



# Doing Business in Russia - Industry Overview

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Prepared by VM Consult

Russian Federation

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## Executive Summary

This report will present a general overview of the most important elements of the Russian market for a target audience of European managers and executives considering a move onto the Russian market. After providing a brief introduction we move on to describing the leading industries in the country and with the help of statistical data and our own experience we analyse the current state of these sectors, identify trends and try to provide a forecast for the future. Next we look at potential driving factors for business relations between Russia and the EU and explain our choice. Following this we draw on our own professional experience as well as reports, testimonies and other data in order to identify and inform about the challenges of doing business in Russia for a foreign entrepreneur. In the conclusion we draw all of our points together and try to provide some points for further reflection.



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## About Us

VM Consult is an international business consulting firm that specialises in Russian market entry consulting. We create value for our clients through attaining a considerable increase in the probability of the success of their venture onto Russian market.

We offer a full spectrum of services for foreign small- and medium-sized enterprises wishing to break into the challenging Russian market - from preliminary market research to building of local partner networks, from analysis of the economic expediency of working in Russia to support with product localisation.

Our core advantages are:

- Result based pricing (we are confident in achieving positive results and are able to base part of our price on achieved results)



- Holistic approach (working with our client we suggest not a set of activities, but a complex approach aligned with the client's goals)

- Industry experience (we can involve not just marketing professionals in projects, but also specialists with specific industry experience)

VM Consult does not promise any secret tools or magic formulas that will provide you with enormous results overnight, but working with us will help you to significantly increase the certainty of your foreign market projects.

## Foreword

The Russian market is regularly referred to as “untapped”, “a gold mine” or “very promising” but also “risky” and “challenging”. It is the task of this report to assemble, arrange and analyse both primary and secondary data from various sources including articles, books, interviews, questionnaires and statistics in order to provide an overview of the main issues, positive and negative, regarding doing business on the Russian market. No study can claim to be entirely exhaustive but we aim to provide a general and well-researched introduction to the topic for both our partners and clients, drawing on domestic, in-house and international experience and testimonials.

### 1. Introduction

With a population of 142 million people and a place within the top 10 economies of the world, Russia is, without a doubt, an emerging economic powerhouse. Following on from the tumultuous early years of the transition to capitalism, since late 1999 and the advent of high oil prices and the arrival of President Putin, the economic situation in Russia has stabilised and in many cases even flourished. On the back of revenues from oil and gas the economy has been given the chance to consolidate and diversify and Russia has climbed to become **the EU’s third trading partner**, with growth rates of around **6-7% over the last 10 years and FDI per capita exceeding 3% of GDP**, which is a figure comparable to China.<sup>1</sup> It is easy therefore to see why Russia has shed its image of lawlessness and danger and transitioned into a promising and profitable market. As such, it seems that the administration has chosen to adhere to the conviction of Putin’s political idol, former Prime Minister Stolypin, when the latter asserted:

*“Give me twenty years of [domestic] peace, and you will not recognise Russia!”*

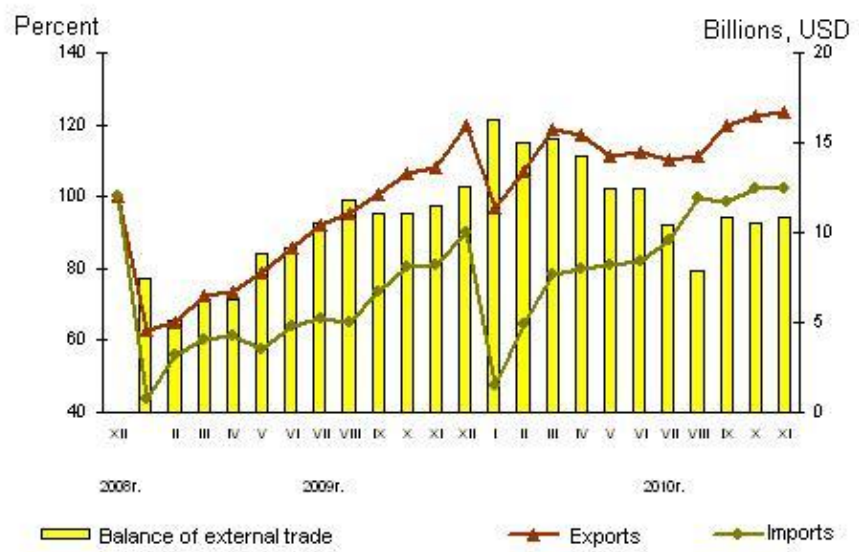
However, problems remain. A poor infrastructure combined with instances of endemic corruption and bureaucracy reminiscent of the Soviet era and a general uncertainty as to the long-term political direction of the country lead some to write Russia off as “too risky”. Despite this many European businesses continue to prosper in Russia, with a significant proportion even resolving to weather out the worst of the financial crisis and bear any short-term losses associated with remaining in Russia in order to maintain a foothold in what is seen as an invaluable strategic investment. As an expert international

<sup>1</sup> De Souza, L.V., Foreign Investment in Russia in *ECFIN Country Focus*, Vol. 5 Issue 1, 11.1.08



business consultancy specialising in opening up the Russian market for European firms it is our job to objectively analyse these benefits and risks for our clients and to assist them in whatever decision they may take; this report will attempt to do just that.

