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From the Desk of...

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December 2007: Russia - one of the best-kept business secrets in the world, according to Dr. Daniel Thorniley, commentator and writer on emerging markets, and to the business executives he deals with in Russia and Eastern Europe.

China may have dominated much of the attention of head offices, but what about Russia? How are western companies really fairing and how sustainable are prospects in this BRIC economy?

If you do business in Russia, you will lose all your money because your Russian business partner will steal it from you because he or she is a thief; you will also die because the Russian mafia will kill you in your hotel room when you visit Moscow. This is the standard view on business in Russia and it's almost entirely rubbish! Russia is one of the best-kept business secrets in the world and company results and hundreds of corporate case studies support this. Most western executives on the ground express immense frustration that the western media and their own boardrooms "just don't get it".

As developed markets fail to generate much beyond low single-digit growth, corporates are turning to the emerging markets (notably the 'BRIC' economies Brazil, Russia, India and China). More often boils down to just China and India, which means many are missing simply the Russian boat.

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Sales growth in Russia is one of the fastest in the world. Western consumer goods companies are growing the annual top line at 20-30%, just as fast as China. Procter & Gamble's sales in Russia now represent 65% of those in China, making it their 7th largest market in the world. Nestle too stated three years ago that in ten years Russia would become their biggest market in Europe. Russia is a priority growth market for companies like Coca Cola and beer companies, who are struggling for growth globally, record some of their best annual growth figures (7-9%) in Russia, a market usually among the top five European markets for the industry, including Heineken and Carlsberg. Russian consumers are also very brand aware and will pay for the privilege. The retail sector remains unconsolidated and is less able to demand high prices for shelf space from the consumer goods companies. But domestic companies are already proving tough competitors, especially in the mid-price sector.

And it's not just a consumer goods boom. Western IT companies, such as IBM, Oracle and Microsoft have been growing their annual sales well over 50% p.a., and in some cases even 100% for several years. Piracy levels are admittedly high, but declining, and with every percentage point fall, this means tens of millions of dollars in profits for IT companies. The big Russian companies want to improve transparency and corporate governance in order to go for IPOs, and so this is driving IT sales. Industrial companies such as Dow Chemical, DuPont, Eaton and Emerson are reporting some of their best global results in Russia too, with average annual growth of 30% or more. These companies now look to in-country manufacturing. Several western industrial companies consider they have a few of years' breathing space before Russian companies start to catch up and compete more strongly. Pharmaceuticals and healthcare companies are growing at around 25-35% and most have now established legal entities in Russia so they can get into the local rouble market and diversify their distribution and therefore boost growth in sales dramatically. Service companies are also having a ball; for one of the Big Four accounting firms, Russia is the fastest growing market in the world. Western banks have conducted a flurry of mid-size acquisitions in the last year with Raiffeissen International at the forefront with its $550mn acquisition of a 100% stake in Impexbank. Retail banking is seen as the jewel in the crown.

Surveys conducted by the Foreign Investment Advisory Council (FAIC) and the Economist Intelligence Unit (EIU) underscore these results. The

FIAC survey shows 86% of all companies growing faster than 10% p.a. while the EIU's shows 100% doing so. Furthermore, the FIAC survey reports 65% growing by more than 20% p.a. and 40% of companies expanding over 30% each year.

Market leaders have recently experienced a lot more sales pressure as western and domestic competitors proliferate. But few are panicking thanks to scale of business they have already achieved. Dandy Stimoral (a privately-owned Danish chewing gum company) built up a hugely successful business and got first-entry market advantage over Wrigley who were much more conservative. Dandy's operations include over $100mn of investment in plant, several thousand staff and a sales network of more than 500 distributors and 500,000 retails outlets. Little wonder that Cadbury Schweppes bought out this Russian operation two years ago.

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Western energy companies are facing very well-publicised pressures but they can look after themselves and come back for more. Their successes are less well reported. BP for example has notched up huge dividends of some $2.5bn on its original investment in March 2003 of $6.7bn. Russian profits propped up the company's global results. One major US chemical company says, "We know what the Russian government is doing in restructuring the energy sector. "*We've seen this kind of thing in the Middle East and Latin America, so it's no big deal. As far as we're concerned there's a lot of political stability*".

Half of country managers asked say that their boards now want to do more in Russia, after seeing such superb results quarter after quarter. But the other half complains that HQ remains reluctant to invest, especially mid-sized US and UK companies. As the regional manager of a major western FMCG company said, "*If we want to invest $25m in China, the decision takes a few weeks; if we want to invest $5m in Russia, it takes a few years*". In the eyes of many country managers the bar is set unreasonably higher for Russia. One piece of advice is to grab the CEO by the scruff of the neck and bring him to Moscow to let him see the bright lights of Tverskaya and the traffic jams and most importantly to talk with talented Russian staff. It might then be a good idea to take him 100 kilometres outside Moscow to mange expectations downwards. Moscow, of course, is not Russia.

