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# Dipping into the Bear's Honey Pot

*Opportunities and Risks in  
The Russian Banking Market*

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## DIPPING INTO THE BEAR'S HONEY POT

### *Opportunities and Risks In the Russian Banking Market*

It would be easy to understand if foreign banks were reconsidering their plans to enter the Russian market. It has not been a reassuring few months for those seeking to do business in this politically complicated country. The bitter tug of war over TNK-BP, the joint venture between British Petroleum and a quartet of Russian oligarchs, served as a reminder that the Russian business environment and working ethos is tricky at best for foreign companies. Prime Minister Vladimir Putin's recent public remarks about Mechel, a Russian steel company, resulted in a loss of almost \$6 billion in stockholder value in one day and demonstrated the potential impact of government intervention. The Russian military's activities in the Caucasus, a few months later, created even more queasiness among foreign investors. Some of them have been pulling out of Russia, wary of the geopolitical risks, according to reports in the *Financial Times*. And finally, the global credit crunch seems to be catching up with Russia, with local banks and businesses beginning to feel the liquidity squeeze.

For foreign banks that are able to navigate these risks, however, we believe that Russia represents a significant opportunity. Indeed, the opportunity may be greatest for foreign players that establish their footholds now, whilst the uncertainty is at its height.

This is the first in a series of articles that Booz & Company will publish on the Russian banking market. In this installment, we provide a high-level view of the magnitude of the opportunities—and obstacles—confronting foreign banks that want to do business in the land of the bear. Future articles will focus on the strategic choices for local Russian banks, of which there are more than 1,200. In our view, there are different options available to Russia's top six banks, which can support both organic and inorganic growth; the mid-tier, which will need to focus their strategies on particular market segments or capabilities; and the long tail, which should consider “boutique” positions, invite acquisitions, or pursue joint ventures. We will leave our in-depth analysis of those strategic choices for our subsequent articles.

## Russia's Economic Resurgence: Reflections On the Nation's Banking Industry

The emergence of Russia as an industrial and commercial power cannot be disputed. Since the turn of the century, Russia has made huge strides in industrial output, foreign exports, and domestic affluence. It has also gotten better control of its fiscal policy, with a level of foreign reserves that gives its policymakers the flexibility to deal with fluctuations in global markets, as well as fluctuations in Russia's access to global capital.

With a 2008 gross domestic product (GDP) that is likely to be three times Poland's, Russia is the largest of the emerging markets across central and eastern Europe (CEE) and among the Commonwealth of Independent States (CIS). Russia's GDP continues to grow faster than those of most CEE and European Union (EU) countries, albeit with a rate of inflation that is relatively high.

Russia's recent growth has been fueled principally by

the commodities and energy sectors—two areas in which global demand is likely to be sustained, along with strong market prices and associated profits. Yet tertiary industries are now beginning to grow even faster. This overall growth has benefited the general population: By 2012, the percentage of mass affluent and affluent people in Russia will rise to 30 percent from 8 percent today (those with more than \$35,000 in annual income are considered mass affluent; those with more than \$50,000 are affluent). In addition, more than seven in 10 Russians live in an urban area. In a country of 141 million people, that's an addressable urban market of more than 100 million.

This dynamic potential is reflected in a banking market that is already the CIS' and CEE's largest, with revenue of \$55 billion last year—3.5 times the banking revenue in Poland and 5.5 times that of Ukraine. The Russian banking market is also growing much more quickly than those of its geographic neighbors; bank

assets have surged 49 percent on a compound annual basis for the past five years and are expected to have a 33 percent CAGR through 2012. Russia's potential as a market for bankers may be easiest to see when compared to other countries in the region (see Exhibit 1). According to estimates by Booz & Company and others, Russian banking revenue will rise to approximately \$100 billion by 2012.

