BUSINESS OPPORTUNITIES IN THE SOVIET UNION:
LOOK AT REAL ESTATE JOINT VENTURES

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ABSTRACT

Political and economic reforms within the Soviet Union appear to offer new opportunities to western partners considering real estate joint ventures. An overview of the existing building industry with an emphasis on the differences between Western and Soviet approaches, provides the framework for a discussion of what real estate joint ventures offer the Soviet Union, why they have become popular and what a foreign partner can expect from the existing building industry. Under Perestroika, many changes have begun to be instituted that affect the outcome of real estate joint ventures. The impact of these proposed reforms is evaluated in light of the most recent laws that have been passed. Drawing from field research in the Soviet Union, a study of four joint venture partnerships illustrates the difficulties that have traditionally been associated with conducting business in the Soviet Union as well as how foreign partners need to approach development strategies in the future.

It was found that despite the tremendous number of reforms proposed under Perestroika, some of the measures intended to make investment more attractive have resulted in more confusion, consequently the emergence of real estate joint ventures is a reflection of larger political and economic problems within the Soviet Union rather than a new phenomenon. Investment in real estate development in the Soviet Union will remain a high risk venture due to political instability, and the resulting lack of effective economic reforms. However, this will not curb the flow of western developers interested in the tremendous opportunities that this market holds. Ad hoc real estate joint ventures will continue to be negotiated. In the short term, companies that succeed in forming joint ventures will focus on the profit generated by meeting foreign building requirements and in the long term re-focus on the real estate opportunities offered by the Soviet market.

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"Few topics have become more fashionable in international economic circles than talk about joint ventures in the Soviet Union. The only thing that is surely more fashionable is talk about the difficulties and obstacles to the establishment of joint ventures or to the introduction of any economic reform in the Soviet Union." \(^1\)

Proposed political and economic reforms within the Soviet Union appear to offer new opportunity to western partners considering real estate joint ventures. The validity of these opportunities will be explored through an analysis of real estate development versus the constraints of registration and operation.

This paper provides an overview of the subject, focusing on three aspects of this issue. First, within the framework of the existing Soviet development process, why have real estate ventures become popular? What do they offer the Soviet Union? And what can a foreign real estate partner expect from the centrally planned building industry? Second, although many changes have been proposed under Perestroika\(^2\), what specific changes have affected the viability of real estate joint ventures, and are these reforms structured to work? Third, drawing from research in the Soviet Union, a study of four joint venture partnerships illustrates the difficulties associated with establishing and operating real estate joint ventures in the Soviet Union.

Each chapter is organized to look at a different aspect of real estate joint ventures. Chapter One focuses on the
construction process in a centrally planned economy. Using five key differences between the Soviet and American development process, the reader will develop an understanding of the fundamental problems that exist within the building industry. More importantly, they will begin to understand the constraints involved in establishing a real estate joint venture.

The thrust of Chapter Two is real estate legal reform under Perestroika. Although amendments have been made to the Joint Venture law making it more attractive for foreign firms, fundamental economic issues within the system remain unresolved. Until these issues are resolved, joint ventures will continue to serve an isolated and limited purpose within the Soviet Union.

Chapter Three focuses on the difficulties of developing real estate in the Soviet Union. Four joint venture partnerships will be used as a backdrop for explaining the major constraints facing prospective developers.

Several key conclusions have been reached regarding the viability of real estate joint ventures:

1. Joint ventures are not a new phenomenon. There have been scattered examples that date back to the 1950's and earlier. However, real estate as a joint venture is new and is symptomatic of the economic and political problems that
are being faced in the Soviet Union.

2. Joint ventures are more difficult than ever to get approved and to execute. This is despite the changes that have been proposed under Perestroika. The process is stymied by the oppressive nature of the central bureaucracy in the approvals process, the lack of effective economic reform measures and the emerging presence of local government.

3. The risks associated with developing real estate in the Soviet Union are too dynamic to use standard measures. In the current political climate, projects cannot be evaluated solely on their financial and market feasibility. Risk evaluation needs to address the political, economic and social impacts on project's success.

4. Real estate joint ventures can succeed in the Soviet Union, despite the difficulties of doing business. However, until sweeping economic reform is implemented they will continue to be hard currency projects structured for the foreign consumer.
CHAPTER ONE:

REAL ESTATE DEVELOPMENT IN A CENTRALIZED ECONOMY:

WHAT ARE REALISTIC EXPECTATIONS

The roles and responsibilities of the players within the development process are extremely different in a planned economy like the Soviet Union. These differences are evident in every aspect of the building process from determining demand to deciding on the structural system of the building. Understanding these differences has never been more important. As new policies oriented to a free market system are recommended under Perestroika, the entire centrally planned economy is in a state of flux. Proposed changes have not solved the economic conditions and the original system is functioning at a sub optimal level. Understanding the existing Soviet construction process is necessary to determine how real estate joint ventures can work in this changing system.

This chapter will analyze the construction process in a centrally planned economy by exploring five key differences between the Soviet and American development processes. Some of the issues, (such as the lack of quality building materials, the sophistication of the construction methods used, and the lack of skilled labor) directly impact joint venture strategies. Others, including the concept of profit
and the developer as coordinator of the development process, are fundamental reflections of the construction industry after seventy years of central planning and allocation.

These difficulties are not highlighted to criticize the Soviet construction system, but rather to provide a point of reference for western developers. Along with recognizing the differences, potential foreign partners need to realize that simply superimposing and importing the standards, techniques and Western ways is not enough. Any success that is achieved will be a direct result of the foreign partner's ability to understand and work within the existing development process and adapt to the changes that surfacing in the Soviet Union.

THE DEVELOPER DEFINED

The developer as someone who directs all aspects of the construction of a building is an unfamiliar concept in the Soviet Union. (See the organization chart included as Appendix A). Each entity, including the central planning agency the central supply agency the city the architect and the contractor, works within its own set of state directed mandates. Each of the players is responsible for his piece of the construction process and no one assumes responsibility for making sure the project makes sense, is cost effective, will be completed on time or is soundly built. As a result, plans are established and directives are issued with no real or perceived accountability for the end product.
Specifically, there are several Soviet State committees that are responsible for planning all construction within the Soviet Union.\(^3\) Gosplan (the Central State Planning Committee) designates the amount of funding that is available for all building types, determines the number of square meters that will be built, and works with Gosgражданстрой and Gosстрой (two subordinate committees) to establish the overall construction program for the Soviet Union. Gosstroy is responsible for defining what constitutes the main technical and scientific problems in the field of construction and architecture. Using residential construction as an example, Gosgражданстрой and Gosstroy provide a wide range of functions in support of Gosplan, including: initiating and coordinating work on standard designs for housing and civil construction, developing scientific research in the field of pre-fabricated building, working with Gosplan to determine the average estimated cost of erecting living space, and working with Gosplan to establish the national economic plan for housing.

Foreign joint venture partners will need to take an active rather than a passive role in directing the development process. Foreign developers cannot assume that there is an existing sets of checks and balances within the Soviet system that will ensure the completion of a project on time and within budget. Strict project oversight will be required. Additionally, the role of developer will be defined to many of the players in the process.
PROFIT AS A MOTIVATOR

The motivation of profit as an incentive to produce more housing or more materials to finish a construction project faster, or to ensure the quality of what is being built is nonexistent in a centrally planned economy. The traditional approach has resulted in workers producing nothing more or less than what they must, as pay is not dependent on productivity. In Western countries demand generates supply. In the Soviet Union the state, as the planner, producer, builder and banker, determines supply, and how much will be produced, as well as who will be supplied. The state covers the costs. As the supplier of everything from food to homes, the state has not created incentives to increase production.

