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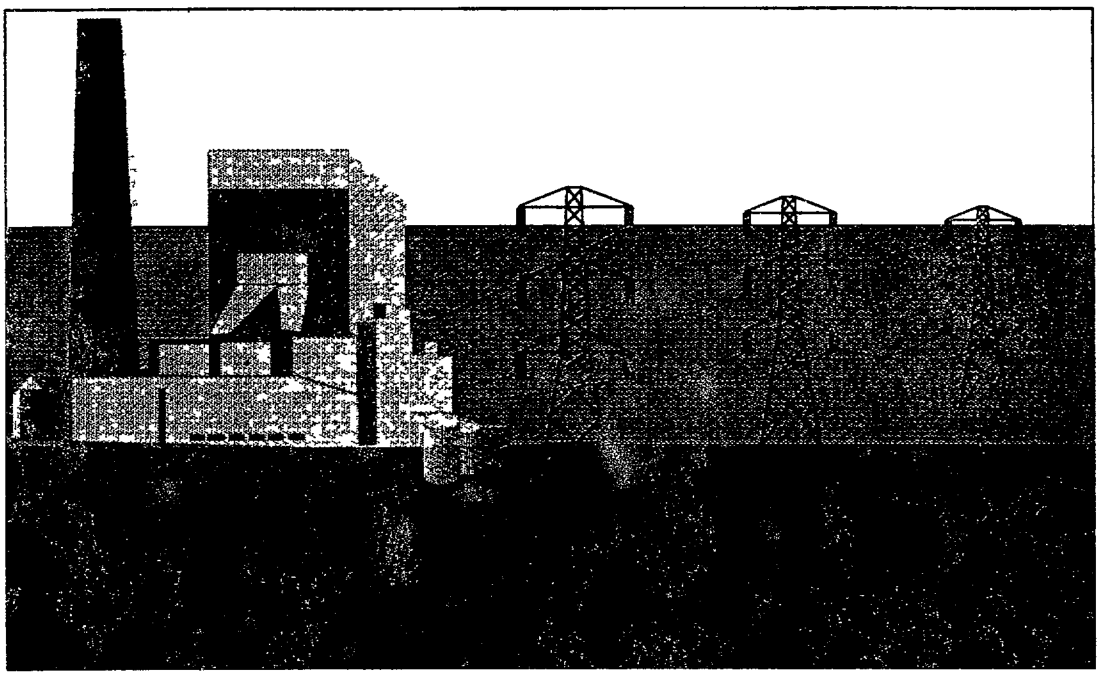
Russian Joint -Stock Company for Energy and Electrification (RAO EES Rossyi)



Financial Management & Corporate Governance

Under sub-contract with
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January 1995

Price Waterhouse

Agenda for
Seminar on Financial Management
and Shareholder Relations Issues
24-25 January 1995

Tuesday, 24 January 1995

Time	Subject	Presenter
09 30	Opening Remarks	Baranovski
10 00	Opening Remarks Introduction to Shareholder Relations	Redko, RAO EES Rossii, Head of Department PW Corporate Governance Group
10 30	I Corporate Governance in a Changing Market Environment 1) The Joint Stock Company and its Environment in a Market Economy - Competitive Environment - Regulatory Environment 2) Stakeholders Conflicts and Common Interests - Organizing Shareholder Relations	Flynn, Price Waterhouse, Manager
11 30	Coffee	
12 00	II Decision Making Structures in the Company 1) Joint Stock Company Management Organization - Responsibilities of Shareholders Meeting and Boards (Russia) - US and German Models for Managing the Joint Stock Company - Duties of Individual Boards' Members 2) Ways to Increase the Effectiveness of the Board of Directors' Operations	Flynn
13 00	Luncheon	

Time	Subject	Presenter
14 30	Shareholder Communications and Relations 1) Ownership - Recognition - Protection of Shareholder Minorities 2) Voting mechanisms - Voting Procedures - Proxy Process - Cumulative Voting - Shareholder Proposal 3) General Meeting of Shareholders - Agenda - Logistics	Flynn
16 00	Coffee	
16 30	Financial Reporting and Information System 1) Public Disclosure - Annual Report - Prospectus 2) Financial Statements - Overview of Primary Statements 3) Management Information System - Information Needs - System Development	Flynn
17 30	Parent Subsidiary Relations 1) Relations with Subsidiaries 2) Relations with Minority Shareholders of the Subsidiaries 3) Participation of the Dominant Corporation in the Election of the Directors to the Boards of the Dominated Enterprises	Tihaze, Price Waterhouse, Senior Consultant on Legal Issues Rich, Price Waterhouse, Manager
18 30	Adjournment	

Wednesday, 25 January 1995

Time	Subject	Presenter
9 00	Financial Issues Facing RAO EES Rossii and the Joint Stock Companies - Energos	Borisov, RAO EES Rossii, Head of Department
9 30	Increasing the Effectiveness of Asset Management	Melnikova, RAO EES Rossii, Head of Department
10 00	Cash Management - Accounts Receivable - International Experience	Atkinson, Price Waterhouse, Senior Manager
11 00	Coffee	
11 30	Cash and Current Assets Management - International Experience	Bazoev, Price Waterhouse, Senior Manager
12 35	Questions and Answers	(Panel)
13 00	The Importance of Capital Markets to RAO EES Rossii and Regional Energos, Overview of the Capital Markets	Andrienko, Price Waterhouse, Senior Manager
14 00	Luncheon	
15 30	Overview of Sources of Capital and Providing Access to Capital Markets (Bank Credits, Bonds, Stock Capital)	Andrienko, Price Waterhouse, Senior Manager
16 15	Coffee	
16 30	Development of Enterprise Business and Financial Strategy	Price Waterhouse Corporate Governance Group Marc Flynn
17 30	Concluding Remarks and Adjournment	

Corporate Governance and Competitiveness

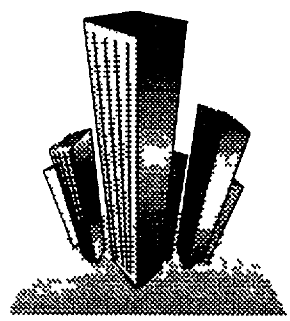
Workshop for RAO EES Rossii

Agenda

- Module 1 Corporate Governance in a Changing Environment
- Module 2 Corporate Structure and Decision Making Mechanisms
- Module 3 Shareholder Relations and Communications
- Module 4 Financial Reporting and Information Systems
- Module 5 Business Strategy

Corporate Governance in a Changing Environment

Module 1



Module 1· Agenda

- The firm and its environment in a market economy
  - Competitive environment
  - Regulatory environment
- Stakeholders Conflicts and common interests
- Role of corporate governance

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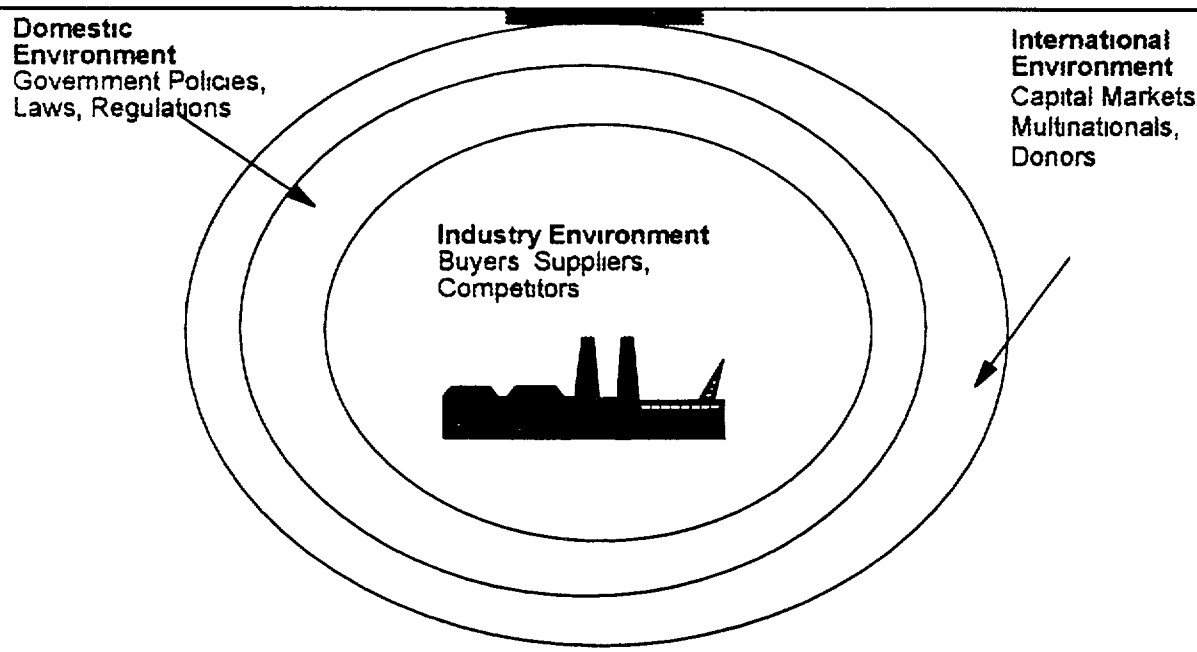
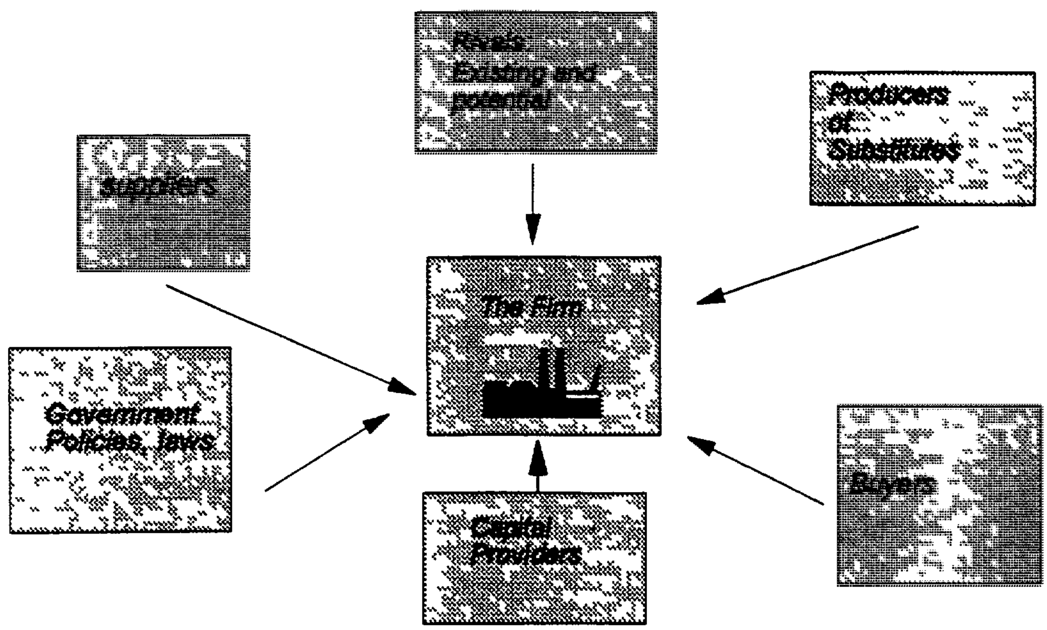
The Firm as an Entity

- A firm is an independent legal person with rights and obligations
- A firm is composed of
  - Management
  - Employees
  - Intangible assets
  - Physical assets
- A firm's value to shareholders derives from how well all assets are employed to generate cash and profits
- Shareholders own the firm and are represented by the Board of Directors
- Directors are legally accountable to <u>all</u> shareholders

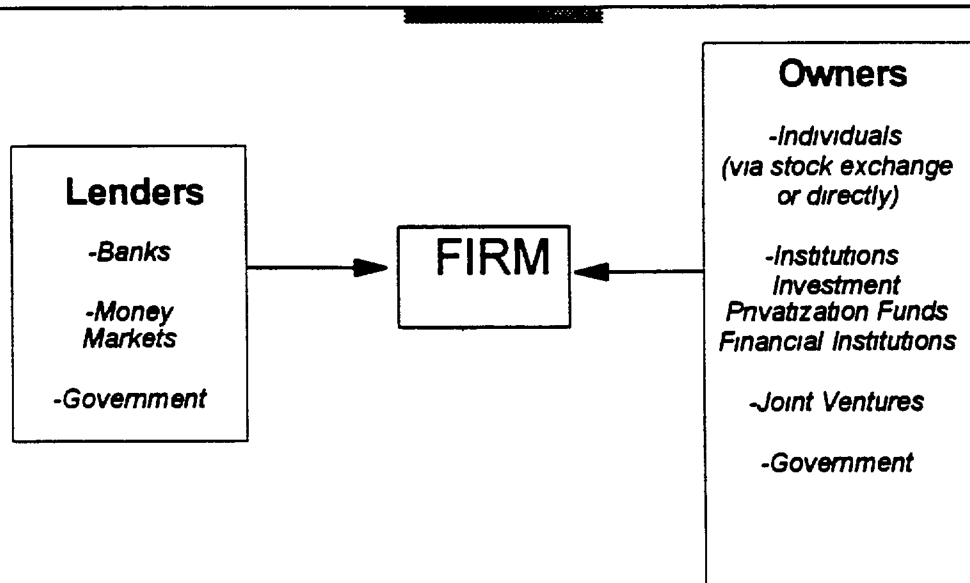
The Firm's Environment



New Competitive Environment



Capital Providers



Regulatory Environment (Russia)

- New legal and regulatory structures in Russia affect relationships between the firm and actors in the environment For example
- Statute on Joint-Stock Companies
- Law on Enterprises and Entrepreneurial Activities
- Law on Securities
- Taxation Laws
- Bankruptcy Law
- Regulation relating to energy sector

Regulatory Bodies (Russia)

- Securities Commission
  - Protects investors and the public
  - Ensures that securities are issued and traded in a fair, orderly and efficient manner
  - Monitors market participants and enforces securities laws
- Ministry of Finance
  - Administers other corporate legal issues such as creation of companies and taxation
- Ministry of Fuel and Energy
  - Sets tariffs and other regulations for energy sector

Types of Stakeholders

- Includes shareholders, who own the firm and other stakeholders who are affected by actions of the firm
- Shareholders
  - State
  - Employees
  - Management
  - Investment Privatization Funds
  - Individuals
- Other stakeholders
  - Community
  - Potential investors
  - Banks
  - Buyers/Suppliers

Employee Shareholders

- Priorities
  - job security
  - salary increases
  - keep social benefits
  - dividends
  - increased size and reputation of firm

Management

- Priorities
  - job security and remuneration
  - increase reputation and size of firm
  - new technology
  - responsibility towards employees/community
  - financial performance of firm
  - dividends

Investment Privatization Funds & Outside Investors

- Investment Privatization Funds
  - Priorities
    - Increase share value
    - dividends (cash flow for operations)
    - influence on the firm to make required changes
- Individual investors
  - Priorities
    - dividends
    - increase share value

Government

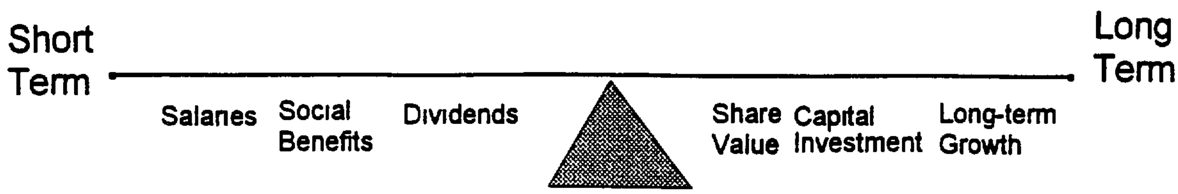
- Public access to sufficient energy
- Stability
- Employment/Social benefits
- Taxes
- Environmental issues

Shareholder Objectives Common Objectives and Possible Conflicts

Priorities

	Salaries	Social Benefits	Dividend	Long-term	Control
Employees	High	High	Med	High	Low
Managers	Med	Med	Med	High	High
VIFs	Low	Low	High	Med	High
Other Outside	Low	Low	High	Med	Low
Government	Med	Med	Low	High	High

Shareholder Objectives A Continuum of Interests



Common Frustrations

- New environment
- Uncertainty of future
- Changing laws and regulations
- Lack of information to make decisions
- Lack of experience
  - competitive market
  - procedures of corporate governance

Common Goals

- Viable long-term enterprise resulting in profits and employment
- Increase in share value and dividends
- Access to outside capital and technology
- All shareholders are sources of additional capital for firm
- Reduction of corporate taxes

Achievement of Common Goals through

- Communication between shareholders and management
- Accountability of management
- Transparency of process
- Manage shareholder expectations
- Provide information

Corporate Governance - Why ?

A tool for achievement of common objectives

- Adoption of sound corporate governance practices helps ensure efficient running of an enterprise and enhances value to shareholders while protecting rights of all stakeholders

Corporate Governance - What ?