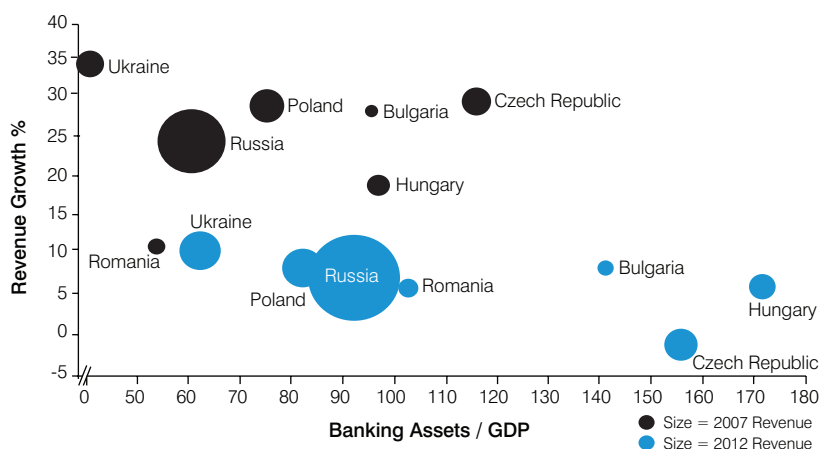
## Russian Banking in Focus: Understanding the Players and Their Positions

The Russian banking market is concentrated at the top, with a few large players, and quickly fragments after that (see Exhibit 2). State-controlled banks comprise 39 percent of the market, with only one of those—Sberbank of Russia—having double-digit market share in terms of assets. (Sberbank has been experiencing a market-share decline, as we will discuss shortly.) Private banks as a group have the biggest share of assets—44 percent—but the largest among them, the Bank of Moscow, has only a 2.4 percent share market share. Foreign banks hold 17 percent of all assets in the country, but none of them has anything like a dominant position. (For a profile of the most successful foreign bank operating in Russia, see "Raiffeisenbank Case Study from 1998 Crisis," page 9). The majority of the 1,200 banks in the country have market share of less than 1 percent.

With these low market shares, consolidation is inevitable. There has already been a 15 percent decrease in the number of banks since 2003, as consumers have become more demanding and have gravitated to banks that could meet their needs.

### Exhibit 1

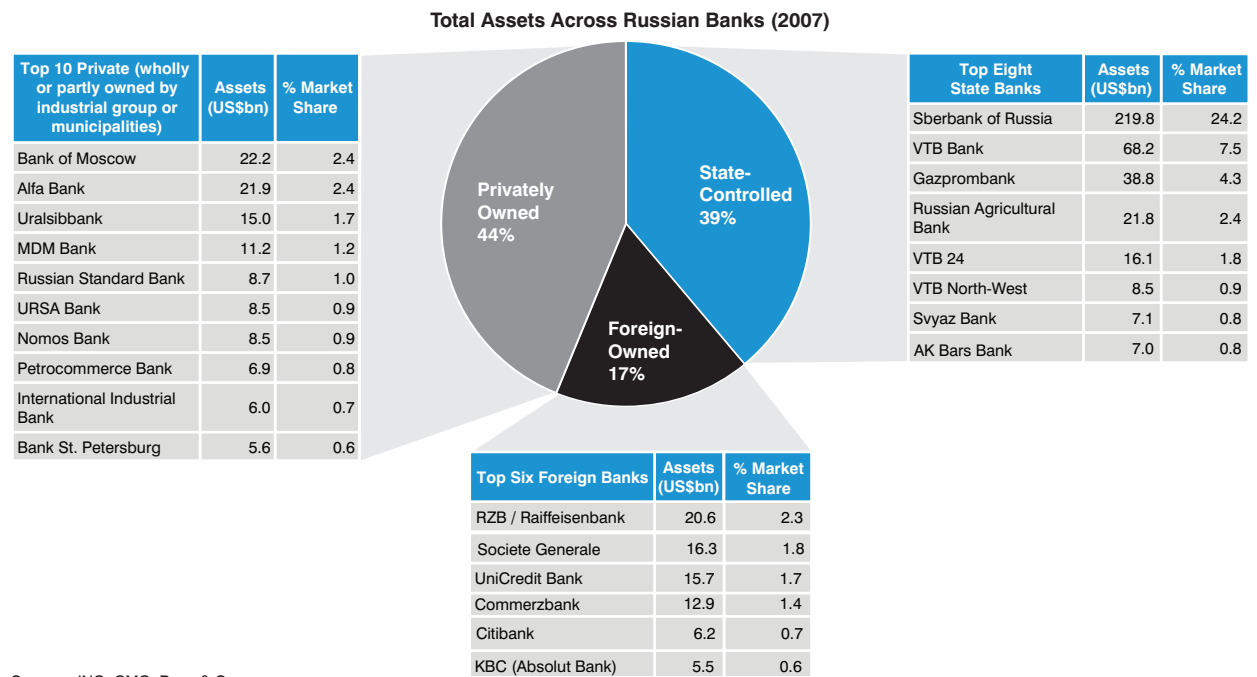
Maturity and Revenue Growth in Russia and Selected Countries



