DOING BUSINESS IN Azerbaijan

HLB Azerbaijan LLC

FOREWORD

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HLB Azerbaijan LLC

November 2011

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Up-to-date information and general assistance on international matters can be obtained from any of the member firm partners of HLB Azerbaijan LLC listed in this booklet or from the Executive Office in London.

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GENERAL INFORMATION

Location and Climate

Azerbaijan is located on the shores of the Caspian Sea in South-western Asia, between Iran and Russia, with a small European portion north of the Caucasus range. The Republic of Azerbaijan (including its non-contiguous exclave of Nakhchivan) shares common borders with the following countries:

- Armenia ï 787 km (566 km with Azerbaijan proper and 221km with Nakhchivan);
- Iran ï 611 km (432 km with Azerbaijan proper and 179 km with Nakhchivan);
- Georgia ï 322 km;
- Russia ï 284 km; and
- Turkey ï 9 km (with Nakhchivan).

Baku is the capital of Azerbaijan. It is located on the Absheron peninsula at the easternmost point of Azerbaijan, on the shores of the Caspian Sea. Azerbaijan falls within the Central European Time zone (GMT+4).

The country covers an area of 86,600 sq. km and falls within nine climatic zones.

The large flat Kura-Araz Lowland forms the approximate centre of the country, with the Caucasus Mountains to the north and Karabakh Upland to the west.

The most populous cities in Azerbaijan are:

Cities	Population
Baku	2,039,700
Ganja	313,000
Sumgait	279,086
Mingacevir	99,775
Shirvan	75,453

Constitution and Population

According to the Government of Azerbaijan statistics, the population of Azerbaijan was estimated at 8.9 million people in 2010.

Ethnic composition (Azerbaijan State Statistical Committee, 2010):

Azerbaijanis	90.6%
Lezgins	2.2%
Russians	1.8%
Armenians	1.5%
Talysh	1.0%
Turks	0.5%
Others	2.3%

Currency and languages

Currency

The Azerbaijani language is spoken in Azerbaijan. The official currency of Azerbaijan is the New Azerbaijan Manat (AZN).

Languages

Azerbaijani	92.3%
Lezgi	2.2%
Russian	1.8%
Other	3.7%

Legal System

The legal system of Azerbaijan is based on civil law.

The highest judicial authority in Azerbaijan is the Constitutional Court.

The Constitutional Court resolves disputes between the legislative, executive and judicial branches of government and gives formal interpretations of the Constitution and other laws.

Unlike the common law based judicial systems of the United States and Great Britain, Azerbaijanõs civil law-based system does not extensively or exclusively rely on case law or judicial precedent. The civil law of Azerbaijan considers the 1995 Constitution, acts adopted via a referendum, and legislation passed by the Milli Majlis as the primary sources of law.

The Supreme Court, the Appellate Court, the Economic Courts and the General Jurisdiction Courts are subordinate to the Constitutional Court and hear only those cases that are within their jurisdiction.

The Constitutional Court also considers international treaties to which Azerbaijan is a signatory as a source of law. Thus, international agreements take precedence over national law if they contradict each other.

Azerbaijan is a presidential republic, with the President as the head of state and the Prime Minister as the head of government. Executive power rests with the President, the Prime Minister and the Cabinet of Ministers. Legislative power is vested in the parliament, the National Assembly (Milli Majlis) of Azerbaijan.

Under the 1995 Constitution, the executive, legislative and judicial branches of government in the Republic of Azerbaijan are separate and independent of each other.

The President is also the Supreme Commander-in-Chief of Azerbaijanõs armed forces.

Economy and economic arrangement

Economic environment

Major industrial products

- Oil and natural gas
- Petroleum products
- Oilfield equipment
- Steel
- Iron ore
- Chemicals/petrochemicals
- Cement
- Textiles

Major agricultural products

- Cotton
- Grain
- Rice
- Tea
- Tobacco
- Livestock
- Fruit
- Wine

Overview

Throughout the Soviet period, Azerbaijan's economy had always been more industrially developed than neighbouring Armenia and Georgia, but was also less diversified as a result of low levels of investment in non-oil sectors. With a history of industrial development going back more than 100 years, Azerbaijan has proven to be an economic powerhouse in the Southern Caucasus region from the tumultuous aftermath of the Soviet collapse in the early 1990s up to the present day.

After Azerbaijan regained its independence in 1991, the country underwent a lengthy period of transition from a Soviet-style command economy toward a modern, market-driven economy, concentrated on the production and export of its hydrocarbon resources.

Hydrocarbons currently form the economic lifeblood of Azerbaijan's economic future – the country possesses an estimated 7 billion barrels of proven oil reserves and 2 trillion cu m of proven natural gas reserves. This makes Azerbaijan a leading exporter of oil and natural gas, which accounted for about 90% of its exports in 2010. Last year, revenues from hydrocarbon exports resulted in a US$ 10.17 billion current account surplus.

More than US$ 60 billion was invested in Azerbaijan's oil industry by global oil majors operating in the BP-led Azerbaijan International Operating Company (AIOC) consortium. Oil production under the first Production Sharing Agreements (PSAs) with AIOC began in November 1997. Currently, Azerbaijan exports over 529,000 barrels (bbl.) per day.

Azerbaijan's prospects for boosting its oil exports brightened considerably in May 2006, when the US$ 4 billion Baku-Tbilisi-Ceyhan (BTC) pipeline pumped its first oil from Baku to the Turkish port of Ceyhan on the Mediterranean. The BTC pipeline was designed to transport 1 million barrels per day (bpd) at maximum discharge, with inflow from both Azerbaijani-produced oil and Kazakhstani oil, which is shipped across the Caspian to Baku.

Azerbaijan still faces a number of challenges for its further development. Among those are the need for stepped-up foreign investment in the non-energy economy, the on-going conflict with Armenia over the Nagorno-Karabakh region, corruption, and the potential for a sharp downturn in the construction and real estate sectors.

Trade with Russia and the other former Soviet republics is declining in importance, as Europe and Turkey increasingly become key trading partners. Azerbaijan's long-term prospects will depend on world oil prices, the discovery of new oil reserves and the development of gas pipelines in the region, as well as Azerbaijan's ability to manage its energy wealth to promote sustainable growth in non-energy sectors of the economy and spur employment.

