

A Speech by Bob Djurdjevic

Go East, Young Man!

Eastern Europe & Russia: The New Frontier

May 2006

[SLIDE 1 – HEADER]

Opening

[INTRODUCTION & JOKES]

[5:00mins]

I want you to know how excited I am to be here. I have been saying for over 16 years now that Eastern Europe and Russia are the places to be for any multinationals looking for growth. And finally, some of my clients are listening and acting upon this advice. And that's very encouraging.

[SLIDE 2 – HEADER/TOC 1/2]

Since this is a conference on innovation, I have selected two of the 16 life-altering forecasts and trends that I have identified in the last 25 years. First, I'll talk about the impact of the PC and Internet revolutions on life and business in general, and about a refusion of arts and sciences that's taking place as a result.

Then I'll also talk about the three new trends that are contributing to a revival of IBM hardware business.

In the part about global investments, you'll see why I think that Eastern Europe and Russia are the new frontier, especially when it comes to research and development.

Okay, so here we go... PC and Internet revolutions...

[SLIDE 3 – Annex Research - Searching for the Holy Grail]

Every so many years, computer industry gurus are asked to go search for a new Holy Grail. The **PC and Internet revolutions** were

first identified back in 1994. Both leveled the playing field and empowered individuals and small companies to compete more effectively with giant enterprises.

I compared them to the invention of a handgun. With a gun in her hand, a little old lady could confront a 500-pound gorilla - and win! That's what the PC and the Internet did for individuals and small businesses.

[SLIDE 4 – PC, Internet Lead to Refusions of Arts, Sciences]

But they did more than that. They changed our way of life. They freed Homo Sapiens from the shackles of the industrial revolution.

The shackles of the industrial revolution? Now, I know that's heretical talk among scientists and engineers. But since I am one of them, I feel I can speak my mind freely.

Let me try to illustrate this point with an example.

[\[CLICK TO ANIMATE DA VINCI IMAGE\]](#) [\[ROLE PLAY DA VINCI - CNN INTERVIEW\]](#)

Do you want to know what my answer would have been? “Son, I haven't the faintest idea what you're talking about. What is the difference between the arts and sciences?” [\[PAUSE\]](#)

You see, the industrial era created an artificial distinction between the arts and the sciences, elevated the latter, hailed it as progress, and rewarded the scientists handsomely. Yet they automated only simplest forms of life – the physical part.

Meanwhile, the industrial era neglected the much more complex forms of life – the arts. [PAUSE]

When I first identified this trend back in 1994, the only example I could think of was the job of a webmaster. Today, thanks to the PC and the Internet revolutions, there are thousands of new jobs being created around the world where both artistic and scientific skills are needed. [10 :00 mins]

In short, computer technology is returning man back to nature. Signor Da Vinci would be pleased. [PAUSE]

The refusion of arts and sciences is also good news for those of you who are graduates of liberal arts colleges and universities. There is a light at the end of the tunnel, as you can see. And it's not an oncoming train. [PAUSE & SMILE]

When I outlined this view to a group of senior IBM executives in Armonk back in 1994, I also added, “did you ever consider that maybe IBM has too many engineers and not enough musicians?”

Most people in the room were stunned at the idea. But one man smiled and nodded in agreement. That man is today the head of IBM research and development. No wonder IBM is the industry leader in innovation.

[SLIDE 5 – Header: Recentralization & Reintegration]

And now, let's fast-forward from a 12-year old trend to three very recent ones...

[SLIDE 6 – IBM Systems Group - Revenues]

You may have noticed that IBM hardware is growing again.

[PAUSE & POINT TO CHART]

The revival process started about four years ago with the top-of-the-line zSeries mainframes. It spread across other hardware lines when IBM put all of its servers under one roof, and appointed Bill Zeitler to head up the Systems & Technology Group. Big Blue never looked back.

What is the reason for this revival?

[12 :00 mins]

Actually, there are three: **Recentralization, virtualization and reintegration**. All three are based on **openness** and **Linux** support. All three are customer-driven trends. No wonder Linux demand is outpacing Wintel by about 4-to-1.

The **zSeries**, or **System z**, as IBM now calls it, is the main beneficiary of the first two trends. The **iSeries**, or **System I**, profits especially from the third. All IBM servers benefit from virtualization.