Exports and Imports in Russia in Percentages.



Source: Rosstat

Year to Year Comparison of MPI

Countries	2009	2008	2007	2005	2004	2003	2002	2001	2000	1998	1997	1996
	Rank	Rank	Rank	Rank	Rank	Rank	Rank	Rank	Rank	Rank	Rank	Rank
Singapore	1	3	3	2	2	2	2	1	1	1	1	1
China	2	2	1	3	4	5	5	5	6	5	2	3
Hong Kong	3	1	2	1	1	1	1	3	2	2	4	2
Korea, South	4	5	6	4	3	3	3	2	10	3	9	5
Czech Rep.	5	6	7	7	7	7	7	7	7	7	7	19
Israel	6	9	5	5	5	4	4	8	4	4	5	4
Poland	7	10	10	8	9	8	8	9	9	12	6	13
Hungary	8	7	8	6	6	6	6	10	11	11	16	15
Russia	9	12	13	11	12	15	13	19	19	19	21	23
Malaysia	10	14	12	13	14	13	17	15	16	8	13	7
India	11	11	9	9	8	9	10	11	8	10	10	10
Turkey	12	13	11	15	15	14	14	20	17	18	19	18
Chile	13	15	16	14	10	11	9	16	13	14	11	14
Mexico	14	8	14	10	11	10	11	14	15	22	14	9
Saudi Arabia	15	20	18									
Brazil	16	23	23	18	20	17	16	18	21	20	22	20
Egypt	17	21	19	16	16	19	21					
Argentina	18	17	17	21	19	23	15	13	14	17	3	12
Thailand	19	16	15	12	13	12	12	12	18	13	15	8
Pakistan	20	24	20									
Peru	21	25	25	17	21	18	18					
Indonesia	22	19	21	19	17	16	22	21	23	16	17	21
Philippines	23	18	22	20	18	20	19	17	12	15	18	22
Venezuela	24	27	26	23	24	22	23	23	20	23	20	16
South Africa	25	22	24	22	22	21	20	22	22	21	23	17
Colombia	26	26	27	24	23	24	24					

Source: The Economist/MSU-Ciber Market Potential Index for Emerging Markets, 2009



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## 2. Leading Industries in Russia

**2.1 Energy** – 30.3% of EU crude oil, 7.9% of hard coal and 30.7% of natural gas imports originate in Russia.<sup>2</sup> Nordstream AG, a Russian-European joint venture to establish a natural gas pipeline under the Baltic Sea is a prime example of the ability of Russian and European firms to work together and to garner government support. Moreover, the recent BNP-Rosneft deal regarding exploitation of Arctic oil fields is another landmark in EU-Russian business cooperation. Russia can boast more than 35% of proved natural gas reserves and around 15% of total world oil reserves, but many of these reserves are in inaccessible areas such as around the arctic shelf or in mountainous areas. In order to bring the sector to full capacity enormous sustained investment is required, presenting enormous opportunities for foreign engineering and energy firms.



**2.2 Construction** – The “Russian Transport 2008” project presented in Sochi details a 13 trillion RUB investment package in infrastructure over the period 2010-2015. More than 17,000 km of federal, regional and local roads, and more than 100 air fields will be built or upgraded. The capacity of Russian sea ports will be increased to more than 400 million tons per year and more than 3000 km of new railway lines will be constructed. Many of the projects will be Public Private Partnerships on the British model and will seek foreign partners. This package, approved by the state Duma represents **the largest ever investment programme in Russia**. Moreover, according to the British Chambers of Commerce Russia export guide, demand for high quality building products is estimated to be growing at a rate of 10-15% per year and the market for building products valued at around 5 billion USD. According to FINAM forecasts the construction market should grow to reach around 150-160 billion USD in 2011. Problems on the market however include regulation, licensing and the presence of some powerful competitors such as Inteco the PIC group and DSK-1. Nevertheless, with the Russian government’s commitment to modernisation, the approaching Winter Olympics in 2014 in Sochi and the World Cup in 2018, prospects for the construction industry remain good.