Economic forecast

Azerbaijanøs projected growth rate is expected to be driven by oil industry-related construction and especially by the oil export revenues as large fields come on-stream and new pipelines boost oil exports to Western markets.

In response to increased dependency on oil revenues, the government is trying to ensure that Azerbaijan develops a diverse economy. Large amounts of foreign investment in the oil sector have precipitated rapid growth in others, particularly in the trade, construction and service sectors. The decline in the agricultural and non-oil manufacturing sectors has largely been halted and has exhibited some tentative signs of growth. According to the State Statistical Committee, Azerbaijanøs foreign trade turnover amounted around US$ 25 billion in 2010. In the past five years, foreign trade turnover has risen by more than 83%, while GDP steadily increased by 25% each year during the peak growth period between 2005 and 2007.

- **Oil & gas**

According to a 2009 estimate, Azerbaijan possesses over seven billion bbl. of proven oil reserves both on land and offshore in the Caspian Sea. With the well-developed Azeri-Chirag-Guneshli oilfield serving as the countryøs key oil production platform, Azerbaijan pumps up to 1.2 million bbl. per day. The new BTC pipeline, which can handle up to 1 million bbl. per day, is the regionøs Main Export Pipeline and transports Azerbaijani oil to Western markets via Turkey.

Established in 1999 Azerbaijan a State Oil Fund of Azerbaijan (SOFAZ), which accumulates energy-related windfalls and serves as the countryøs macroeconomic stability fund.

- **Oil export issues**

Prior to completion of the BTC pipeline in 2006, Azerbaijan suffered from inadequate oil export routes. The existing pipeline infrastructure in the Caspian region could not efficiently handle exports of AIOC/Azerbaijan - produced oil, as the daily discharge capacity was too low, while the network itself was designed to link the Soviet Union internally and routed through Russia. AIOC has been exporting its oil via the Northern and Western routes since the end of 1997.

Since the opening of BTC, the problem of limited export capacity has largely been alleviated, while spare pipeline capacity is reserved for cross- Caspian oil transport from Kazakhstan.

- **Oil export routes: The Northern route**

The Northern route pipeline, more commonly known as the Baku- Novorossiysk pipeline, runs from the Sangachal terminal south of Baku to the Russian Black Sea port Novorossiysk. Oil transportation via the Northern route pipeline began in 1997, when the State Oil Company of Azerbaijan (SOCAR), AIOC and Russiaøs Transneft reached a trilateral agreement. The maximum discharge of the pipeline is 5 million tons of oil per year; however, SOCAR planned to export only 2.2 million tons via the Northern route in 2010. SOCAR exported approximately 2.5 million tons to Novorossiysk in 2009.

There are, however, a number of limitations to exporting oil via the ñNorthernò route. Essentially, the pipeline is heavily reliant on Russian participation, once again tying European energy security to Russian transit. AIOC has also voiced concerns over political instability in nearby Chechnya and Dagestan, which provide transit routes for the pipeline. Lastly, exporting oil via Novorossiysk involves tankers traversing the crowded and environmentally sensitive Bosporus strait, making transit into the Mediterranean expensive and inefficient.

- **Oil export routes: The Western route**

The Western route, more commonly known as the Baku-Supsa pipeline, runs from the Sangachal terminal south of Baku to the Supsa terminal on Georgia's Black Sea coast. The 145,000 bpd (at maximum discharge) pipeline is operated by BP and was commissioned in 1999.

The pipeline recently underwent a series of large-scale upgrades, which were finished in April 2008 following a two-year hiatus in oil exports to Supsa. With some old sections of the pipeline replaced, the Baku-Supsa route is now fully operational and may see an increase in capacity up to 600,000 bpd after further upgrades.

- **Oil export routes: The Main Export Pipeline (MEP)**

The Main Export Pipeline (MEP), or as of May 2006 the Baku-Tbilisi- Ceyhan (BTC) pipeline, was designed to be the key route for exporting Azerbaijani oil to European markets. The decision to build a pipeline with a maximum discharge of 1 million bpd was primarily driven by AIOC's estimates that the limited capacity of existing export routes would have prevented the consortium from reaping the maximum benefit from increased oil production. With AIOC estimating annual production of 40 million bbl after 2010, BTC has proved to be the only export route with enough capacity to handle Azerbaijan's daily oil output.

Of three initial route options for the MEP, the Baku-Ceyhan route gained strong political support from the West, which was keen to build a pipeline bypassing Russian and Iranian territory, thus boosting European energy security. Moreover, BTC solved the so-called "Bosporus problem", so Azerbaijani oil exports were routed directly to the Mediterranean and bypassed the crowded Dardanelles.

Currently, ownership stakes in BTC are held by: BP (30.1%), AzBTC (25.00%), Chevron (8.90%), Statoil Hydro (8.71%), TPAO (6.53%), ENI (5.00%), Total (5.00%), Itochu (3.40%), INPEX (2.50%), ConocoPhillips (2.50%) and Hess (2.36%).

The total cost of the pipeline was estimated at about US$ 3.6 billion, making BTC a major investment in expanding oil exports to global markets. In comparison, the Baku-Supsa pipeline cost only about US$ 1.8 billion.

To attract foreign investment to the MEP project, Azerbaijan, Georgia and Turkey have signed and ratified the Host Government Agreements, granting considerable legal, tax and currency benefits to foreign investors.

- **The legal status of the Caspian Sea**

As of 2011 the precise legal status of the Caspian Sea, and particularly the territorial rights of the littoral states, is subject to dispute. A fundamental disagreement over the demarcation of territorial waters in the southern Caspian between Iran, Azerbaijan and Turkmenistan continues to pose a strategic threat to the development of offshore oil and gas fields.

Prior to the collapse of the Soviet Union, the Caspian Sea was bordered by only two states – the USSR and Iran. Under the Soviet-Iranian bilateral treaties of 1921 and 1940, Iran agreed to divide the sea along the Astara-Hasankuli line, a straight median between the relevant cities in modern-day Azerbaijan and Turkmenistan. However, with the emergence of Azerbaijan, Turkmenistan, Kazakhstan and Russia as independent political entities, the territorial ownership of the Caspian Sea has become subject to disagreement.

