

NEWSLETTER

INTERNATIONAL

 ENGLISH VERSION



RUSSIA: GOOD TIMES FOR INVESTORS



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“THE IMPACT OF THE EURASIAN ECONOMIC UNION HAS SO FAR BEEN LIMITED”

How do you assess the results of the Russian import substitution policy so far? Do you expect it to be maintained in the long term?

The Russian economy is slowly leaving the recession. For this year, we are again seeing growth above 1 percent - if not more.

While the production of raw materials has already grown by 2.5 percent last year, the manufacturing sector still stagnated. However, this is already a clear improvement compared to 2015, when the output declined by 5 percent.

Macroeconomic stabilization of the oil price to levels above 50 dollar is the most important factor for this recovery - the effects of the import substitution policy are more subordinate.

However, there is a broad spread of results by sector. The food processing industry grew by 2.4 per cent in 2016, after a plus of 2 per cent in the previous year. Agrarian production also rose by 4.8 per cent in 2016. The production of agricultural machinery rose by almost a quarter. These positive developments in the agricultural and food sectors are supported by Russian counter-sanctions - the import ban on food from the EU.

However, other sectors have also grown, which suggests a broader economic recovery. The Russian chemical industry and the production of plastics show high growth rates of more than 5 percent. The textile and leather goods sector also grew by more than 5 percent in 2016.

However, there are still issues: sectors such as the petroleum processing industry and the automotive sector shrank in 2016. The number of cars produced fell by 7.4 percent to 1.1 million last year.

Gross fixed capital formation was also likely to decline slightly in 2016, which could have disappointed high expectations on the positive effects of the import substitution policy. Nevertheless, a move away from the policy of import substitution is rather unlikely in the short term, especially if Western sanctions and Russian counter-measures remain in force. In addition, tendencies towards more protectionism could be strengthened globally after the election of President Trump in the USA. Here Russia would be a pioneer in a certain sense.

What opportunities and challenges do foreign companies face under the new conditions since 2014?

The most important challenge on the Russian market was the loss of purchasing power associated with the rouble decline and the recession. Here, the situation should improve with a somewhat more positive economic development and a surge in consumer demand this year.

With an estimated potential growth of 1 to 2 percent per year and a relatively large domestic market, Russia should also have a certain attractiveness for foreign companies in the future. The Russian rouble has settled to a new level of equilibrium around 60 roubles to the dollar.

Statistics on direct investment provide an indication of the attractiveness of the market. According to the statistics of the German Bundesbank, German companies



Andreas Schwabe

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invested almost 2 billion euros in Russia in the first three quarters of 2016 - more than in the previous year.

This is a positive development at first glance. However, around three-quarters of these investments - more than last year - consisted of reinvested profits, which is partly due to the weaker rouble since the end of 2014. The sum of actual new investments to Russia should therefore have been significantly lower.

In the years since 2012, the new investments to Russia have been quite stable around 500 to 600 million euros per year (with a positive outperformance of 1.3 billion euros in 2013). This range also seems realistic for 2016. This shows that the investment activity of German companies in Russia has suffered little in terms of new investments due to the crisis in 2015 and 2016. The German economy remained faithful to the Russian market.

On the other hand, one must also say that the share of the Russian market in German direct investment abroad is very small. Since 2012, it has been between 0.7 and 1.3 percent of German new investments abroad. Russia's economy accounts for about 3 to 3.5 percent of the world economy. From this it can be concluded that Russia is not yet able to attract foreign investment from Germany according to the size of its national economy.

What consequences does the establishment of the Eurasian Economic Union (EEU) have for European companies?

The impact of the EEU on the post-Soviet space has so far been limited. Russia is clearly dominating by the relative size of the economy.

A significant increase in trade between participants or positive growth effects by the EEU have not yet been clearly identified. While Russia also wants to see the EEU partly as a political integration project, the leaders of the other participating countries are very cautious and concerned about their autonomy. They want to restrict the integration strictly to economic issues.

Moreover, the ongoing dispute between Russia and Belarus on gas prices shows that the EEU cannot eliminate bilateral tensions.

However, it is too early for a final judgment and the establishment of rule-based intergovernmental cooperation in the region is certainly a positive development and has further potential.

In some areas, the EEU creates more uniform conditions for companies active in several member countries. However, due to the relatively small size of the other members compared to Russia, the positive economic effects are likely to be limited.

LABOUR MARKET PROVIDES FOR BACKWIND

High labour costs and modest productivity, job hopping and low availability of personnel, especially in the regions: the Russian labour market has long been providing companies with a multitude of challenges.

Above all, the low level of employee loyalty has been a headache for companies during the boom years of the early 2000s. A large number of expanding companies were facing a relatively small pool of qualified candidates who could almost choose their employer.