*“Furthermore, private business should play a part in implementing infrastructure projects. This only makes sense because businesses display interest in these projects.”*

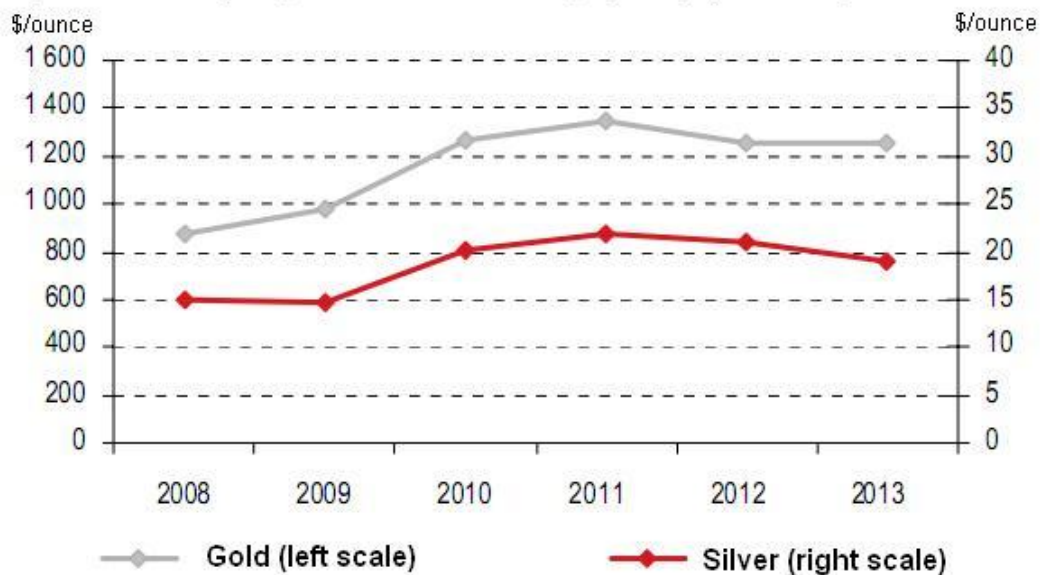
<sup>2</sup>Eurostat



*Another step is to make all forms of public-private partnership attractive and adopt long-overdue amendments to the Law on Concessive Agreements. Business should receive full support from all institutions concerned with development, including the Investment Fund.*<sup>3</sup> V.V.Putin

**2.3 Metallurgy and minerals** – Russia is a leading producer of ferrous, non-ferrous and precious metals. Metals and metal products make up the second largest group in Russian exports. Whereas the oil and natural gas industries were either kept in government hands or reacquired during the transitional period, the metal and mining sector is largely a private enterprise. Russia has huge reserves of all of the world’s major raw materials and is responsible for around 14% of world extraction according to the BRIC Spotlight report on the sector from February 2010.<sup>4</sup> Metal prices fell significantly in the second half of 2008 which has driven many industry leaders to consolidate and increase the efficiency of their operations in the face of sluggish demand from the construction sector. Huge companies such as Norilsk, RUSAL and Severstal are all looking to internationalise – a pattern which will seep down to SMEs. Foreign technology and expertise is needed to modernise the industry especially in the areas of prospecting and extraction. Moreover Chinese demand remains a key factor in determining the prospects of these industries. Meanwhile the prices and demand for precious metals will continue to grow in 2011.

**Dynamics and prognosis of the average yearly price of gold and silver**



Source: FINAM Report “Strategy for 2011”, 17.12.10

<sup>3</sup> Putin, V.V., Sochi, 20/5/08 - <http://government.ru/eng/docs/1383/>

<sup>4</sup> Thomas White Global Investing Report “Sitting on a Gold Mine – Metals and Mining in Russia”



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**2.4 Retail and consumer** – The Russian retail market has shown growth in every sector and is currently the fastest growing market for luxury goods. In 2008, Russia was ranked the third most attractive retail market in the Global Retail Development Index. Although established retailers have carved out a space, the market is by no means saturated – a fact demonstrated by the continued interest in the market shown by the Walmart chain, for example. As with the other sectors, problems and challenges exist (and indeed some of these challenges have plagued Walmart itself) but the expanding idea of a middle class lifestyle which radiates from Moscow and St. Petersburg outwards to Russia's 13 cities with around 1 million or more inhabitants is a strong incentive. FINAM estimates that levels of real disposable income among the Russian population will increase by 2-4% in 2011.<sup>5</sup>