When I did research for two whitepapers in early 2005, I found out that customers around the world are increasingly going through “**server consolidations**.” They all wanted to lower their total cost of ownership. Since the mainframe offers a unique single image view of the world, it is a natural winner in recentralization projects.

[SLIDE 7 – Polaris – System z and System i]

This discovery gave birth to my **Polaris** idea in Feb 2005. I said IBM should rename its mainframes to Polaris. Why? Because Polaris, the North Star or the Lode Star, that `has been used for navigational purposes for centuries. That's because all other stars appear to rotate around it, as this photographic image also proves [POINT TO SLIDE].

[SLIDE 8 – z9 = Polaris: Erich Clementi unveils it...]

I was actually stunned when I learned last July that IBM adopted my Polaris idea in creating its new “z9” mainframe. [PAUSE & SMILE].

[SLIDE 9 –System I Gets Marketing Facelift]

Furthermore, I found out that midsize customers were also going through “server consolidations” for much the same reasons. Since the **iSeries** offers the lowest cost of ownership in the midrange market, thanks to its *integrated design* from way back, it stands to benefit the most from the **reintegration** trend. Plus System i is more *stable* than the Wintel-based servers.

Guess the Russian Pension Fund folks must have realized that when they placed that huge **System i** order last year. Which is why the platform did so well for IBM in 2005, especially in this region (point to the chart).

And now, let us shift gears once again and move on to global investment trends. [15 mins]

[SLIDE 10 – Global Investments Soar...]

From China to India to Eastern Europe and Russia – that seems to be the direction of the \$9 trillion annual global financial tsunami. Eastern Europe, the pale blue bars, was the world's only region to rise consistently in the 2001-2004 time frame. Why?

A polite way of describing the phenomenon would be to say that it is driven by lower labor costs and higher educational quotient. But the truth of the matter is that the fuel of global investments is **greed**, the same force that drives Wall Street investments.

Nothing new there... only the direction – from West to East.

[SLIDE 11 – 19th Century: Go West, Young Man!]

When America opened its western frontiers, some 150 years ago, "[go West, young man!](#)" was the destination slogan for the bold fortune seekers. No longer. "Go East, young man!" (or woman) is where today's global road signs to riches point, at least from an American point of view. That became vividly apparent to me during my last visit to Russia, three months ago.

"There is a small but close-knit group of us ex-pats here in Moscow," a young American told me over drinks at the "Metropol" hotel on a cold and snowy night in late February. "We all came here for the same reason... better opportunities to make money. We think this is the new frontier."

The new frontier!

That's why the enterprising investment banker has even learned Russian so as to better explore his gold mine. "I could never make the kind of money I am making here in Moscow back in the States," he said.

And if that's what a man in his early thirties thinks, who has an Ivy League MBA degrees on his resume, and who hails from one of America's oldest "blue blood" East Coast families, then you'd better believe that serious western money is either already in Russia, or will soon follow.

And where is the money going to?

[SLIDE 12 – 21st Century: Go East, Young Man...]

Into the energy and banking sectors, of course, but also to R&D. Since the end of the Cold War, China has become the **world's factory**, India the **global help desk**, and I am here to tell you that Eastern Europe and Russia will be the **world's next R&D lab** or **innovation center**.

Why? Because of its enormous human capital... [18 mins]

[SLIDE 13 – To Russia, with Love and \$\$\$]

The chart ranks the most attractive countries in the world in terms of the percentage of university-educated people relative to the GDP per capita. In other words, the "best bang for the buck" when it comes to highly educated talent. Six of the top 10 nations, led by Ukraine, Belarus and Russia, are from this region.

Poland is also in the top 10. At a time when everybody is talking about the outsourcing of American and other western jobs to India, it was refreshing to see an example to the contrary – an Indian company outsourcing its work to Poland. That's what I found out when I was here three months ago and talked to the IT manager for Thomson Displays. His new Indian bosses preferred the Polish IT peoples' skills to those of their own or the Chinese.

Meanwhile, the "Old Europe" countries - Germany, Norway, Belgium, Netherlands... along with Japan, are in the cellar of the list.

[SLIDE 14 – Global R&D Investments – Top 10]

The same is true in terms of global R&D spending. The R&D expenditures in Japan, Germany and France are declining, while they are rising in the U.S., China and Eastern Europe and Russia.