Sources: Economist Intelligence Unit; Global Insight; Booz & Company

## Exhibit 2

### Composition of Russian Banking Market



Whilst state-owned banks have enjoyed better access to funding, they have not all been equally successful. For instance, Sberbank has been losing share to more nimble organizations that have done a better job of improving products and services to appeal to customers. Nevertheless, state banks as a whole have increased their market share—and we think they will continue to do so for the next few years (see Exhibit 3). The same is true of foreign banks, which have been attracted by Russia's growth potential and have gained a foothold either through M&A or by launching innovative products. Foreign banks have also benefited from their parent companies' willingness—and ability—to invest.

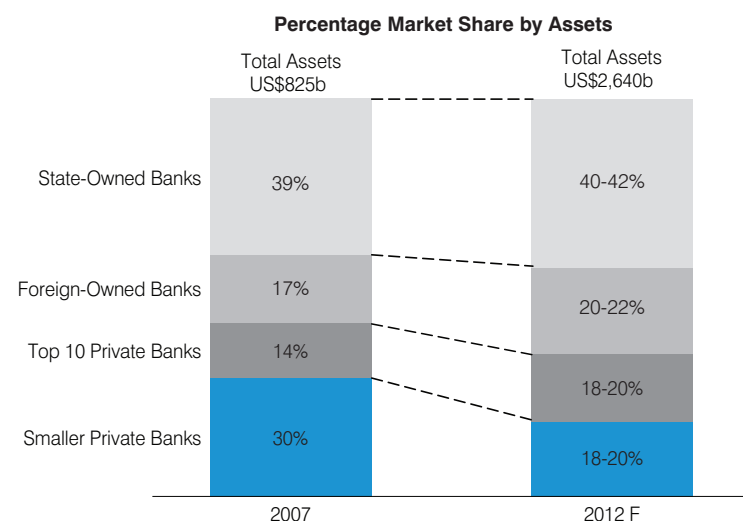
The twin assault from state-owned banks and foreign banks has taken a toll on Russia's private banks, particularly the smaller ones. Bigger private banks

like the Bank of Moscow and Alfa Bank have more capital and have generally had more success in growing with the market. The country's small private banks,

however, have limited access to capital and may need to change their positioning in order to survive in the long term. In the event of any serious credit

## Exhibit 3

### Competitive Changes in the Russian Banking Sector



Sources: CBR; ING; Booz & Company

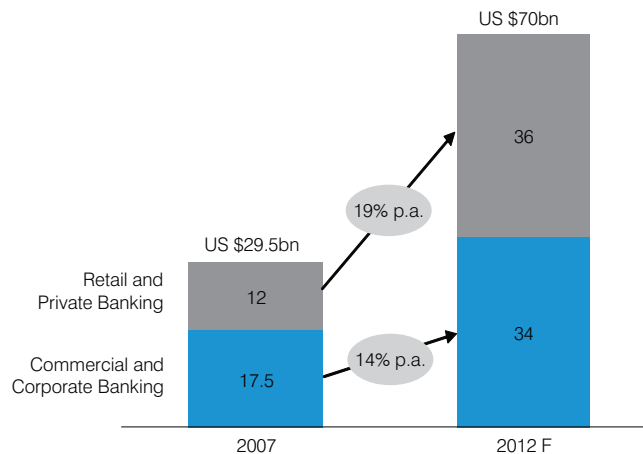
shortage, it is not clear to what extent the Russian government will come to the aid of the smaller private banks. For some of them, survival will be impossible. We believe there will be fewer than 1,000 banks within a few years.