The situation is further complicated by uncertainty over whether the Caspian is legally considered a sea or a lake. Iran, having consistently insisted that the Caspian is a lake, claims to possess an equal share (20%) of the seabed, well beyond the Astara-Hasankuli line.

And while the division of the northern Caspian seabed has been recently agreed by Azerbaijan, Russia and Kazakhstan, the status of the southern Caspian remains uncertain. Although both Turkmenistan and Iran have claims to 20% shares of the seabed, these states remain in direct conflict with each other as well as with Azerbaijan.

Currently, Azerbaijan and Iran are locked into a dispute regarding the Alov field in the southern Caspian, just above the Astara-Hasankuli line. Azerbaijan and Turkmenistan also disagree on the status of the Kapaz field, which continues to be claimed by both sides.

- **Natural gas**

Azerbaijan produced 50.8 million ton oil in 2010, its record level. However, it was just 0.9 per cent higher than in previous year. Natural gas output, on the other peak, increased by 11.2 per cent. There should be noted that it is estimated to reach the pick of oil production by 2014 when its annual production level will be around 60 million ton. This suggests that the growth in oil GDP will be lower. In the absence of new oil and gas discoveries, the non-oil sector seems to be taking the role of the main driver of growth in the next few years. As opposed to the oil sector, the growth rate in the non-oil sector in 2010 has reached 7.9 per cent which was main driving force of GDP.

However, there are several downside risks to non-oil sectors, reflected in the dynamics of investment. The main factor of concern is the trend in investments. The growth in the previous years was mainly driven by foreign private investments, albeit to the oil sector. In 2004, private sector investments were accounted for 90.7 per cent of total investments, and foreign investment accounted for 73.1 per cent. However, since 2005 domestic public investments have gained pace, while private and foreign investments have been decreasing. As a result the private sector’s share in total investments had decreased to 29.6 per cent by 2009 and foreign sourced investment’s share declined to 24.8 per cent. These declining trends in the foreign and private investments pose serious downside risks to growth rates in the next few years. While it is reasonable for public investments to increase in order to compensate for falling private investments during crisis years, especially given the fiscal capacity to do so, it is imperative to attract more foreign and private investments in order to achieve sustainable and strong economic growth.

- **Shah Deniz**

Discovered in 1999 off the coast of the southern Caspian Sea, the Shah-Deniz field is the largest accumulation of offshore gas in Azerbaijan. The gas field covers an area of about 860 sq. km and is estimated to hold 1.5-3 billion bbl. of oil and 50-100 billion cu m of gas for extraction. Shah-Deniz is expected to be one of the primary sources for Europe’s future natural gas supplies, either via the planned Nabucco pipeline or alternative routes.

The Shah-Deniz project is operated by BP (25.5% stake). Other partners in the PSA include Statoil (25.5%); SOCAR (10%); Total (10%); LukAgip (an Eni-LUKoil joint venture, 10%); Naftiran Intertrade Co. (10%); and TPAO (9%).

The South Caucasus Pipeline (SCP) was completed in 2006 and operates to transfer Shah Deniz reserves from Baku to Erzurum, Turkey, via Tbilisi. The maximum discharge of the pipeline is 20 billion cu m per year as of 2012.

- **State Oil Fund of Azerbaijan (SOFAZ)**

Created in December 2000, Azerbaijan’s State Oil Fund (SOFAZ) is an extra-budgetary fund designed to ensure macroeconomic stability for the future and promote investment in non-oil sectors of the economy.

Another key reason for the establishment of SOFAZ is to boost the transparency of oil revenue management. Currently, oil revenue profits from the development of new offshore oil fields flow directly into SOFAZ, contributing to its US$ 13 billion fund.

SOFAZ is also believed to be critical in dampening the negative effects of substantial flows of oil revenue into the country's economy. By withholding a large share of total oil revenues from the country's immediate income flow, SOFAZ helps to counter inflation as well as produces other positive effects on the local economy.

- **Telecoms and IT**

Domestic fixed-line telephony is monopolized by the government, with a low teledensity of 15 telephone sets per 100 persons. However, mobile cellular telephony is growing rapidly, with an estimated teledensity of 80 mobile phones per 100 persons. The number of mobile operators has also risen, with the largest being Azercell, Bakcell and Azerfon (in cooperation with Vodafone).

Azerbaijan currently has 10 television stations and 22 radio stations. A 2010 report also listed approximately more than 2.5 million Internet users in the country. Azerbaijan's Internet country code domain name is .az.

- **Construction**

Azerbaijan has a booming construction market. Driven by extensive revenues from oil and natural gas exports, as well as the increased demand for new homes, Azerbaijan has become fertile ground for the construction of new infrastructure, residential buildings, etc.

The World Bank reported that the growth in construction sector had recovered in 2010 after a decline the year before. The remarkable performance of the construction sector can be explained by low base effect and the government's anti-crisis measures. As a result of the global financial crisis, construction had contacted by 8.2% in 2009. However, measures taken by the government, like measures directed to increase liquidity in the local market, a slow recovery of the mortgage system and its own investments into the sector helped construction to rebound by 20.3 %.

The construction business has evolved into a very competitive sector in Azerbaijan, with a number of strong local companies providing high-quality services for diverse projects, including the development of residential areas, business offices, hotels, etc.

An ambitious plan for renovating the capital city, Baku, has been launched over the past two years, with a number of high-profile projects expected to be completed by 2011-2012.

- **Agriculture**

Azerbaijan has been one of the region's strongest agricultural centres since pre-Soviet times. The country's climatic and ecological diversity allows for differentiation in crop cultivation.

Following the break-up of the Soviet Union in 1991 and the dissolution of collectivised property, Azerbaijan has adopted a policy of deregulation and allowed up to 99% of its agricultural sector to be privatised. Agriculture now accounts for 6% of the country's GDP, and employees 39% of the labour force.

Following the privatisation of farm properties, the focus of Azerbaijani agriculture has shifted to producing profit-yielding crops and increasing self-sufficiency. For instance, rice fields were replaced by grain fields in the 1990s, resulting in a rise in grain production up to 1.5 million tonnes per year.

Azerbaijan continues to be strong in the cultivation of specialised, often rare, crops. Aside from cotton, tea, tobacco and vegetable production, the country produces other potentially valuable crops, including indigenous pink grapes (used for "Madrasa" flavoured wine), persimmons, and other rare crops.