This picture has changed radically in the course of the developments from 2014 on. In the meantime the conditions have practically reversed to the contrary:

- 1. Remuneration:** Although the rouble rate has recovered over the past months against the euro and the dollar, it is still nearly 40 per cent below the rates of autumn 2013. Measured in euros, the employment of Russian employees has therefore become much cheaper. Given the economic downturn, salary growth in most companies has been moderate over the past two years. For many employees there have even been income losses in real terms, taking into account the inflation in 2014 and 2015.
- 2. Employee loyalty:** Executives have much less opportunities in the current labour market than in the past, as demand from both Russian and international companies remains rather low. Companies wanting to invest in Russia and offering a long-term career perspective are thus in a comfortable position. At the same time, the loyalty of employees has increased - as they appreciate stability and reliability in difficult times. Moreover, there are simply fewer offers in the market and therefore there is less inducement to consider a job change.
- 3. The availability of qualified personnel** increases from year to year in the management sector as well as in the fields of production and administration. The foreign companies working in Russia have, over the past 25 years, trained a pool of qualified candidates which is up to international standards. However, this potential is unequally distributed in the country: while Moscow, St. Petersburg and other cities with large clusters of international companies are well equipped, recruiting employees in remote regions continues to be a challenging task.

Situation for expatriates unchanged

For expatriates the situation is still not easy. As a result of cost reductions, many have been laid off in 2014 and 2015. For others, their employment contracts have been switched to rouble base in order to eliminate the risk of exchange rate risks for employers.

So far, no renaissance of the classic expat model (i.e. the secondment of a foreigner from the company HQ) is recognizable.



Christian Tegethoff

Managing Director
CT Executive Search

However, many companies are quite interested in Western European candidates for their key positions, such as General Director. However, candidates should ideally live in Russia and be prepared to work on the basis of a local employment contract.

As a rule of thumb, Western European candidates are able to negotiate remunerations one-third higher than Russian candidates. Expatriate packages with extraordinary high salaries and allowances for residential, school and travel expenses are almost everywhere a thing of the past.

In any case, the companies have a strong position in negotiations with foreign candidates, too.

“LOCAL GOVERNMENTS PAY CLOSE ATTENTION TO INVESTORS IN THE REGIONS”

Why should a foreign company consider setting up a manufacturing site in Russia at this point in time?

I believe that there are many opportunities for setting up production in Russia currently, despite all the political constraints that exist at the moment, and perhaps even because of these constraints.

If market conditions allow a foreign company to consider Russia as a location for production, then Russia can offer the investor several advantages, such as support through tax incentives and competitive salary levels for workers, engineers and management personnel.

What specific issues do companies commonly face when establishing a plant in Russia?

European companies very often follow the approach: „We have worked in different European countries, successfully implemented many projects - and this means we will be successful in Russia, too“.

Yes, during the 25 years after the collapse of the USSR, Russia has come a long way in the direction of a market economy. But this does not mean that the same rules and regulations that apply in Europe are automatically accepted here. Therefore, from my point of view, the main point for investors coming to Russia is the right choice of consultants, who should have extensive experience and qualifications.

These can be either well-known international firms or local companies operating in the Russian market. It is also important to seek support from government agencies and development institutions, such as regional development corporations, which will undoubtedly help in the work.

What are the most important aspects to consider when choosing the site of a new plant in Russia?

Site selection is primarily driven by markets and raw materials, convenient logistics, and perhaps most importantly, the availability of skilled labour.

INTERVIEW



Valery Shatalin

Commercial Director at Stupino-1 Industrial Park.

Stupino-1 is located 80km south of Moscow and provides land and services for the setup of production and logistic facilities.

Next, you need to conduct a detailed legal and technical audit of the site, regardless of whether it is a brownfield or greenfield site.

Thorough verification of ownership of land and existing buildings, checking the availability of utilities, as well as verification of the accuracy of all documentation will save both time and capital investments when deciding whether to make or not to make a certain deal.

Given the import substitution policies, how do local administrations treat foreign companies willing to invest?

Local governments pay close attention to investors coming to the regions. Everyone understands that new businesses create jobs and pay taxes, generating benefits not only for those employed in these companies, but also for all those involved in the local service and production chains.

We can confirm this from our own experience and communication with local and federal state authorities. In the regions, as I said above, there are ministries and corporations dedicated to local development. In our case, these are the Ministry of Investments and Innovations of the Moscow Region and the Moscow Region Development Corporation, which both provide substantial assistance.

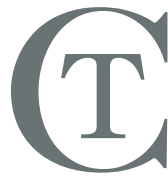
What specific benefits and advantages does Stupino-1 provide for its residents?

The main advantage of our project: We provide a site that is fully prepared for the construction of production facilities, both for Russian and foreign companies.

We have all the infrastructure ready, the site is connected to electricity, gas, water and sewerage, as well as to fiber-optic telecommunications and roads. Security and access-control are provided.

We take care of all matters that are not directly related to production, which is especially convenient for companies that are new to Russia. We support the project from its start (choice of land), through the local administrative procedures (permits and approvals) and project management up to the commissioning of the finished production building, until obtaining the certificate of ownership and other documents.

We also support the companies in their interactions with state authorities to make sure they receive all of the benefits and incentives they are eligible to.



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Via structured and documented searches processes, our consultants ensure access to the best candidates on the market. They are experts in cross-border recruitment processes and familiar with the characteristics that candidates require in order to work successfully in multinational companies.

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