2008 rank	Country	Region	Country risk	Market attractiveness	Market saturation	Time pressure	GRDI score	Change in rank compared to 2007
1	Vietnam	Asia	57	34	67	99	88	+3
2	India	Asia	29	39	78	93	80	-1
3	Russia	Eastern Europe	31	52	50	90	72	-1
4	China	Asia	36	50	45	82	67	-1
5	Egypt	MENA	22	34	90	64	66	+9
6	Morocco	MENA	26	36	80	68	66	+9
7	Saudi Arabia	MENA	49	40	63	50	62	+3
8	Chile	Latin America	44	52	45	58	60	-2
9	Brazil	Latin America	23	60	60	54	60	+11
10	Turkey	MENA	20	53	59	64	58	+3
11	Mexico	Latin America	38	59	40	56	57	-2
12	Algeria	MENA	15	34	90	50	55	+13
13	Malaysia	Asia	40	44	43	61	55	-5
14	Peru	Latin America	17	34	82	54	55	+8
15	Indonesia	Asia	13	41	71	61	53	+9
16	Bulgaria	Eastern Europe	28	32	42	79	51	-4
17	Ukraine	Eastern Europe	42	40	38	60	51	-12
18	Tunisia	MENA	29	34	76	41	51	-7
19	Colombia	Latin America	17	49	56	57	50	+11
20	United Arab Emirates	MENA	61	37	32	45	48	-2
21	Latvia	Eastern Europe	36	32	27	73	45	-14
22	Romania	Eastern Europe	27	30	21	85	43	+5
23	Slovenia	Eastern Europe	65	28	12	58	43	-6
24	Thailand	Asia	30	39	33	61	42	-8
25	Macedonia	Eastern Europe	13	20	74	53	41	NA
26	Philippines	Asia	14	46	76	24	41	-3
27	Guatemala	Latin America	13	15	87	41	40	NA
28	Argentina	Latin America	3	51	42	59	38	+1
29	Honduras	Latin America	4	13	91	45	38	NA
30	Lithuania	Eastern Europe	37	34	17	64	37	-2