### Segmenting the Market: An Overview of the Opportunity Landscape

Banks' profits are still strong in Russia, thanks to a large deposit base, interest rate spreads that average five percentage points, and a low percentage of non-performing loans. For the foreseeable future, these elements seem sustainable. Given the strength of the deposit base, it's hard to imagine any leading banks raising deposit rates and risking margin compression. As for non-performing loans, the Central Bank of Russia puts them at just 1.3 percent of total banking assets, a figure that's lower than in other CEE countries. It's extremely likely that that percentage will increase as the country's banks do more retail and consumer lending. But corporate and commercial lending seems secure, given the performance of Russian industry.

Not every part of the Russian market is equally promising for foreign banks. However, the growth in household incomes makes retail and private banking a particularly promising area. Our analysis suggests that retail bank revenues could triple to \$36 billion in 2012 from \$12 billion in 2007 (see Exhibit 4). The best option for foreign banks would be to go after the affluent and mass-affluent segments in key industrial and commercial regions; those customer segments are growing quickly and are prime candidates for products like mortgages and consumer loans.

**Exhibit 4**  
*Russia Revenue Pool Projection*



Source: Booz & Company

Commercial and corporate banking also represents a good opportunity for foreign banks. This is partly because Russian commercial banking is not as well developed as commercial banking in other major economies, such as the U.K. and Germany. Furthermore, the rapid growth of new Russian industries will create new growth engines, beyond the existing ones of energy and mining. Altogether, we expect corporate and commercial banking revenue to rise 14 percent (CAGR) to \$34 billion in 2012 from \$17.5 billion in 2007 (see Exhibit 4). Whilst lending will be the main driver, there will also be increased revenue from transaction banking services, including cash management and trade services. Foreign banks will have an easier time gaining traction in the mid-corporate, corporate, and multinational segment; they should steer clear of the small and medium enterprise segment, which, whilst underserved, isn't the right starting point for foreign banks.

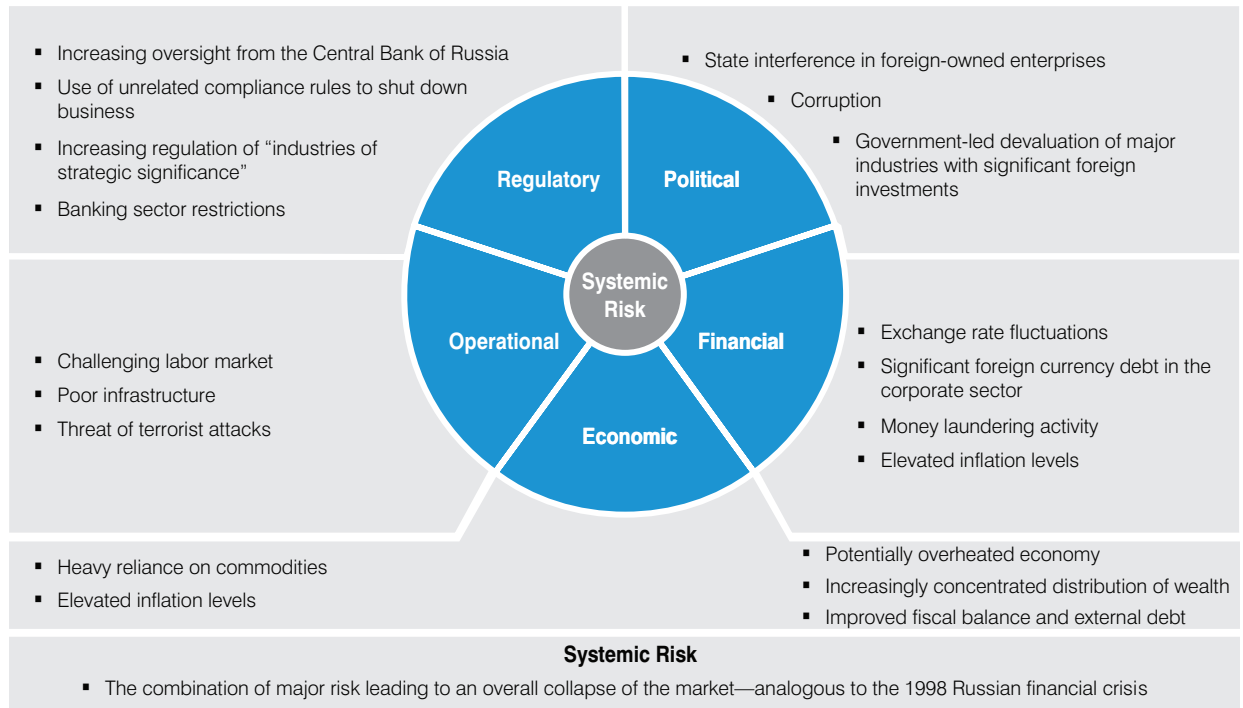
Investment banking and capital markets is the third and trickiest