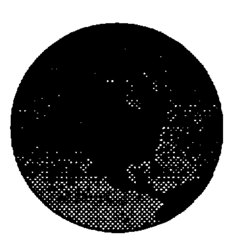
- Defines
  - Rights of shareholders on the firm
  - Relationship between shareholders and their representatives (Board of Directors)
  - Roles and responsibilities of Board members and management (as Boards and individually)
  - Structure of the organization
  - Responsibility of the firm towards other stakeholders
  - Procedures and guidelines

The Russian Corporate Governance Model

- Based on the Statute on Joint-Stock Companies [reg 601]
- Statutory Bodies
  - General Meeting of Shareholders
  - Board of Directors
  - Management Board
  - Audit Commission

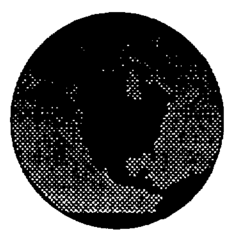
Different Approaches to Corporate Governance around the World

- But all companies in a market economy share basic characteristics
  - General Meeting--a mechanism for guaranteeing shareholder participation in corporate decision-making
  - Management structure responsible to General Meeting
  - Shareholder right to sue or seek redress



Different Approaches to Corporate Governance around the World

- Globalization of trade and capital are leading to convergence of governance practices
  - Increased disclosure
  - Increased protection of minority shareholder rights (voting mechanisms)
  - Increased transparency

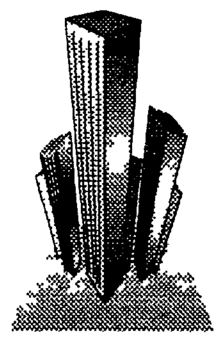


Corporate Governance: Summary

- Corporate governance is a process which enhances the competitiveness of the firm while balancing the needs of the shareholders with those of other stakeholders

Decision-Making Mechanisms in the Company

Module 2



Module 2 Agenda

- Corporate Governance structure
  - Roles and responsibilities of shareholders and boards (Russia)
  - US and German models
  - Duties of individual Board members
- Effective board operations and decision-making

International Corporate Governance Models - An Overview

- Why ?
  - Russian laws and regulations are adapted from these models
  - Adapt lessons-learned from other systems to Russian reality
  - Foreign investors expect Russian firms to follow internationally accepted corporate governance principles

Shareholders - Common International Standards

- Ultimate authority in the firm
- Economic interest is realized through dividends and/or increase in share value
- Exercise authority through voting at General Meeting, electing representatives to the Boards, and voting on major issues

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Generally Accepted Shareholder Rights

- Right to vote at shareholder meetings
- Right to sell or transfer shares without approval or unreasonable costs/procedures
- Right to dividends
- Right to information concerning enterprise
- Right to fair and equal treatment of shares of same class
- Right to enforce loyalty and adherence to the company charter by their representatives (directors and managers)
- Liability limited to initial investment

Exclusive Role of Shareholders (Russia)

- Elect, dismiss and set compensation of Board of Directors
- Approval of changes to charter and charter capital
- Approval of proposed merger
- Approval of proposed sale or disposal of significant part of assets which could change nature of the business
- Election of audit commission
- Approval of liquidation of the firm

Audit Commission

- **Definition:**
  - *Represents interest of shareholders and oversees auditing activity of the firm*
- **Composition**
  - *Elected from shareholders*
  - *Cannot be an executive director*
- **Role**
  - *Effectuates audit at its own initiative or upon demand of shareholders possessing more than 10% of stock in aggregate*
  - *Right to demand from society officials all necessary documents and explanations*
  - *If no independent auditors, it is responsible for drawing up opinion on annual reports and balance sheet*
  - *Must convene extraordinary meeting if detects serious threat to firm*

Shareholders What they Should Not Do

- Due to lack of information and knowledge it is preferable that they do not get involved in
  - day-to-day operations
  - specifics of long term business plans
  - selection of management
  - buying and selling of assets in normal course of business

Structure of Corporate Governance in Market Economies

- A modern corporation requires that two very distinct functions be fulfilled

Managing and Directing

Roles of Management and Directors

	Directors	Management
Responsible for	Approving long-term strategy Approving financing Approving Major investments Ensuring that management is operating within *the Articles of Incorporation* *Goals set out by General Meeting of Shareholders* *Legal framework* Ensuring accuracy of the financial statements	Developing long-term strategy Planning financial requirements Managing firm operations on a day-to-day basis Ensuring accuracy of the financial statements

Role of Directors/Managers

- The role of Directors should be dynamic
  - As the environment changes, and as the firm acts to change its environment, corporate survival and growth will depend on the extent to which the firm can use the special talents and skills from management and its directors
- But the one unchanging and basic goal and function of Directors/Managers is to ***Enhance Shareholder Value***

Determinants of Corporate Governance

Attitudes & Politics

↓

Financial Organizations & Markets

↓

Corporate Ownership Structure

General Comparison: US and European Models

- US
  - One-tier system
  - Wide dispersion of shareholder power encouraged by anti-trust legislation
  - Management Use of Proxy Vote for Control
  - Greater use of courts to test and settle shareholder disputes
- Europe
  - Mix of tiers
  - Interlocking directorates and concentration of shareholder power
  - Proxies used by large shareholders to control voting blocks
  - Less litigation and more reliance on "backroom" consensus"

German Model - Lessons learned

- Pros
  - Longer-term outlook and investment planning
  - Stability
  - Strong information handling and decision-making systems
- Cons
  - Discourages new ideas and limits entrepreneurial leadership
  - Slower adaptation to changing competitive environment
  - Risks of conflict of interest (banks as lenders and representative of shareholders)

US Model - Lessons Learned

- Pros
  - Ease of exit, if shareholder unsatisfied with performance
  - Able to adapt quickly
  - Threat of takeover has accelerated needed restructuring
- Cons
  - Directors/Management tend to be short-term oriented (influenced by stock market and short-term contracts with firm)
  - Removal of management in under-performing firms has been slow due to management dominated boards

US Board Structure - Outside vs Inside Directors

- Good corporate governance suggests that a majority of Board members should be "independent" outside directors so that Board may objectively oversee performance of management
- Additional advantage of outside directors is to acquire expertise and increase contacts
- Recent trend is moving towards a majority of outside directors on the Board
- Recent debate on the "independence" of outside directors For example, the nomination of the firm's consultants and lawyers to the Boards

Checks and Balances on Management Performance Role of Financial Markets

- Markets discount share value of poorly managed and poorly performing companies
  - Markets judge company performance together with industry performance and overall economy
- Opportunity cost and risk
  - Global competition and ease of capital flows discipline inefficient management
  - Institutional and strategic investors have many more options today

The Russian Corporate Governance Model

- Based on the Statute on Joint-Stock Companies [reg 601]
- Statutory Bodies
  - General Meeting of Shareholders
  - Board of Directors
  - Management Board
  - Audit Commission

Charter

- Includes
  - Definition of general scope of business activities
  - Authority of and procedures for holding General Meetings
  - Board of directors and management board Number of members, definition of powers, and decision-making mechanisms
  - Principles of distribution of profits
  - Procedure for modifying capital stock
  - Procedure for amending charter

Statutory Role of the Board of Directors

- Ultimate authority between shareholder meetings (within powers specified in charter)
- Appoints and dismisses General Director and members of Management Board
- Oversee activities of management
- Determines compensation of Senior Management

Role of the Board of Directors

- Provide advice to company management
- Ensure that company procedures comply with laws and regulations
- Attempt to balance employee/social factors with interest of shareholders
- Conduct General Meeting
- Not be involved in the day-to-day management

Board of Directors - Composition

- Determined by charter, but minimum specified by regulations and should be an odd number
- Individuals, elected for a fixed term, but can be replaced at anytime by shareholders, at a General Meeting

Outside vs Inside Directors

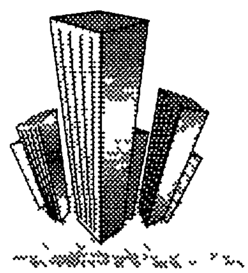
- Good corporate governance suggests that a majority of Board members should be outside directors so that board may objectively oversee performance of management
- Additional advantage of outside directors is to get expertise and contacts

Management Board - Role

- Primary executive body of the firm
- Conducts day-to-day operations of the firm (within guidelines set by the charter and the Board of Directors)

Shareholder Communications and Relations

Module 3



Module 3 Agenda

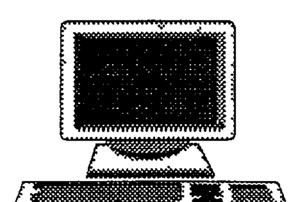
- Ownership
  - Recognition
  - Protection of minority shareholders
- Voting mechanisms
  - Voting procedures
  - Proxy process
  - Cumulative voting
  - Shareholder proposals
- General Meeting
  - Agenda
  - Logistics

Recognition of Ownership

- Recognition of ownership is essential in order for shareholders to exercise their rights to dividends, to voting at General Meetings, and to selling their shares
- Methods
  - Stock certificates (Named or bearer)
  - Shareholder registry
  - Beneficial vs nominal owner

Shareholders' Registry

- What is it?
  - A reference of all transactions and the identities of shareholders
  - Should include
    - shareholder's name and place of residence
    - number and class of shares
    - date of acquisition



Shareholders' Registry

- Why maintain it?
  - Legal requirement for all publicly-held companies
  - Increases transparency, improves shareholder & investor relations
  - Only official record of share ownership, without being registered, shareholders cannot vote or receive dividends
  - Management is required to maintain accurate records and register transactions on a timely manner
  - Registry should be accessible to all shareholders for proper corporate use

Shareholder Registry - Use of Independent Outside Agent

Russian companies with more than 1000 shareholders must use an independent outside share registrar

- Advantages
  - Increased transparency increases confidence of potential investors
  - Specialized agency has more expertise and computer capabilities to provide efficient service
- Disadvantages
  - Management remains responsible if agent is not competent
  - Loss of control
  - Cost

Establishing Voting Procedures

- To make the voting process proceed smoothly, and to ensure transparency, firms must adopt policies with regard to
  - Board nominations
  - Shareholder proposals
  - Recognition of ownership and setting a record date
  - Recognition of power of attorneys/proxys
  - Confidentiality of voting
  - Neutrality of voting inspectors

Shares - Legal status

- Authorized shares
  - Number of shares that can be issued by firm, according to charter
- Issued shares
  - Number of shares that have been sold to the public
- Outstanding shares
  - Number of shares issued minus shares repurchased by the firm
  - Only outstanding shares have voting rights and receive dividends
- Treasury shares
  - Repurchased by the firm from the public
  - Do not have rights to vote or dividend

Protection of Minority Shareholders

- Directors have a fiduciary responsibility to *all* shareholders
- Super majority voting on key issues (66%, 75%)
- Cumulative voting (i e Proportional representation on Board of Directors)
- Quorum Requirements
- Preemptive rights on new share issues (Offer new issues proportionally to existing owners)
- Increase efficiency of secondary market (ease of exit)

Proxy Process - US Experience

Goal Firm must facilitate the voting process in order to give shareholders their voice in corporate governance and attain a quorum

The firm includes with the Notification of the General Meeting

- Proxy Statement, including
  - Board Proposals
  - Shareholder Proposals
- Proxy Card
  - allowing the shareholder, who cannot attend General Meeting, to vote or transfer voting power on one or all issues to a designee

Elements of a Proxy Statement - US Example

- Explanation of voting procedures, both for proxy and in-person
- Information on board nominees, including
  - Background, professional affiliations
  - Compensation and share holdings
- Information on other Board initiatives
- Shareholders' Proposals
  - Shareholders' statement of support
  - Board's response

Proxy Card - US Example

- Based on information in the proxy statement, shareholders can vote on specific issues or empower a designee to vote on their behalf
- The designee is empowered to vote on the shareholder's behalf only on that particular occasion
- Shareholders can limit their proxy's voting power to particular issues
- Shareholders can cancel a proxy at any time

Qualifying Shareholder Proposals - US Experience

- Not all shareholder proposals should be included in a proxy statement and be voted on at a General Meeting Examples of common criteria include the following
  - The proposal can be initiated by a shareholder controlling a significant number of shares (ie Russia 10%)
  - The proposal must be concerned with matters of corporate policy, not operational matters
  - The proposal must not interfere with the board's discretionary authority previously granted by the shareholders
  - Proposal must be sent to Board in advance (45-90 days) of the mailing of notification of the General Meeting

Proxy Process - Russia

- Requires notarized power of attorney
  - Entails cost and time
- Legality and practicality of US-type proxy system

General Meeting

- Required by Joint-stock Company Act and must be held once a year
- Shareholder's primary vehicle for exercising their rights
- Board must ensure transparency, clear procedures and equal treatment of shareholders
- General Meeting requires substantial planning

Logistical Preparations for a General Meeting

- In preparing for a General Meeting, provisions must be made for the following
  - Prepare notification and agenda
  - Prepare voting procedures
  - Meeting room facilities, registration procedures and security,
  - Food or other amenities to be provided to attendees
  - Any organization of company tours or product displays which will complement the meeting
  - Press coverage or public relations

Notification of General Meeting

Goal To provide notification of the General Meeting, in a timely and effective manner to all shareholders

- Includes
  - Date, time and place of meeting
  - Meeting Agenda (Items to be voted upon)
- Method
  - Issued a minimum of 30 days prior to meeting
  - Sent by mail or via newspaper advertisements, according to charter

Notification of Shareholders- Record Date

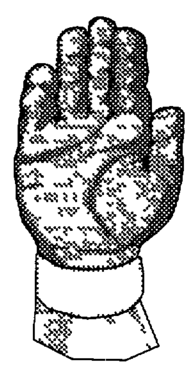
- All shareholders listed on the shareholder registry on the record date must be notified of the General Meeting
- Record date is the date set by the firm which determines which shareholders are entitled to vote at the General Meeting
- Record date should between 30 and 60 days prior to meeting

Meeting Program

- Prepared by Board of Directors and includes
  - Election of Meeting chairman, minutes clerks, and voting inspectors
  - Opening remarks by Chairman
  - Chairman's Report
  - Audit Commission report
  - Voting by shareholders
  - Questions and comments from shareholders

Questions and Comments from the Floor

- Shareholders may want to question directors about
  - financial soundness of the firm
  - plans to restructure
  - potential investors
  - social benefits
  - shareholder dividends

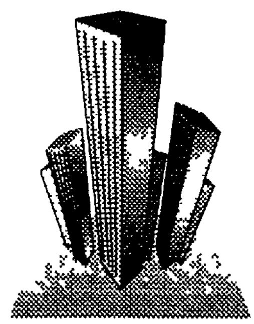


Module 3 Summary

- Growth of the firm depends on access to capital
- Access to equity capital depends on existing shareholders' and potential new investors' confidence in the structure and procedures within the firm which would enable them to make changes when required to protect their investment

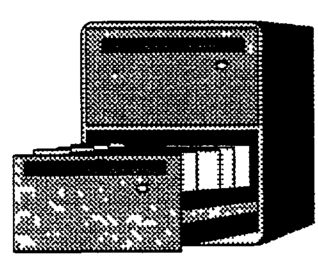
Financial Reporting and Information Systems

Module 4



Module 4 Agenda

- Public disclosure
  - Annual report
  - Prospectus
- Financial statements
  - Accounting principles
  - Overview of primary statements
- Management Information Systems
  - Information needs
  - System development



Public Disclosure: Goal

- To provide all shareholders, the public and the regulatory bodies equal access to fair and accurate general and financial information on the activities of the firm on a regular basis

Types of Disclosure

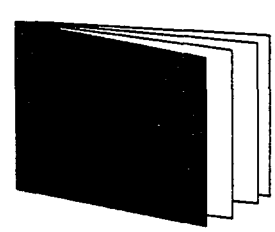
- **Periodic disclosure**
  - **Annual report**
    - **audited financial statements**
- **Special disclosure**
  - **Prospectus**
  - **Extraordinary events**

Public Disclosure - Why ?

- For shareholders and lenders
  - Primary source of information
  - Evaluate management performance
- For potential investors
  - Compare performance relative to other investments
- For state regulators
  - Ensure compliance with regulations
- For the public
  - Full disclosure increases trust in the markets and market reform

Elements of an Annual Report

- Chairman's and/or CEO's (General Director) message to shareholders
- Audited financial statements
- Business unit review
- Information on Board members and management
- General information

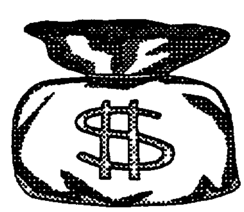


Chairman and General Director's Letters to Shareholders

- Questions to address
  - How well did the firm meet its financial and strategic performance goals?
  - What drove firm performance, and what detracted most from it?
  - What is the overall strategy for the immediate future?