**Key**

On the radar screen

To consider

**Legend**

0 = high risk  
100 = low risk

0 = low attractiveness  
100 = high attractiveness

0 = saturated  
100 = not saturated

0 = no time pressure  
100 = urgency to enter

Note: MENA = Middle East and North Africa

Source: AT Kearny Global Retail Development Index 2008

<sup>5</sup> FINAM Report "Strategy for 2011", 17.12.10

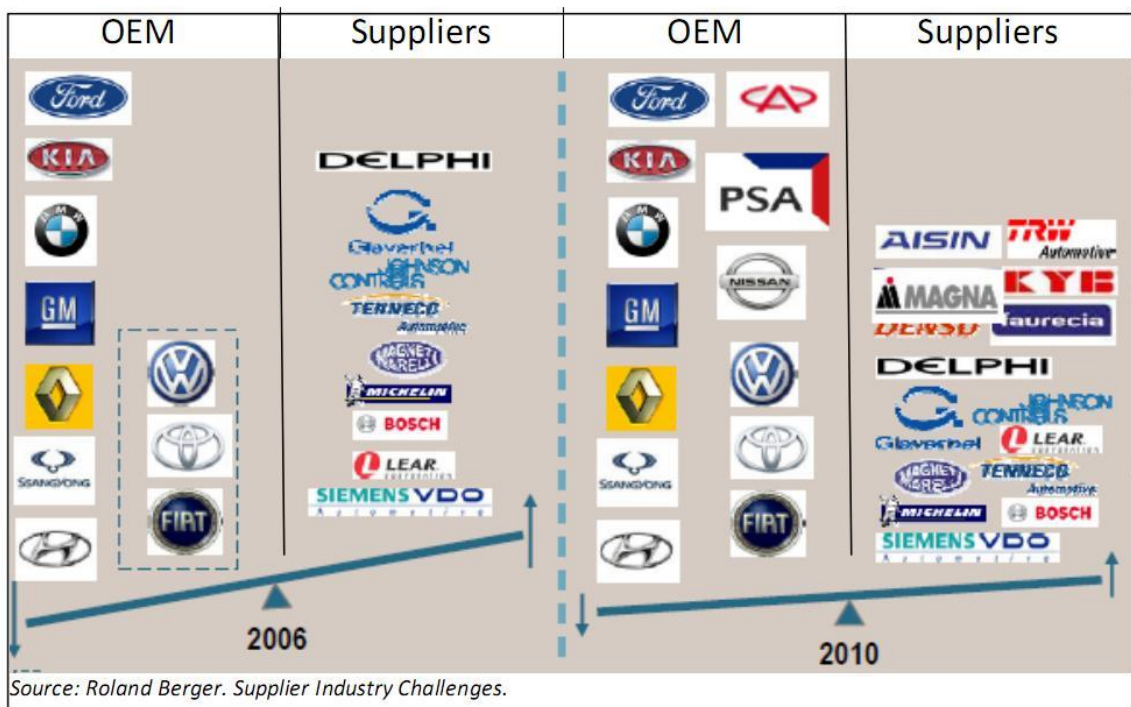


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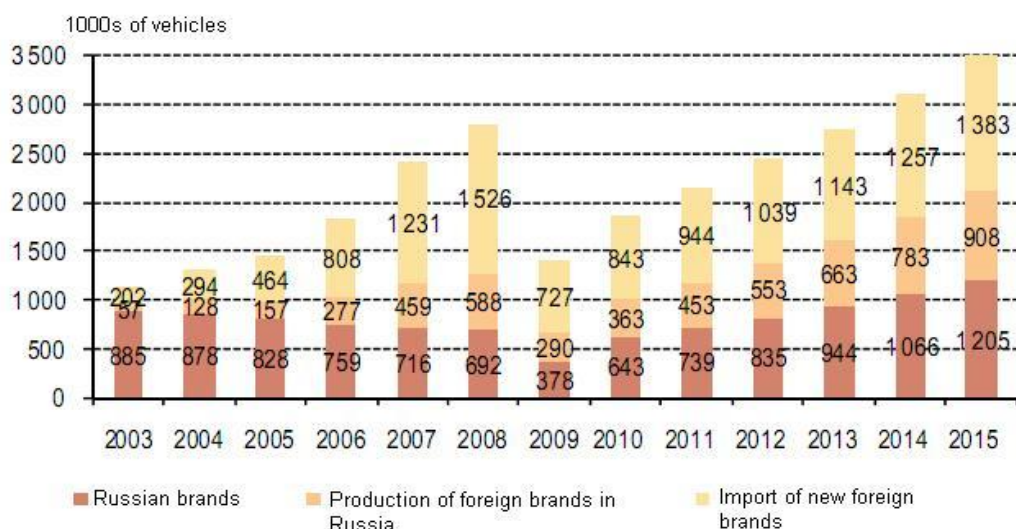
Moreover, established giants such as Pepsi and Danone have moved onto the Russian retail market, recognising the potential benefits. Pepsi’s acquisition of the Russian food and beverage firm Wimm-Bill-Danone’s merger with Unimilk prove the high-level of attractiveness of the Russian retail market.

**2.5 Automotive** – The development of the automotive industry is one of the top governmental priorities; a fact illustrated by the support shown for automobile manufacturers such as AvtoVAZ and by the introduction of a scrappage scheme during the recent financial crisis. Many predictions were made before the crisis as to the Russian automobile market’s potential to become the biggest in Europe and although these have mostly not come true, car ownership remains at a third of European levels (0.213, Rosstat) and the signs of economic recovery in late 2010/early 2011 may well put the market back on track. Some international component manufacturers have entered the Russian market, mostly by means of joint venture, but the number remains relatively low and so success stories such as Toyota and Hyundai have the potential to be repeated on a smaller scale. The government measures surrounding the market such as the scrappage scheme favour products (even foreign products) produced within Russia, making the establishment of production facilities in Russia an attractive proposition. FINAM estimates growth in the sector of imported vehicles in 2011 to be around 11% and growth in the sector of foreign brand vehicles produced on Russian territory to be around 25%. Moreover, paradoxically, the sometimes poor quality of Russian roads make the market for replacement components an especially attractive proposition also. Localisation of products and services is also an important factor to consider on the automotive market in Russia as recent changes in the law (December 2010) mean that up to 55% of production must be locally sourced within 6 years for new factories and up to 60% for existing factories. These changes favour Russian manufacturers and provide an additional, although not insurmountable obstacle for foreign companies.



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Sales in the sectors light and light commercial vehicles (2003-09) and forecast until the year 2015. 1000's of vehicles.



Source FINAM Report, “Strategy for 2011”, 17.12.10

**2.6 Information and Communications Technologies (ICT)** – The Russian ICT market represents 2% of the world ICT market and is still less developed in comparison with Western Europe. More than half of the Russian market consists of hardware products but the highest potential growth area is software products. Attesting to this fact, 70% of software is currently imported. **The most promising sectors are manufacturing, utilities and the public sector.** Thanks to the strong Russian educational system (around 2/3 of the population are educated to degree level) there is a large highly-skilled and, in comparison with Western Europe, cost-effective labour pool. The 2.6 billion USD “e-Russia” programme as well as the “Skolkovo” technology park project demonstrate the support and focus on the industry emanating from the highest echelons of government and industry.

### 2.7 Chemicals

The market for chemicals had largely recovered and reached pre-crisis levels in Russia by the end of 2010 and the prospects for the future look good in most branches. The International Fertilizer Association forecasts that by 2014 the volume of demand for mineral fertilizers should grow by almost 12%<sup>6</sup> as a result both of population growth worldwide and the reducing amount of fertile farmland. Owing to the wildfires which plagued Russia during the summer and caused significant damage to the harvest, demand for fertilizing chemicals remains high. The nitric fertilizer industry appears to be stagnating somewhat but the demand for phosphorous- and potassium-based fertilizers is forecast to grow strongly.