- **Tourism**

Businesspeople currently account for the majority of foreign visitors to Azerbaijan, many of whom stay for only short periods. However, Azerbaijan offers substantial opportunities in tourism, with a number of international hotel businesses, such as Hyatt and Radisson BLU already operating in Baku. A series of renovation projects in the centre of Baku, as well as the construction of elite Four Seasons, Marriott and Hilton hotels, is expected to boost Baku's attractiveness as an elite recreation spot.

Azerbaijan has a number of attractive historical sites, such as Shirvanshakh's palace, the Walled City of Old Baku or the Sheki Khan Residence, while its Eco diversity accounts for many natural resorts. The country's nine climatic zones offer the potential for developing mountain ski resorts, beach resorts, and mineral baths and medicinal health spas. A resort in Naphtalan offers treatments using a unique indigenous therapeutic oil.

- **Banking**

Azerbaijan's financial sector has grown rapidly and consolidated over the past few years. The Central Bank of Azerbaijan (CBA), serves as the banking sector regulator, monetary policymaker and key facilitator of price stability. At the moment, there are about 150 financial institutions operating in the country, of which over 40 are local and foreign banks.

In recent years, limits on foreign participation in Azerbaijan's banking sector have been reduced. Foreign investors may now own stakes of up to 50% in Azerbaijani banks. All restrictions on withdrawing foreign currency in Azerbaijan were lifted in 2002. Since the global economic crisis of 2008- 2009, Azerbaijan's monetary policy has expanded, with the refinancing rate cut from 15% to 2% and the reserve requirement ratio reduced sharply from 12% to 0.5%. The CBA continues to pursue exchange rate stability by pegging the Azerbaijani currency, the Manat (AZN), to the US Dollar.

Annual average inflation rate % (Azerbaijan State Statistical Committee)

2006	8.3%
2007	16.7%
2008	20.8%
2009	1.5%
2010	5.7% (est.)

INVESTMENT FACTORS

Investment climate

As of today, the stock of foreign direct investment (FDI) in the Azerbaijani economy. exceeds US$ 8.3 billion with investment in the oil and natural gas sector constituting more than 80% of the total amount. The World Bank (WB) reports on per capita FDI inflows rank Azerbaijan near the top among CIS and Eastern European countries. According to the WB, in2004, private sector investment accounted for 90.7 % of total investments, and foreign investment accounted for 73.1 %. However, since 2005 domestic public investments have gained pace, while private and foreign investment has been decreasing. As a result the private sector's share in total investments has decreased to 29.6 % by 2009 and foreign sourced investment's share has declined to 24.8 %.

Azerbaijan's average annual economic growth rate was about 10% over the past few years. In 2009, despite the global financial crisis, Azerbaijan's rapidly developing economy grew by 9.4% and has continued its rapid expansion. In 2007, at the peak of economic growth, the country's GDP rose by an unprecedented 25%.

Development of investment law

There are no restrictive licensing regulations for foreign businesses in Azerbaijan, although exceptions for certain businesses (primarily telecommunications, construction, etc.) do exist. In addition to the license-free regime, foreign investors are protected by a number of legal guarantees, such as:

- Guarantee of free profit repatriation
- Guarantee of protection from nationalisation
- Guarantee of protection from the changing legislation

As of 2010, 75% of the economy has been privatized. However, while the privatization of Azerbaijan's largest "blue chip" state enterprises began back in 2002, the process is still incomplete.

According to the Azerbaijan State Statistics Committee, 30.3% of total capital investment in Azerbaijan is in the oil sector. The vast majority of oil-related foreign investment is related to the development of the Azeri, Chirag and Guneshli oil fields and utilisation of the BTC pipeline. An overall capital investment in the economy of Azerbaijan in 2010 was more than US$ 10 billion, which is 21.2% more than in 2009.

Foreign investment

FDI-friendly laws

Azerbaijani law is evolving in accordance with the government's strategic goal of creating a welcoming environment for foreign businesses. Foreign investments are thus protected by guarantees provided under law. These include:

- Guarantee against deterioration of legislation: According to the general rule, a foreign investment is subject to the legislation in effect at the time it is made. Thus, the foreign investor is assured that the laws governing its investment will remain in force for a period of 10 years from the initial investment.

- Guarantee against nationalisation and requisition: Foreign investments are not subject to nationalisation (except in cases of harm to the population and the state) and requisition (except in cases of natural disaster, epidemics, accidents, emergencies). Foreign investors are guaranteed immediate, adequate and effective compensation in case of nationalisation and requisition. Compensation should be commensurate to the amount of the investment at time of nationalisation or requisition, payable in foreign currency and freely transferrable abroad;

- Guarantee of compensation of damages: Foreign investors are entitled to compensation for damages, including compensations for lost profits resulting from the illegal acts of state authorities;

- Guarantee of profit repatriation: Foreign investors are entitled to repatriate profits derived from foreign investments subject to applicable taxes and duties.

The government is expected to continue its policy of supporting privately held enterprises, including those with foreign capital and owned or operated by foreign nationals.

There are no general trade barriers or embargos for the import of goods into Azerbaijan. Exports are not subject to customs duties or restrictions. Regulations exist only for the export of strategic commodities such as electricity, petrol, cotton and non-ferrous metals. Azerbaijan's legislation is rather liberal regarding the employment of expatriate staff.

Green-field investing can be particularly favourable in the context of Azerbaijan's geographic location.

Other substantial comparative advantages of doing business in Azerbaijan include such important factors as Azerbaijan's macroeconomic and political stability over the past decade, as well as Baku's strategic position on the shores of the Caspian Sea. Baku is the only capital city with a sizable population and a well-developed business environment on the shores of the Caspian.

Under the 1992 Foreign Investment Law, foreign investment in Azerbaijan may take any of the following forms:

- Participation in enterprises and organizations jointly established with Azerbaijani legal entities and citizens;

- Establishment of enterprises that are wholly owned by foreign investors;

- Purchase of enterprises, property, buildings, structures, shares, bonds, securities, etc., subject to Azerbaijani laws governing foreign ownership;

- Acquisition of proprietary rights to use land and other natural resources;

- Conclusion of agreements with Azerbaijani legal entities and citizens providing for other forms of foreign investment.