Financial Information

- **Includes**
  - **Balance Sheet**
  - **Profit and Loss Statement**
  - **Cash Flow Statement**
  - **Notes to statements**
  - **Auditor's report**
  - **Summary of accounting policy**



- **Management should comment on**
  - **Significant changes in financial results from past years.**
  - **Provide information of new public offerings**
  - **Future events which may materially affect financial situation of the firm.**

Business Unit Review

- Provide a synopsis of financial and strategic performance for each business unit Include comparisons over past few years and forecasts for
  - sales
  - profits
  - capital investments
- Note reasons for any significant restructuring and management changes

Information on Board Members and Senior Management

- Include
  - Names, titles, and principal affiliation of board members
  - Members of Board committees
  - Names and responsibilities of senior management

General Information

- Include
  - Headquarters address and phone
  - Shareholder contact for additional information
  - Name and address of independent auditors

Methods of Disclosure

Goal Adequate and equal access to relevant information by shareholders and the public

- Direct mailings to shareholders
  - Costly
  - Financial statements not understood
- Publication
  - Inform shareholders of access to information
  - Mail upon request

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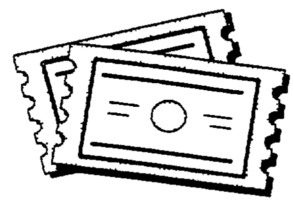
Special Disclosure - Prospectus

- Prior to issuing new shares or bonds, a firm must provide adequate information for individuals to make buying decision
- Prospectus must be approved by Ministry of Finance



Elements of a Prospectus

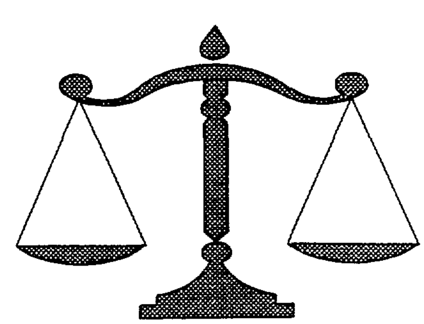
- **Basic information**
  - Information on primary shareholders
  - Board of Directors members and senior management
- **Financial information**
  - Present and past audited statements
  - Information on loans and bonds
- **Business activities**
  - Competitive situation (i e Market share)
  - Past capital investments
  - Overall business strategy
  - Planned investments
- **Information on security issue**
  - Type of security (share, bond)
  - Date of issue
  - Distribution

Special Disclosure - Extraordinary Events

- Goal Inform shareholders, the public and the regulator of major events which could substantially affect the value of the shares or the future of the business such as
  - Bankruptcy proceedings
  - Major lawsuit
  - Significant changes in senior management
  - Takeover attempt

Basic Accounting Principles

- Statements provide a fair and accurate representation of the firm's activities
- Based on recognized International Accounting Standards
- Consistent use over time of accounting principles
- Going concern
- Prudence
- Limit subjective judgment



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Principal Financial Statements

- **Balance sheet**
- **Income statement**
- **Cash flow statement**

- Statements should be accompanied by additional explanations
- Statements must be audited by independent and qualified auditors to ensure use of good accounting principles and procedures
- Principle statements represent past results They **do not** reflect future results

The Balance Sheet

- *The Balance Sheet is a picture of the company's financial situation at a single moment in time*

It is defined as

Total Assets = Total Liabilities + Equity

The income generating resources owned by the firm

The sources of funding that provide the company's assets

Net Worth or Book Value

Balance Sheet

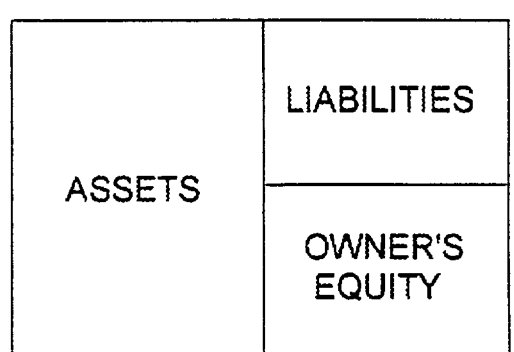
- Analysis of Balance Sheet helps determine
  - Types of assets the company has
  - Liquidity of those assets
  - What part of assets are funded by owners and lenders
  - Type of debts firm must repay
  - How it has changed over time

Balance Sheet Structure

ASSETS
Cash
Accounts Receivable
Inventory
Total Current Assets
Fixed Assets
TOTAL ASSETS

LIABILITIES & EQUITY
LIABILITIES
Accounts Payable
Short-Term Debt
Total Current Liabilities
Long-Term Debt
TOTAL LIABILITIES
SHAREHOLDER'S EQUITY
Paid in Capital
Retained Earnings
TOTAL LIABILITIES & EQUITY

$$\boxed{A = L + OE}$$



Example Balance Sheet
(as of December 31, 1994)

ASSETS		LIABILITIES & EQUITY	
		LIABILITIES	
Cash	25	Accounts Payable	20
Accounts Receivable	30	Short-term Debt	30
Inventories	35		
Total Current Assets	90	Total Current Liabilities	50
		Total Long-term Debt	47
Gross Fixed Assets	115		
Less Accum Depreciation	47		
Net Fixed Assets	68	TOTAL LIABILITIES	97
		SHAREHOLDER S EQUITY	
		Paid in Capital	30
		Retained Earnings	31
		TOTAL EQUITY	61
TOTAL ASSETS	158	TOTAL LIABILITY & EQUITY	158

Balance Sheet Limitations

- Balance sheet has some important limitations
  - Items are listed at <u>historical costs</u> NOT market value
  - Effects of inflation are not accurately reflected
  - Non-quantifiable assets are not reflected
    - strong management
    - established reputation
    - community involvement

Value of shares

- Par value
  - Nominal value, not significant
- Book value
  - Accounting value Assets minus liabilities
  - Not necessarily good indicator of future value
- Market value
  - Present price of shares on secondary market
  - Market prices are based on investor expectations of future profits
  - Price affected by past performance, dividend policy, macroeconomic factors, potential mergers/takeovers
  - Change in market value does not affect financial statements of the firm However can affect cost of issuing new shares in the future

Dividend policy

- **Policy must balance needs of the firm and expectations of shareholders and the market**
- **Needs of the firm**
  - **Cash flow situation**
  - **Capital investments**
  - **Cost of other types of funds**
- **Expectations of shareholders**
  - **Looking for growth in share value or steady income**
  - **Can firm use retained earnings to make future profits**
  - **Looking for consistent dividend policy**
  - **Tax treatment of dividends vs capital gains**

Buying of Shares by Firm

- Purpose
  - Reduce size of firm and number of shareholders
  - Increase leverage (mix of equity and debt)
  - Increase earnings per share in order to increase value of shares
- Method
  - Buy on secondary market
  - Tender offer
- Affect
  - Potential increase in value of shares

Income Statement

- *An income statement measures profits (or losses) over a certain period of time* ***It helps answer:***
  - *Where did revenue come from in past year?*
  - *What expenses were incurred?*
  - *Did the firm make a profit or a loss during the year?*

It is defined as

Net Income = Revenues - Expenses

Income Statement Structure

Revenues
Cost of goods sold
Gross Profit

Operating Expenses
Operating Profit

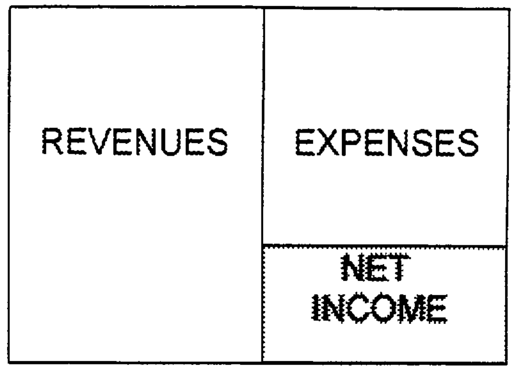
Interest Expense

Income Before Taxes

Corporate Tax

Net Income

$\boxed{R - E = NI}$



Example Income Statement

(January 1- December 31, 1994)

REVENUES	**220**
Materials	54
Direct Labor	44
Depreciation	12
Cost of Goods Sold	110
GROSS PROFIT	**110**
Sales Expenses	30
General & Administrative	30
Subtotal	*60*
OPERATING PROFIT	**50**
Interest Expense	15
PROFIT BEFORE TAX	**35**
Tax (@40%)	14
NET INCOME	**21**

Income Statement Limitations

- Does NOT indicate which products or divisions are generating profit
- Does NOT indicate how much cash was generated
- Does NOT look at how much cash was invested to generate the profit
- Does NOT identify the flow of cash in the business

Cash Flow Statement

Cash Flow =

Net Income + Depreciation - Capital Investment - Δ Working Capital

Working Capital = Current Assets - Current Liabilities

Why Concentrate on Cash Flow?

- Cash Flow provides resources for
  - paying suppliers
  - paying employees
  - making capital expenditures
  - repaying debts

- A company will cease to exist without sufficient cash flow
- Therefore, working capital management is essential

Use of Balance Sheet for Cash Flow Calculation

	1993	1994	Change
ASSETS			
Cash	25	25	0
Accounts Receivable	20	30	10
Inventories	25	35	10
Total Current Assets	70	90	20
Gross Fixed Assets	100	115	15
Less Accumulated Depreciation	35	47	12
Net Fixed Assets	65	68	3
TOTAL ASSETS	135	158	23
LIABILITIES AND EQUITY			
Accounts Payable	15	20	5
Short-term Debt	20	30	10
Total Current Liabilities	35	50	15
Long-term Debt	60	47	(13)
Shareholder's Equity	40	61	21
TOTAL LIABILITIES & EQUITY	135	158	23

Example Statement of Cash Flow
January 1/1994 - December 31/1994

FROM OPERATIONS		
+ Net Income		21
+ Depreciation		12
+ Interest payments (1-t)		9
- Increase in Net Working Capital		(15)
Cash Flow from Operations	27	
FROM INVESTMENT		
+ Sale of Assets		0
- Purchase of New Assets		(15)
Cash Flow from Investment		(15)
FROM FINANCING		
+ Increase in Short-Term Debt		10
+ Increase in Long-Term Debt		(13)
- Interest payments (1-t)		(9)
Cash Flow from Financing		(12)
NET CHANGE IN CASH		0

Ratio Analysis

- Information from financial statements can be used in ratio analysis
- Ratios have many uses
  - *Facilitate determination of company's performance*
  - *Provide focus for management decisions*
  - *Identify areas where improvements are needed*
  - *Provide basis for comparison to other companies and industries*
  - *Inform investors of best investment opportunities*

Ratios. Summary

- A useful tool, but beware
  - Ratios do not explain reason for change
  - Ratios alone do not give an answer
  - Ratios are calculated specifically on the basis of numerical data, without considering factors like economic situation, management strategy etc
  - Management can manipulate ratios
  - Ratios from different companies may not be comparable subject to different accounting systems
  - Ratios are calculated on the basis of book values, which do not always reflect market value

Management Information Systems

- Provide information for
  - Decision making
  - Public disclosure
  - Filing corporate income tax
  - Regulators and government statistics

Decision-making process

- Gathering, selecting and summarizing information
- Analyzing information
- Planning and goal-setting
- Budgeting
- Monitoring performance

Adequate and efficient management information systems are crucial to good decision-making by directors and managers and therefore to the success of the firm

Information Required

- Internal
  - Operational information such as
    - Plant efficiency
    - Billing and collecting efficiency
  - Management accounting such as
    - Sales revenue by region
    - Profitability by division
- External
  - Competitive information such as
    - Cost and capacity of alternative sources of energy

Management Accounting

- Differences with Financial Accounting include
  - No standard format and not regulated
  - Intended to plan future rather than describe the past
  - Less emphasis on precision
  - Focuses on parts as well of the whole of an organization
  - Includes more non-monetary information

It is means to an end, rather than an end in itself

System development Identify Criteria & Characteristics

- What information do you want this new system to provide?
- Characteristics
  - what personnel needs?
  - what technology needs?
  - what information needs?
  - what organizational needs?

Identify Problems with Present System

- Design
  - Past system designed for state planning and control, not decision-making information
  - Considerable amounts of data No selection
- Organizational
  - Information flow top-to-bottom only
- Personnel
  - Lack of understanding of new information requirements and techniques
- Technology/Computerization

Determine Options

- Examine possible systems that will meet your criteria and needs
  - cost/benefit analysis
- Prepare for implementation

Implementation

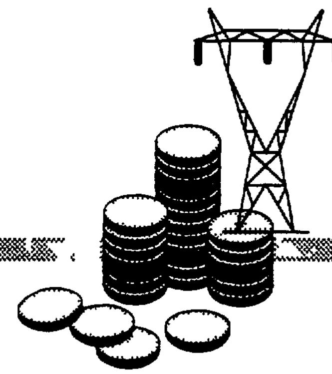
- Define project priorities, risks, and availability of resources
- Address transition issues
  - determine interim organization
  - financial cost, length of transition, organizational disruption
  - short/long-term staffing and equipment needs
  - schedule must be realistic & practical
- Management involvement
  - monitor progress regularly
  - continuously update system to changing needs

Module 4 Summary

- Success of the firm depends on
  - access to capital
  - fulfilling regulatory requirements
  - development of competitive strategy
  - implementation of competitive strategy

The key to success is information

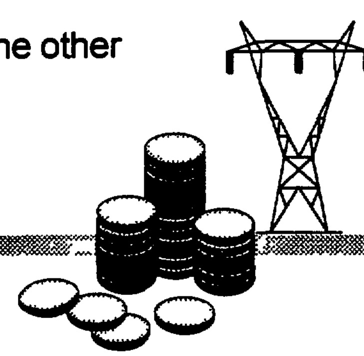
Parent Subsidiary Relations



K.K. Tikhaze

Possible ways for one company to influence another company management

1 Strengthening relations between two independent joint-stock companies via an agreement
2 Organization of a group of several companies to gain a controlling interest in another company
3 One company to possesses the greatest number of shares in the dominated company
4 One of the companies has more than a 50% share of another company's stock
5 One of the companies possesses 100% of the other company's stock



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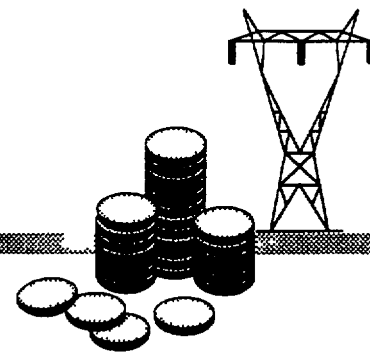
Advantages of the system of parent and subsidiary companies

1) Possibility to reduce transactions cost
2) Possibility for controlling a fully integrated manufacturing process
3) Possibilities for diversification
4) Consolidated financial accounting within the entire system to off-set profitable activities with losses

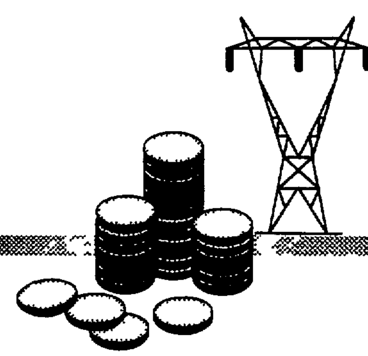


Weakness of the system of parent and subsidiary companies compared to a single large company:

1) Complicated hierarchical system

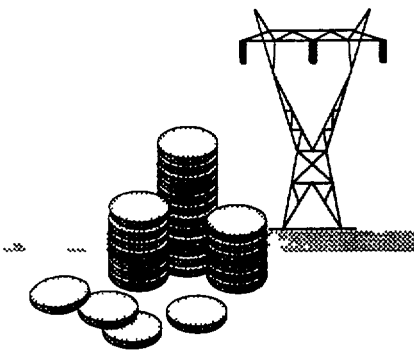
2) Additional expenditures related to organizational procedures at each enterprise reporting, shareholder meetings etc

3) Need to perform financial reviews at each enterprise



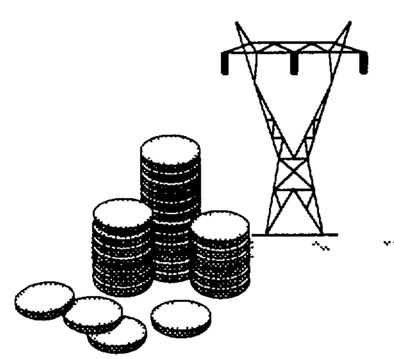
Advantages of the parent-subsidiary system

- The system of parent and subsidiary enterprises reflects the style and the structure in which a large group of enterprises is managed
- the system helps to avoid the extremities of centralization and complete decentralization by allowing an intermediate, neutral variant



Parent companies - Russian experience

- Parent companies that were created in Russia differ from those existing in the West
- In Russia, the public policy goal is to preserve earlier created enterprises within the new system of privatized intercorporate relations



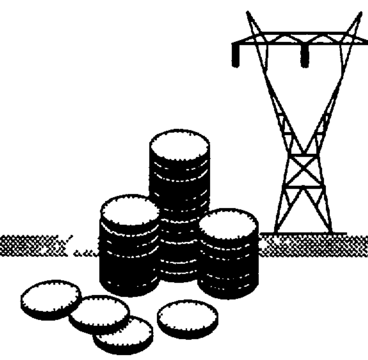
Article 105 of the Russia's Civil Code

A business enterprise shall be considered a subsidiary company under any of the following circumstances

1) the dominating entity owns a controlling share of a dominated company's stock or

2) there is an agreement providing for domination of one by another or

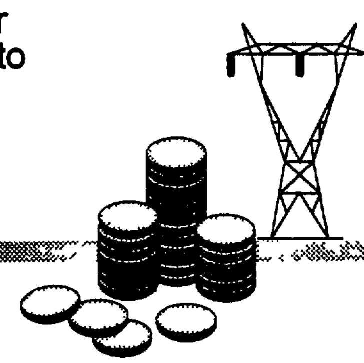
3) if one company has the ability to determine the decisions of another



The Civil Code of Russia
Part One
Rights and Obligations of the Dominated Company

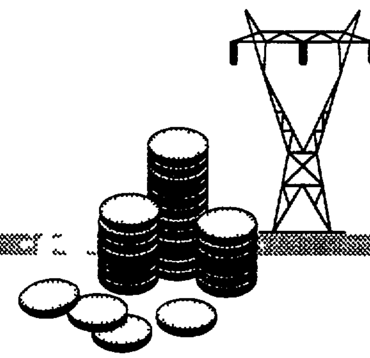
- If the dominating company has the right to enforce the instructions it gives to the subsidiary company, it shall bear a responsibility equal to the responsibility of the subsidiary, with respect to transactions performed by the subsidiary in a bid to fulfill such instructions