This lack of profit motivation has severe ramifications: fewer highly skilled laborers, and a decline in the production of building materials. This had led to a shortage of building materials for both internal consumption and international export. With the inability to generate hard currency through export, the technology and machinery have fallen into disrepair.

Foreign partners will need to structure business plans that address this severe constraint to productivity. Solutions may lie in looking for Soviet partners that are involved in material production or are a construction enterprise. The lure of hard currency combined with production quotas would
provide an additional incentive to Soviet enterprise. A second, more costly solution, is the importation of foreign building materials and skilled labor. This has proven to be a particularly good strategy for Finnish construction firms due to their geographical location.

CENTRALLY PRODUCED SHORTAGES
There has been a chronic shortage of building materials produced within the Soviet Union over the last few years due to the shortage of raw materials, the lack of skilled labor, and the waste that results from poor quality control. When this situation is overlaid with subsidized prices and a centralized distribution system, the result is a system that is based on whether enterprises and consumers can access the products, rather than whether they can afford the few products that are available.

"...It is not the amount of money one earns that decides what one can buy, but the kind of friends one has, what ones position is at work, where one lives and other considerations that have no direct connection with work."4

In the construction industry, the material allocation is different for state and non state enterprises. Price is not the distinguishing factor. Rather, decisions are based on organizational affiliation, private versus state operated, and state project versus a joint venture with a foreign firm.
For example, a state enterprise involved in the production of high technology, military or export materials are in a favored status to obtain building materials: requests are given priority and there is a greater chance of obtaining the quantity and quality of materials required. Non-priority state enterprises will receive some of the construction materials requested, but not enough to complete the building program established by Gosplan. Although building cooperatives were in 1988 authorized to operate as separate building enterprises, regulations have prohibited their ability to secure building materials through official state supply agency (Gosnab) channels, unless a building is being constructed for the state. Building cooperatives involved in contracts for private entities are required to negotiate directly with a factory or work through a network of personal friends. Both of these channels generally require working through some element of the black market.

Unlike soviet enterprises that are subject to the dictates of the state allocation plan, foreign joint ventures operating in the Soviet Union are given the choice of using Soviet raw materials or importing from abroad. Although the state cannot effectively meet it's own requirement for building materials, this policy for foreign partnerships is yet another mechanism for generating hard currency.
Even though the state allocation system provides for the distribution of raw materials to foreign joint ventures, there are several constraints facing developers considering the use of internally produced materials. First, the raw materials potentially available to foreign enterprises are limited to concrete, cement, steel, gravel, sand and limited amounts of lumber. Therefore, importing other building materials, including mechanical, plumbing and electrical components as well as finish materials, is required. Second, the availability of these materials are constrained by the same production problems that affect all building materials within the Soviet Union, namely, a lack of skilled workers, a lack of quality control and a lack of raw materials. Frequently, the quality of materials is such that they can't be used. Finally, the experiences of Finnish and Swedish construction firms indicates that a fall back strategy for getting the materials delivered on time is mandatory. This logistical constraint adds project risk due to down time, delays and the costs of contingency planning.

DESIGN AND CONSTRUCTION

Some historical context is required to understand the role of architectural design and construction in the development process as well as in real estate joint ventures. In the 1920's the Council of People's Commissars complained about the extravagant design and construction costs. In response, the government began to issue decrees mandating the reduction of costs and the use of standardized designs as early 1930.
While centrally administered systems were being implemented to meet these decrees, the Soviet Union was experiencing a tremendous loss of human resources to both the war and to Stalin's purges. As the combination of these events took hold, architecture was reduced to developing standardized designs that could be manufactured on a massive cost effective scale.6

Manifestations of this philosophy are still firmly embedded in the development process of today. For example, in the Soviet Union, the use of large scale, precast concrete panels is the sole method of constructing state produced housing. In contrast, other countries have several residential construction systems existing side by side. In the Leningrad region there are three factories dedicated to mass produced housing. Under the auspices of the Gosgrazhdantroi and Gosstroii, these factories are each responsible for the design and construction of pre-cast concrete panels of a particular height range (4-10, 10-12 and 12-17 stories each). Each factory employs a staff of architects and engineers. Using centrally directed guidelines, these professionals produce a "series" of working drawings that are used and site adapted for 5-7 years. Although minor changes are made to the designs every year to reflect changes in current housing technology, the production facility decides when a new series needs to be designed. The last series produced in the 4-10 story factory was in 1983.7
As previously mentioned, the primary motivation for the use of pre-fabricated, large scale concrete panels has traditionally been the government's interest in cost reduction. This in turn has met other Soviet objectives, including the industrialization of construction, and the production of more residential units than had previously been built under other systems.

"...The use of standard designs and industrial techniques went hand in hand with the erection of high rise blocks of flats. These trends necessitated the rationalization of the building industry by creating fewer and larger units (factories for the production of panels)..."\(^8\)

The simplified explanation for this dates back to the Kruschev period when major reforms were instituted to eliminate communal living and provide every family with their own flat. To accomplish this objective a minimum square footage requirement (9 square meters per person) was established and mass production began. The proportion of all state and state cooperative housing that has been built using this system has risen from 1.5 percent in 1959 to over 80% in the early 1980's.\(^9\) There are currently 650 pre-cast concrete residential factories throughout the Soviet Union.

There are four primary reasons why there is such a strong commitment to the use of pre-fabricated concrete panels in
residential construction. The first is the significantly higher production output that the Soviets have realized using this system. Second, they feel concrete is a more efficient building material; they can meet their minimum quality standards and yet produce on a mass scale. Additionally, they have internal access to relatively inexpensive raw materials, such as cement, concrete, steel, sand and gravel. Third, there is an extensive infrastructure that has been built over the years to produce this product. The ramifications of considering a change in construction methods would be significant due to their dependence on this one system. The fourth reason is particularly constraining at this time. Although there are significant wood resources within the Soviet Union, wood is a major export material and one of their main sources of hard currency. The wide scale use of wood construction would potentially deplete this resource.

There are several design and construction implications for real estate joint ventures. Namely, building codes are limited to the use of pre-cast concrete panel systems. Deviation isn't currently allowed, and therefore design and engineering solutions are limited to this building system. An example of this was the Rosinka project in Moscow. Despite attempts by the foreign partner to use wooden construction methods, it was impossible to obtain the necessary building approvals. Foreign partners need to
understand the Soviet commitment to concrete, while at the same time not give up on ultimately succeeding with creative alternatives.

LABOR
The skill level of Soviet construction workers has steadily declined over the last few years. This factor has been a major contributor to the state housing shortfall and the poor quality of existing buildings. Several reasons have been articulated for this decline. From a historical perspective, the Soviet Union lost 60 million people as a result of World War II and Stalin's purges. This loss, combined with the industrialization of the construction process, left the Soviet Union with a dearth of skilled craftsmen. More recently, the low prestige associated with manual labor, the recruitment of unskilled workers from the countryside and the evolution of building cooperatives have been blamed for the lack of skilled construction workers and the poor quality of state construction.