segment for foreign banks. To be sure, there are some positives in investment banking. For instance, M&A activity in Russia has been strong—though mostly focused on smaller deals. Foreign exchange cash flows have until recently outgrown GDP. And the trading operations of investment banks' capital markets units have done well. But investment banking is an area likely to be squeezed by the global credit crunch, and hurt by the political fallout from Russia's recent foreign policy moves. Our recommendation to foreign banks is that they tread carefully in the investment banking segment until Russia's political picture becomes clearer and the Russian equities market shows signs of becoming less volatile.

### Going In with Eyes Wide Open: Russia's Risks for Foreign Bankers

Up to this point, we have focused on the upside of the banking market in Russia—why foreign banks would want to get in. We will now consider the downside—Russia's risks, which need to be understood and weighed.

**Exhibit 5**  
*Overall Risks of Operating in Russia*



Source: Booz & Company

We can view the risks of operating in Russia through a number of lenses—political, regulatory, operational, economic, and financial (see Exhibit 5). In early 2008, we would probably have started this discussion with the regulatory and operational risks. However, given recent events in Russia, the political risks are now most relevant.

*Political risks:* After a few years of sustained growth, improved relationships with the international community, and steady albeit slow market reforms, the geopolitical environment in Russia is again in a state of flux. Russia’s entry into the World Trade Organization now seems unlikely. This may have minimal impact on domestic

commercial growth, because the underlying factors driving Russia’s economy, as we have said, are strong. But it certainly won’t make Russia more open to foreign banks.

The bigger question—one that has been debated in the media—is whether a new cold war is developing. Things may not get to that point, but new political blocs are definitely forming in Eastern and Western Europe, and their shapes are likely to influence the environment for foreign banks. For instance, the Baltic countries may look to further isolate themselves from Russian influence; Ukraine, Poland, and possibly Georgia could create a different axis in line with the North Atlantic Treaty Organization (NATO), the U.S.,

and the U.K.; Germany and France may be more conciliatory and try to stay in the center; and more eastern countries, including Austria and those in the Balkans, may try to maintain close business links with Russia. Generally, Eastern Europe is more reliant on Russian energy; countries there may not see themselves as having the option of raising Russia’s ire. The result may be that Austrian and Hungarian banks will not encounter obstacles in Russia, but U.S. and U.K. banks will.

In any event, it would be foolish to discount the possibility of Russian state participation in marketplace matters. Anyone who watched as Russia denied a new work visa to the CEO of BP-TNK knows the country is willing to play hardball,

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no matter the public relations impact. In the energy market, Russia pushed Royal Dutch Shell to sell assets it had developed on Sakhalin Island to Gazprom, the Russian natural gas giant, for below-market prices.