<sup>6</sup> International Fertilizer Industry Association



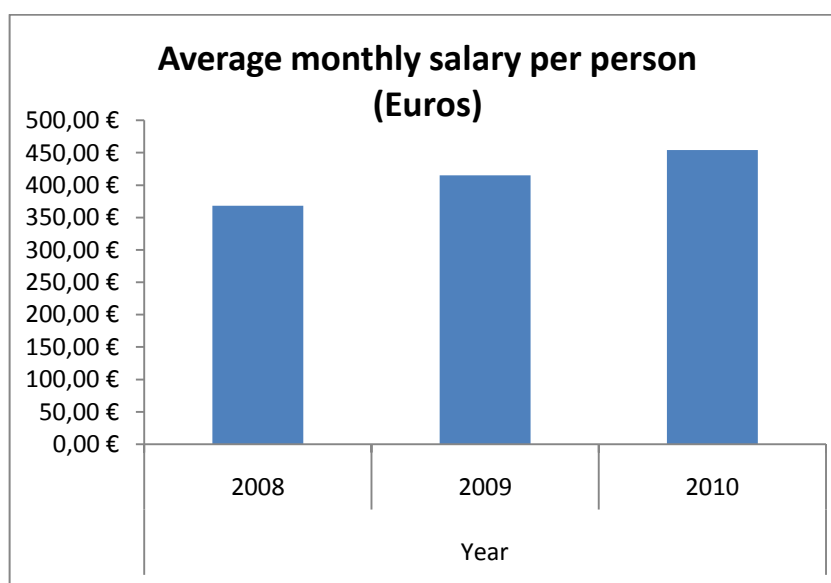
### 3. Driving Factors for Russia-EU Business

Below are compiled some of, what we consider to be the most important factors which can, or already are contributing to an intensification of Russia-EU business relations in the near future:

**Current success stories** (GSK, Fuller's, M&S, BP, IKEA, Sbarro, Pepsi, Danone) – There is no shortage of well-known European and American companies which have moved onto the Russian market and are prospering. These success stories will serve as examples and inspiration for a plethora of SMEs to emulate their actions.

**Simplified visa regime** – Following the “reset” of Russia-USA relations, talk of a simplified or even visa-free regime with Russia has intensified in Europe. With the backing of key European states such as Finland and Italy we can speculate that prospects for a visa-free (or much simplified) visa regime between the EU and Russia within the next 5-10 years are good.

**Growing Russian middle class** – Estimates vary, but according to many Russian sociologists between 15-25% of the country's 142 million strong population belong to the middle class or middle class periphery. Most of this number are concentrated in Russia's two main cities: Moscow and St. Petersburg. The UNDP report on Russia's regions 2006-7 notes that: “Personal incomes of Muscovites are around 20% of personal incomes in Russia, although the share of Moscow in the country's population is only 7%”<sup>7</sup> This disparity between the regions and the centre represents a major opportunity for tenacious businesses as the regions try frantically to match the living standards of the centre.