The state solution? Increase hiring of foreign construction firms. Using hard currency reserves, the Soviets have hired Finnish and Swedish construction companies for priority projects. Examples of these projects are in the cities of Leningrad and Moscow, where historic hotels such as the Astoria, Europenska and Metropole are currently under renovation by foreign firms.
One solution for real estate joint ventures faced with the dilemma of finding skilled labor, is to follow the Soviet example and hire a foreign construction company. Foreign construction firms have been doing work in the Soviet Union for many years and are easily mobilized for projects of any scale. Two more creative alternatives are the implementation of training and incentive programs for Soviet workers. An example is found in the Perestroika Joint Venture. Structured to improve management skills, a training program was developed for employees of the Soviet partner. An incentives program has also been established. In the opinion of the General Manager, both have contributed to improved productivity.

WHAT THIS MEANS
Real estate joint ventures have introduced a flexibility to Soviet enterprise. For instance, economic directives from Gosplan are no longer prerequisites to getting a facility built, materials can be more easily cleared through customs, and local government is able to access hard currency more readily.

However, until major economic reforms are instituted, these ventures will be nothing more than a hard currency source for the Soviet Union. The centralized planning and allocation systems will not change until a free market system is instituted, private enterprise is free to prosper, and
building standards become more open. Economic change of the scale required in the Soviet Union is, at best, slow and difficult.

Real estate development will remain a high risk investment. Upfront capital expenditures, significant travel expenses and extensive hours will be required to form joint ventures. Risk of failure is greatest during the registration stage. Due to the bureaucracy involved, joint ventures should consider forming partnerships where follow on projects are possible.

Joint ventures will have to develop comprehensive resource acquisition strategies. Under the current system, this will include extensive contingency plans and ethical decisions regarding the role of "blat". Contingency plans will need to address problems with internal resources as well as plans for externally sourced building materials, technology and labor. Armed with an understanding of the formidable process, developers seeking to do joint ventures can design successful strategies.
CHAPTER TWO:

CHANGE UNDER PERESTROIKA:
THE IMPACT ON REAL ESTATE JOINT VENTURES

Many isolated economic policies have been proposed under Perestroika in the last three years. For example, the Law on Joint Ventures, the Law on Cooperatives, the legalization of private ownership and the proposed construction of 30 million new apartments and houses by the year 2000.12 Talked about, but unsupported by economic change, these policies are are not substantially different from other historical attempts at reform.

This chapter examines the legal real estate reforms that have been proposed under Perestroika. Although amendments have been made to the Joint Venture law that make it more attractive for foreign firms, fundamental issues within the system remain unresolved. Before real estate joint ventures can become more than ad hoc solutions to the Soviet shortfall of hard currency, sweeping economic reform is required.

Examining why these isolated reforms are not working includes discussion of: the lack of a free market system, the convertibility issue, the role of lawyers within the system, the lack of a structural framework to deal with land use, the role of a top driven reform, and how local government has begun to react to ineffective central direction. While these
reforms may seem simplistic to the Western eye, many are revolutionary by Soviet standards.

PROPOSED LEGAL REFORMS
Since the Decree on the Formation of Joint Ventures between Soviet organizations and foreign partners was issued in January 1987, numerous guidebooks have been published on the subject. While these guidebooks highlight the current statutes and provisions, as well as provide "how to..." sections, none have specifically addressed the positive and negative ramifications of this legislation and amendments to real estate joint ventures.

THE LAW ON JOINT VENTURES
Six primary amendments have been made to the Law on Joint Ventures since its issuance in 1987. Of particular significance is the delegation of approval authority from the USSR and Republic Council of Ministers to the superior administrative body of the Soviet partner. In many cases this body will be the Executive and City Councils of the city in question.

Another change was the elimination of a ceiling on the percentage of foreign ownership in a venture. Previous legislation limited foreign ownership to 49%. It is now up to the partners to establish ownership, as long as it is less than 100%.
Previously, the law required both the Chairman of the Board and General Director to be Soviet citizens. This has been amended and one or the other of these positions can now be headed by an appointee of the foreign partner.

The right of joint ventures to independently establish employee compensation was amended several times. The most recent amendment provides flexibility regarding this issue as long as compensation meets minimum Soviet standards.

As of 1988, shares in a Soviet joint ventures may be transferred to a third party upon mutual agreement of all partners. Amendments did not however abolish the Soviet partner's priority right to acquire the shares. Prior to that, approval of the USSR Foreign Economic Commission was required.

Soviet auditing requirements have been relaxed. Along with allowing foreign accounting systems, Soviet auditing is limited to the assessment of tax payments.

Finally, foreign employees of the joint ventures are now entitled to pay for housing and services in roubles instead of hard currency.

All of these amended provisions would appear to facilitate the formation and operation of joint ventures. However, many of provisions have contingency conditions that limit the
overall positive implications. For instance, approval authority is delegated to local bodies which potentially eliminates time delays in the approval and registration process. Yet, central authorities still retain strong control over the formation of joint ventures through the requirement for the USSR Ministry of Finance to register the partnership.

To undercut the power established in the ownership and appointee amendments, an additional amendment was passed requiring a unanimous vote by the Board of Directors for all "fundamental issues" related to the Joint Venture. Fundamental Issues have not to date been defined, and should be given particular attention by both parties when drafting both the by laws governing the partnership as well the JV agreement.

The amendment allowing foreign partners to pay for housing and services in roubles is a fallacy. In practice, severe shortages make it difficult to access these necessities for hard currency much less rouble currency.

LEASING, PROPERTY AND LAND LAWS

Leasing Law

In January 1990 the formal leasing legislation passed by the USSR Supreme Soviet went into effect. This law established the basic legal structure for lessor-lessee relationships within the Soviet Union. The law does two primary things.
It allows local City Councils to outlease property within their jurisdiction, and it outlines the types of property that are allowed to be outleased.

Important to real estate transactions, the law provides for land, buildings and equipment to be outleased. It specifically states that both Soviet individuals and organizations, foreign individuals and organizations, and joint ventures may be potential lessees. It also establishes that the Lease Agreement shall be the "fundamental document that shall govern relations between a lessor and a lessee".

Property Law
The property law was established in March 1990. It provides joint ventures the right to own the assets required for their activities as outlined in the joint venture by laws and Agreements. Although land is generally considered property, the right to own land is limited by the Land Law and ownership is limited to personal, agricultural and residential use.

Land Law
Established in February 1990, the Land Law provides for land use regulation. The power to regulate land has been delegated to the Soviets of People's Deputies. The law enables them to outlease land to organizations, and handle "the registration of ownership and usage rights over land and of agreements on leasing of land." This law establishes a
formal system for land rights that local governments have been assuming in an adhoc manner until now.

ESTABLISHING LAND VALUATION TECHNIQUES

Land valuation techniques are emerging at the local government level within the Soviet Union. Although unsophisticated by Western standards, these are first attempts at establishing a formal value structure. Promulgated in Moscow, two directives have been issued.

Issued in 1988, the first directive divides the city into five concentric zones radiating from the Kremlin. Every zone has been assigned a value per hectare. This value is irrespective of the specific location of the parcel, or the existing condition of the property. The only distinction regarding value is the addition of a clause that mandates a 50% surcharge for all sites located within 500 meters of a large urban thoroughfare or subway station. Although the land is only transferred on a lease basis, the established value is based on rights in perpetuity concept. The same value applies to the property regardless of the length of the lease.