For western companies planning for sustainable sales growth of 15-25% over the next 5 years, a major challenge for managers will be managing corporate expectations downwards. When other European markets struggle to grow or are growing in single digits, then HQ invariably may well look to squeeze more out of Russia. In Central Europe some companies are insisting on cost cuts as the business slows. This is not happening in Russia, though some managers complain though that they are not receiving enough resources to meet ambitious growth targets.

The 89 Russian regions give horizontal scope to more business. The average western company does business in 10-13 regions and wants to expand as Moscow tightens up. If an average company sells an index of 100 in Moscow, it will sell 25-30 in St Petersburg and 5-15 in other regions. Moscow now rates only third among the best-performing regions for some companies. Distribution and retail, even in mining towns such as Kemerovo, are becoming highly sophisticated. Now, more regional governors active encourage foreign investment as the competition picks up to entice investors out to different regions, whereas they were previously far too.

Sales will remain good, but profits may creep down thanks to higher levels as salaries for Russian staff, rising office rentals and advertising rates pick up. One major US IT company complains that they can't get decent office space 'for love nor money' in downtown Moscow, so more companies move to the suburbs or the regions. 2002-05 were probably the bonanza years for profits in Russia when sales were booming and costs were under strict control. Profit levels are now under more pressure but still very attractive.

In the 1990s some investors struggled with joint ventures, which is why today companies prefer green field operations. Those who have invested on the ground in plants have done well in recent years. International Paper followed their earlier successful investment in 1990s with a $400mn stake in a Russian pulp plant. Ford Motor recouped good returns on its manufacturing plant too. Saint Gobain is reportedly doing well from it acquisition of a local glass plant. Until 2003 FDI was a sad joke at a mere $2-3bn per annum. 2006 saw that figure jump to £23bn and will now average $20-25bn for the next five years. And the money is not just going into oil and gas -- investments are pouring into metals, food processing, banking, consumer goods, packaging. The FIAC survey indicates that more than 90% of foreign investor plans to invest more in Russia in 2008.

"If we want to invest $25m in China, the decision takes a few weeks; if we want to invest $5m in Russia, it takes a few years!". In the eyes of many country managers the bar is set unreasonably higher for Russia

Is this all another flash in the pan with another rouble crash around the corner? It seems very unlikely. The rouble is now one of the world's strongest currencies, appreciating 7-10% in real terms against the dollar for the last four years with foreign currency reserves at over $266bn compared with $8bn in 1998. Even if the rouble were to fall by 30%, it would only reach 32-33 roubles to the dollar which wouldn't worry the government much and would of course delight Russian exporters. Oil looks set to stay over very high for the coming years, while Russia makes money on oil at around $14 a barrel, its party time at only $25!

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The business environment has much improved in recent years; credit rating agencies granted Russia investment grade on its debt, we have full rouble convertibility, leading to higher domestic investment and more financing opportunities for western investors, a rising stock market and an even stronger rouble. WTO entry will further boost business opportunities for westerners, though may not help Russian companies as much - which is why they have resisted it.

The outlook for the economy: the economy is surging and looks sustainable for the next 5 years at least, which is the most you can say of any economy. GDP will grow over 6% for the next three years. GDP per head will pick up from $9,000 in 2003 to over $15,000 in 2009. The retail sector is growing at 30% per annum with food sales rising 45%. Annual disposable income will grow at 13% per annum until 2011 – one of the fastest levels globally. In many markets real wages are flat but consumers use credit, as in the USA; in Germany consumers hardly spend because their wages are flat and they don't like credit. Whereas in Russia consumers are spending their higher wages and credits: real wages (after inflation) rose 14% in 2006 year – perhaps the fastest real wage growth in the world. And propping up those wages, domestic credit leapt 110% in 2005 to a still small $50bn but credit emission will still be growing 30% annually in 2010, reaching $160bn. People are borrowing to buy houses, cars and white goods. On the industrial front, fixed investment will grow at 10% each year until 2012. But this is below potential, relies too much on the energy sector and the quality of manufactured exports is often not competitive.

Companies globally want to focus more on their human resources to drive business. And Russia has some of the best human resources in the world --office, managerial and factory floor. This is largely thanks to the Soviet educational system which instilled learning by rote and provided a solid background in maths, sciences and engineering, less so in social sciences and history. As one executive from Oracle notes, "Our Russian staff is the best in the world, better than Europe, better than the US and better than California. full stop!". Western companies are building on the skills foundation. Russian staff may need training in sales and marketing but the results are then excellent. Ernst & Young, for example, has many expatriates working in Russia but just as many Russians working abroad now.