The legislation stipulates that foreign companies seeking to invest in Azerbaijan may be engaged in any type of economic activity provided it is not prohibited under Azerbaijani law.

The Law on Protection of Foreign Investment provides information with respect to the legal forms of doing business that are specific to foreign investors. The following points provide information about the ways legislation applies to foreign legal entities in Azerbaijan.

<u>General regime for foreign investments</u>

Foreign investments are generally defined as all types of tangible and intangible rights, including intellectual property rights, contributed by foreign investors to entrepreneurial and other types of activities for the purpose of making a profit. They include, among other things, participation interests and shareholdings in Azerbaijani companies, acquisition of immovable property, the acquisition of securities and other assets owing to purchase by foreign investors under Azerbaijani law, and contractual agreements with Azerbaijani individuals and legal entities that provide for other forms of foreign investments.

<u>Definition of a foreign investor</u>

The following entities and individuals may be considered foreign investors in Azerbaijan:

- Foreign legal persons
- Foreign citizens, stateless persons, and citizens of Azerbaijan with a permanent residence abroad subject to registration in their country of residence for engaging in economic activity
- Foreign states
- International organizations

<u>Registration of foreign investors in Azerbaijan</u>

All companies operating in Azerbaijan are required to be registered. Without formal registration, a company may not do business in Azerbaijan (e.g. maintain a bank account, clear goods through customs, etc.). As a part of the on-going business law reforms, a “One Window” principle was introduced from 1 January 2008. Registration procedures involving several governmental bodies (e.g. Ministry of Justice, tax authorities, Social Insurance Fund and Statistics Committee) have been eliminated, obliging businesses to register only with the Tax Ministry.

A considerable number of documents are required to register a company with the Tax Ministry. Some must bear an apostil (or some other form of legal authorisation) from the investor’s country of incorporation.

Azerbaijan is a party to the Hague Convention on Abolishing the Requirement of Legalization for Foreign Public Documents and, thus, does not require the legalization of documents produced and executed in Hague Convention signatory countries (with the exception of a few countries).

The established period for state registration with the Tax Ministry is officially set at three days for commercial organizations.

<u>Legal forms of doing business by foreign investors</u>

The law stipulates that any company with foreign investment operating in Azerbaijan must be organized as a joint-stock company, limited or additional liability company, or partnership, or any other structure that is consistent with Azerbaijani law.

Employment Regulations

<u>Labour law</u>

Labour relations in Azerbaijan are covered extensively by the 1999 Labour Code, which comprises legislation from the early 90s with a number of later lower-tier regulatory acts expanding the general code’s provisions.

A standard working week is 40 hours. Overtime and work performed on days off (Saturdays, Sundays, public holidays and one mourning day) must be compensated at double the daily rate.

Employment relations are established by the employment contract, which, in most cases, does not necessarily indicate a fixed term of employment.

An employer must give an employee two monthsô notice of termination in the event the employee is made redundant. However, certain exceptions to this rule are available (e.g., in the case of a gross violation of the employeeõs duties). An employee can terminate their employment contract at any time but must give one monthõs notice.

Termination of employment contracts with certain categories of employees (e.g. pregnant women, women with children under three years of age) is prohibited.

Upon making employees redundant, or upon the companyõs liquidation, the employer must provide the affected employees with severance pay, which must be a total of up to three months of the employeesô regular salary.

The Azerbaijani Labour Codeõs procedures for employment and employment termination should be followed very closely, as employees tend to be favoured in legal disputes with their employers.

<u>Obligatory social insurance</u>

Employers and employees are required to make payments into the social insurance fund. Employers must ensure that social insurance contributions are paid into the relevant state bank accounts on time. Thus, employers are required to withhold employee contributions (3% of an employeeõs gross salary), along with employee income tax, and transfer these amounts to the state. This must be done on the behalf of employees.

Employers are also required to make monthly social insurance contributions in the amount of 22% of its employeesô salary fund.

Registered individual entrepreneurs are required to pay social insurance contributions at a rate of 4% of the minimum monthly wage (AZN 30 or approximately US$ 33).

Azerbaijani law also provides for obligatory medical insurance. However, the applicable rates and procedures have not been established to date. Holes in the current legislation make the Law ñOn Medical Insuranceò practically non-operational.

Business entities

<u>Subsidiary</u>

A subsidiary is an Azerbaijani legal entity with foreign ownership, which can be registered as a limited liability company or joint-stock company. Although such an enterprise may be owned by foreign nationals, it is considered as an Azerbaijani legal entity for tax, currency accounting, reporting and other requirements.

<u>Representative Office (RO)</u>

An RO is the locally registered presence of a foreign legal entity and has the ñnon-residentò status in regard to Azerbaijani tax, legal and currency regulations. If an ROõs activities are strictly limited to providing representative services to its head office, it is not subject to any profit taxes. An RO is responsible for the timely payment of all other applicable taxes to the tax authorities, such as personal income tax and social fund payments from employees.

Branch

The relevant legislation does not distinguish between an RO and a Branch. They are both subject to the same legal, tax, currency and reporting requirements. Branches are free of the requirement to have a charter fund and are able to channel income into overseas accounts, provided these accounts are duly registered with the authorities in Azerbaijan.

Oil Production Sharing Agreements (PSA) and Host Government Agreements (HGA)

Currently, there are 31 ratified PSAs and HGAs for oil and gas production, although some of them have been terminated or remain dormant. Each PSA and HGA is subject to its own exclusive tax and accounting regime. PSAs and HGAs provide for a more favourable legal and tax regime (e.g. simpler reporting regime, deductibility of expenses, fixed rate of Profits Tax, exemption from certain taxes and duties, etc.) for its participants, contractor parties and subcontractors.

TYPES OF BUSINESS ORGANISATIONS

Commercial legal entities

The Azerbaijani Civil Code stipulates the following legal forms for doing business in the country:

General Partnership (GP)

An enterprise established by two or more physical and/or legal persons. The owners of a GP have ñunlimitedò liability for the obligations of the GP.

Limited Partnership (LP)

An LP may be established by two or more physical and/or legal persons, with at least one of the participants bearing unlimited liability for the obligations of the LP and not participating in entrepreneurial activity.