A second directive was issued in 1989. This decree established an annual rental payment for all property leased within the City. The payment is in addition to the one time "lease payment" discussed above.
WHY ISN'T REFORM WORKING?

The Law on Joint Ventures was introduced to promote investment in the Soviet Union and generate hard currency. The law was not part of a set of reforms structured to revitalize the economy. The law has had minimal effect on the Soviet economy. This is witnessed by the limited number of real estate ventures that have been registered, the lack of projects that have been developed for the Soviet market, and the adhoc nature of forming real estate joint ventures.

LACK OF A FREE MARKET SYSTEM

Fundamental reform of the Soviet centrally planned economy is required before real estate joint ventures will begin to meet the building requirements of the Soviet Union. As currently structured, the Soviet planned economy provides very little opportunity for free market trade. The only internal move toward private enterprise was the Law on Cooperatives, introduced in 1988. This law allowed the formation of building cooperatives that would operate independently of state building enterprises. These cooperatives would operate as self-financing enterprises, meaning their revenue would have to cover their costs, and no state subsidies would be provided. They would be required to pay "fair market rates" for raw materials and components. And they would be able to charge fair market prices. However, soon after being made law, the apparat\textsuperscript{16} established a 90% tax on cooperatives making it prohibitive to form one.\textsuperscript{17} More recently, building cooperatives have been prohibited from buying state
controlled building materials unless they are building a state project.

Until prices are allowed to fluctuate with supply and demand, and a free market system is in place, there is no incentive for developer's to satisfy the Soviet demand for space.

CONVERTIBILITY
The lack of rouble convertibility is a significant constraint to Soviet real estate joint ventures. Although non real estate joint venture partners, like Pepsi\(^1\) have structured deals to export Soviet products, real estate does not lend itself to these import/export strategies.

To work around this constraint real estate joint ventures have focused on a real estate market that generates hard currency, which is anything built for foreigners. This has served two purposes. The foreign partner is able to expatriate profits, and the Soviet partner earns hard currency.

However, the viability of this strategy is limited. It has worked to date because of the limited supply of hotel, office and residential space for foreign occupancy and the high rents that can be generated.

The introduction of a joint venture law without the necessary financial instruments to interact in a global marketing is
counterproductive. Before long term investment in the Soviet Union can implemented, rouble convertibility will need to be addressed by the central government. Unlike many reforms that can be implemented from a grass roots movement, this issue will require fundamental economic reform at the central level.

BUREAUCRATS AS LAWYERS
One of the flaws built into the current approach to reform under Perestroika is the continuing role of bureaucrats in establishing the laws and policies. The legal system in the Soviet Union has traditionally been based on laws established by political bodies rather than by a formal legal system. An example of this is the Law on Joint Ventures. Initially drafted in 1987, it has been amended numerous times and still contains many vague, ill-defined clauses. This has enabled the law to be manipulated to suit the purposes of the bureaucrats involved in each specific deal.

"...In the old system bureaucrats made all the decisions... lawyers were the people who had to make laws from what had been decided. Theirs was not to take part in the decision making ...it is easy to see in our new rules and regulations, for example the ones referring to the organization of joint enterprises that lawyers weren't involved...the wording is often imprecise and capable of several interpretations,while some articles even contradict others...this is of immense advantage to those bureaucrats of the apparat who wish to retain their powers and privileges..."" 

Foreign joint venture partners are frustrated working without strict legal guidance. Each new amendment requires assessment and the nuances of the system can easily escape the foreign partner.
CENTRALLY DRIVEN REFORM

Unlike Poland, the changes proposed under Perestroika have been driven from the top. Local and satellite political bodies have not until recently, been involved. Thus, there is no sense of contribution or commitment to a common cause. The reforms are considered largely ineffective due to the lack of substantive social change.

Local and satellite leader's are now taking reform into their own hands. Newly elected city council members and mayor's are grappling with solutions to local problems. For example, in Leningrad the City Council is looking at how they can develop a land valuation system. The Moscow City Council has established a legal office to negotiate joint ventures.

What does this mean to real estate joint ventures? Isolated laws combined with ineffective economic reform policies at the national level have been juxtaposed with local action. This has resulted in confusion for everyone involved in the establishment of joint ventures. Foreign partners no longer have a clear understanding of who is responsible and Soviet state agencies are unsure of their approval authority. This politically instable period has resulted in many delays in getting projects underway and approved.

The lack of a local infrastructure overlaid with ineffective central economic reform will continue to create problems for those interested in establishing real estate joint ventures.
However, several things are clear. The role of local government will become larger rather than smaller. Local City Councils are empowered and are assuming control from the centrally planned administration. Decentralization of authority will continue, as local governments determine their requirements and begin to establish city specific guidelines for working with foreign joint venture partners.

Additionally, the lack of strong central economic reform will continue to make the execution of real estate joint ventures difficult. The process is complicated, replete with bureaucratic pot holes. Until real estate joint ventures are able to charge fair market rents and repatriate roubles, real estate joint ventures will continue to be structured for the foreign market. Isolated policy changes, like the Law on Joint Ventures, will not lead to economic reform on the scale required for the Soviet Union.
There are few real estate joint ventures that have been registered and are operating in Moscow and Leningrad. The major reason is the difficulty in registering a joint venture. The Law on Joint Ventures outlines the following sequence of steps for project initiation and registration:

- select an appropriate Soviet partner. This is one of the most critical steps and must include an examination of the superior authorized agency.
- prepare a letter of intent (protocol) between Soviet and foreign partner.
- prepare the joint feasibility study.
- negotiate the terms of the statues and joint venture agreement.
- submit study and joint venture documents to the Soviet partner's authorizing agency for approval.
- forward to Ministry of Finance for approval and registration.

There is a tremendous amount of variation in how these ventures proceed through the bureaucratic registration maze. Although no two projects are alike, there are some valuable lessons learned by analyzing their individual processes. The following chapter will focus on the four primary barriers to project development in the Soviet Union: Finding the Right
Soviet Partner, Structuring the Deal, Financing the Project, and Evaluating the Risk. Appendix A provides four cases studies depicting these challenges.

A PROFILE OF JOINT VENTURE ACTIVITY

Of the case studies summarized below, two are registered and operating. The other two have approved by-laws and joint venture agreements and are awaiting registration by the Ministry of Finance.

Perestroika

Touted as the first real estate joint venture in the City of Moscow, the Perestroika Joint Venture has completed the renovation of three office buildings that are fully leased. The primary Soviet partner of this joint venture is the construction enterprise responsible for all infrastructure in the City of Moscow. Other partners include the Moscow Architectural Association, the Moscow Hotel Association, Dialogue and the American partner, The Worsham Group. The joint venture is structured as a 40-40 deal between the primary partners, with the remaining interest distributed between the other three partners. The joint venture has been self-financed to date, with ten year pre-paid leases covering the costs of construction.

Amstroi

This joint venture is designed to renovate and construct an addition to an office building in Moscow. The partners are
the Moscow High Rise Housing Authority and an American development team. The project will serve both Soviet and foreign tenants. Each partner has a 50% interest in the venture. One of the more recent real estate joint ventures, Amstroi has been working through the quasi-legal office of the Moscow City Council. They are currently awaiting registration with the Ministry of Finance. Project financing consists of internal capital, pre-leasing commitments and construction financing through a Finnish construction company.

