



Building a Silicon Valley in Russia: An Ill-Fated Kremlin Experiment?

Since President Dmitry Medvedev's February announcement that Russia would create a center for high-tech business and innovation – its own Silicon Valley in suburban Moscow – the plans have been the talk of investment and technology circles across Russia. Described by Medvedev as a “prototype for the city of the future,” Skolkovo offers a range of tax incentives for firms that establish a presence and invest in its start-ups.

These incentives will be critical to Skolkovo's success, as investors have grown increasingly apprehensive about Russia's rampant corruption, weak investor protections, and bloated bureaucracy. Indeed, foreign direct investment fell by 41% last year.

It is not yet clear whether Skolkovo will truly develop into a hub of innovation and progress, or be left to decay like the Soviet era “monograds” – cities built around a single industry. **To avoid a similar fate, Skolkovo must create an environment that is attractive for major financiers and preeminent technical experts, who will have to decide whether the returns will outweigh the risks.** Ergo engaged our experts to assess the prospects for success in Russia's incipient innovation capital.

A Realistic Approach

Although the Russian government has publicized Skolkovo as a new Silicon Valley, many observers dismiss these statements as merely PR intended to raise confidence in the project. Our experts tell us that in reality, **neither Russian officials nor foreign investors have illusions of Skolkovo becoming a Silicon Valley replica.** “Not a single country, not a single [high-tech] cluster has achieved the same success as Silicon Valley,” says Olga Orlova, Editor-in-Chief of the first-ever Russian TV series dedicated to innovation and high-technology business.

Margaret O'Mara, a prominent Silicon Valley historian and consultant to similar initiatives around the world, agrees. “We now have this global network of many, many places that have a role in the economy,” she says. Indeed, cities from Tel Aviv, Israel, to Hsinchu, Taiwan, are attempting to position themselves as 21st century hubs of innovation. Skolkovo could achieve similar success as a Russian counterpart to other blossoming high-tech centers around the world.

Despite the challenges, Orlova insists Skolkovo will make positive contributions to Russia and its technology sector. “No matter what happens, **something good will come of it; some successful companies will emerge,**” she says.

Sizing Up the Risks

While the Russian government is touting the promise of Skolkovo, potential investors in the city's **companies and facilities are faced with considerable risks.**

First, despite the media flurry surrounding Skolkovo's tax, visa and tariff incentives, much of the enabling legislation is still being reviewed. “Not all of these issues have been resolved yet,” says Orlova. “The people who want to do something [in Skolkovo] are fighting for these incentives.” A failure to provide these incentives could leave the effort stillborn.

But even **exemptions from VAT and profit taxes may be insufficient to retain the world's top specialists and companies.** “People want good jobs – and a salary or tax issues are only part of what makes a good job. They want a nice place and exciting work,” says Esther Dyson, an angel investor who sits on the boards of Yandex and IBS Group, two of Russia's leading technology companies.

Intangible factors (professional mobility, quality of life, etc.) will contribute to determining whether Skolkovo thrives in the long term – but they will not be easy to achieve in **a country plagued by corruption, an overgrown bureaucracy, and vulnerable property rights.** “Forget foreign investment; there are serious deterrents within Russia for Russians,” laments Dyson.

Other issues are less apparent but equally troubling. In particular, Orlova warns that **Russian government officials are likely to execute their personal vision of a project even if it contradicts the advice of technical experts.** “We have experts in Russia, but when decisions are made they are not given the appropriate authority,” she notes. As a result, there is a risk that Skolkovo's design, management, and operations may not reflect the recommendations of specialists who understand what the project needs to flourish. “The authorities are reluctant to give up their power,” Orlova says, “and that can be a very serious risk for businesses of this [scientific] nature.”

However, most of Ergo's experts predict a high tolerance for these risks. In a country where relationships inside the Kremlin are critical to doing business, **investing in Skolkovo could be a good opportunity to make inroads with the Russian government,** says Aleksandr Kostinsky, the head of infrastructure projects for Russian Venture Company, a government vehicle for developing local venture capital funds. Moreover, inefficiency and corruption have not been

serious deterrents for high-tech investments in other emerging markets. “At the end of the day,” O’Mara says, “the tech ecosystem is all about generating good ideas and making money off of them. If it’s not something that will be detrimental to the bottom line, it’s not going to be a barrier.”

Indicators of Progress

What might investors monitor to track this initiative’s development? Ergo’s work reveals several signposts that could signal a successful trajectory for Skolkovo.

1) The center will need to balance top-down and bottom-up models of growth. Our experts consider the Russian government’s management and financial backing an effective launching pad for Skolkovo – but they believe state support must gradually wane in favor of organic growth. “It has to be more of a combination. Otherwise it won’t be successful,” says Dyson.

2) The involvement in Skolkovo of major technology companies could propel the city’s development. “The Russian government has been able to attract companies like Cisco and Nokia. That really is going to give them the critical mass of technical and business people to get this thing started,” explains Brian Jacobs, a venture capitalist who was part of a special delegation that met last May with Dmitry Medvedev and Skolkovo Foundation President Viktor Vekselberg. “If we see five or six large tech companies choose Skolkovo as their base of operations in that region of the world, then that’s another indicator that the critical mass is taking shape.”

3) Look to the response of the Russian expatriate community. Many Russian scientists left the country in the 1990s to pursue careers in North America, often in computer engineering and information technology. A major test for Skolkovo will be to reverse this brain drain and persuade Russian expats to return. But several experts, including Vladimir Babkin, an advisor to the Russian State Duma’s Committee for Science and Technology, doubt this will occur. “Those who are successful overseas will not return,” he acknowledges.

4) Skolkovo’s self-sustainability will be a key sign of success. “It’s more than just having Microsoft open a branch there. You need a grassroots home-grown company,” says O’Mara. To truly thrive, Skolkovo will need to breed small start-ups of its own. Jacobs hopes that mid-level employees of Russian tech giants like Yandex will amass the wealth and skills to start their own firms. “That’s an important milestone, an important ingredient and one of the first indicators of the kind of innovation that the government wants to foster,” he says.

ERGO'S VIEW

Skolkovo is a typically Russian venture: potentially lucrative – but not for the faint-hearted.

Despite the comparisons to Silicon Valley, Skolkovo is unlikely to enjoy the unparalleled success of its Bay Area archetype. Nevertheless, Medvedev's project has the potential to put Russia on "the technology map," much in the way that Bangalore did for India and Tel Aviv did for Israel.

Growth and innovation will not come quickly or easily. Skolkovo's technology industry – like any other sector in Russia – will feel the strain of corruption, property disputes, and government meddling. These risks should be mitigated as the city's legal framework takes shape; observers should watch for critical pieces of the innovation puzzle to fall into place, such as robust intellectual property legislation and details on tax preferences.

Meanwhile, investors and companies doing business in Skolkovo will need to be patient in the face of administrative obstacles and creative in carving out a niche for their products. With a weak domestic market, identifying and targeting consumers overseas will ensure that Skolkovo's technologies gain practical applications and earn solid returns.

Ergo has provided actionable insights to clients on the business and regulatory environment in Russia and the CIS. We have helped dozens of clients identify threats to their intellectual property and to develop risk mitigation strategies in turbulent markets.