Limited Liability Company (LLC)

An LLC is an enterprise which is established by one or more physical and/or legal persons. The legal fund of an LLC is divided into authorised shares as specified in its charter. The shareholders of an LLC have limited liability commensurate with their shares in the LLC.

Additional Liability Company (ALC)

The legal status of an ALC is similar to that of an LLC, with the exception that the participants of an ALC may assume liability in excess of their contributions.

Joint-Stock Company (JSC)

A JSCôs structure is similar to that of an LLC. JSCs may be established either as ñopenò or ñclosedò business entities. An ñopenò JCS is able to offer its shares to investors, while a ñclosedò JSC can only redistribute its shares among its founder shareholders and other predetermined persons.

Under the Privatization Law, foreign investors may participate in Azerbaijanôs mass privatization programme by acquisition of state privatization options.

Currency regulations

Foreign exchange transactions are governed by the Law on Currency Regulation of 21 October 1994. The Central Bank of Azerbaijan set foreign exchange policy and issues regulations relating to foreign exchange controls.

The Azerbaijani Manat is the legal tender of the Republic of Azerbaijan. Payment for all goods, work and services sold in Azerbaijan must be made in Manats, except where the payee holds a special license issued by the CBA.

Foreign exchange regulations allow residents and non-residents to transfer foreign currency from Azerbaijan in certain situations (e.g. repayment of loans, royalties, franchising fees, etc.).

In January 2006, Azerbaijan denominated its currency into the New Azerbaijani Manat (AZN), which is pegged to the US Dollar by the CBAôs monetary policy.

Accounting Requirements

Accounting regulations are set out in the Law of the Azerbaijan Republic ñOn Accountingò (March 1995). In 2004, the Azerbaijani government took steps to improve the transparency of financial reporting and accelerate the economyôs integration into the global financial system, as well as modernise the national accounting system and reporting with respect to the international standards.

The Law ñOn Accountingò, adopted in June 2004, stipulates the implementation of the International Financial Reporting Standards (IFRS) in organisations involved in commercial activities within Azerbaijan. The Law defines the types of organisations liable to various accounting standards.

Public interest entities are defined as credit organisations, insurance companies, private pension funds and legal entities with stock market share listings. Entities that meet at least two of the following criteria are also considered public interest entities: 1) revenue of AZN 30 million (approximately US$ 24 million); 2) an average of 1,200 employees, and 3) a total balance sheet of AZN 100 million (approximately US$ 80 million) All public interest entities in Azerbaijan must adhere to IFRS. Commercial organisations must either follow IFRS or the National Accounting Standards for Commercial Organizations (NASCO). Small businesses are allowed to follow simplified accounting rules approved by the Ministry of Finance. Alternatively, they may choose to follow NASCO.

Small businesses are defined as such with respect to the size of the business in the exclusive sphere of their operations. For instance, for industry and construction, an entity with fewer than 40 employees and an annual turnover of less than AZN 200,000 is considered a small business.

NASCO regulations are largely based on IFRS (2006 release). However, their intention is not to duplicate IFRS, but to simplify the principles for implementation.

The use of IFRS and NASCO standards became compulsory for commercial entities and public interest entities on 1 January 2008. These standards have also been in force for non-commercial organisations since January 2009.

For all form business organisations balance date concur with calendar year (1 January - 31 December).

Audit Requirements

The transition period is specified as one year for small businesses, two years for Public Interest Entities, and three years for non-commercial and non-governmental entities. The Civil Code contains general provisions on financial reporting and audit requirements for legal entities. JSCs and limited liability companies are required to use an independent auditor to audit their annual financials (JSCs must also publish their annual accounting reports and balance sheets). Depending on the value of the assets on the balance sheet, or annual revenues, companies are required to have their balance sheet audited.

Licensing

Banking activities, including the acceptance of deposits, maintenance of correspondent accounts, cash operations, and money transfers and lending, are subject to licensing. The CBA has the exclusive right to grant banking licenses.

Licenses are still required for banking, insurance, auditing, transportation, securities dealing and other types of activity. Foreign individuals, legal entities and their branches and representative offices engaged in licensable activities in Azerbaijan, must be licensed according to the legally prescribed procedure. A licenseôs term of validity is usually five years with the right to extend it.

State duties for licenses are up to AZN 22,000 (about US$ 26,500).

Privatisation

Under the Privatisation Law, the following are considered to be foreign investors:

- Foreign legal entities and their subsidiaries;
- Azerbaijani legal entities with participation of foreign investment in excess of 50% charter capital share;
- Foreign nationals; and
- Stateless persons.

Privatisation of state property began with the First Privatisation Programme (1995-1998). Four methods of privatisation were then authorised: privatisation of small enterprises; privatisation of medium and large-scale enterprises; privatisation of banks; and sale of specialized investment fund shares. In this first stage, 167 JSCs were founded.

In 2000, the second phase of the privatisation programme was approved by the president to allow privatisation of the country's remaining largescale enterprises, as well as strategic holdings in the oil and gas, chemical, petrochemical, infrastructure and metallurgy sectors.

After experiencing a lengthy crisis in agriculture, Azerbaijan launched the Farm Privatisation Project (FPP) in 1997. Originally conceived as a pilot project to improve land use, the FPP was aimed at restructuring selected former collective and state farms, and transferring their assets to the local population. The scheme is expected to reduce poverty through private sector growth, off-farm job creation, and the provision of community based services.

Since 1998, the privatisation process in Azerbaijan has slowed down, and sales of medium and large-scale firms have dwindled. Based on reports by the World Bank, IMF and EBRD, structural reforms, good governance, modernisation of infrastructure, and adequate access to financing are necessary to boost private sector development.

Currently, agricultural land is largely privatised (almost 99%) with landowners gaining the right to grant land shares and receive land titles. The State Committee of Land and Mapping was established to supervise the development of a market in land.

According to the State Statistics Committee, approximately 81% of all Azerbaijani enterprises are privatised as of 2010. The private sector continues expand its share of the Azerbaijani economy. In the first half of 2010, 360 small enterprises were privatised and 30 JSCs established. Today, up to 40,000 small enterprises have been privatised and up to 1,800 JSCs are operating.