Rosinka
Rosinka will be an 82 acre residential community located 24 kilometers from the Kremlin. The project will consist of 528 units of housing for members of the foreign community. The Soviet partner, a collective farm, brings land and building approvals to the joint venture with the American partner bringing the marketing and development expertise. Each partner has a 50% interest and financing for the project is currently being sought. The Finnish government has agreed to back the 100 million dollar project.

Filco
Located in the City of Leningrad, the partners are a Finnish and a Soviet construction company. This joint venture has in turn joint ventured with the Leningrad City Council (Lensoviet). The Finnish and Soviet partners each split 60% of the venture, with Lensoviet receiving a 40% interest.
Financing has been secured through a Finnish Bank. Financial guarantees have been secured through the Finnish construction company's parent company.

FINDING THE RIGHT PARTNER

Many established joint ventures are heralded as "well connected" within the Soviet government. This has historically been the way to conduct business in the Soviet Union. However, the modus operandi is becoming more complex as the political structure changes from a centralized system to one with numerous parties and several levels of government.

One of the side effects is the difficulty foreign partners have distinguishing between potentially viable Soviet partners and political cronies. Many state agencies are defunct under recent political reforms. However, some of these agencies continue to be represented to foreigners as potential Soviet partners by ex-agency officials. For example, on a recent trip to the Soviet Union, a developer from Boston was invited to a meeting of potential Soviet partners. The meeting seemed to be a positive first step in the pursuit of a Soviet partner. However, when the American businessman reviewed the list of attendees, a Soviet acquaintance informed him that half of the "agencies represented" were no longer operating.
The increasingly significant role of local City Councils contributes to the difficulty of finding a Soviet partner. Whereas deals used to be negotiated with state officials, local government agencies and enterprises now negotiate their own deals. This has proven to be a double edged sword. Despite their interest in getting the project approved, local government involvement is another cog in the bureaucratic wheel. Newly elected City Councils are exerting power in many areas where they have little expertise. Additionally, more local governments and enterprises now interested in joint venture opportunities, thereby adding to the chaos. The Moscow City Council has created a quasi-legal organization, Mosinter, to deal with this increased interest in joint ventures. The Mosinter charter is to review, negotiate and recommend action all new joint venture proposals in the City.

The concepts of lobbying and business networking are unfamiliar in the Soviet Union. As a result, there are no trade organizations or professional societies available to provide contacts for potential foreign partners. Organizations like the USSR Union of Architects are the closest example of a professional society. However, unlike its western counterparts, the Union exists to provide an intellectual forum for the discussion of architecture.²⁰

It is critical to find a partner that can assist in the approvals and development process. However, this can be one
of the most difficult aspects of a partner search. The Perestroika Joint Venture is unusual in the expertise that the Soviet partner brings to the team. Most Soviet partners bring the land or building component to the venture but do not offer a local real estate development expertise. The Amstroi and Rosinka projects are more representative of what a foreign partner can expect to find in the way of Soviet partners. Soviet partners unfamiliar with the construction process will look to the foreign partner for this expertise. This places a great deal of responsibility on the foreign partner to succeed in the bureaucratic maze, and places the project at greater risk.

STRUCTURING THE DEAL

The case studies demonstrate four obstacles in structuring a real estate joint venture. These include: providing for follow on projects, establishing long term strategies within the current economic and political constraints, assessing the value of each partner's contribution and developing a mutually satisfactory operation and management style.

Long term holding strategies are required due to the large upfront capital expenditures in real estate joint ventures. Although currently strong, the market for hotels, offices and residences for foreigners is limited. Eventually, development firms will need to expand into new markets. Unfortunately, joint ventures cannot, at this time, develop effective long term strategies to meet this untapped demand.
Standing in the way are economic constraints such as the inability to expatriate roubles, and the lack of a free market system. While motivated by hard currency profits, Filco and Perestroika are in better positions to spend roubles because of the large numbers of Soviet workers they employ.

Registration is perhaps one of the biggest challenges in establishing a real estate joint venture. Therefore foreign partners ought to develop strategies to include long term Soviet partners that offer follow on potential. For example, City Councils and large state enterprises with access to property and resources enables start up costs to be amortized over a longer term.

Agreeing on the value and timing of each partner's contribution is a difficult part of the negotiation process. The difficulty stems from the lack of a universally accepted valuation system for land and buildings in the Soviet Union. Compounding this situation, is the long standing western reliance on market appraisals and brokers.

This became an irreconcilable difference is the Perestroika Joint Venture. As originally structured, the Soviet partner contributed three buildings as equity, and the foreign partner contributed capital. However, during negotiations
the value of the buildings and the timing of the capital contribution could not be agreed upon. The result was a split up, and the introduction of a replacement partner.

Finally, joint venture by-laws need to address management and operational issues. How will differences in management styles be resolved and what will be the specific roles of each partner in the day to day operation? As highlighted in the book *Behind the Factory Walls*,²¹ there are fundamental differences between Soviet and American management styles. These differences need to be understood and worked into a strategy that meets both partner's objectives.

The Perestroika Joint Venture provides a good example of how management and operational issues have been resolved between the Soviet and American joint venture partners.

FINANCING A DEAL

Despite the market demand and profit potential, financing real estate projects in the Soviet Union is a difficult undertaking. There are mixed reviews on the viability of lending money to these new ventures. As the economic issues of other Eastern nations surface, and the short term Soviet debt rises to 3 billion dollars,²² foreign investment in the Soviet Union may tighten.
There are three primary problems: the tremendous political and economic uncertainty, the lack of international business experience and the shortage of Soviet collateral and financial guarantees.

European governments and banks are being more aggressive in Soviet real estate joint ventures. For instance, in the Rosinka venture, the Finnish government guaranteed the total project cost, 100 million dollars. The Filco joint venture secured bank financing through a Finnish bank, and the financial guarantees were provided by the Finnish parent company.

In lieu of securing short and long term financing from traditional sources, several other approaches have been undertaken with real estate joint ventures in the Soviet Union. A common financial strategy is to use pre-paid leases to cover construction costs. For instance, the Perestroika Joint Venture was able to leverage it's ten year pre-paid leases and the Rosinka project receives payment for years four, five and six at the time of occupancy. Another approach is to give the foreign construction company a percentage of the profits in exchange for their financing of the construction costs.

These approaches have only been possible for two reasons. First, tremendous foreign demand for office, hotel and
residential space has enabled owners to charge high rents, and obtain pre-paid leases. Second, the development projects have been relatively small in scale. With the current economic and political instability in the Soviet Union, the outlook for future financing is unknown. Prospective foreign partners should not underestimate this formidable challenge to Soviet development.

THE EVALUATION OF RISK
There are tremendous risks associated with doing business in the Soviet Union. A primary difficulty facing foreign partners is how to evaluate the risks which range from the traditional start up investment of capital and time, to fundamental problems with the Soviet political and economic systems.

The first risk to evaluate is whether sufficient capital resources are available. Doing business in the Soviet Union is very expensive. Foreigners find there are substantial hidden costs associated with operating in the secondary economy. This economy, informally established for the foreign community, operates separately from the centralized economy and offers commodities and services to hard currency patrons. It is still illegal for foreigners to spend hard currency in other than state operated enterprises. However, foreigners will find it virtually impossible to conduct business in the Soviet Union without using hard currency. Additionally, the prices charged hard currency patrons have
no relationship to the prices charged Soviet citizens. The distinguishing factor is that there is virtually nothing for Soviet citizens to spend roubles on, and there is plenty for foreigners to buy.