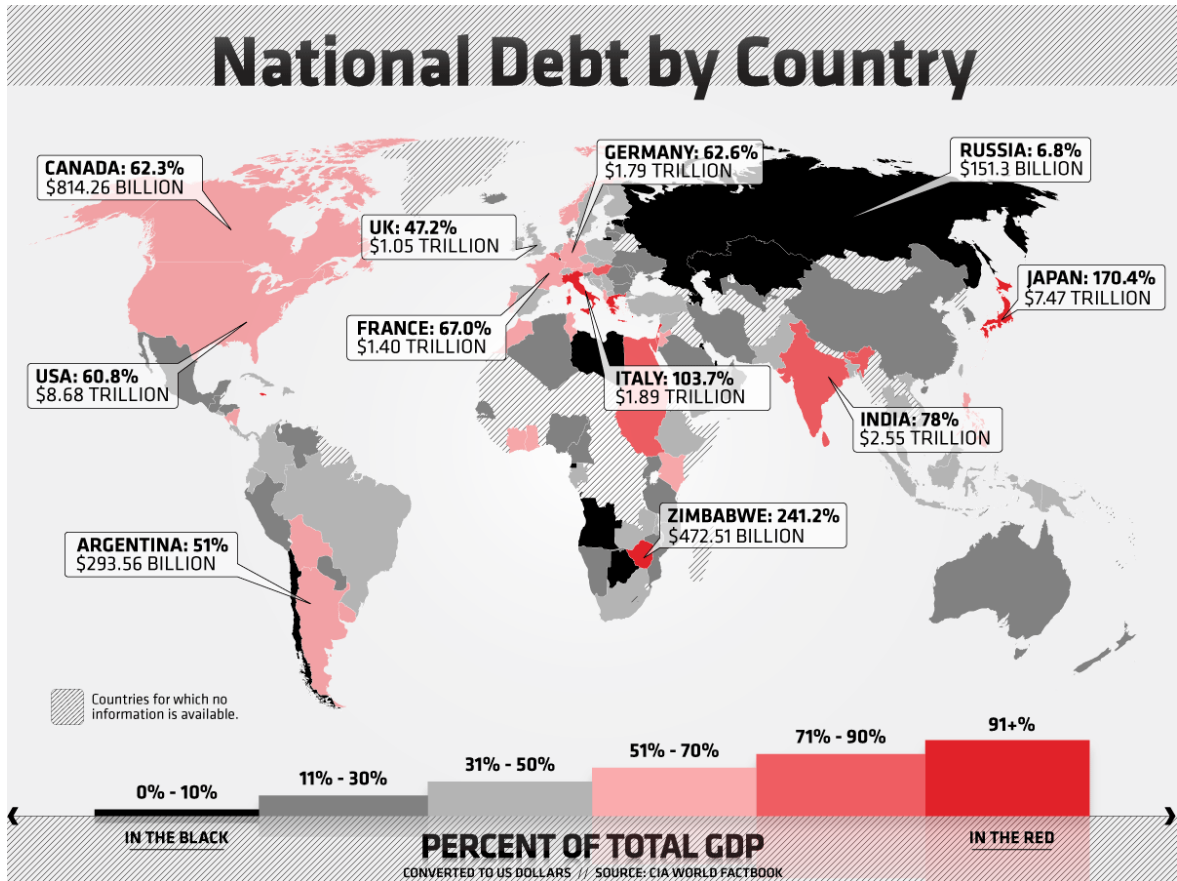


Source: Rosstat

<sup>7</sup> <http://europeandcis.undp.org/home/show/9F97FBF7-F203-1EE9-BC75CCA4A0B0D23E>, p.15



**Decline of growth rates in the traditional EU, US markets** – Growth rates in traditional markets have slowed in many cases and even stagnated in others with figures of below 1% becoming more and more commonplace. By contrast, Russia even after the economic crisis retains a relatively low ratio of per capita GDP to national debt and seems to be emerging from the crisis in a good position with continued focus on diversification to avoid the boom-bust cycles typical of resource-centred economies.



**sochi.ру**  
**2014** 

**Sochi 2014** – The approaching winter Olympics to be held in the Black Sea resort of Sochi in 2014 promise a wealth of opportunities for foreign firms and investors. A total of 47 transport infrastructure construction and modernization projects are underway and there are also plentiful opportunities in terms of telecoms, energy and environmental protection. The 14 billion USD investment package in Sochi and the determination of the government to make the Olympics a domestic and international success make Sochi an attractive proposition.

**WTO membership for Russia** – Should Russia finally be accepted into the WTO in 2011, solving the current problems with the organisation on issues such as protectionism, state enterprises, the cost of oil/gas and intellectual property rights, this will mean amongst other things that Russia will provide for improved market access for foreign firms and a much healthier competitive environment domestically. Through commitment to WTO rules and norms, trade with, investment in and expansion onto the Russian market will become much more predictable for foreign firms, thus reducing the “risk cost” of the entry ticket onto the market. The most recent reports suggest that Russia could be looking at an April 2011 accession to the organisation.<sup>8</sup>

**A closer political relationship** – With an emerging foreign ministry in Europe and 4 roadmaps for cooperation currently regulating EU-Russia cooperation, prospects for a closer political relationship are good. Some of the most powerful and influential EU states such as Germany, the UK and Italy all pursue very close ties with Russia and prize their business relationships with the country. The value of this relationship is clearly illustrated by the fact that the UK remains one of Russia’s main investors despite the plethora of political issues over the last years which could have de-railed this cooperation.

#### 4. General Challenges of Doing Business in Russia

**Bureaucracy** - Corruption, the rule of law, questions as to the independence of the judiciary, red tape and customs formalities are just some of the problems which can be located under the broad umbrella of bureaucracy. The enduring problems with bureaucracy increase the transaction costs of any potential venture on the Russian market and must be taken into account when planning.

**Language and culture** – Language remains an obvious stumbling block for many would be entrepreneurs both from small and large companies. Competency in Russian as a foreign language remains relatively low in Europe and despite improvements in the English language competency of many Russians it is still to be expected that many firms will not communicate effectively in English. There are also some differences in corporate culture and etiquette which should be anticipated and researched thoroughly.

**The “risk” factor** – This commonly heard cliché refers to the idea that Russia is an inherently risky place to invest. Political stability has been achieved but it is young and widely criticised and the Russian government is known for making u-turns in policy and sometimes attacking the very foreign assistance it once encouraged, as in the case of BP and TNK in the late 90s/early 2000s. High-profile cases such as the Yukos affair highlight the sometimes capricious nature of the authorities and while progress has been

<sup>8</sup> <http://www.themoscowtimes.com/business/article/wto-sights-set-on-april/429186.html>