The nightmare scenario in banking is that the state-run Sberbank purposefully reduces its lending rates or increases deposit rates, hurting other players that don't have state backing.

Overall, we do not expect the state to rock the banking market. Domestic banking revenues aren't strategic enough (at this point) for Russia to risk losing more-important export business to irritated trading partners. But the bear can be unpredictable. At the very least, Russia could institute controls that would limit the flow of capital across its borders.

*Regulatory risks:* Russia's regulatory environment is undergoing reform, but it is still difficult to navigate. For instance, the Central Bank of Russia sometimes insists on approving management changes—which is certainly not something that empowers companies.

The extent to which foreign banks will experience such interventions isn't clear. Russia's economic policymakers generally take a selective approach to industry regulation, taking aim at the most strategically important industries, like oil and gas, whose domestic players they want to protect. To date, banking hasn't moved onto the protectionist part of Russia's map. But there are little things, like the series of steps required for a bank to receive a license (for a foreign bank that hasn't started the

process, the steps can take two years), that make it clear that the regulatory environment requires careful monitoring.

*Operational risks:* Foreign banks also face operational risks, including instilling basic service discipline (Russia doesn't have a strong service culture at the moment) and coping with labor shortages. Banks in particular face high staff churn rates, and it may be necessary for foreign banks to pay a bit more to get and keep the best workers. In addition, there is always the risk of terrorist attacks. In the short term, Russia's political maneuvers in neighbouring nations may increase the likelihood of such events.

In our view, foreign banks will need to lean on the strength of their brands to attract and retain staff. They will also need to bring in external expertise and ideas, both to fill in knowledge gaps and to forge a deeper relationship with their employees.

*Economic risks:* Russian growth is driven by the commodities and energy sectors and is therefore vulnerable to any slowdown in these markets. Recently, global demand has softened along with a reduction in world prices. However, a severe slowdown seems unlikely given the rate of growth in countries like China and India, even with recession threatening some parts of the world.

The general market perception has been that the financial industry in Russia is relatively immune to the global financial crisis. However, recent events have contradicted that notion. The softening in energy and commodity prices, compounded

by a reduction in international trade and the scarcity of funds in capital markets, have shaken retail customer and investor confidence to some extent.

The problem for Russia is that it is a net exporter and does not have a comparatively strong internal market. It is hence sensitive to external demand and economics and not as self-sustaining as, say, the U.S. Russians are now beginning to feel that they are not as independent as they had thought.

Many Russian consumers had been using stock market gains to offset their debts; recent drops in banking shares have undermined their sense of security. Furthermore, Russian companies are beginning to face liquidity constraints and thus struggling to get access to debt. With many corporate bonds due at the end of 2008, many companies will need to find financing by year-end.

Nonetheless, we do not believe Russia is heading toward anything like the overall banking collapse of 1998. However, the current situation may temper the projected increases in domestic growth and retail wealth over the next three years.

Finally, in terms of in-country economic factors, such as inflation and GDP growth, we do think that GDP growth will slow as the effects of inflation start to be felt and global oil prices recede from the highs in early 2008. But inflation in Russia has generally been trending down, and we believe the country's overall economy is resilient in the medium to long term.

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*Financial risks:* The bad news on the risk-management front is that Russia is still relatively immature when it comes to disciplines like risk assessment and credit checking. The good news is that loan default rates in the lending market have traditionally been low. This isn't to say that foreign banks shouldn't leverage their external experience in credit and risk management and instill good lending behaviors with their Russian operations—they should. After all, even a mild slowdown in Russia's GDP could put pressure on the loan book.

Finally, foreign banks will need to be vigilant about compliance and anti-money laundering procedures, taking steps to protect their assets and those of their customers. If they do not, regulators could step in, in a way that might materially hurt a foreign bank's prospects.

