of Moscow and St. Petersburg and into the regions. The Russian telecommunications market grew rapidly in 2003 and is expected to continue at a healthy rate for the foreseeable future. Growth is driven by Russia's continuing strong economic performance and by the need to upgrade the inadequate telecommunications infrastructure. According to Russian Minister of Communications Leonid Reiman, in 2003 investment in the telecom sector reached US\$2.8 billion, a 40 percent increase over 2002. For 2003, the Russian market for telecommunications services was US\$6.6 billion, more than 24 percent growth over 2002, while the number of cellular and Internet subscribers doubled. The voice-over-IP service volume increased by 2.8 times in 2003, reaching 1.95 billion minutes, or 10 percent of all voice telephony. The estimated annual growth for the period 2002-2004 is 15 percent, which could result in a telecommunications services market of around US\$10 billion annually by 2005.

Over the past decade, private providers have entered the market with newer, better and cheaper technologies, including:

- The provision of high-quality domestic, long-distance, and international telecom services by private sector fixed-line operators;
- The arrival of mobile network operators as the delivery mechanism of choice for voice and Internet services as subscriber rates grow exponentially; and
- The expectation that wireless and convergent technologies will offer cost-effective solutions to Russia's massive telecommunications deficit. As a result, investment opportunities are emerging at a rapid pace, most notably in the many cities with populations of one million or more.

Key Market Factors for Investors

A number of factors point to a significant near-term opportunity in the financial services, consumer goods, and technology, media and telecommunications sectors, among others, of the emerging Russian market economy. These include the following:

- An expanding consumer market with a strong and growing demand for goods and services;
- A literate and technically-skilled labor force;
- Scarcity of institutional investment capital;
- Attractive valuations; and

- Increasing opportunities for exit, particularly through trade sales to both domestic and international strategic investors.

Equity Capital Market

From the public securities market standpoint, the second tier of companies is continuing to outperform the blue chips by a wide margin. Several new funds are being established in Moscow, most of them focused on the mid caps. Because of limited supply of the better second-tier assets, pricing is very competitive.

2003 and 2004 produced several landmark deals in Russia generally. In 2003, BP acquired a 50 percent stake in Tuymen Oil Company for US\$3 billion in cash and stock, making it the most significant transaction in post-1998 Russia. Templeton Fund invested in a leading retail chain, Perekryostok, which in turn, acquired SPA Middle Volga from TUSRIF in 2004. Glencore committed US\$100 million to acquisitions in the Russian agriculture sector. And towards the end of 2004, GE Capital International Finance bought DeltaBank from TUSRIF and other co-investors for approximately US\$100 million. Such deals attest to substantial improvements in market attractiveness and liquidity.

WTO Perspective

WTO is a mixed blessing from a Russian standpoint. The potential benefits may be limited, while the costs may be significant. Russia is mainly now an exporter of raw materials, including hydrocarbons, metals, weapons, chemicals and capital goods, so the impact of tariffs on such exportation is limited. Oil prices are high, inviting further import duties. Military

hardware is sold only to governments. Third-world buyers of Russian capital goods generally have no domestic machinery industry to protect, except for chemicals that are subject to tariffs. The Europeans seek to force up domestic gas prices, thereby eliminating Russia's competitive advantage. Russian steel manufacturers are penalized by European and U.S. tariffs, and no relief would be expected under WTO. These markets are protected by a wide variety of "anti-dumping" and other tariffs so it is very doubtful that Russian steel exports would thus be allowed to rise substantially. The Europeans are not inclined to end agricultural subsidies, or to drop anti-dumping tariffs, or to cease protection of inefficient steel mills. That leaves consumer goods for Russia. But it seems unlikely that Russia will develop into a significant exporter in this area any time in the foreseeable future. Nor is the Russian financial services industry, in its nascent state, likely to challenge either the Europeans or the Americans on their own turf. In the debit column, though, there are some significant trade effects. Whole segments of the Russian economy, such as banking, telecommunications, insurance, and automobiles, could be threatened or destroyed. This might bring immediate advantages to Russian consumers, but it also would reinforce the position of Russia as a wholly commodity-dependent economy, arresting development of a diversified economy, which is in the longer-term interest of the country. European manufacturers are unlikely to set up export-oriented industries in Russia as long as wages remain low in the accession countries. Indeed, it seems most likely that they would supply the Russian market from their Eastern European plants.

Similarly, the main effect of more rigorous enforcement of intellectual property rights relating to copyrights and trademarks would be an outflow of large sums per year to Western software and movie companies. The

fact is that, despite rampant piracy, Russian film and music are enjoying a major renaissance. Whether WTO trade tribunals would bring fairness in the process for Russian producers is open to debate. Nevertheless, an equally great failure is the current liberal orthodoxy which holds that countries must encourage the flow of economic activity to wherever the comparative advantages are to be found, regardless of the consequences for domestic economic activity. This view ignores the need for countries to maintain at least some industrial base and to diversify their economies.

The Russian government is now successfully applying a growth strategy to the automobile industry. Russian cars, which clearly are two to three generations behind current international engineering standards, should be made extinct. But the Russian automotive industry definitely should not be. To do so would be to destroy a million industrial jobs, rendering Russia all the more dependent upon the Saudi oil-based model of development. Instead, by reducing tariffs on automobile parts while maintaining high taxation of new car imports, the government has sparked the establishment of several joint ventures with foreign automobile manufacturers, Renault, Toyota, and GM among them, all of which are building domestic plants. Russians will soon have a taste of both worlds: safe, clean and reliable automobiles, without sacrificing their industry.

Of course there are negatives. For businesspeople and financiers, high returns do not occur in a perfect environment. This environment is not perfect, but it is in the process of defining itself, not unlike the days of the American Revolution or of other countries during their infancies.

In our view, Mr. Putin has a job no one should want. He faces an extraordinarily challenging set of circumstances. And the primary issue is confidence, confidence of the Russian people in their growing institutions.

There is an abiding fear among Russians that all will be stolen. Yukos was a prime example, where bribing people on an unprecedented scale, including in the West, was about to work. The Russian population, by-and-large, supported efforts to stop that.

There is an underlying and basic distrust of government, which Mr. Putin must overcome. The weakness of the banking system is serious, and is being addressed, though slowly. It is needed to fill the long-term infrastructure needs of the economy, as well as those of the consumer. The court system is chaotic, but improving. Some 70% of the individual and corporate disputes on taxes currently are being won against the state, Yukos notwithstanding.

So, progress is being made in Russia. The magnitude of the challenge Russians face is hard for most Americans to understand, for the Russian people must write a whole new script for themselves. At TUSRIF, we seek with them to write entrepreneurship into this national script, as a key driver of economic democracy and growth. With support, it will work.

* * *

I have attached to this written statement a chart to which I will refer in my oral testimony which assists in an understanding of the organizations I am privileged to manage.