A second risk to be evaluated is the ability of the joint venture to secure Soviet building materials and labor. Depending on the strength of the Soviet partner this may be easy or difficult. For instance, it is reasonable for the Perestroika joint venture to expect to use Soviet materials and labor, while the Amstroi joint venture should anticipate having to bring resources into the Soviet Union. This distinction is based solely on the connections of the Soviet partner.

Finally, risk cannot be measured by market and financial posture alone. Rather, one needs to consider the dynamic political, economic and social conditions. For instance, at face value the financial and market risk of building office space in Moscow is negligible. Office space is being developed for the foreign community and despite the high rents, the saturation point is years away. However, an evaluation of the political situation will dictate whether there will be an ongoing demand for this type of product in the short term.

SUMMARY
The difficulty then becomes how do you evaluate the political
and economic stability of a country with the size and diversity of the Soviet Union. This evaluation is not easy.

Although changes in the Law on Joint Venture have theoretically increased the advantages of forming a joint venture and made the approval process easier, the constraints of operating in the Soviet Union have not significantly changed.

For those enterprises, that evaluate the constraints of doing business and understand the system there may be an opportunity for long term gain. Real estate development strategies need to address a myriad of issues that are unique to the Soviet Union. There is a risk associated with inaction as well as action. As highlighted in a recent article, those companies that get in early, learn the idiosyncrasies of the Soviet system and ways of the bureaucracy will have an advantage over those who wait for no risk.23

Projects will continue to be initiated to meet the demand driven by the presence of foreign firms on Soviet soil. However, until further economic reforms are established, including the convertibility of the rouble and the establishment of a free market system, there will be very few real estate development projects that will be structured to meet Soviet needs.
CHAPTER FOUR
CONCLUSIONS AND RECOMMENDATIONS

It is difficult to remain objective about the potential success of real estate joint ventures in the Soviet Union. The excitement is contagious! The demand appears endless, enthusiasm on behalf of Soviet partners is strong, for once government seems to be sincere in following through with much needed reform, and the returns would be promising. But these motivations alone do not tell enough of the story. Real estate joint ventures are extremely capital intensive, time intensive, frustration intensive and RISKY, even in one's home country. What multiple factors do you apply when transferring these expenses to the Soviet Union today?

The objective of this thesis has not been to comment on the ultimate success or failure of real estate joint ventures in the Soviet Union. Rather, it was intended to provide the prospective developer with an overview of the constraints and opportunities that might be encountered in developing real estate in the cities of Moscow and Leningrad.

Problems with current real estate joint ventures are symptomatic of the larger economic and political issues faced by the Soviet Union. Perestroika is not a remedy to a minor depression in the Soviet economy. Seventy years of a centralized economy has resulted in inefficiencies in every sector that are now crippling the entire economy. There are
many critics who believe the country is beyond repair and that tumultuous change, as we have already seen in other Eastern block countries, will be the only recourse to what now ails the Soviet economy. It is against this background of skepticism, bordering on "doom and gloom" by some noted authorities, that we must measure the relative successes of joint ventures to date.

In the past, joint ventures were primarily used as a way of exporting Soviet products abroad and importing technology and commodities. However, with the decline in the export of Soviet oil and other exports over the last few years, joint ventures have provided the Soviets with an alternate source of hard currency. Due to the dire need for hard currency, the emphasis placed on joint ventures has changed from one of wanting technology and imports/exports to a critical interest in any joint venture that will generate hard currency. The result has been the emergence of real estate joint ventures structured to satisfy the hard currency base of the growing foreign demand for office, hotel and residential property in the Soviet Union.

While the rationale has political support, and reforms have been introduced, the economic infrastructure required to make real estate joint ventures function is not in place. Until further economic reforms are established, including the establishment of a free market system and convertibility of
the rouble, real estate development projects will continue to be adhoc solutions in a declining market.

Despite the tremendous number of changes that have been proposed under Perestroika, the overall ability of local partners to execute real estate joint ventures has not improved. Two primary reasons can be offered. First, legislation proposed at the Supreme Soviet level did not address the fundamental lack of an economic, legal and institutional framework within which real estate joint ventures could operate. Issues such as the lack of a convertible currency, lack of appraisal and valuation techniques, and lack of value pricing mechanisms are severe impediments that cannot be addressed internally by any joint venture agreement. Secondly, the system set up for executing real estate joint ventures does not reflect the dissipation of political and economic authority from the state to the republics and city governments that has begun to emerge in recent months. The benefits of having local government involvement in the development process are being offset by the continuing presence of the central administration in the approvals process. There is indecision on the part of Soviet approval authorities and confusion on the part of foreign partners. The climate for negotiation is fraught with uncertainty.

There are countless difficulties and risks associated with
conducting business in the Soviet Union today. Some of these, such as the limited access to international telephones and faxes, and the lack of Xerox machines make everyday business difficult. For example, a businessman in Leningrad cannot make a phone call to his home country without a 3-5 day advance reservation, and even then the chances of getting through are remote. Others like the lack of title search capability and the endless bureaucratic maze involved in getting a project registered are inherent aspects of operating in a centrally planned economy. The everyday simple tasks of operating a day to day business become insurmountable and taxing of time and money. Nothing is easy.

Developers evaluating potential risk need to assess which of these factors are likely to change in the lifetime of their project, develop short term and long term strategies for resolving these issues, and develop contingency plans. Above all they will need to develop patience.

However, despite the difficulties that have been highlighted in this thesis, real estate joint ventures can be structured to work. There is supporting evidence for this claim. The process will not be easy, and as previously stated, perseverance, patience and luck will play a role.

What are the short and long term outlooks for real estate
joint ventures in the Soviet Union? In the short, 6-12 month term, significant improvement in the economic and political situation can not be expected. Fundamental change is in the process, but the result is unknown. However, if some of the change witnessed in the rest of the Eastern European community takes hold in the Soviet Union, we can expect significant changes to result for real estate joint venture opportunities in the next 3-5 years.

At the moment, the only viable approach to real estate development in the Soviet Union is to start small, develop good working relationships, remain flexible and patient, develop projects for the foreign market, but look for opportunities to expand into Soviet driven markets, and develop a strategy for taking advantage of new opportunities as they emerge.
APPENDIX B

CASE STUDIES

PERESTROIKA JOINT VENTURE (PJV)

Touted as the first real estate joint venture in the City of Moscow, the Perestroika Joint Venture has completed renovation and achieved full occupancy of three office buildings.

By contrast to the many other joint venture "deals" that were conceived and executed in the Soviet Union, this joint venture was the result of a meeting in Washington D.C. between various Soviet and American business leaders in 1987. The discussion that prompted the partnership was initiated between Andre Stroyev, the General Director of Mosinzhstroil, (the Moscow City Council enterprise responsible for all infrastructure construction within the city boundaries) and Paul Van Ward, the president of the Delphi Organization, a Washington based research organization.

Stroyev's interest in acquiring advanced technology and equipment was matched by Van Ward's interest in executing a joint venture in the Soviet Union. The joint venture was strategically established to include several other key players in the development process. These partners included the Moscow Hotel Administration, the Moscow Architectural Association and Dialogue, a previously registered American/
Soviet Joint Venture involved in selling and servicing personal computers within the Soviet Union.