### **The Bottom Line: Capabilities That Foreign Banks Need to Succeed in Russia**

Foreign banks' attitudes toward risk will be the primary determinant of whether they make a move into Russia. The risks fall into two buckets. There are the individual risk categories described above; these are largely prescriptive and can mostly be mitigated. There is also the question of the bank's overall risk profile, at a global level. This is more complex and will require internal analysis and discussion, as the bank considers its exposure and capabilities at the organization level.

Indeed, capability is a key consideration for banks that want to establish a greater presence in Russia at a time

when others may be hesitating. What capability can the foreign bank bring that might allow it to mitigate against the various risks inherent in the Russian environment? Can it provide an environment in which employees feel they are developing new skills? Can it offer those employees international exposure and training? Can it hedge against financial risks by leveraging an international balance sheet? Can it stay the course if the going gets tough?

Let us be clear here. We do not believe foreign banks can become market leaders within the current environment. Foreign banks will need focused strategies, will need to target specific segments, and will need to be prepared to manage the ongoing risks.

One hopeful historical lesson may come from studying banks' reactions to the 1998 economic crisis in Russia. Many foreign banks withdrew, fearful of losses and further economic turmoil, as Russia reeled from a drop in oil prices and other spillover effects from the Asian financial crisis. Those banks that took a riskier approach and stayed the course did suffer some short-term pain, but ended up with stronger market positions (see "Raiffeisenbank Case Study," page 9).

To those banks that want to get in now, acquisitions may offer a starting point. Moreover, recent reductions in bank share prices may provide added opportunity for purchasers. In our view, existing Russian banks will favor acquirers that bring strong brands and capabilities and substantial external assets. The challenge for acquirers will

be to find local banks that have broad distribution networks or significant market share. As we noted earlier, however, such targets are rare. Inorganic moves into Russia may thus provide better opportunities for skill and knowledge acquisition than for market or distribution access. Some banks may decide acquisitions aren't worth it at all, and forge strategies founded on organic growth.

### **Conclusion**

In our view, there is a sustainable opportunity in the Russian banking market. There is potential in both the personal and corporate markets, where the fundamentals are in place for continued strong growth and where banking penetration is relatively low.

Foreign banks will find it challenging to create a broad physical distribution base. Therefore, they will have to make shrewd decisions about the target segments they can penetrate and the services that will help them do so. Most promising at the moment are the mass affluent or affluent segments, online or other forms of non-branch banking, and corporate banking. Foreign banks would also do well to make some geographic calculations about where new opportunities are emerging; new industrial centers outside of Moscow and St. Petersburg are likely possibilities.

As a market for foreign banks, Russia still has many risks. Chief among them is the recent confrontation between Russia and the international community, which no one expects to stabilize overnight. Whilst there may not be a

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new cold war, there will be new realities on the ground, including a new front between Russia and the international community. The good news is that Russia's economy is fundamentally strong and its resources are in high demand, meaning there is little question of its commercial relationship with the outside world faltering. To be successful, however, foreign banks will have to take a position they can

sustain through the political cycle, leveraging their internal capabilities and making their moves with a clear-eyed view of what could go wrong.

The foreign banks that have been successful in Russia have tended to start organically, wait for things to stabilize, and then expand via inorganic steps, taking advantage of their newfound knowledge and experience. Strictly inorganic

plays are possible, but they are best used to establish an initial toehold: The nature of the Russian banking market makes it very difficult to buy one's way to a strong starting position.

The opportunity, realistically, is for the medium to longer term. But it is a sizable opportunity for foreign banks willing to play the game—whilst keeping an eye on the bear.

## Raiffeisenbank Case Study from 1998 Crisis

**Context:** The Asian financial crisis and low worldwide energy and commodity prices hit Russia hard in 1997 and 1998. Major manufacturing and energy companies did not pay taxes and the country's foreign exchange reserves fell. The Russian government was hamstrung and unable to meet many of its commitments across the nation. The decline in foreign reserves led to a fall in the ruble's exchange rate, undermining investor confidence. Capital flight set in.