Since 2002, the privatisation of large enterprises has been under way, with approximately 2,000 medium to large enterprises having been privatised. Although the government has allowed large-scale FDI in the oil sector, SOCAR has not been privatised. The main venture has been the Azerbaijan International Operating Company (AIOC), a consortium between 10 major international companies and SOCAR, which was established in December 1994.

The International Bank of Azerbaijan (IBA), one of the largest banks in the country, has been slated for privatisation since 1998, but 50.2% of the shares still remain in state hands. The IMF has been recommending the bank's privatisation for almost the last 10 years.

TAXATION

General structure

Azerbaijan currently has three different tax regimes: 1) the statutory tax regime, 2) Production Sharing Agreements (PSA) and 3) Host Government Agreements (HGA), which are exclusively for the BTC and South Caucasus pipelines. The statutory tax regime applies to all legal entities (both local and foreign) with the exception of those that are governed by a PSA or HGA, each of which has its own tax rule. The PSA/ HGA tax regimes also generally apply to relevant oil operating companies, foreign investors serving as contractor parties and all foreign service companies working with such parties.

The following sections outline the statutory and PSA/HGA tax regimes in detail.

Statutory tax regime

In general, taxes are levied on a calendar year (1 January ï 31 December) basis. VAT is always levied on a calendar month basis.

Azerbaijan adopted a new Tax Code in 2001, which introduced 220 new articles and abolished a number of old tax laws.

All foreign legal entities doing business in Azerbaijan through a ñpermanent establishmentò must register with the tax authorities regardless of whether its activities are subject to profits taxation. Tax registration of a Representative Office or a Branch should take place within one month from the start of operations. Termination of an ROôs or a Branchôs activities should be reported to the authorities one month before the cessation of operations. The major taxes applicable under the statutory tax regime are outlined below.

Corporate taxation

Profits Tax

The Tax Code applies the same tax rate and principles of taxation to all types of legal entities with a registered presence in Azerbaijan. All those who pay profit tax are legal entities (including foreign legal entities) engaged in business activity in Azerbaijan.

Profit tax is computed on the basis of an enterpriseôs taxable profit. Taxable profit is generally determined on the basis of gross realization (receipts), minus deductible expenses, which are defined as any costs related to generating profits.

From January 2009, banks, insurance and re-insurance companies are exempt from profit taxes on funds directed towards the increase of charter capital over a period of three consecutive years.

From 1 January 2010 the tax rate on an enterprise profits was reduced from 22% to 20%.

An enterpriseôs Profit Tax liabilities should be calculated and paid quarterly in advance.

In addition to Profit Tax paid by the non-residentôs permanent establishment, each amount transferred from the net profit of the permanent establishment is taxed at a rate of 10%.

Dividend withholding tax

A 10% Dividend Withholding Tax applies to both domestic and foreign shareholders and is levied in the currency in which the dividend is paid. Double taxation treaties ("DTT") may reduce the rate at which dividend tax applies. See the section below for a brief overview of DTTs in Azerbaijan.

Other withholding taxes

Foreign legal entities without a permanent presence in Azerbaijan are subject to Withholding Tax on income, which is derived from the following sources:

Interest	10%
Rent and royalty	14%
Freight income	6%
Telecommunication services	6%
Financial leasing and insurance payments	4%
Other income	10%

From January 2010, individuals are exempt from personal income tax on interest from bank deposits and dividends for a period of three years.

Value Added Tax (VAT)

Generally, VAT is charged at the rate of 18% for each taxable operation and for the value of each taxable import. There are detailed requirements for registration and accounting for VAT, with penalties for noncompliance.

From January 2010, legal entities with taxable transactions exceeding an annual threshold of AZN 150,000 (approximately US$ 187,000) and individuals with an annual turnover of more than AZN 90,000 (approximately US$ 112,000) must register as VAT payers. Other companies carrying out business activity in Azerbaijan may register voluntarily. Only registered VAT payers may charge VAT and claim credit for input VAT.

VAT is also applied to goods imported into Azerbaijan at customs unless exempt or % rated. There is also the self-assessment of VAT (reverse-charge) for services rendered by unregistered non-residents in Azerbaijan. In general, VAT paid on purchases (i.e., input VAT), is recoverable against the output VAT that is charged on the sale of manufactured goods or the provision of services in Azerbaijan.

Goods imported into the mountainous regions (1,300 m above sea level) for the purpose of tourism sector investments are exempt from VAT. This exemption is only applicable if the said goods are otherwise unavailable in Azerbaijan. The VAT exemption is also applicable to goods imported into special economic zones (excluding those that are subject to an excise tax).

All registered VAT taxpayers must pay the value of the goods (work, services), excluding VAT, to a normal bank account of the vendor, and the VAT amount (input VAT) must be remitted to the so-called VAT deposit account, a treasury account created for the allocation of VAT.

Taxpayers will not be able to recover input VAT paid into any other account (i.e., not the VAT deposit account).

Failure to remit VAT into the VAT deposit account is subject to a penalty of 50% of the unpaid VAT amount.

All VAT-registered taxpayers must issue electronic VAT invoices instead of paper ones.

Interest and penalties

Interest and penalties are applicable for failure to comply with tax legislation. Interest on outstanding tax liabilities is currently being accrued at a rate of 0.1% per day. Administrative penalties of up to AZN 50 may be applied for failure to file declarations, register a taxpayer with the authorities, notify the authorities of a change of address, etc. Tax law violations have a three-year statute of limitation.

Mining tax

Legal entities and individuals involved in the recovery of minerals in Azerbaijan are obliged to pay the Mining Tax. The rate depends on the type mineral extracted and varies from 3% to 26% of its total wholesale price.

Excise tax

Excise goods produced in or imported into Azerbaijan are subject to Excise Tax, unless the said goods are specifically exempt.

The following goods are considered excisable goods:

- Spirits, beer and all types of alcoholic beverages;
- Tobacco products;
- Petroleum products;
- Light vehicles (with the exception of motor transport means for special purposes, with special markings and equipment); and
- Leisure and sports yachts, as well as other floating transportation vehicles stipulated for the aforementioned purposes.

Property tax

Companies operating in Azerbaijan are required to pay property tax at a rate of 1% of the fixed assetsô average annual residual value.

Land tax

Land Tax is levied as a fixed payment. The economic activity level of the landôs tenant/owner does not influence the Land Tax payment.