And the R&D is highly concentrated. The top 10 countries, led by the U.S. with 41% of the world's total, account for 87% of the worldwide total. Only two developing countries (China and Korea) feature among the top 10.

America's R&D spending is outpacing the world by 6% to 3% per year, but China's is growing at 21%.

[SLIDE 15 – E Europe & Russia Coming on Strong]

R&D is even more concentrated in developing countries where top 10 account for 97% of the total.

Russia is the only E Eur country in top 10. The region's R&D spending in 2002 was \$57 billion or 8.4% of the world total (\$677 billion), up from 7.7% in 1996.

Similarly, there has been a rise in innovation output (as measured by the number of patents issued). The share of foreign patent applications from developing countries to the US Patent Office, jumped from 7% to 17% between 1993 and 2003.

While in absolute terms East Europe and Russia is still a relatively small market on a global scale of things, it is **four times bigger** than China's share of the world's R&D, and **15 times larger** than India's. And that's nothing to sneeze at.

[SLIDE 16 - Global Investments Up Slightly in 2004]

Also, after years of relative neglect by the global multinationals, Russia's oil and gas industry helped the world's largest country start to get some business recognition that it had been sorely lacking since the end of the Cold War. The Russia investments soared by 47% in 2004 to \$11.7 billion, a five-fold increase since 2001. Many IT companies have also rushed into Russia (pun intended). Still, relative to China and India, for example, that's small potatoes.

[SLIDE 17 – China Real Cold War Winner]

If you follow the money, it is clear that China, not America or the West, is the Cold War winner. China attracted \$753B in 1990-2004, more than any other country in the world except the U.S. Well, strike

“except” now. For the last three years, China got more foreign investments than the U.S.

[24 mins]

[SLIDE 18 – “A Passage to India”]

And then came India’s turn. Some **3 million** American service jobs are on a “passage to India” by 2015, the New York Times reported in Mar 2003.

IBM, Microsoft, Oracle, EDS, HP, Accenture, Capgemini... are all among the passengers.

All in all, about 450,000 U.S. computer industry jobs could be transferred abroad in the next 12 years, representing **8%** percent of the nation's IT employment.

[SLIDE 19 – India Follies to Follow China’s?]

The reason? Cheap labor. India graduates 250K engineers/yr (at \$5K/yr starting pay) vs. 140K in the U.S. at 10 times higher salaries.

Perhaps that’s why the Indian government is trying to reassure the international community that it’s a “free trader.” HP’s big win at the Bank of India in 2004 was a case in point.

[SLIDE 20 – OECD: Offshoring Job Losses a Myth]

But not all agree that offshoring leads to job losses at home. The OECD, for example, and organization of developed countries, reported earlier this year that,

"The idea that offshore outsourcing has a detrimental impact on jobs is simply a myth. In the long run, the positive benefits of services offshoring outweigh the costs."

And what are these positive benefits? The OECD suggested that increases in demand for services have raised demand for these types of occupations in domestic markets.

Oh well, nothing is ever what it seems, is it? Which reminds me of that famous trial attorney who finished his summation to the jury with the following words:

“And those, ladies and gentlemen of the jury, are the conclusions upon which I based my facts.” [PAUSE & SMILE]

[SLIDE 21 – India Investments Still Much Smaller Than China]

Meanwhile, some facts are indisputable. For all the political noise and rhetoric, India has attracted FAR LESS capital than Red China, which has largely escaped public lashing in the U.S. In 2004, for example, even after a hefty 25% annual increase in foreign investments, India attracted “only” \$5.3 billion of foreign capital. China, on the other hand, got \$95 billion, as you saw earlier. The discrepancy between the two countries is even larger over a longer period of time. Since 1990, for example, China has attracted 22 times (!) more capital than India.

Yet American politicians, especially the Democrats, are screaming bloody murder with respect to “offshoring” of American jobs

to India, while remaining mostly mum about those that have gone to communist China, or about its currency manipulations.

[SLIDE 22 – Russia Still a Bogey]

Similarly, Russia is still largely treated as a bogey by the multinationals. On a per capita basis, the tiny Israel and Hungary, for example, got 24- and 17-times more foreign investment dollars than Russia. Yet Israel, for example, is one of the world's most *unstable* countries.

And capital, we are told, is supposed to be a coward? Hm...