- In the event of illiquidity (bankruptcy) of the dominated company by fault of the parent company, the latter shall bear a subsidiary responsibility with respect to its debts



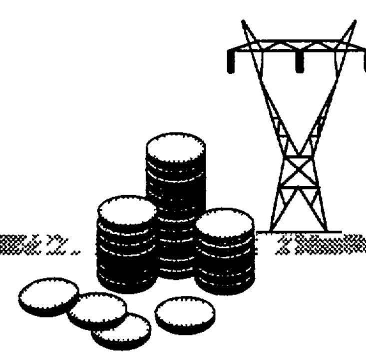
Subsidiary companies' rights and obligations

- Not responsible for the parent company's debts
- Shareholders of the subsidiary company have the right to claim damage caused by the dominant company



German Model

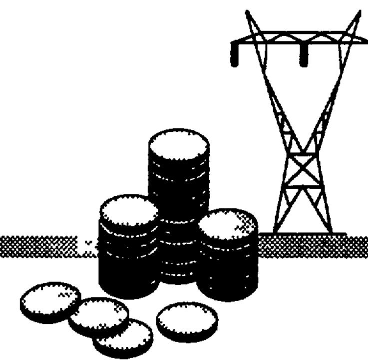
German Law reflects a public policy to provide maximum protection of the rights of a subsidiary's creditors, and to a lesser extent the protection of rights of minority shareholders who are harmed as a result of dependence upon the parent company



German Model

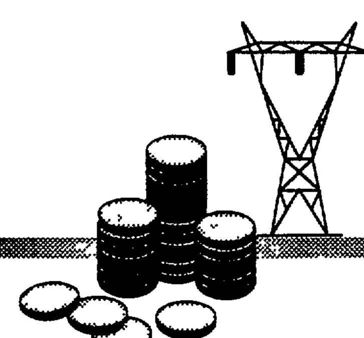
German Law stipulates two possible options for regulating relations between the parent and the subsidiary

- relations regulated directly by the law (in the absence of an agreement)
- relations based on an agreement concluded between the parent and the subsidiary



German Model

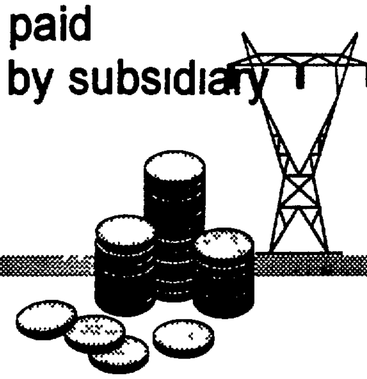
In the absence of an agreement between the parent and the subsidiary, German Law stipulates scrupulous reporting of intercorporate transactions



German Model

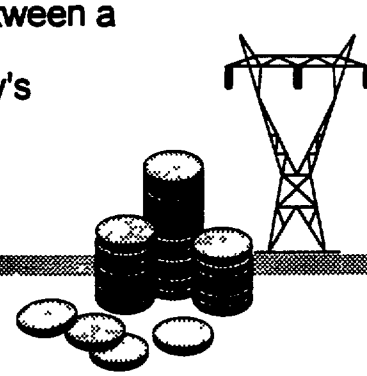
In order to conclude an agreement between the parent and the subsidiary company (a contract of domination), certain terms important to the subsidiary's shareholders must be specified These include.

- minimal amount of dividends to be paid
- terms for the forced sale of shares by subsidiary minority shareholders



Provisions of the German Law that protect minority shareholders of the dominated company

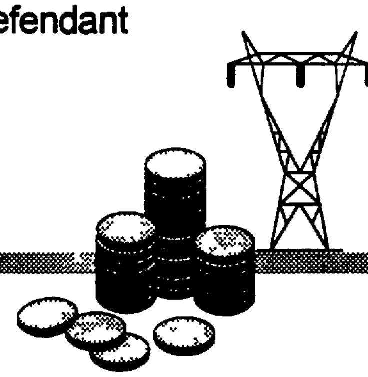
- shareholder suits on behalf of the dominated company against the dominating company
- minority shareholders are given access to courts to assert the unfairness of the purchase price and terms for the forced purchases of their stock shares
- courts have the discretion to appoint independent auditors to assess whether minority shareholders' claims are reasonable
- The conclusion of contractual relationship between a parent and subsidiary companies can be prevented by 25% of the votes of a subsidiary's shareholders



US Model

US Law provides the following mechanisms for protecting the rights of minority shareholder rights

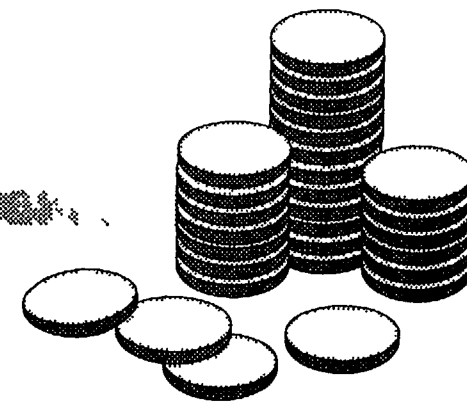
- shareholder derivative suits
- class action suits
- consolidation of cases
- burden shifting to the defendant dominating corporation to prove the fairness of an intercorporate transaction
- attorney's fees paid for by an unsuccessful defendant



Financial Management and Corporate Governance

Strengthening Industry Enterprises' Financial Positions

E.I. Borisov



Strengthening Industry Enterprises' Financial Positions

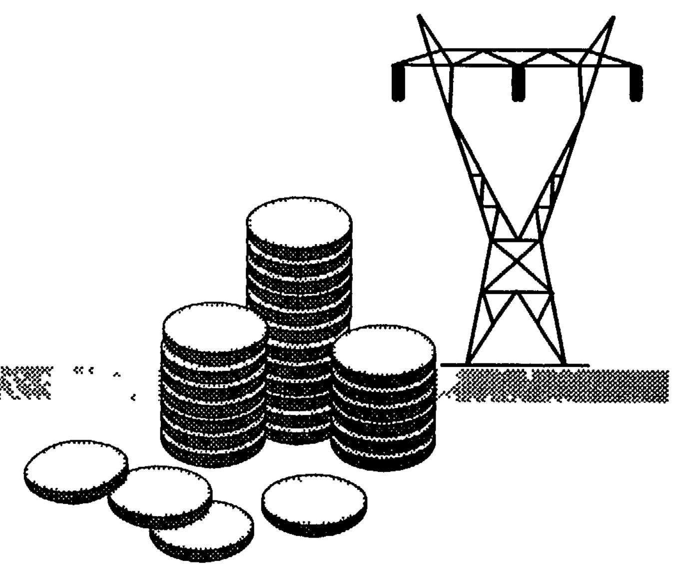
1 The issues related to providing financial basis for operations and the implemented investment program in an non-payments environment determine the major directions for strengthening industry enterprises' financial positions

- Settlement system
  - Cash

    Problems and objectives
  - Loans

    Problems
- Nontraditional methods of settlements
  - Mutual settlements

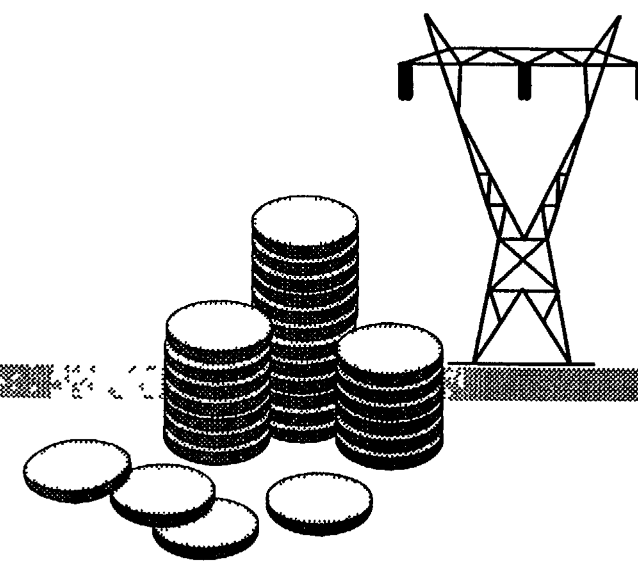
    Weaknesses and Problems
  - Bills
  - Treasury bills



Strengthening Industry Enterprises' Financial Positions

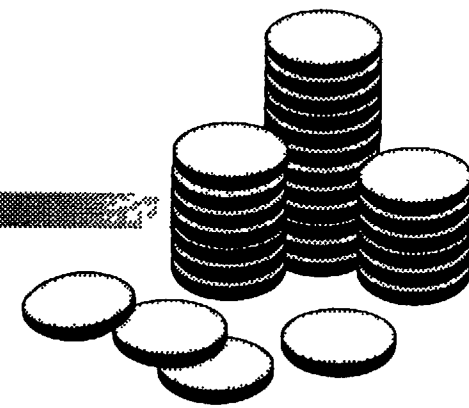
2. Investment Projects Financing
   - Problems and objectives.

3. Research and Scientific Activities Financing
   - Problems and objectives



Financial Management and Corporate Governance

Increasing the Effectiveness of Asset Management



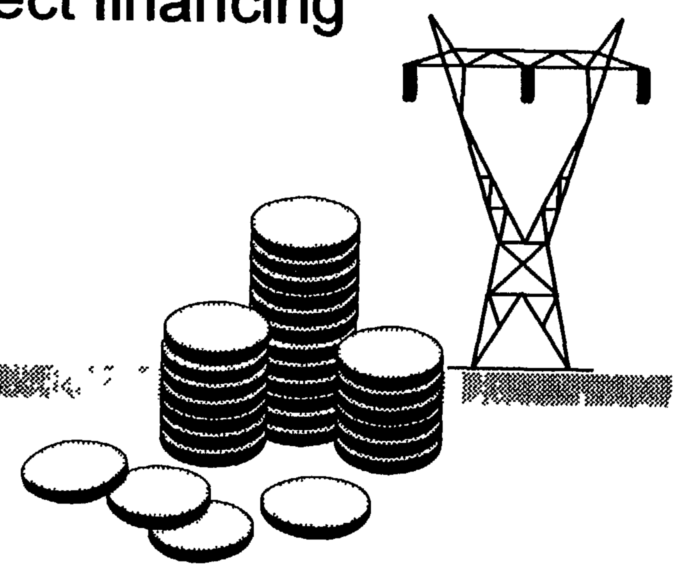
A.V.Lopatin

Increasing the Effectiveness of Asset Management

The goal of asset management is to establish an adequate balance of a comprehensible asset structure and respective liabilities.

Asset Management includes:

- management of long-term and short-term investments (including cash and investments made in fixed assets)
- managing accounts receivable and accounts payable
- determining a strategy for investment project financing (conservative and aggressive)



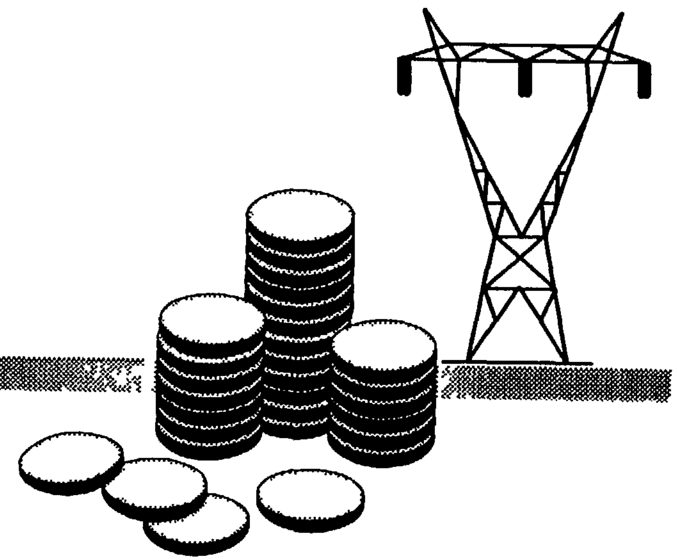
Increasing the Effectiveness of Asset Management

Asset management is based on the analysis of the status of respective components of the balance sheet and the overall structure of the balance sheet as well as analysis of the financial accounting policy

It would be interesting to analyze the Energos' financial indices for 9 months of the year 1994 based on the above

The existing accounting procedures misrepresent the real value of the following

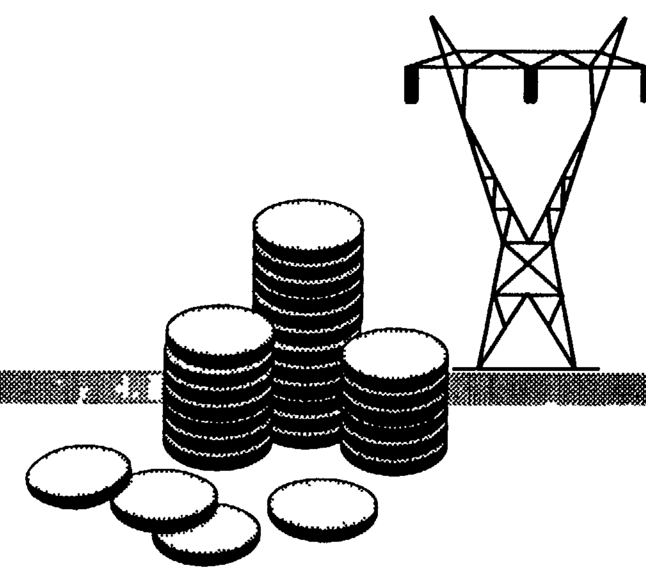
- fixed assets,
- A/R and A/P,
- long-term financial investments,
- equity capital



Increasing the Effectiveness of Asset Management

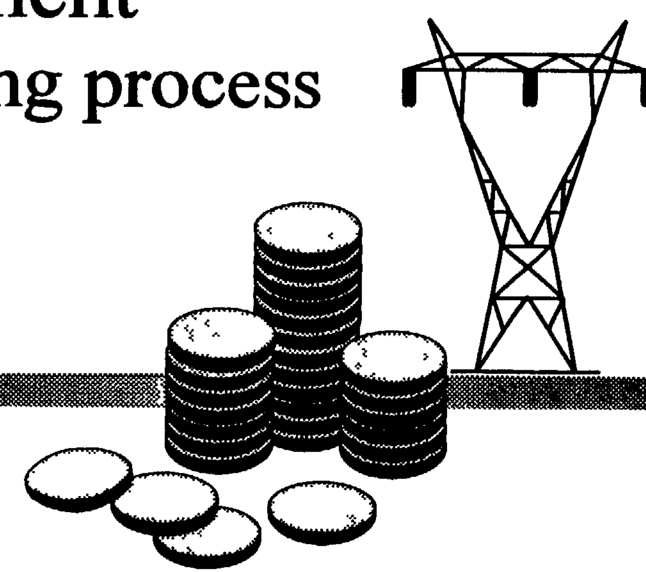
- The sources of the company capital are the following:
  - equity capital (shares, profits)
  - loan capital (short and long-term, bonds)
  - accounts payable

- In 1994, the hard currency denominated items in the balance sheet increased by 30-70%
  - equity capital - 10-30%
  - loan capital - up to 20%
  - accounts payable - 50-80%



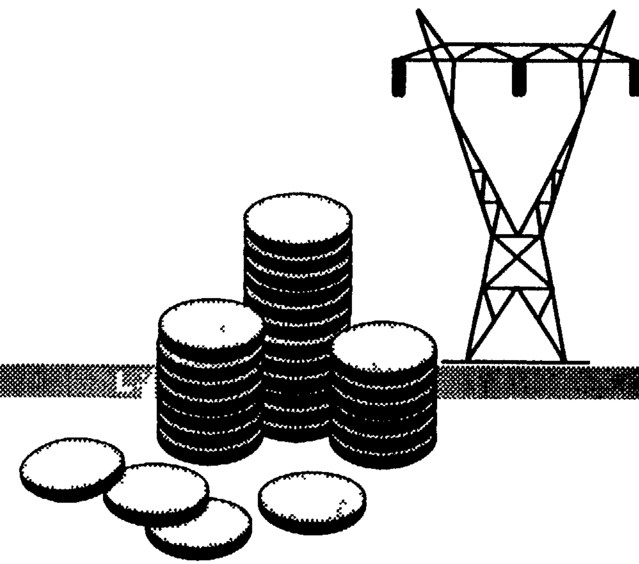
Increasing the Effectiveness of Asset Management

- Long-term investments
  - evaluate their effectiveness and liquidity
- Short-term investments
  - evaluate their liquidity
  - highly liquid assets are transformed to other
- Inventories and uninstalled equipment
  - do not participate in the manufacturing process



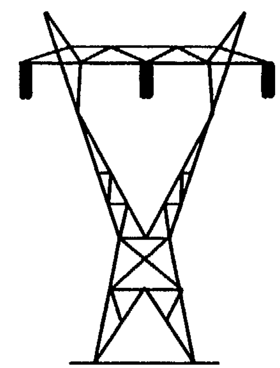
Increasing the Effectiveness of Asset Management