Individuals and/or entities who own or use land within Azerbaijan are subject to Land Tax.

The Land Tax rate is between AZN 0.1 and AZN 10 per 100 sq. m of a plot.

The rate varies depending on what the land is used for ï e.g., industry, construction, transportation, etc.

Road tax

Legal entities and foreign nationals are subject to Road Tax. The Road Tax rate varies depending on vehicle engine volume, number of axles, weight carried, and how long the vehicle will be in Azerbaijan (for foreign vehicles). The tax may be assessed at a maximum of AZN 2,800 per year.

Simplified tax

This tax is intended to ease the tax burden for small enterprises and is levied in place of general Profits Tax. Simplified Tax is charged at the following rates on the taxpayerõs gross revenue:

Operation in Baku	4%
Operation outside Baku	2%

From January 2010, legal entities with annual turnover of up to AZN 150,000 (approximately US$ 187,000) and individuals with annual turnover up to AZN 90,000 (approximately US$ 112,000), are eligible to be registered as Simplified Tax payers. Those paying Simplified Tax are also exempt from VAT, Profits Tax and Property Tax. Simplified tax is levied on a quarterly basis.

Customs duties

Customs duties are levied on the value of the imported commodities. They vary from 0% to 15% of the total value of the imported good, depending on its type.

Goods imported into the mountainous regions (1,300 m above sea level) for the purpose of tourism sector investments are exempt from customs duty. This exemption is only applicable if the said goods are otherwise unavailable in Azerbaijan. This exemption is also applicable to goods imported into special economic zones (excluding those that are subject to an excise tax).

Customs processing fees of up to AZN 275 are payable upon import/ export. Should customs clearance take place in a location other than the customs area and outside of business hours, the customs handling charge doubles to AZN 550.

Employment taxes and contributions

Income tax

Employments are required to pay income tax. The tax basis for income tax purposes is the calendar month.

From January 2010, the maximum rate of Personal Income Tax is reduced from 35% to 30%. Income Tax in Azerbaijan is hence charged at progressive rates of 14% & 30% of gross income.

The taxable income of individuals engaging in entrepreneurial activity is subject to tax at 20%. The tax year for income tax of individuals is the calendar year (1 January ï 31 December).

Social insurance fund

Employers and employees must make payments into the Social Insurance Fund. The employer pays the equivalent of 22% of an employeeõs gross salary, and employees pay 3% of their gross salary (withheld from their salary by the employer).

All payroll taxes and withholdings should be paid to the relevant state budget bank accounts. This should be done no later than the 20th day of the month following the net (take-home) salary month.

Following the amendments in the Social Insurance Law, foreign citizens are also subject to social insurance contributions. Foreign employees working under the PSA/HGA tax regime are exempt from social insurance payments.

Double tax treaties

Azerbaijan has ratified to cease double taxation treaties with 24 countries.

In the meantime, due to administrative barriers imposed by the Azerbaijani tax authorities, the benefits of double tax treaties have not been fully utilised. The tax authorities require that taxes due be paid before the taxpayer lays a treaty claim. Following the submission of a full payment, a non-resident enterprise may file a refund/offset claim for overpaid taxes.

As the process of gaining a refund or an offset is tedious, lengthy, requires filing a great deal of paperwork and involves the risk of a tax audit, few taxpayers have chosen to file a treaty claim.

Production Sharing Agreement (PSA) tax regime

There are currently 31 ratified PSAs (including the inactive/terminated PSAs), with an exclusive tax regime for each one. The PSA tax regimes are applicable to each contractor party (signatory to the PSA), the operating company, and the subcontractors (in particular, foreign subcontractors). Additionally, tax protocols that provide guidance on paying taxes and filing reports are negotiated with the Azerbaijani government.

The PSAs ratified by the Milli Majlis and granted the force of law have their own separate tax regime in Azerbaijan. Foreign companies operating as PSA subcontractors in Azerbaijan are referred to as foreign subcontractors (FSC), and are subject to a simplified tax regime (withholding of tax in place of Profits Tax). This simplified corporate income tax regime does not apply to Azerbaijani legal entity subcontractors.

Other Taxes

Value Added Tax (VAT) and customs duties

VAT (both input & output) and customs duties for activities conducted under the PSA regime are charged at a rate of 0%. Exemption certificates must be obtained from the tax authorities and the State Customs Committee to confirm this tax relief.

Foreign subcontractor tax

Foreign subcontractors are subject to Withholding Tax (from 5% to 8%, depending on the PSA regime) on the gross payments received for goods and services supplied within Azerbaijan. Withholding Tax satisfies all FSC tax obligations. The only exception is Personal Income Tax for FSC employees. Personal Income Tax for FSC employees may be subject to the tax residency and tax deduction benefits.

Some PSAs envisage the application of the statutory profit tax regime for FSCs during the PSAǒs development and production period.

Customs regimes

Azerbaijani law recognises several customs regimes pertinent to goods imported into Azerbaijan. Such procedures as transit, customs storage, bonded warehouse, temporary import, and processing in/outside of customs territories may be of interest to foreign investors.

If the import is temporary, no customs duties may be applied it, and it must be exported from Azerbaijan within a certain period of time. The deadline for exporting a temporary import is established by the customs authorities. Goods brought into Azerbaijan under the temporary import regime should be exported without substantial changes to their form/ structure.

Goods imported into Azerbaijan are subject to imports duties (ranging from 0% to 15% per metric unit). Excise Tax applies to certain types of goods (e.g., tobacco and alcohol products). According to the destination VAT principle, VAT in Azerbaijan is payable (subject to an applicable customs regime) on the declared value of the goods (including assessed import duties and Excise Tax). Certain categories and types of goods are exempt from import duties and are subject to 0% VAT.

A customs clearance fee up to AZN 550 is applicable to nearly all imports/ exports. Exports are exempt from customs duties, except for certain types of metals and metal products. Under a PSA regime, contractors, their agents and subcontractors are entitled to import and re-export from Azerbaijan free from import duties and restriction goods used in hydrocarbon activities. Imports under a PSA regime are subject to 0% VAT. A similar regime applies under HGAs.

Stamp duty

There is no stamp duty levied in Azerbaijan.

Real estate transfer tax

There is no real estate transfer tax levied in Azerbaijan.

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