So, does that mean that you should lie down and give up? Not at all. Just choose a different field of battle. One where the odds are better...

[BIKER JOKE]

[28 mins]

Moral of the story?

First, action speaks louder than words. Second, a smart person will choose his own field of battle; the field where the odds are better.

In your case, you should know that when it comes to global investments, greed will win out over emotions every time. You've got that on your side. As western European economies are slowing down, Eastern Europe and Russia are looking better every day.

And here's why...

[SLIDE 23 – Global Market Opportunities – GDP Growth]

The region's \$3.6T GDP is growing at 6.2% year. That's 1.8 times faster than the U.S., which is growing quite rapidly itself; 2.4 times faster than Brazil, and 4 times faster than the EU.

[SLIDE 24 – E Europe “Renaissance II” (1996)]

No surprise there. Ten years ago, I traveled through Eastern Europe and Russia on another research mission whose purpose was to determine if this market may ever become a Mecca for western investors. My conclusions in the affirmative were summarized in the report “Eastern Europe’s ‘Renaissance II’” (June/96).

I pointed out, for example, that the top six Eastern European economies even back then were growing nearly four times faster than the "G6" (the world's top developed countries) **[POINT TO CHART]**.

“From recession to growth - a real "Renaissance II" is under way” – I said in a series of lectures given in Warsaw, Prague in Oct 1996, and in Moscow in Mar 1997, and in this report. **[31 mins]**

[SLIDE 25 – E Europe/Russia: Huge Market Potential]

Ten years later, it is a reality. Here's the “new Europe” – Eastern Europe and Russia – an area 7 times bigger than the EU, and with population also a little larger than the EU.

Consider a country with over 2,000 banks, most of them growing in double digits. The big ones are swallowing the smaller fish like the whales eating the minnows. New businesses are opening their doors

at a rate of 30% to 50% per year. They are all frantically building their infrastructures.

America - at the turn of the century last? No, Russia today - the new frontier. That's also true in terms of taxation.

[SLIDE 26 – E Europe/Russia: Lowest Tax Rates]

Five of Top 10 countries with world's *lowest* income tax rates are from Eastern Europe.

As you can see from the following chart that combines average top corporate and individual income tax rates, Russia and Hungary top the list of the 31 major countries we have analyzed.

They are joined among the Top 10 by Poland, Slovak and Czech Republics, Portugal and Mexico. Ireland, Switzerland and Iceland are the only western countries in the Top 10.

The U.S. ranks 21st. The “Old Europe” - France, Denmark, Germany - and Japan, hold up the rear. They the least attractive places in the world for foreign investments based on tax rates.

So besides the human talent, the journey “To Russia with Love and \$” is happening for another reason: low taxes.

[SLIDE 27 – Cross Border M&A's]

And factors like that are music to the global bankers' ears. Why is that important? Because cross-border M&As (mergers and

acquisitions), have been the main drivers of the foreign investment explosion in the post-Cold War era (2/3 of the \$9 trillion since 1990).

Clearly, therefore, the globalization of the world is no spontaneous event. It is a bankers-driven trend! Which means it is a trend born out of greed and self-interest – the best kind from a business point of view.

[SLIDE 28 – Summary]

[REVIEW SUMMARY POINTS ON THE CHART]

Today, we've talked a lot about India. I would like I'd like to close with some words of wisdom written by the Indian poet Rabindrant Tagore many years ago:

"He who knows not, and knows not that he knows not,
is a **fool** -- **shun** him;
He who knows not, and knows that he knows not,
is **ignorant** -- **teach** him;
He who knows, and knows not that he knows,
is **asleep** -- **wake** him;
But, he who knows, and knows that he knows,
is a **wise man** -- **follow** him."

Good luck in finding a wise man you can follow.

Ladies and gentlemen, the sign I got from a wise man 16 years ago read: "Go East, young man!" Those in the West who choose to ignore it will do so at their peril. **[PAUSE & SMILE]**

[SLIDE 29 – REPEAT HEADER + web address + e-mail]

You've been a wonderful audience. I invite you to check out the Annex Research web site for more information on the topics we discussed, and many more.

Also, for those of you who would like to get a copy of my speech and view the slides, please send me an e-mail identifying yourself as a participant in today's conference, and I will give you a User ID and password to access them.

[37 mins]

THE END