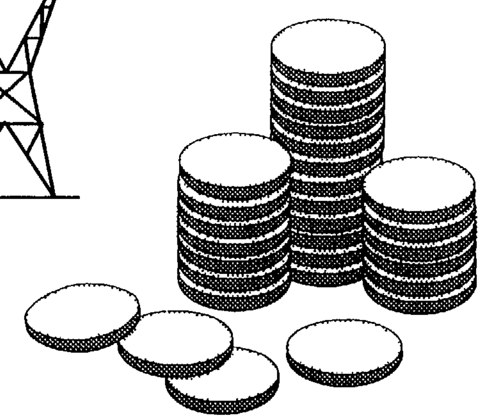
- Accounts Receivable
  - analysis of structure
  - does not reflect the VAT and Special Tax
  - certificate on non-cash interest free credit
  - inflation rate and speed of turnover's impact
- Accounts Payable
  - analysis of structure
  - keeping to the established ratio in the A/R and A/P growth
- The correlation between the A/R and A/P Changes during 1994
- Analysis of profits
- Major factors influencing financial positions



FINANCIAL MANAGEMENT AND CORPORATE GOVERNANCE

Accounts Receivable





J.Atkinson

Introductory Chart

Accounts Receivable

Cash Flow

Internal Cash Financing

External Financing

Chart 1

RAO EES Accounts Receivable

Versus

Selected U S Companies

	Ratio of Accounts Receivable to Total Assets
Selected Group of Six U S Companies	**2.1%**
RAO EES	**29.5%**

Chart 2

Why Accounts Receivable

Will Continue to Grow

Inflation in the General Economy

Tariff Increases

Increasing Customer Payment Resistance

Chart 3

Key Categories
<u>of Recommendations</u>

Organizational Issues

Control Programs

Accounting

Further Studies

Customer Communications

Regulatory and Legislative Initiatives

Chart 4

Organizational Issues

RAO EES Advisory Role

Asset Management Directorate Role

Energo Role

Chart 5

Accounts Receivable

Control Programs

Bills of Exchange

Late Payment Charges

Prompt Payment Discounts

Deposit Program

Levelized Billing

Service Theft

Chart 6

Bills of Exchange

Chart 7

Late Payment Charges

Methodology:

Tariffed Charge + Late Payment Charge

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Chart 8

9

Prompt Payment Discount

Methodology:

Invoice= Tariffed Charge + Prompt Payment Discount

Payment
Amount= Tariffed Charge

Chart 9

Deposit Program

In Advance

Following Payment Default

Chart 10

Levelized Billing Program

Benefits Both RAO EES

and Customers

Chart 11

Service Theft

Chart 12

Accounting

Chart 13

Further Studies

Inflation Indexing

Regional Differences

Performance Measures

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Chart 14

Customer Communications

Critical to Acceptance

And

Understanding

Chart 15

Regulation and Legislative Initiatives

Chart 16

Questions and Answers

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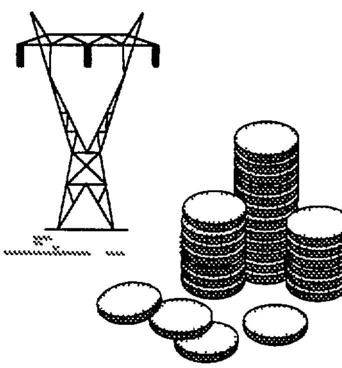
FINANCIAL MANAGEMENT AND CORPORATE GOVERNANCE

Asset Management



S Z Bazoev

Asset management

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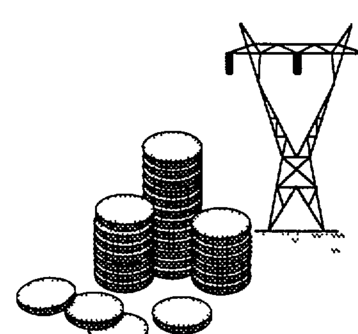
- Introduction
- The Notion of Cost of Capital for Enterprises
- Cash and Other Current Assets Management
- Financial Investments Management



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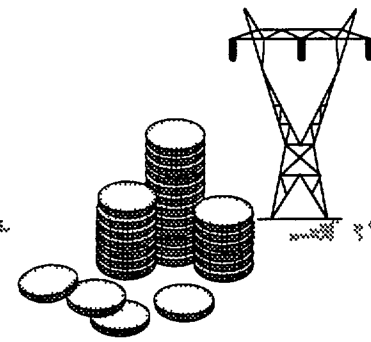
Introduction

- Difficult to speak of cash management in a non-payments and inflationary environment
- Hope that the situation will become more stable and the information presented herein will be useful



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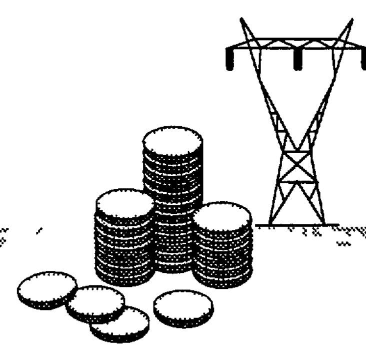
Cost of Capital for Enterprises

- "New" multi-purpose index
  - to evaluate the efficiency of the enterprise assets' use
  - perform feasibility studies
  - evaluate the cost of maintaining superfluous (excessive) assets



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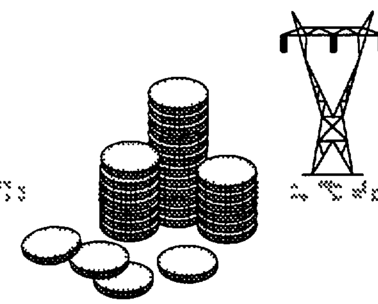
Cost of Capital for Enterprises

Assets	Liabilities	Before privatization	After privatization
	shareholders equity →	state financed	considerable increase of cost, a higher role of equity capital
	loans →	interests on bank credits were symbolic	considerable increase of the banking capital cost



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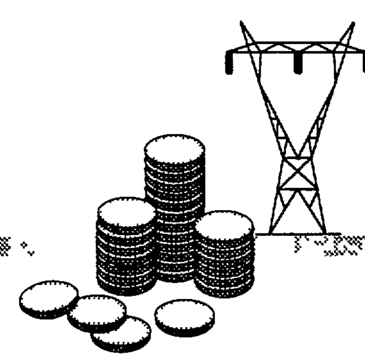
Cost of Capital for Enterprises

- Each enterprise has its specific cost of capital which depends on many factors and is determined by external investors
- The enterprise managers need to know this specific cost of capital to use this index in their operative activities
- How is this cost determined?



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Cost of Capital for Enterprises

Calculation of the Average Cost of Capital (WACC)

WACC (Russia)

$$[K_{dcb}(1-T) + K_{Dcb+}]*D/K + K_E*(1-D/K)$$

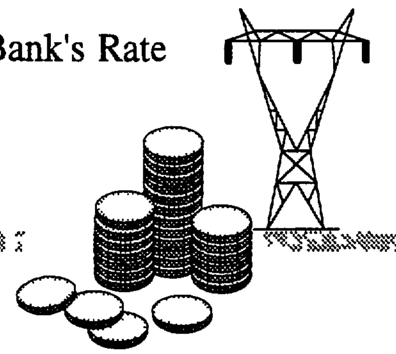
D/K-share of debt in long-term liabilities

K_{dcb} - Russia's Central Bank Rate

K_{Dcb+} - Interest on Loans in Excess of the Central Bank's Rate

T - Income Tax Rate

K_E - Anticipated rate of return on stock (firm equity evaluated at its market value)



Example to page 6

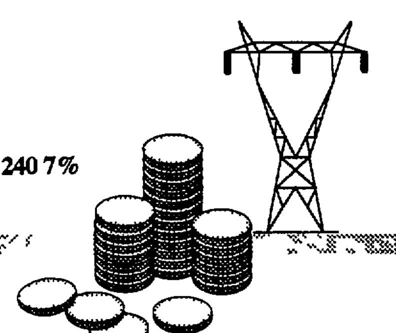
Assets	mln.Rbl	Liabilities	mln Rbl
I. Fixed assets and other extra budgetary assets	40,000	I Ownership assets	35,000
II. Inventory and expenditure		II. A/P and other liab-es	
		- short-term	5,000
III Cash, A/R	15,000	- long-term	17,000
Total	57,000	Total	57,000

Assumptions:

Market value of the stock capital л = 50,000

- D/K = 5,000/55000 = 0.09
- %D = 200% a year
- %E = 250%
- % CB RF = 170%
- Income Tax Rate = 35%

WACC = [170(1 - 0.35) + 30] * 0 09 + 250 * 0.91 = 12 6 + 227.5 = 240 7%



Cost of Capital for Enterprises

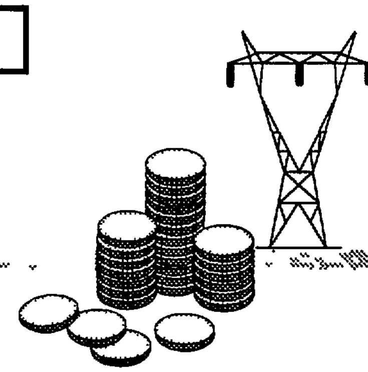
Evaluating the cost of maintaining excessive assets

The ACC for our enterprise = 240% or 20%/month

Excessive Cash = 5 000 mln Rbl

Cost of their maintenance =

(every month)



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Cash Management

How to use excessive funds

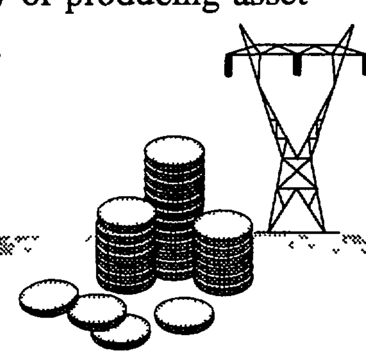
→ 1 Determine whether they are excessive

2 Pay dividend/pay debt

3 Capital Investment - transfer to the category of producing asset

→ 4 Transfer to short-term financial investments

→ 5 Transfer to long-term financial investments



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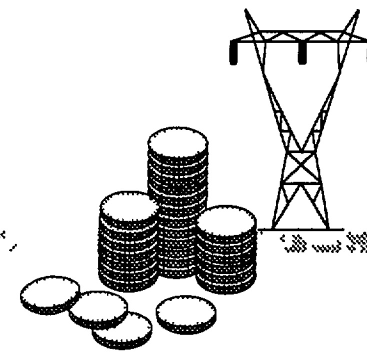
Cash Management

How to determine the most effective cash balance?

- similar enterprises' experience - benchmark
- use the scientific approach
- managers' intuition



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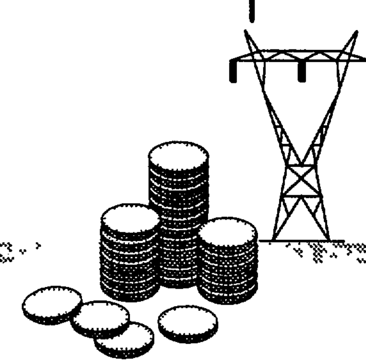
Cash Management

	NY State Electric&Gas Corp	ConEdison	CP&L	Allegheny Power System, Inc	Midwest Resources	NSP	Average
Cash							
% of assets	0 1%	2 4%	0 1%	0 3%	0 9%	0 3%	0 7%
% of earnings	0 2%	4 8%	0 4%	0 7%	2 0%	0 7%	1 5%



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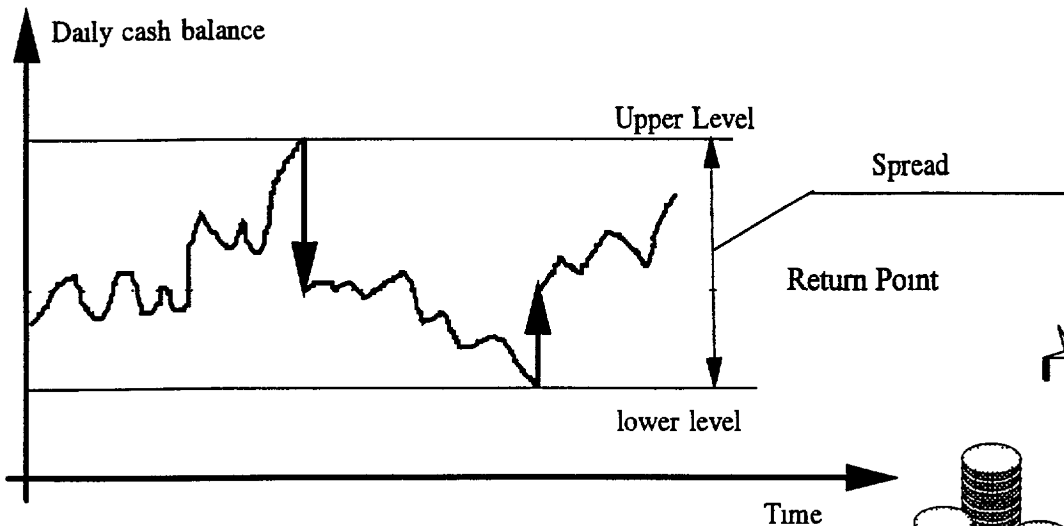
Cash Management
Scientific Approach



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Cash Management

$$\text{Spread} = 3\left(\frac{3/4 * P * O}{\%}\right)^{1/3}$$

Return Point = Lower Level + Spread / 3

Assumptions:

P = transaction cost per single sale or purchase of securities

O = variance of the daily net cash flow

% = daily interest rate on securities

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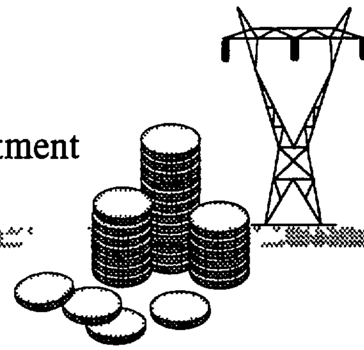
Cash Management

Which securities should one invest in?

- T Bonds
- Bills of Banks
- Banks' deposits

Time of the deposit - up to three months

High liquidity is an important requirement of investment



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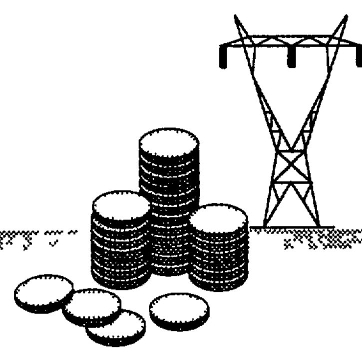
Material Inventories Management

- The principle for evaluating excessive inventories is the same
- Requires a more complex suppliers' relations restructuring



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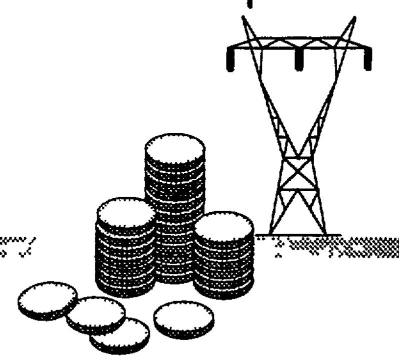
Material Inventories Management

	NY State Electric&Gas Corp	ConEdison	CP&L	Allegheny Power System, Inc	Midwest Resources	NSP	Average
Fuel inventory % of assets	1 3%	0 8%	1 4%	2 5%	1 0%	1 0%	1 3%
% of profit on operations	4 8%	1 7%	3 8%	5 4%	4 0%	2 5%	3 7%



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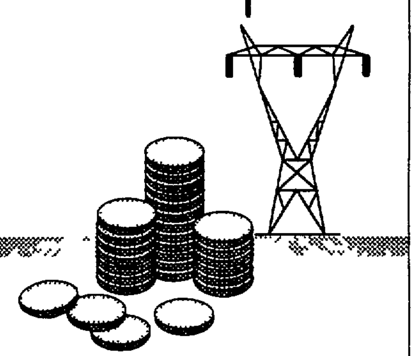
Construction In Process

	NY State Electric&Gas Corp	ConEdison	CP&L	Allegheny Power System, Inc	Midwest Resources	NSP	Average
% of assets	3 4%	3 7%	3 3%	8 2%	1 3%	2 9%	3 8%



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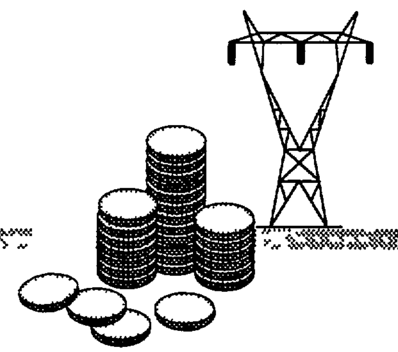
Cash Management

Long-term financial investments management

- Making decisions on financial investments
- Accounting of Investments
- Evaluation of Investments' Efficiency



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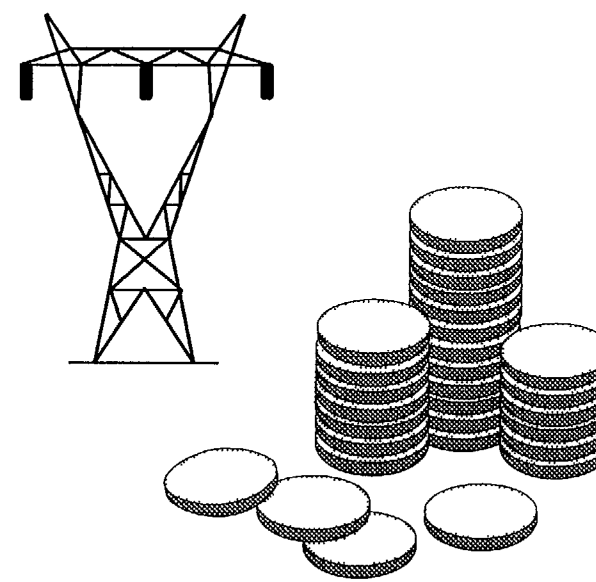
FINANCIAL MANAGEMENT AND CORPORATE GOVERNANCE

Capital Markets I



V.Andrienko

Profile of the Capital Markets and Investment Decision-making Criteria Used by Financiers

I. The Importance of Capital Markets for RAO and the energos
II. Providers of Capital
III. Laws and market rules on raising funds

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I. The Importance of Capital Markets for RAO and the energos

- New market environment
- Declining state subsidies
- Inflation erodes the ability to finance rehabilitation and to make new capital investments.
- Non-payment by customers

II. Providers of Capital

Providers of capital may provide capital in the capacity of:

- investors,
- lenders, or
- guarantors of loans or contracts.