Using the Dialogue joint venture by-laws, statues, and agreement format as a guide, the Perestroika JV documentation was assembled and the venture registered within 6 months of its conception.

Within a few months irreconcilable internal issues began to surface between the two principals. It was decided that rather than dissolve the partnership, that Delphi's interest would be sold to a third party. Stroyev returned to the United States and sought a new partner. By early in 1989, the restructured Perestroika Joint Venture was operating with a new partner, The Worsham Group out of Atlanta.

Each partner brings different strengths and personalities to the joint venture. Andre Stroyev characterized in a German magazine as the Soviet Union's Donald Trump is a unique businessman by international standards much less typical Soviet standards.

"...His resume reads like it should be published in a guide to beating socialist systems. Every few years during the last decade he has climbed the proverbial ladder higher and higher, getting appointed to chairmanships of bigger and bigger state-owned construction companies...."
Earl Worsham, the co-chairman of this venture, is equally suited. When negotiating the Worsham Group's contribution and percentage in the partnership, he was able to negotiate their equity contribution down from 2.5 million to 1 million and their share of the partnership up from 20% to 40%.

Although the main focus of PJV is the development and re-development of real estate, the joint venture is also involved in real estate management, construction management and is beginning to enter into other investment and international activities, including the acquisition of a construction management company.

The Soviet partner, Mosinzhstroi, acts as the General Contractor for all construction projects. The joint venture in turn hires a foreign construction company as a subcontractor for the majority of construction. Mosinzhstroi has assumed the responsibility for securing pre-development approvals as well as commissioning the architectural design from Soviet architects. In addition, the Soviet partner provides all infrastructure to the site, provides skilled local laborers, and supplies materials such as concrete, cement, steel, gravel, sand, and lumber as available.

Mosinzhstroi is distinguished from most state construction enterprises by its classification as a self financing organization. This distinction requires the organization use a cost accounting system whereby it is responsible for
meeting it's expenses through the revenue generated by construction projects. The agreement between Mosinzhstroi and PJV has been structured to pay the construction enterprise for it's labor and materials in both hard currency (50%) and roubles (50%).

The three buildings developed to date, consist of Class A space and were completed in 8-10 months each. The three original buildings were part of the equity brought to the venture by the Soviet partner. Although an option with some foreign construction companies doing work in the Soviet Union, Perestroika does not look to the construction sub-contractor for construction financing. Rather construction is financed through the pre-payment of office leases. These leases are generally ten year pre-paid leases with rents ranging from $600-800/ square meter/ year.

The joint venture has found unique ways of compensating it's employee's, not the least of which has been the funding of a training program that was organized by KPMG/ Peat Marwick. This program oriented PJV management to courses in basic business management techniques, budgeting processes, and improving productivity. As part of the program, Soviet managers spent a month in the United States observing these management policies in practice.
AMSTROI JOINT VENTURE

Despite what would appear to be the vast uncertainties of doing business in the Soviet Union, the international business community particularly within Moscow, is a small community. Peggy Hughes of Millpond International became interested in the potential of doing business in the Soviet Union after a tourist visit several years ago. In the process of doing research through both HUD in Washington and the Commerce Department's US Commercial Office (USCO) in Moscow she began to make contacts with other individuals that had been involved in real estate joint ventures. Through one of her contacts, she was put in touch with the Delphi Organization and in turn one of their staff Larry Kaufer.

Kaufer having just finished working on the Perestroika Joint Venture negotiation was breaking off from Delphi to start his own consulting practice. Hiring Kaufer as a consultant, he assisted her in getting established in Moscow and provided access to numerous local and international contacts that were valuable to the emerging partnership.

It was through one of these contacts, Nona Fedortseva that Millpond's Soviet partner was found. Acting as a Moscow liaison, she handled local logistics, provided a network within which Millpond was able to access potential Soviet partners, and provided translation services. After six months of looking for both the appropriate site/building and
a viable Soviet partner, Millpond was introduced to the Moscow High Rise Housing Authority. This group responsible for the management of housing in Moscow, was initially interested in forming a joint venture that would renovate a movie theater in Moscow. It was only during follow on meetings that the possibility of a renovation and addition to their office building surfaced and ultimately became the initial project of the Amstroi Joint Venture.

As the momentum and direction of the partnership took hold, several other players were made partners. Otto Dvorak of Steffian Bradley Associates was brought in for his design and development expertise and Larry Kaufer for his knowledge of executing business agreements in the Soviet Union. All three partners have been intimately involved in all stages of the strategy and negotiation of the project.

One of the first steps in the development process was determining that the Soviet partner had rights to the land and was legally entitled to enter into a lease arrangement for the parcel. This approval was separate and distinct from the protocol, statue, agreement and design approvals that were also required of the newly formed joint venture. Falling under the auspices of the Moscow City Council (Mossoviet), approval to outlease the land and to enter into a joint venture was required of the city council.

Adding to what is already a complex and lengthy procedure for
registration of joint ventures, the Moscow City Council had recently established a quasi state legal office, Mosinter, to assist both soviet and foreign parties in the negotiation and approval of joint venture agreements. For a fee, Mosinter reviews all joint venture documentation, negotiates changes to the documents, and makes recommendations to the Mossoviet and then the Ministry of Finance for approval. Although not an entity empowered to approve agreements, the unwritten understanding is that the recommendations made will more likely be approved.

The Amstroi Partnership was one of the first joint ventures required to work through this new organization. As such they have encountered some of the frustrations with regard to conducting business in the Soviet Union. Of these, the primary challenges have been how to conduct business without reverting to blat and secondly how to negotiate effectively with a party bureaucrat. Despite these hurdles, working through Mosinter the first stage of approvals, the Protocol, was approved within two weeks.

With the assistance of their own legal counsel, and in conjunction with Mosinter, the feasibility study, the statues and the agreement were drafted. Although the subject of lengthy and difficult negotiations, the agreements have been forwarded to MOSSOVIE for approval and will then go on to the Ministry of Finance. Registration of the joint venture is anticipated in October 1990 and construction started in
April 1991.

While awaiting Ministry of Finance registration, the Request for Proposal has been issued to Austrian, Italian and Finnish building contractors that are experienced with working in the Soviet Union. The firm selected, will be responsible for completing the working drawings, importing materials and executing construction. Amstroi intends to look to the foreign construction firm for the construction financing.

As currently planned the office building will be leased to both Soviet and foreign tenants. Each tenant will pay in their respective currency. With local costs of operation being covered by the rouble rent revenue. Millpond International is committed to a long term holding strategy and has begun to look at other real estate ventures in Moscow. Although small by some standards, the partnership' strengths are in their patience and perseverance, and their understanding of the system. They have been approached by several large American developers that are interested in real estate joint venture opportunities and are looking for projects that might be appropriate.
ROSINKA--A RESIDENTIAL COMMUNITY

Begun in 1988, Rosinka will be an 82 acre residential community located 24 kilometers from the Kremlin. The project will consist of 528 units clustered in groups of 44 units. The project will be a self supporting complex consisting of a sports complex, retail shops and restaurants. As one of the founders pointed, "this project has not been structured for the Soviet market... but I am optimistic that the legal framework within the soviet Union is changing and that there will be opportunities in the future that enable foreign partners to assist the Soviets in meeting some of their residential construction needs." 26

Rosinka like many of the real estate development projects currently under development, is being marketed to the foreign business community that is flooding into the Soviet Union. In this particular project 80% of the units will be leased to foreign firms for hard currency. The remaining 20% will be set aside for the Soviet employees of foreign firms doing business in the Soviet Union and will be leased for roubles. The lease term is 6 years and requires the prepayment of years 4, 5 and 6 at the time of occupancy. In addition a letter of credit guaranteeing this payment is required at the time of leasing the unit. There are four different unit configurations and rents range from $45,000 to $82,000 a year.
One of the first of its kind, and the one that is closest to being executed, this residential joint venture was structured as a 50-50 partnership. The Soviet partner, a collective farm, brings land and building approvals to the joint venture, with the American partner bringing the financing, marketing and development expertise to the project. The collective farm intends to buy machinery and equipment from the West with their hard currency proceeds. As part of the deal the partnership will develop 60 acres of other land nearby into kitchen garden plots for the Collective's use, and will build infrastructure and roads for the adjacent town.