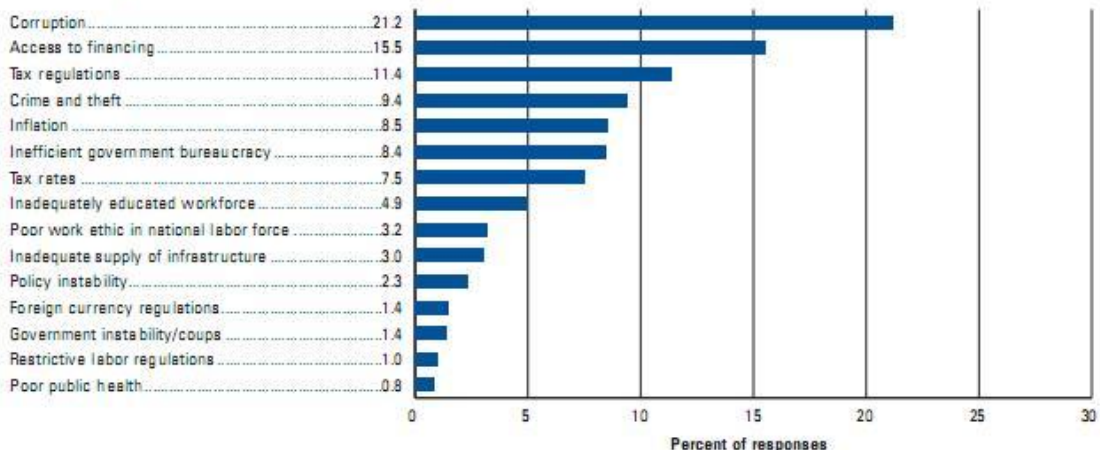


made in the spheres of property rights and the rule of law, for example, a potential investor must carefully weigh the benefits and risks associated with any move onto the Russian market.

**Difficulty in raising capital** – Businesses continue to complain of strict credit terms and a lack of available credit from Russian banks. Interest rates remain high in comparison with Western counterparts and terms remain mostly short which makes locating capital for large, complex and time-consuming ventures difficult. The situation has improved somewhat with the entry onto the Russian market of leading European and Western banks such as Barclays, HSBC, Raiffeisen and others but this still lack of capital still hampers small- and medium-sized enterprises especially. Tax evasion as a means to increase cash-flow still takes place among some Russian businesses.

**Finding the right partner** – In numerous surveys of representatives of business, (when the question is included) difficulty in finding partners is nearly always listed as a key concern for foreign companies. The difficulty is not one which besets only small- and medium-sized enterprises but, in fact, has proved a decisive factor even for giants such as Walmart which recently closed (temporarily at least) its Russian office which had been engaged in trying to find a partner for the retail behemoth for years.<sup>9</sup> Visa regulations for foreign workers have become stricter over the last years which makes finding local partners a more pressing need yet language problems, cultural differences and a lack of equivalency to Western/European standards all make the search for an effective partner a difficult affair.

#### The most problematic factors for doing business



Note: From a list of 15 factors, respondents were asked to select the five most problematic for doing business in their country and to rank them between 1 (most problematic) and 5. The bars in the figure show the responses weighted according to their rankings.

Source: WEF Global Competitiveness Report Russia, 2010-11

**Poor infrastructure in Russia** – The Russian rail network is around 85,000km long, making it the second longest in the world and it is this network which handles the bulk of freight transports within the

<sup>9</sup> <http://www.npr.org/2010/12/14/132046158/Wal-Mart-Abandons-Efforts-To-Enter-Russian-Market>



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country.<sup>10</sup> Major investment is occurring in Russian ports, especially in the Northern Sea route as this is a prerequisite necessary to support Russia's expanding role as an energy superpower and net exporter of resources, yet they remain inefficient. The situation with the ports is compounded by the fact that most rivers in the centre of the country run from North to South/South to North rather than from East to West/West to East as may benefit the transport industry. Road density is very low at 40m per km<sup>2</sup> and the majority of roads are of low quality with asphalt used in many cases as an inferior alternative to the more expensive concrete. As a result average speeds achieved on the country's roads remain low and the frequency of accidents remains high. Moreover, there is an acute lack of roads throughout the country with many more remote areas being served by nothing more than dirt roads. There is also a lack of competition and know-how within the Russian logistics sector which can exacerbate the problems with infrastructure. All in all, across rail, roads, sea ports and airports there is a lack of efficiency and a dearth of modern facilities and practices.

## 5. Conclusions

Russia is no longer Churchill's "riddle, wrapped in a mystery, inside an enigma" but the market is certainly challenging. A lot of the spectacular growth that has occurred has had more to do with catching up than with real dynamic processes within the country but this does not detract from the fact that a huge and tantalising market awaits the bold entrepreneur. For most experts the transition period has come to an end and regardless of one's views on the path of Russian democracy, from 1999 onwards we have seen a comparatively transformed climate for business and a resurgent population desperate to share in the nation's new-found wealth. The wealth is, however, not new-found; it has always been there awaiting efficient and strategic exploitation and the direction and wisdom from above necessary to see that an abundance of natural resources is only a stepping stone to long-term, sustainable prosperity.

With the right assistance and preparation the Russian market presents numerous enticing opportunities for both small- and medium-sized enterprises as well as multi-national corporations. As we have seen throughout this report, prospects in Russia are promising and the country is emerging from recession in a strong position but the pitfalls inherent to doing business here must be thoroughly researched, understood and planned for before any venture onto the market. However, as the cliché goes, "fortune favours the bold".

<sup>10</sup> Handbuch Logistik Russland | Doborjginidze / Abelman 2005 ([http://www.logit-club.de/fileadmin/upload/Handbuch\\_Russland.pdf](http://www.logit-club.de/fileadmin/upload/Handbuch_Russland.pdf))



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*This report was compiled by Steven Kelly on behalf of VM Consult Ltd. in January 2011.*

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