Providers of capital which can be found both inside Russia and outside Russia can generally be grouped into five categories:

- strategic investors
- banks
- governmental and international governmental organizations
- Institutional (portfolio)
- individuals (retail)

Strategic Equity Investors

- The largest category of active investors.
- Strategic business motives for making an investment.
- Invest with a longer term perspective than institutional investors.
- Want to maintain an on-going relationship with the directors, officers, and managers of the corporate entity.

Strategic Equity Investors

- These investors constitute largest category of active investors.
- These investors have particular strategic business motives for making an investment.
- These investors invest with a longer term perspective than institutional investors.

Strategic Equity Investors

- These investors are more willing than other investors to accept unconventional terms and conditions but in turn will make more specific demands for reciprocal benefits and rights.

- These investors will insist upon the provision of specific detailed information from the corporate entity in which they invest and from the other primary investors in the corporate entity.

- These investors will investigate the reliability of information provided to them and the conditions that will affect the future prospects of the corporate entity in which they invest.

Specific investment criteria applied by strategic investors

- Similarity of the line of business to that of the investor;
- Willingness of company directors to work with the strategic investor;
- The ability to obtain control of the company;
- Cash flow and projected rates of return and the reasonable likelihood of profits;
- Expectations of the likely profitability of the corporate entity in itself and in conjunction with the other lines of business of the investor;
- The quality and extent of financial disclosure;
- Confidence in the directors of the present corporate entity;
- The ability of the investor to utilize the corporate assets; and
- The existence of defined property rights and the ability to protect those rights in the country where the assets of the corporate entity are located.

Banks

Banks often act as lenders and guarantors, and in some countries make direct equity investments.

German and Swiss banks extend large amounts of credit and work closely with the companies to which they lend.

Banks, as well as other debt holders, will want a utility to forego investments and transactions that might jeopardize the ability of the utility to pay back money owed.

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Types of institutional investors

- **Professional money managers;**
- **Pension funds;**
- **Mutual funds;**
- **Insurance funds; and**
- **Endowment funds.**

Characteristics of institutional investors are as follows:

- **Responsible for approximately 80% of trading on the New York Stock Exchange;**
- **Own over 50% of all US public company shares (representing an invested amount of over $ 2,500 billion); and**
- **Serve as generally passive investors (some of which by law or by charter are prevented from controlling another entity).**

Specific investment criteria applied by institutional investors

- History and stability of cash flows;
- Quality of past projections and reasonableness of assumptions in current projections;
- Rate of return projected and reasonableness of its expected likelihood;
- Confidence in the management of the corporate entity;
- Protection offered to shareholders investment by the terms of the corporate governance agreements and the conduct of the board of directors in the management of the company and the terms of the specific stock certificates issued to investors;
- The ease of selling and buying shares in the corporate entity;
- The existence of securities laws and defined property rights and the ability to protect those rights in the country where the assets of the corporate entity are located;
- The fullness of financial disclosure; and
- Diversification of risk among different industries.

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Governmental and international governmental organizations which participate in financing corporate entities and transactions

- **Provide financing not available from commercial lenders**
- **Assist utilities insulate selves from risks of operations in emerging markets via guarantees and insurance**
- **Ability to act limited by their official authorizations**
- **Decisions affected by institutional goals, national goals and international politics**

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Specific investment criteria applied by governmental and international governmental organizations

- Likely profitability of a project or a company.
- Priorities of the organizational sponsor (e.g. the World Bank or OPIC) and of the government of Russia.
- Potential for donor country benefits or participation (for national development and aid organizations)

Retail Investors

- Typically invest in conservative securities available in Western securities markets.
- Participate in Western markets mainly through pension funds and mutual funds.
- Likely to follow investment trends set by other investors and to rely on institutional investors to invest for them.
- May make decisions based upon information in the popular press and promotional information disseminated by a company.

Capital Provider	Relationship with Company
strategic investors	Active
banks	Active or Passive depending upon amount of funds
governmental and international governmental organizations	Passive unless terms of obligation not met
Institutional (portfolio)	Passive
Individuals (retail)	Passive

Composition of Securities Ownership in the US in 1993

Type of Investor	Percentage of Securities Ownership
Households	49.2%
Banks	3.5%
Private Pensions	17.6%
Insurance Companies	4.5%
Public Pension Funds	8.3%
Foreign Investors	5.2%
Mutual Funds	11.0%
Other	.7%

LIKELY BUYERS OF RUSSIAN SECURITIES

Money in the 100 largest emerging market funds by region of domicile

Region	Percentage
USA	40%
Asia	20%
Offshore tax havens	20%
Europe (excluding UK)	10%
UK	10%

In the 100 largest world wide market equity funds, $ 54.2 billion was assembled by mid 1994.

III. Laws and market rules on raising funds

- Inside Russia
- Outside Russia

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Important factors that will affect the ability and willingness of financiers to make investments in Russia:

- **Decree on the Regulation of the Securities Market to address Russia's needs for well functioning securities markets. (Decree No. 2063).**

- **Declaration of Shareholders' Rights**

Decree on the Regulation of the Securities Market
(Decree No 2063)

- **Government power to regulate the securities market.**

- **Comprehensive framework for future Russian security market development.**

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Decree on the Regulation of the Securities Market (Decree No. 2063) gives to the Federal Commission on Securities Market the authority to:

- **issue binding regulations**
- **license securities market participation**
- **regulate all activities affecting the securities markets**
- **regulate new securities issues by private companies**
- **oversee stock exchanges**

Declaration of Shareholders' Rights

- **Establishment of disclosure standards for equity issuance.**

- **Failure to observe this standard will cause unease among investors. Investor unease would make it more difficult and more costly to raise funds.**

Laws and market rules on raising funds outside Russia

- Securities laws and regulatory institutions
- Stock exchange listing requirements

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The United States 1933 Securities Act

- **Requires registration information of securities offered to the public**
- **Certain information must be distributed to prospective buyers and sellers of securities via a "prospectus"**
- **Registration of information is the method by which the information is disseminated to the public.**

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The United States 1934 Securities Exchange Act and the Securities and Exchange Commission

- **Created the United States Securities and Exchange Commission**
- **Requires disclosure of certain information**
- **Bans manipulative and deceptive schemes to raise money**
- **Mandates that US securities exchanges, clearing agencies, transfer agents and securities information processors register and submit to supervision by the SEC.**

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Stock exchange listing requirements

Each stock exchange has its own listing requirements. The New York Stock Exchange, the premier US stock exchange, applies three criteria when it determines a company's eligibility for listing:

- the degree of interest across the US in the company;
- the relative stability and position of a company within its industry; and
- whether or not the company is in an expanding industry with the prospect of maintaining its relative position in the industry.

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Stock exchange listing requirements

The New York Stock Exchange requires specific information as to the history and business, capital structure, properties and management of company. Specific information required includes:

- A summary statement of earnings prepared in accord with Generally Accepted Accounting Principles (GAAP) for the last five (5) years.

- Consolidated financial statements prepared in accord with GAAP with the report by the company's independent accountants

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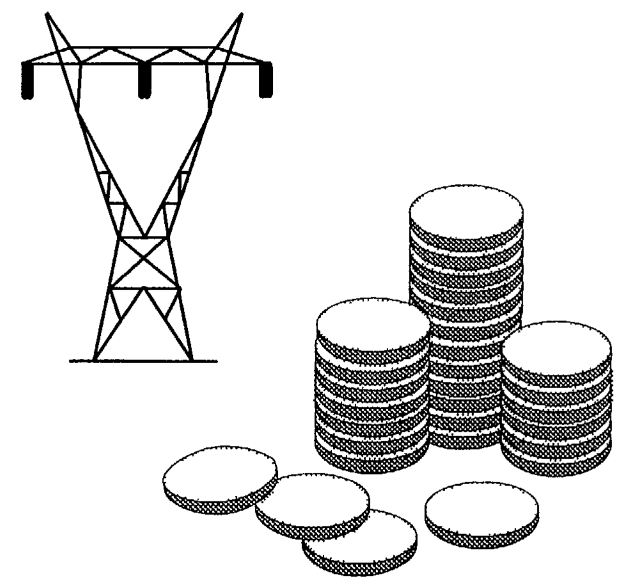
FINANCIAL MANAGEMENT AND CORPORATE GOVERNANCE

Capital Markets I I



V.Andrienko

ISSUES TO CONSIDER WITH REGARD TO FINANCING OPTIONS

Any entity organized as a joint stock company (акционерная компания) (company) has four vehicles for the raising of funds from the investment community to finance its physical assets and operations

These vehicles include equity financing, commercial credit financing, bonded debt financing and project financing

Options for Raising Capital

- Equity Financing (финансирование путем выпуска новых акций)
- Debt Financing (финансирование путем получения займов, заемное финансированеи)
  - Commercial Credit (коммерческии кредит)
    Bonded Debt (облигационный заем)
- Project Financing (проектное финансирование)

Equity financing allows an investor to obtain ownership rights in a company in return for the investor's investment in it

Debt financing allows a lender or an investor to obtain a stream of payments (поток платежей) from a company in the future in return for the lender or investor providing the company a specific sum of money initially

A company can obtain debt financing from either a commercial lender or from investors

Money obtained from an entity engaged in commercial lending as a business, such as a bank, is debt financing based upon commercial credit

Money obtained from investors to finance a debt of a company that is evidenced by a financial instrument that commits the company to pay back the principal amount (основная часть долга) lent plus interest is bonded debt

Money obtained by a company from investors or from commercial lenders for a specific project is called project financing Project financing allows investors and lenders to limit the risk of their investment to a particular project which has specific expected costs and expected earnings associated with it

Any company has conceptually 2 methods by which it may raise financing -- via selling ownership (equity) interests in itself or by obtaining debt

The chart below illustrates the value to a company of financing investments via debt A company may borrow money to improve its assets As a company's assets increase in value, the value of the company increases as well As a company borrows more money, the company though will have to make greater periodic payments of interest and will have to repay principal

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A company benefits from borrowing funds as long as the borrowed funds are used to procure capital assets that generate more revenues than the costs of the borrowed funds

	Company that has not borrowed funds	Company that borrows funds
Capital assets	$ 100 Million	$ 200 Million
Debt	$ 0	$ 100 Million
Profit before interest payment	$ 20 Million	$ 45 Million
Interest Payments	$ 0	$ 20 Million
Profit after interest payment	$ 20 Million	$ 25 Million

The chart illustrates a company that has $ 100 million of capital assets and no debt and a company that borrows funds and has capital assets of $ 200 million

The profit generated before interest payments on the debt for the first company is $ 20 million The company that has borrowed money to increase its capital assets, has a profit before interest payments of $ 45 million

As the chart illustrates, initially, there is a value to a company of borrowing funds as long as those funds are put to efforts that will yield greater revenues than the cost of borrowing those funds There is also a tax benefit in many countries to borrowing because the interest on borrowed funds is a business cost, decreasing profits and therefore decreasing the tax burden

Now, note the interest payments that must be paid by the "leveraged company' (the company which financed its purchase of assets by taking on debt) The "leveraged company' (компания, использующая заемные средства) must make payments of $ 20 million annually These payments are due regardless of the revenues collected by the company Thus, the company that borrows money to finance its capital investments may earn greater revenues as a result, but the company then has to devote funds to paying the interest and principal on the debt back to the lender

At some point, the cost of additional borrowing of funds will be greater than the revenues generated by the use to which the borrowed funds would go As more periodic payments of interest and principal are due, then the risk that a company would not be able to make those payments increase

Lenders of funds, whether commercial lenders or private investors, lend funds based upon the risk associated with a specific investment

As a commercial lender's or an investor's perception of the risk associated with a project increases, the investor will want a higher return on the amount lent to a company

This means that a company can exert control over the cost of the debt which it takes on The chart below illustrates three methods by which a company can take on debt and effect the cost of that debt The two basic options available to a company are to issue secured debt and unsecured debt (обеспеченныи застразованный и не~, не~ риск)

Approaches to Debt Financing

```
     /\        |
     |         |                                   Unsecured
     |         |                                   Debt
               |
Investor's     |                 Revenue
  yield        |                 Backed Debt
Requirements   |
               |
     |         |      Secured
     |         |      Debt
     \/        |
               |
               |
               |
               |
               |________________________________________

              -------   Investor's Perception of Risk ---->
```

A company may decrease the cost of its borrowing of funds by agreeing to give a lender an interest in specific property of the company This is called secured debt because the funds that the company borrows are secured by specific property of the company If the company should fail to pay back the company's debt, then the lender may take control of the specific property securing the debt and sell that property in order to obtain the payment owed the lender

A company may also decrease the cost of its borrowing of funds by securing the payments owed by the company on a specific debt with a stream of expected revenues from a specific activity A company would agree to dedicate a stream of revenues from a specific activity to pay off the debt As the risk that a stream of revenues will not materialize decreases, then lenders will provide funds on more favorable terms

The riskiest type of debt and hence the costliest for a company to issue would be unsecured debt Using this vehicle, a company would only give lenders a promise to pay back the funds lent to it plus interest Lenders would have no claim to any specific corporate assets or revenues to secure the money owed to them by the company

A company has 2 options for debt financing A company may seek either a commercial loan from a bank or it may issue bonded debt

If a company should issue bonded debt, it may issue one of three generic types of bonds A company may issue regular bonds (обычные облигации), zero coupon bonds (нулевые облигации на предъявителя), or convertible bonds (конвертируемые облигации)

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Approaches to Bond Selection

	Advantage	Disadvantage
Bond	Less costly than equity	Periodic payments
Zero Coupon Bond	No payment due until maturity (срок выплаты обязательства)	Higher costs
Convertible bond	Lower cost bond	Dilution of owners' equity

A regular bond operates as follows The company would obtain a certain sum based upon the bond's successful issuance Then, the company would have to make periodic interest payments such as quarterly or annually The company would also have to pay a lump sum of principal at the maturity date of the bond The terms of the bond may require the company to set aside funds in a sinking fund on a periodic basis to pay back the principal owed to investors when the principal becomes due

Another type of bond that a company might be able to issue is a zero coupon bond If a company issues such a zero coupon bond, the company will not have to make any periodic payments No payment on the money raised by such a bond is due until the bond maturity date At the time of the bond maturity date, though, the entire payment of interest and principal is due Since the holder of a zero coupon bond incurs the risk of being paid only in the future as opposed to being paid on a periodic basis, the holder will want a greater return on investment than for a regular bond Thus, the costs of issuing a zero coupon bond are higher than a regular bond

A convertible bond is a bond that can be exchanged for a specified amount of stock This type of instrument allows the bond holder the option of sharing in the company s distributed earnings, just as any stock holder If a convertible bond holder decided that he would be better off by sharing in the risk of a company, then that bondholder could exchange his right to receive interest payments and principal due him for equity stock shares If the investor has the option of converting the bond so that the investor has the option of enjoying the benefits of fruitful company business plans, then the company would be able to raise more funds than under the other vehicles presented here The disadvantage of issuing such a convertible bond is that if the conversion option is exercised, the ownership and control interests of the existing equity shareholders are diluted

For example, if a purchaser of convertible bond exercised his conversion rights, then the purchaser would own a certain amount of equity stock shares The exercise by this former bondholder of his conversion right has several affects on a company and its shareholders First, the company no longer has the burden of paying to the former bondholder any periodic interest or any principal Second, when the company declares dividends, dividends will be paid to all of the company's shareholders, including the company shareholder who obtained his shares because he converted his bond to shares Thus current shareholders will receive a smaller dividend than they would have had the bondholder not exercised his conversion rights Third, the former bondholder who exercised his conversion rights, now, like all shareholders has the right to vote in elections to determine the composition of the company s board of directors Thus if many convertible bonds were converted to equity shares, there could be a shift in control of the company

In addition to raising funds by taking on debt, a company may raise funds by allowing investors to purchase ownership rights in the company as an entity

Again note that an investor will demand a greater return on his investment from the company as an investor perceives greater risk associated with the investment

There are four prototypical equity investment vehicles common stock, preferred convertible, plain preferred, and cumulative preferred