The bad news is that the neglect of the educational system is finally showing up. The talents of the poorly paid, women teachers had kept the system afloat. But now about 15% of companies now report a marginal erosion of HR quality. The last couple of years have also seen the start of wage inflation. Until 2004 western companies had it easy with great staff on moderate wages. They now resort to poaching from each other and cash-rich Russian firms will pay well over the odds for people they want.

Western expatriates used to arrive in Russia with a sense of doom but a large number fall in love with the place. A Russian posting now looks good on the corporate CV of international staff. Despite this, spouses are not always enamoured with Moscow and keeping the spouse happy remains an operational headache.

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But Russia has not invested enough in its people, i.e. in their education nor health. Given the massive budget surpluses, this is quite scandalous with potential long-term negative impacts for society and business. Poor control of HIV has dire potential to turn Russia into another South Africa. The demographic outlook is not healthy. President Putin spoke of more investment in these sectors but this looks like guilt money -- too little too late.

Perhaps the firmest and most inaccurate prejudices concern the legal system. Nearly all western law firms and the Big 4 accountants argue that Russia has a functioning tax and legal system which functions well for their western clients who now win 85-95% of their cases against the Russian tax authorities.

Most Russian business partners are trustworthy and most western executives actually enjoy working with Russians, developing personal relations brings good commercial rewards. This trustworthiness can be judged by hard facts; do you get paid in Russia? Invariably yes - bad debt levels in Russia are reported at 0.2-0.5% of sales.

Corruption exists but is largely overblown and is no worse than other big emerging markets like China and India. Surveys by the EIU of country and regional managers who know the market intimately feel that it is not getting worse and that it is manageable.

Putin wanted to ensure his legacy and to have placemen in the political and economic commanding heights. At the same time more is being done to liberalise the economy at the middle and lower levels. Only a tiny proportion of western companies is under the Kremlin's microscope, and only potentially in energy, metals, infrastructure, aerospace and defence, but that's about it. The recent struggle over shares in energy assets has no impact on other western manufacturing companies.

The three main business risks ahead; oil prices, political stability and a potential rouble crash …

However, there are three main business risks ahead. First, if the oil price collapses, this will damage certainly Russia, however the oil price outlook is steady and Russia is building massive reserves in its Stabilisation Fund. Second, political succession to Putin; but this looks looks highly unlikely as Putin is putting all the pieces in place to ensure his legacy, and stability and even possible continued influence. He obtained popularity ratings in objective opinion polls of over 65% because, for most Russians, the last 5 years have combined economic success with political stability. Third, the rouble: currently it looks very strong and continues to appreciate. If the oil price fell to $45 per barrel and a spate of Russo phobia were to be prevalent, the markets might make a bet against the rouble. But currency reserves look strong enough to combat this and a rouble drop of 20-30% would not faze the government.

… but western companies in Russia will face more mundane commercial challenges; sales growth stabilises, costs rise, managing more regions, retaining good staff, raising productivity

But western companies in Russia will face more mundane commercial challenges in the next five years. Sales growth will stabilise, while costs will rise so executives will have to manage expectations downwards as the market matures. Companies will have to manage more regions. Retaining the best staff will require excellent HR skills. Consolidation will take place in most sectors especially retail, beer, paper and agro-food. Distribution will remain murky but more companies will undertake their own. Companies will invest more in factories and look to factory floor efficiencies to raise productivity. In corporate structures, executives will ponder where to stick Russia; increasingly, as the market grows, it may become a stand-alone market, reporting to global headquarters.

And maybe one day the Russian government will do itself a favour and spend $250mn on the services of a slick Manhattan PR agency to build up the image of business in the country. Western managers on the ground know how good it can be, but few others do.

About Danny Thorniley

Dr. Daniel Thorniley is a Senior Vice President of the Economist Intelligence Unit and head of the Central and Eastern Europe, Middle East and Africa office of The Economist Group based in Vienna. He has over 25 years' experience observing and advising senior executives about global business strategies, with special focus and expertise on the emerging markets, especially Russia, China and India, along with others of Central and Eastern Europe. He manages the Economist Intelligence Unit's client advisory and research services and runs two senior executive programmes and personally chairs top level discussion at Economist Conferences' Government Roundtables. Dr. Thorniley has briefed countless corporations on the development of their business strategies and at the highest level, including the Chief Executives, Chairmen and Boards of major global organisations

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