Located on the periphery of the City of Moscow, Rosinka required the approval of both the Regional City Council (Oblast) as well as the Moscow City Council (Mossoviet). Approvals were also required of the City Council of the town having jurisdiction, the two surrounding towns, the Agricultural committee (because the collective farm fell under their jurisdiction), the KGB and the defense department.

Approvals have been granted by all parties, and the joint venture statutes and agreement has been forwarded to the Ministry of Finance for approval. Even though the outlook is positive and a ground breaking is scheduled for September 1990, due to the political turmoil within the Soviet Union there have been times as recently as six months ago when the
project looked very tenuous. Of particular concern were the municipal elections in March 1990. One of the mayoral candidates was adamantly opposed to a foreign party being involved in the development of the site. Despite the strong support from other sectors had he been elected the project would have been derailed.

The Rosinka Joint Venture intends to use a Finnish construction company under a turnkey contract. The conceptual drawings were prepared by an American firm and the units are designed to have a New England "feel". A Finnish construction firm will provide the working drawings, materials and construction. Although not the developer's first choice of building materials, due to the existing building code the units will be constructed out of pre-cast concrete. The Finnish construction firm will not be a partner in the venture and will not provide the construction financing. However due to the strict guarantees provided by the contractor regarding fixed time and fixed fee, Rosinka's relationship with a Finnish contractor has enabled them to secure a government guarantee from the Finnish Government for the $100,000,000 project. Several US lenders were approached, however, it is the opinion of the American partner that there is resistance to funding real estate in the Soviet Union at this time.
Located in the City of Leningrad, the FILCO partnership is a joint venture between a large Finish construction company, Haka and the Soviet construction company, Lenstroi. The FILCO partnership in turn has a joint venture with the City Council of Leningrad (Lensoviet). This partner has access to city owned property and buildings which it brings to the partnership. The Soviet construction company contributes lumber, steel and concrete, with Haka importing Finish finishing materials and sewage infrastructure.

The partnership is structured with FILCO receiving a 60% interest (50% each for Haka and Lenstroi) and Lenstroi receiving a 40% interest. Agreements between FILCO and Lensoviet are based on economic agreements regarding the use of land and buildings (in other words a lease or rental payment for use) rather than a land lease.

Although Finnish construction contractors are not strangers to the construction business in the Soviet Union, their traditional involvement has been limited to construction contracts. This particular joint venture was initiated by Haka as a way to remain competitive in the tightening construction market within the Soviet Union. The joint venture agreement was signed in 1988 and the partnership was registered in 1989.
The underlying strategy is one of a long term relationship. The partnership was not structured to do one project and disband but rather to provide an ongoing concern that could provide services as needed to the City of Leningrad. Additionally unlike several of the other joint ventures that have been profiled, this JV does develop projects for the Soviet market.

Projects that are on the drawings board include the construction of housing units for a soviet factory, the renovation of a historic building in the city center, a hotel complex near the University and a factory for the production of slabs on grade.

The projects are basically structured as follows: the housing units will be built for a factory, on land that has been authorized for use by the LenSoviet. The factory will purchase the units from the partnership and provide the housing to their employees. The building in the center will be renovated into a mixed use complex. There will office space, retail space, residential flats and underground parking. The space will be leased to foreign firms doing business in Leningrad. Office rents will range from 80-100 roubles/ square meter per year and will be paid 80% in hard currency and 20% in roubles. Payment for the residential units will be 50% in roubles and 50% in hard currency.
Plans for the hotel include building a 5 star hotel with 300-400 rooms. It is anticipated that 75-80% of the revenue will be in hard currency with 20-25% in roubles. The joint venture is in the process of interviewing hotel operators and plans for the operator to assist with securing the financing. The deal will leave FILCO with a 10% interest, Lensoviet with a 20% interest, the operator with a 10% interest and the investors with a 40-60% interest in the property.

The construction plant has been sited in a Leningrad suburb and will bring in another partner. FILCO will both build the factory as well as integrate the product into their future projects, Lensoviet will in effect contribute the land, and a third partner will bring the production equipment to the deal. The plan is to amortise the costs of using the slabs within the Soviet Union by eventually being able to export the technology abroad.

An interesting reflection of how risk is evaluated are the guarantees that have traditionally been required by foreign banks lending money in the Soviet Union. Until 1989, banks required the guarantee of one of the following Soviet agencies:  

- Bank for Foreign Trade
- All Union Ministries
- All Union Government Insurance
- Local City Councils (Moscow, Leningrad, etc.)
Aeroflot
Shipping Company

However, as of 1990, the list of acceptable guarantors has been reduced to two agencies, the All Union Ministries and the All Union Government Insurance (Ingostrab).

The FILCO joint venture has avoided this constraint by taking advantage of the strong financial standing of the Finnish parent company, Haka. The Finnish Bank Oko will be providing project financing. And Haka will be the guarantor of these loans. It is the opinion of the FILCO Soviet partner that the problem of securing financing has not been an issue of perceived market risk but rather the political and overall economic instability of the Soviet Union. (reference meeting with Alexander Vehnistrov General Manager FILCO).
FOOTNOTES


2. Perestroika translates as reconstruction. The notion of Perestroika was created by Mikhail Gorbachev in 1985 primarily as a remedy to the growing stagnancy in the Soviet Economy.

3. Interview with Vladimer Linov, Chief Architect at Lenniitag, (June 10, 1990)


5. Interview with Jukka Suominen, Project Manager Astoria Hotel Leningrad. Vit Corporation (June 12, 1990)


7. Interview with Alexander Tobveen, Chief Architect at Lenproject (June 12, 1990)


9. Ibid., p.g 160

10. Telephone interview with Chris Senie, The Rossinka Project (July 13, 1990)

11. Blat is the term used to define gifts, bribes, and incentives given as part of the process of getting something accomplished.


15. Coudert Brothers, Moscow. "Legal Issues in Real Estate Transactions in Moscow" (June 1990)

16. Apparet is defined as the bureaucracy of central party members that have traditionally made decisions in the USSR.


20. Interview with Dimitrij Podjapolskij. Architect in Moscow. (June 20, 1990)


22. Interview with Marshall Goldman. Professor of Russian Studies, Harvard University. (July 16, 1990)


26. Telephone interview with Chris Senie. The Rosinka Project (July 13, 1990)

27. Interview with Alexander Vahnistrov. General Manager, Filco Joint Venture (June 15, 1990)
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