Approaches to Equity Financing

```
                   |
         /\        |
         |         |                                         Common Stock
         |         |                                         (обычные    акции)

Investor's         |                          Preferred
  yield            |       (привилегированные конвертируемые акции)          Con
                                                                             vert
                                                                             tible
Requirements       |
                   |
         |         |                  Plain
         |         |                 Preferred
         \/        |           (привилегированные акции)
                   |
                   |    Cumulative
                   |     Preferred
                   |(кумулятивные привилегированные акции)
                   |_____________________________________________

                    -- ----  Investor's Perception of Risk ---->
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A company could issue common stock This equity vehicle is perceived as the riskiest to an investor because the holder of the stock will only receive dividend payments after period interest payments have been made to bond holders and dividends have been paid to the preferred shareholders On the other hand, the payments due to the bond holders and the preferred shareholders are fixed Thus the common stock offers its shareholders potential to harvest any distributed earnings that are in excess of these fixed amounts

A company could issue preferred convertible shares This vehicle would allow preferred shareholders the option of converting their preferred shares into common shares From a company s perspective, this allows a company to pay fixed dividends when dividends are declared and then allows the shareholder the option of sharing in growth at the preferred shareholder's election

Plain preferred issuance allows a company to pay fixed anticipable dividends when dividends are declared

Holders of cumulative preferred shares are entitled to be paid a certain stipulated amount periodically Investors like the relative certainty of payments If a company were to fail to make specific payments to cumulative preferred shareholders, these shareholders would be entitled to be paid their missed dividends before any other shareholders could be paid For instance if a company did not pay dividends to cumulative preferred shareholders in 1997, then in 1998 a company could not distribute dividends to any other class of shareholder until all cumulative preferred shareholders were paid the dividends owed to them Since cumulative preferred shareholders have a greater claim to dividends, then a company can raise more funds from purchasers than from the issuance of plain preferred

Note the interconnection between dividend policy and the ability of a company to raise funds through the issuance of shares US shareholders in electric utilities generally expect to receive dividend payments The only US companies that generally do not declare dividends on its equity shares are either high growth companies and companies in financial peril High growth companies in the US will reinvest their profits in the company, to give shareholders lucrative future returns Even US electric companies, heavily burdened with debts will strive to make dividend payments in order to reassure the financial community of their financial viability Note that debt burdened US electric companies with a ratio of debt to equity of 1 13 will pay out enormous amounts of their net income to shareholders The average US electric utility will payout dividends per share of $ 1 68 on a net income per share of $ 1 75

If a company does not pay dividends periodically and of a consistent amount on its equity shares, the financial community will take it as a signal that there is something seriously wrong with the company's finances

There are 5 general issues which a company should consider as it seeks financing These issues include management activities and the alternative use of debt and equity financing in order to achieve an optimal capital structure Financing options issues include the following

Financing Options Issues (критерии)

- Stability of corporate governance structure
- Management and financial credibility to investors
- Financial disclosure obligations including audited financial statements
- Encumbrance (залог) of corporate assets
- Adequate tariff structure

Stability of corporate governance structure The issuance of equity securities ultimately affects the rights of existing company shareholders The terms of debt issuance affect the ability of a company to conduct its activities

Management and financial credibility to investors The investment community will note the terms of any financing mechanism utilized by a company Prospective investors and lenders will base the terms of their investment and lending in reaction to management actions Critical management actions judged by prospective investors and lenders will include those that affect a company s capital structure (the amounts of a company s equity and debt) and its short-term and long-term finances Actions affecting the management and financial credibility of a company to outside investors and lenders include the record of payments to a company by a company's customers a company's record of payments to its suppliers and lenders, a company's dividend pay-out policies, and the number of outstanding legal claims against a company Elements of management credibility include a company's business strategies and the experience and qualifications of a company's managers, advisors, officers, and directors

Financial disclosure obligations and Audited Financial Statements Different financing options will require a company to disclose different aspects of its finances At minimum, lenders and investors will want audited financial statements Additional disclosure may be required by relevant stock exchanges under the terms of their listing agreements and by governmental regulatory agencies such as the United States Securities and Exchange Commission

Encumbrance (обременены) of corporate assets Debt financing options may entail encumbering corporate financial assets in order to secure the indebtedness A company should take on additional debt in order to finance its capital needs The least cost debt will be debt that is secured by corporate assets As a company utilizes its most valuable assets to secure debt, additional debt will be more costly for a company to utilize One major aspect of financial credibility to a

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company's investors and lenders is the clarity of ownership of assets by the company Lenders that own debt secured by corporate assets will want to have the first claim against those assets, if a company were to default in its payments on its debt

Adequate tariff structure Investors and lenders will want a company to be earning sufficient revenues to pay respectively dividends and debt payments as those payments become due The means by which a company will obtain these revenues is by having an adequate tariff structure in place

These financing options issues should be kept in mind as a company continues with its plans to seek external financing Now, we will outline the general step to obtain financing which a company is in the process of pursuing The general steps within this financing process are as follows

Steps to Obtain Financing

- Record Financial Data
- Obtain Specialized Financial Expertise
- Attain Flexibility in Operations and Financing
- Develop Business Plans
- Prepare Audited Financial Statements
- Prepare Prospectus
- Identify Potential Lenders and Investors

Record Financial Data This step entails collecting financial data on a company and a company's subsidiaries This financial information is essential to the development of financial statements Financiers will utilize these financial statements to decide how to structure terms of lending to or equity investments in a company As part of this step a company develops the internal financial expertise in order to negotiate terms of future investments in the company and lending to the company by financiers

Obtain Specialized Financial Expertise This step entails developing a core of corporate staff
- versed in the theories of finance,
- able to prepare the financial reports and gather detailed financial information about the company, and
- able to manage teams of Russian and foreign lawyers, accountants, bankers, and underwriters

This step also encompasses consultation with financial advisors by company managers Financial advisors should advise the company on how to initiate processes to raise capital on favorable terms to the company in ways that will help the company to achieve the company's objectives Financial advisors will help a company to define options for capital investment and will help the company to define options for the company to structure itself organizationally and financially in order to best achieve the company's objectives

Attain Flexibility in Operations and Financing This process will enable a company to actually obtain the best terms when financiers offer to invest or lend to it The company will attain flexibility in financing by increasing its collections The company will attain flexibility in operations by its efforts to improve all aspects of its business activities

Specific activities that a company will wish to undertake in this regard are those that will assist develop a basis for a conducive regulatory environment to ensure the company has access to sufficient revenues in the future

Develop Business Plans The development of business plans allows a company to market specific projects to financiers Business plans may entail efforts to reorganize a company, to develop specific projects to finance, and to leverage both the company and company subsidiaries through debt These business plans will guide corporate investments activities

Prepare Audited Financial Statements The preparation of audited financial statements will assist a company to obtain financing from financiers and from stock exchanges These financial statements are necessary for a company to obtain financing on a US stock exchange

Prepare Prospectus A prospectus will be developed for each particular business plan marketed to investors The prospectus will provide financiers information about the company's planned use of the funds that a company is seeking The prospectus should also provide information about the economic and legal context of the entity into which the funds will be directed

Identify Potential Lenders and Investors Once a company has completed the previous steps, the company will be in a good position to identify and then approach potential lenders and investors Potential lenders include international financial institutions such as the International Bank for Reconstruction and Development (which is called both the IBRD and the World Bank), foreign governments, suppliers, commercial bankers, and financiers Potential investors include private investment funds and private financiers, as well as investors who invest via world capital markets At this stage the company will have the information necessary to begin the process of negotiating with lenders, investors, and underwriters

As the company seeks financing, it will be able to choose among commercial credit, bonded debt financing and equity financing methods Note that these equity and debt financing methods can be used by the company and by its subsidiaries on a project financing basis

Commercial credit offers a company one method by which it can finance new capital investments There are advantages and disadvantages to the use of commercial credit These advantages and disadvantages are summarized below

Commercial Credit

Advantages	**Disadvantages**
Company Managers Decision	Shadow Partner
No External Legal Restrictions	Immediate Demand on Cash Flows
Facilitated Access to Capital	Higher Cost to Further Borrowing
Lender's Specialized Expertise	Obligation to Pay Back in Hard Currency to Foreign Lenders
Spreading of Lender Risk by Syndication	
Loan Guarantors	
Leveraging	

The advantages of the use of commercial credit from a bank or other lending institution are numerous Note that commercial credit may be extended by a lending institution or by a supplier of capital equipment or other goods to the company The advantages of the use of commercial credit include the following

Russian Company Managers' Decision Russian company managers have the authority to seek commercial loans

No External Legal Restrictions No external laws or rules preclude Russian company managers from obtaining commercial loans

Facilitated Access to Capital Commercial lenders which extend commercial credit to a Russian company will be able to facilitate access to other sources of capital The relationship which a company establishes with its commercial lenders will enable the company to develop relationships which will facilitate access to capital in the future

Lender's Specialized Expertise Commercial lenders, with which a company will be in contact, will have employees with specialized expertise in appropriate industries and in project finance These individuals will be able to advise the company on how to best structure projects and deals in order to obtain the most favorable financing terms

Spreading of Lender Risk by Syndication Commercial lenders can help a company obtain the most favorable terms for the financing of deals through the process of syndication A commercial lender would act as the "lead lender' for a syndicate of lenders (a group of lenders) Each lender will extend part of the funds for the loan and therefore the risk will be shared by all the lenders in the syndicate, rather than be borne by simply one This spreading of the risk of the loan will enable a company to obtain a lower interest rate and more favorable terms

Loan Guarantors A commercial lender or group of lenders may be able to obtain a loan guarantee from an international financial institution (such as the Multilateral Investment Guarantee Agency, abbreviated as MIGA) or from governmental agencies (such as the United States's Overseas Private Investment Corporation, abbreviated as OPIC, or the Export-Import Bank, abbreviated as ExIm Bank) Such a guarantee will reduce the cost of the credit to the company

Leveraging As mentioned earlier, "leveraging' is one of the great advantages of the use of commercial credit There is a value to a company of borrowing funds as long as those funds are put to efforts that will yield greater revenues than the cost of borrowing those funds A company's taking on of debt may therefore increase the value of the company

On the other hand, there are disadvantages to the use of commercial credit

Shadow Partner A company will be gaining a shadow partner when it enters into agreements with commercial lenders A lender will ask the company to make periodic payments to the lender and may specify that the company observe specific management practices A lender may also wish to specify that the lender will have the right to demand immediate repayment upon the occurrence of certain events that make the lender less secure of the prospect of the lender being repaid Such events might include the event of the company missing payment of amounts owed to others, including amounts that the company might owe company employees If a company should violate the terms of an agreement with a commercial lender, the commercial lender may take legal action against the company abroad, making it difficult for the company to obtain capital or supplies from abroad until the company fulfills the terms of its agreement The effect of the right of a lender to take legal action against the company creates the prospect of the company being "locked-in" to working with certain financiers (i e certain bankers and investors)

Immediate Demand on Cash Flows A company will have to make periodic payments to a commercial lender, until the lender has been repaid the principal amount of the loan and interest on the loan These payments may be scheduled to begin almost immediately, placing immediate demands upon the company s cash flows

Higher Cost to Further Borrowing If a company seeks additional funds after it has entered into an agreement to borrow substantial amounts of money, then the company will likely have to pay

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higher interest rates for future borrowing This is because the earlier lenders will have greater priority to claiming the right to be paid by the company

Obligation to Pay Back in Hard Currency to Foreign Lenders A major disadvantage to taking on a commercial debt is that the company will incur obligations to pay back the debt in a hard currency If the ruble declines in value, the company will have to generate greater amounts of rubles in order to pay back a loan denominated in a foreign currency The company will also have to obtain the currency in which it would have to make payment

In addition to the use of commercial loans for debt financing, the company may utilize bonded debt financing to raise funds This method is accomplished by the issuing of bonds There are advantages and disadvantages to this financing method

Bonded Debt Financing

Advantages	**Disadvantages**
Lower Immediate Impact on Cash Flow	External Legal Requirements
More Flexible Terms	Greater Preparation
Potential Convertability	Totally Undeveloped Marketplace
Availability of Underwriting	Complicated Access to Foreign Market
Ability to Limit Legal Liabilities	Formalities of Investor Relations
Availability of ADRs, GDRs, and Foreign Flotation	

The advantages to the use of bonded debt financing are as follows

Lower Immediate Impact on Cash Flow The terms of bonded debt can be more easily structured such that funds need not be paid back as early and on as strict terms as would a commercial loan

More Flexible Terms The terms of bonded debt can be structured to be more flexible than the terms of a commercial loan

Potential Convertability One method by which the cost of borrowing by a bond can be reduced is by issuing bonds that have conversion options The conversion option would allow the bond holder to convert the bonded debt into an equity interest in the company Since such a bond holder would have the prospect to share in the profitability of a company or a subsidiary, the convertible bond holder would be willing to pay more for the convertible bond, therefore lowering the cost of borrowing to the company

Availability of Underwriting (андеррайтинг, гарантирование размещения ценных бумаг) The availability of underwriting of bonded debt will enable the company to shift the risk of not being able to raise the necessary funds to an underwriter (андеррайтер, гарант размещения ценных бумаг), thereby guaranteeing the company access to borrowed funds

Ability to Limit Legal Liabilities The terms of the agreement upon which the bonds are issued, will be controlled by the company The terms of the company's obligations will be expressed in a "Trust Indenture Agreement" Since the company can control the terms of the Trust Indenture

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Agreement (Соглашение о Контрактах между держателем акций и компанией, их выпускающей), the company can control its exposure to legal liabilities in Russia and abroad

Availability of American Depositary Receipts (ADRs), Global Depositary Receipts (GDRs), and foreign flotation If a company should wish to access capital from foreign markets, the company could issue American Depositary Receipts (ADRs) or Global Depositary Receipts (GDRs) that would evidence ownership of the company's bonded debt held in a Depositary Bank If the company wished, it could access foreign markets directly by selling bonded debt in particular foreign markets

The disadvantages of the use of bonded debt financing are as follows

External Legal Requirements If a company issues bonded debt, it will have to comply with Russian laws which presently require, among other things, three years of financial statements based upon three years operations as a joint stock company

Greater Preparation Greater preparation will be required for the issuance of bonded debt than would be required for a commercial loan

Totally Undeveloped Marketplace The marketplace, both domestically and internationally for bonded debt issued by Russian corporate entities is undeveloped The lack of a developed marketplace for bonded debt creates additional risk to investors Consequently, it will cost a company more to issue bonded debt than if a developed marketplace existed for the debt of Russian corporate entities

Complicated Access to Foreign Markets There will be a complicated process to access foreign markets Even if the bonded debt were privately placed, a company would probably want to file for a formal exemption from United States securities law requirements to limit potential legal liabilities of the company and its officers and directors If the company seeks to access funds from public marketplaces, the company will have to comply with governmental laws such as US Securities and Exchange Commission filing requirements and to comply with stock exchange listing requirements If a mechanism such as an American Depositary Receipt or Global Depositary Receipt will be the basis for foreign ownership of bonded debt, then the company will have to enter into a Deposit Agreement with a depositary bank to hold the underlying company security

Formalities of Investor Relations A company will have to develop and maintain a formal investors relations program to manage enquiries that will be made by investors If the company should issue bonded debt in public markets, the stock exchanges on which the debt is listed will impose their own specific requirements Governmental entities in countries where the bonded debts are placed or traded may also impose their own requirements

Besides debt financing, the company may raise investment funds by equity financing Equity financing offers the company advantages and disadvantages These advantages and disadvantages are listed on the following chart

Equity Financing

Advantages	Disadvantages
No Immediate Impact on Cash Flow	Potential Loss of Control
Control Over Dividends	Short-term Performance Pressures
No Encumbrance of Assets	External Legal Requirements
Management Retains Control of Operations	Decision Making Subject to Market Influence
Availability of Underwriting	
Strong Market Yields More Funds	Restrictions on Stock Issuance
Availability of ADRs, GDRs, and Foreign Flotation	Complicated Access to Foreign Market
ADR and GDR Deposit Agreements can Limit Legal Liabilities	Potential Legal Liabilities
	Formalities of Investor Relations

The advantages of equity financing are as follows

No Immediate Impact on Cash Flow The issuance of equity shares in the company will have no immediate impact upon its cash flows Unlike debt financing, obtaining financing via equity issuance imposes no obligation on the company to make any periodic payments to the holders of equity shares