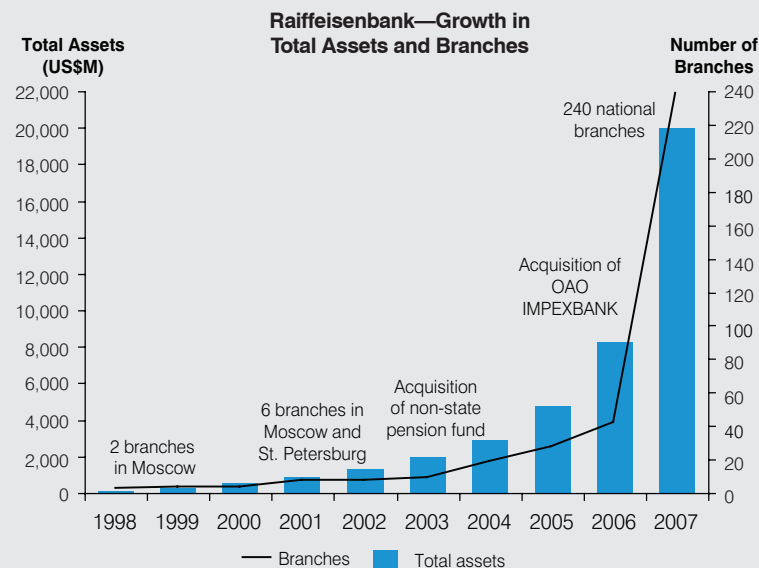
**Impact on the banking market:** During 1998, inflation breached 80 percent and more than 200 banks shut down as a result of the crisis. The government defaulted on its debt, causing banks to lose their investments in state bonds and about 20 percent of their total assets. The bank closings cost many ordinary Russians their bank deposits, leading to a widespread loss of confidence in the banking system.

**One foreign bank's response:** Raiffeisen International is part of RZB Group and a publicly listed Austrian holding group focusing mostly on CEE markets. Raiffeisen International had entered the Russian market in 1996 to focus on corporate and investment banking. Based initially in Moscow and St. Petersburg, Raiffeisenbank was the first foreign bank to make an additional capital investment after the financial crisis in 1998.

That investment posture has continued. In 2004, Raiffeisenbank expanded further into large Russian industrial towns such as Jekaterinburg, Samara, and Nischnij Novgorod, and acquired a non-state pension fund. Last year, Raiffeisenbank merged with OAO Impexbank, which specializes in personal banking, to increase its size and reach and offer a fuller set of banking services.

### Exhibit 6

#### Raiffeisenbank Growth Timeline



Sources: Raiffeisenbank, Booz and Company

**Capabilities leveraged:** In expanding its business in Russia, Raiffeisen has been able to leverage a number of key capabilities across its footprint in eastern Europe. Chiefly:

- **Knowledge of emerging markets:** Raiffeisen has a footprint in more than 15 countries ranging from Belarus to Ukraine and Kosovo.
- **Experience with entry strategies:** Raiffeisen's emerging and new markets experience has given it a unique capability and confidence in recognizing opportunities and devising appropriate strategies. Raiffeisen's general strategy has been to enter new markets as a universal bank focused on corporate banking, an area in which it has a long history, and then expand into retail and private banking. The bank has followed up its initial entry with a focus on the SME sector.
- **Acquisition and integration experience:** Raiffeisen has been able to leverage a mix of organic and inorganic strategies. For instance, in Belarus it initially invested in a local bank, and later took a majority position. In other geographies it has developed an initial base and grown mostly organically, whilst acquiring some additional businesses along the way.
- **Risk appetite and shared strategy:** Raiffeisen has understood the inherent risks in some of its target markets, yet has been willing to take positions to gain market presence. In Belarus, for instance, it established an initial position a few years before the shape of the market became clear. It is a strategy of allowing regional or "network" banks to operate under challenging local conditions that has been supported by the Raiffeisen board.

**End result:** Raiffeisenbank's investments have paid off. At the end of June 2008, Raiffeisenbank had about 1.4 million customers in Russia, a branch network of 246 outlets, and total assets of approximately \$20 billion. It is the leading foreign bank in Russia.

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