Control Over Dividends When dividends ultimately distributed to holders of a company's equity shares, the company will have control over the amount of funds distributed The amounts of funds distributed as dividends are under the control of the board directors of the company Thus, if the company should wish to retain earnings to reinvest those funds in the company itself rather than distribute the funds, the company could do so The company can control the timing and amounts of distributions

No Encumbrance of Assets Unlike debt financing which will likely be secured by the company's assets, equity financing is not secured by underlying assets Thus, equity financing leaves the company s assets available to secure debt financing to leverage the company The use of the company's assets to obtain additional debt financing will increase the value of the equity shares held by all company equity holders

Management Retains Control of Operations Equity financing, specifically equity financing obtained through the marketplace, leaves a company's management in control over the company's operations Commercial lenders and private investors would more likely impose restrictions on the latitude of corporate management to control the company's operations

Availability of Underwriting The availability of underwriting of equity financing, enables a company to shift the risk of not being able to raise the necessary funds to an underwriter, thereby guaranteeing the company access to the funds which it seeks

Strong Market Yields More Funds Unlike commercial debt which will be negotiated individually with a lender, a company could time the issuance of its securities to coincide with market swings, thereby raising more funds

Availability of ADRs, GDRs, and Foreign Flotation If a company should wish to access capital from foreign markets, a company could issue American Depositary Receipts (ADRs) or Global Depositary Receipts (GDRs) ADRs and GDRs evidence ownership of equity shares held in a Depositary Bank If a company wishes, it can access foreign markets directly by selling equity shares in particular foreign markets

ADR and GDR Deposit Agreements can Limit Legal Liabilities The use of ADRs and GDRs are advantageous to a company and its officers, directors, and managers The Deposit Agreements for ADRs and GDRs, like Trust Indenture Agreements for bonded debt, can be structured to limit legal liabilities

The disadvantages of equity financing are as follows

Potential Loss of Control As a company allows new investors to own equity shares in it, this creates the prospect that an investor or group of investors will purchase enough of the company's stock shares to elect the company's Board of Directors and thereby control of the company

Short-term Performance Pressures As a company relies more on equity financing via the issuance of equity shares on stock exchanges, the company will face increasing short-term performance pressures The market price for the company's shares will depend upon the company's financial performance and the company's activities, particularly in the short term Market participants will pay particular attention to the company's reported earnings and to the company's dividend policies Market participants will expect the company to eventually issue quarterly financial reports

External Legal Requirements If a company issues additional equity shares, the company will have to comply with external legal requirements imposed by the government of Russia If the company issues equity shares abroad or if the company issues ADRs or GDRs based upon equity shares issued in Russia, then the company will have to comply with reporting and disclosure requirements imposed by relevant governments and by stock exchanges on which those securities are traded

Decision Making Subject to Market Influence As a company becomes more dependent upon public markets as sources for equity financing, likely market reactions will affect the decisions of corporate managers, officers, and directors Likely market reactions will affect the company's decisions pertaining to capital investments and other business policies

Restrictions on Stock Issuance There are often limits on the total number of voting and non-voting shares that a company can issue

Complicated Access to Foreign Markets Gaining access to foreign markets will require a company to comply with relevant securities laws imposed by relevant governments The company will also have to comply with reporting and disclosure requirements imposed by the stock exchanges on which those securities are traded

Potential Legal Liabilities The issuance of equity shares exposes corporate directors, officers, and managers or the company itself to potential legal liabilities In foreign countries, these liabilities can be particularly high for not adhering to certain standards of care in exercising corporate decision making (Duty to Exercise Due Care and Duty of Loyalty) If a company should issue ADRs or GDRs, the deposit agreement with a depositary bank can be designed to limit the potential exposure of corporate directors, officers and managers to legal liabilities

Formalities of Investor Relations A company will have to develop and maintain a formal investors relations program to manage enquiries that will be made by investors If a company should issue equity shares in public markets, the stock exchanges on which the shares are listed will impose their own specific requirements Governmental entities in countries where the equity shares are placed or traded may also impose their own requirements Note that if the equity shares are issued in Russia, in October of 1994, a number of Russia's leading industrial firms, including Unified Energy Systems ( ), LUKoil ( ) and Pervy Vaucherny ( ), signed a Declaration of Shareholders' Rights (Декларация Прав Акционеров) This Declaration creates a standard of formal disclosures and procedures which investors would likely expect of a company

There are many issues common to both debt and equity based financing, particularly with respect to the choice of seeking to place securities privately with specific individuals or alternatively when seeking market based financing

The chart below outlines several of the differences that distinguish private placement from public financing options

Specific Market Based Financing Issues

Private Placement (частное размещение ценных бумаг)	**Public Offering** (публичное размещение ценных бумаг)
Greater Investor Demands on Management Decisions	Foreign Rating Systems
Target Specific Investors	More Stringent Reporting
Easier Than Public Offering	More stringent requirements for ADRs, GDRs and Foreign Flotation
Regulatory Requirements for Foreign Placement (e g Rule 144A)	Larger Pool of Available Financing
Smaller Pool of Available Financing	

If a company should privately place debt or equity securities it will have to address the issues set out below

Greater Investor Demands on Management Decisions In exchange for private investors investment in a company, the investors will want to be able to exert control over a company's business decisions and plans At minimum these private investors will want detailed financial information about the company Most likely, these private investors will want to be able to exert influence over a company's major business decisions and plans

Target Specific Investors The great advantage to a company of a private placement of securities, particularly equity securities, is that the company can select the investors which the company will permit to invest in the company This will allow the company to restrict or anticipate the likelihood of the emergence of a new dominant shareholder or a new dominant collection of shareholders

Easier Than Public Offering A private placement will be easier for a company to carry out than would a public offering A company will have fewer legal requirements imposed upon it by governments Also, a company will not have to comply with any stock exchange listing requirements

Regulatory Requirements for Foreign Private Placement (e g Rule 144A) In some countries regulatory requirements affect private placements of securities For instance, the following requirements would come into effect if a company were to issue an ADR based upon an existing company security issued in Russia For such a "SEC Rule 144A ADR" based upon existing company shares, no SEC registration is required and conformity to US GAAP is not required However, we would recommend that a company file for a Rule 12g3-2(b) exemption to preclude the possibility of legal liabilities under the Securities Exchange Act of 1934

Smaller Pool of Available Financing If a company opts to raise funds through securities issuance, but only places them privately, the company will draw upon a relatively smaller marketplace of investors The company's cost of capital will consequently be higher and the terms imposed upon the company will be more stringent

If a company should opt to go to the public marketplace to offer debt or equity securities it will have to address the issues set out below

Foreign Rating Systems If the company should issue securities in the public marketplace, the amounts of funds raised and the cost of those funds will be related to the rating of a company by bond rating organizations such as Standard & Poor's and Moody's The company should work with its financial advisors to develop a strategy to work with bond rating agencies to obtain the best possible rating This process should be planned alongside the company s development of its business plans and approaches to the financial marketplace

More Stringent Reporting When a company approaches public markets, the company will have to comply with more stringent reporting requirements These requirements in the US will be based upon US federal securities law, stock exchange listing requirements, and for ADRs, the deposit agreement with the depositary Bank For a public offering based upon existing company shares, there has to be SEC registration under the Securities Act of 1933 on Form F-6 If there is to be a listing on a stock exchange, then a Form 20-F will have to filed under the Securities Exchange Act of 1934 The form will have to be filed on an annual basis The financial statements of the company must be partially reconciled to US Generally Accepted Accounting Principles (GAAP)

More stringent requirements for ADRs, GDRs and Foreign Flotation A company may gain access to foreign capital markets by the use of either the ADR in the US, the GDR in European markets, and direct flotation on foreign markets GDRs have less onerous legal reporting requirements than direct flotation of securities in foreign markets Publicly placed ADRs have similarly burdensome legal reporting requirements to direct securities issuance However, the terms of the deposit agreement with the depositary bank can limit the legal liabilities of the company, corporate officers, corporate directors, and corporate managers

Larger Pool of Available Financing The greatest advantage of public offerings is that a company will have the widest possible access to financing This will result in the company being able to obtain the lowest cost funds on favorable terms

Conclusions

We will conclude, first with some general conclusions, and then with an action plan

Our conclusions are summarized below

- A Wide Range of Financing Options Exist,
- A Comprehensive Strategy is the Key to the Financial Marketplace,
- If Audited Financial Statements Have Not Already Been Prepared, Any Financing Option Will Require <u>AT LEAST</u> Twelve Months to Implement,
- All Options Require a Base of Common Initial Preparatory Work

(e g an income statement, collection of customer payments), and

- No Internal Corporate Financial Expertise = No Successful Financing

A Wide Range of Financing Options Exist A company possesses a wide range of options to raise financial resources via debt or equity Debt financing options include the use of commercial loans and the issuance of bonded debt Equity financing options include the issuance of varieties of preferred stock shares and common stock shares Securities may be issued in Russia or abroad Abroad, a company may issue securities directly or utilize ADRs or GDRs

A Comprehensive Strategy is the Key to the Financial Marketplace No matter what mixture of debt and equity financing a company eventually pursues, a comprehensive strategy is the key to private and public financial marketplaces A comprehensive strategy will enable a company to obtain the best possible terms from investors and lenders and to raise the most amount of funds at the least cost to the company A comprehensive strategy will also allow a company's equity holders to reap the benefits of the leverage obtained from debt financing of the company

If Audited Financial Statements Have Not Already Been Prepared, Any Financing Option Will Require <u>AT LEAST</u> Twelve Months to Implement Any of the financing options will take a company at least twelve (12) months to implement unless a company already has prepared audited financial statements This is because a wide variety of information will be required of a company by prospective lenders and investors

All Options Require a Base of Common Initial Preparatory Work (e g an income statement, collection of customer payments) All of the options presented include a common base of initial preparatory work Prospective lenders and investors will want a company to provide an audited income statement and a balance sheet detailing the company's assets and liabilities

No Internal Corporate Financial Expertise = No Successful Financing In order to complete the necessary preparatory work in order to obtain financing, a company will have to develop its internal organizational financial expertise This expertise will be essential to gathering financial records, to manage a company s operations, to develop business plans, to assess the full range of financing options, and to negotiate the best possible terms of financing

Action Plan

We propose that any company pursue the following Action Plan in order to raise capital

- Develop a Comprehensive Strategy,
- Strengthen Internal Financial Management Team,
- Prepare Audited Financial Statements and
- Develop Business Plans

Develop a Comprehensive Strategy A company should develop a comprehensive strategy to address how the company should best be organized to provide for the electric power needs of Russia and to be a successful business This comprehensive strategy will include long range plans, financing plans that will support those long range plans, and the plans to develop the organizational capacity to implement a company's plans

Strengthen Internal Financial Management Team As part of the comprehensive strategy, the strengthening of a company's internal financial management team is essential to the achieving of corporate business objectives This internal financial management team can help gather all the information that the company will need in order to go to the private and public marketplaces to

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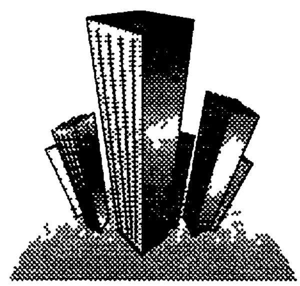
raise funds on the most advantageous terms

Prepare Audited Financial Statements A company will not be able to raise funds of any significant amount without audited financial statements Prospective lenders and investors will want to see audited financial statements before extending any substantial form of financing

Develop Business Plans Critical to the decision of investors or lenders to provide financing to a company is the belief of the investors or lenders that they will earn a return on their money Investors and lenders will want to know how the funds which they extend to a company will be used The company will therefore need to have business plans that detail how the funds that it raises will be utilized

Business Policy

Module 5



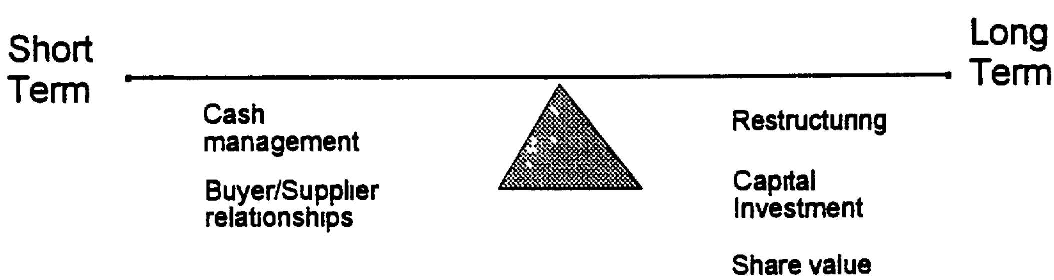
Module 5. Agenda

- Business strategy
  - Competitive analysis
  - Business plan development
  - Restructuring and investment decisions
  - Link to financing and corporate governance

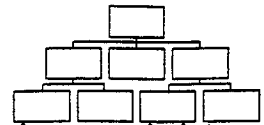
Corporate Leadership (managers and directors) must.

- Understand changing environments, potential threats and opportunities
- Analyze strengths and weakness' of the firm
- Develop short and long-term business plans
- Communicate and implement plan effectively
- Monitor performance and continuously adapt to changing environment

Balancing Short-term Survival and Long-term Growth



Key Strategic Issues Facing Management and Directors



- management & organization
  - management incentives and oversight
  - personnel training and motivation
  - marketing awareness & strategy
- operations
  - business focus
  - productive efficiency per internatio
  - price, quality and availability of inputs

Key Strategic Issues facing Management and Directors (cont'd)

- key financial issues
  - lack of cash
  - lack of cost controls and information
  - working capital quality of accounts receivable
  - current levels of debt, current creditors
  - access to new capital

Addressing these Strategic Issues Requires:

- Creating new management information systems
- Defining strategic objectives
- Focusing on core business units
  - Based on analysis of external competitive forces and internal strengths and weakness'

Analysis of External Competitive Forces

- Intensity of Rivalry
- Power of Buyers
- Power of Suppliers
- Threat of New Entrants
- Threat of Substitutes
- Government Policies

Analysis of Internal Strengths and Weaknesses

- Management
- Human Resources
- Production and Operations
- Marketing
- Distribution
- Information System
- Capital Structure

Strategy Analysis

- Beware of how the following can lead to faulty logic and poor strategy choices

1 **The tendency to underestimate uncertainty** -
do not become overconfident in projections and estimates
2 **Overemphasizing selected data** - do not become seduced by colorful reports, interesting anecdotal information
3 **Becoming too attached to one scenario** - do sensitivity analysis
4 **Seeing opportunities only incrementally** -think imaginatively and dare to break out of the old mindset
5 **Seeking only confirming evidence** -look for what will cause your strategy to fail, not just support your initial predisposition
6 **Using inappropriate analogies** - do not assume that because a strategy worked in one industry or segment it will work in another

Business Plan Your Tool

- a key tool of **general** business management to
  - review past performance
  - develop strategy for the future
  - raise capital
  - plan restructuring

Business Plan (cont'd)

- what the business plan should be
  - a tool for strategy, and implementation
  - focused on a specific time period
  - flexible and forward-looking
  - clear, concise and readable
  - easy to communicate

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Business Plan (cont'd)

- what the business plan is not
  - a five-year plan for each company
  - a rigid outline of production targets and input requirements
  - a treatise on the business and its history

Contents of the Business Plan

I Table of Contents
II Executive Summary
III General Company Description
IV Products and Services
V Marketing Plan
VI Operational Plan
VII Management and Organization
VIII Capitalization and Structure
IX Financial Plan

Business Restructuring

There are four basic approaches to enterprise restructuring, and each has a specific objective.

Restructuring

"Portfolio" Restructuring	Organizational Restructuring	Operational Restructuring	Financial Restructuring
• identify business units • find core strengths • maximize competitiveness	• incentives & compensation • reporting & control • corporate governance	• product mix • distribution • productivity • quality	• recapitalization • cash management • debt reduction • ownership structure

Portfolio Restructuring

Key goals of portfolio restructuring are to focus on core strengths and maximize competitiveness of core business units

<u>Steps</u>.

- **identify business units**
- **evaluate business attractiveness/competitiveness**
- **evaluate interdependence among business units**
- **identify core competence of the company**
- **sell off or liquidate weak and/or non-core business units**

Portfolio Restructuring (Cont'd)

- Should business units be merged? expanded? decentralized? sold? closed down?
- What units are generating the highest profits? greatest cash flow?
- What units are generating the greatest losses? draining cash flow?
- What units contribute the most to revenues? expenses?
- What are the most highly valued assets of the company?

Organizational Restructuring

- Involves changing methods of doing business
- Internal communication
  - Create reporting lines
  - Management information systems
- Creation of responsibilities and accountability
- Streamline labor costs/optimize efficiency
- Evaluate compensation and incentives
- Recruitment of qualified personnel

Operational Restructuring

- Improve efficiency of repair and maintenance
- Improve collection and billing operations
- Improve marketing and selling activities
- Improve production process
- Increase quality control
- Create useful management information systems

Financial Restructuring

- Ensure efficiency in managing cash flows
- Dispose of non-core and inefficient assets
- Restructure, repay, and refinance debt
- Identify potential sources of capital (domestic and international)

Strategy Implementation

- Strategy Implementation Requires
  - *Clear and quantifiable objectives*
    - Must know what the starting point is, and how progress will be measured
    - Establish clear objectives for every business unit
  - *Investment plan*
    - In infrastructure, personnel, information systems
  - *Financing plan*
  - *Personnel development plans*
    - For existing and new personnel
  - *Communication plan*
    - Share vision with all employees
    - Involve employees responsible for implementation in strategy formulation process

Roles of Management and Directors in Restructuring

- **Directors**
- Evaluation and recruitment of new management (if required)
- Communication with external stakeholders
- Review of overall business strategy
- Approval of changes in capital structure

- **Management**
- Internal communications
- Design and implementation of information systems
- Working capital management
- Develop strategy and restructuring implementation plan
- Estimate future capital requirements

Capital Investment

- Expand production facilities?
  - What kind of equipment? technology?
- What financial resources are currently available for these options?
- What financial resources will be required/available for these options?
- *How much cash will the firm require ?*

Cash Flow Forecast - Future Planning

- Where is cash going to come from?
- What is cash going to be spent on?
- Will there be enough cash for on-going operations and for new investments?
- When is the cash going to come in?
- When is cash going to be paid out?

Sources of Capital

- Internal Sources of Cash
  - Retained earnings Undistributed past profits
- External Sources of Cash
  - Loan capital
  - Equity

Module 5. Summary

- Access to capital depends on
  - Focused business strategy
  - Effective restructuring plan
  - Good corporate governance practices
  - Knowledge of capital markets