

NEWSLETTER

INTERNATIONAL

 ENGLISH VERSION

RUSSIA



## RUSSIA SANCTIONS – IMPACT AND OUTLOOK



P. 2

### INTERVIEW:

**Christian Tegethoff**

„SURPRISINGLY LITTLE CRITICISM ON IMPORT  
SUBSTITUTION“ ▶



P. 4

**Stephan Schulte**

„INTERESTING MARKET DESPITE  
CHALLENGES“ ▶



P. 6

**Jens-Uwe Klemens**

„EVERYBODY SHOULD RETURN TO SENSIBLE  
COOPERATION“ ▶

## “SURPRISINGLY LITTLE CRITICISM ON IMPORT SUBSTITUTION”

### How do the Russia sanctions affect your work concretely?

Executive Search is not directly affected by Western or Russian sanctions. However, we do feel the effects indirectly.

Particularly smaller European companies are uncertain about the risks of exposure to the Russian market. It certainly seems that companies tend to leave opportunities unused because they engage in other markets instead of in Russia.

Some of our customers are directly affected by export bans - for example, because they were selling to the Russian defence sector. Of course, these activities have become impossible under the existing sanctions regime. The sale of dual-use items is much more bureaucratic today due to the mandatory applications for export licenses.

The US sanctions are certainly a problem for European companies. Their provisions are often so vague that risks emerging from their possible extraterritorial effect are difficult to predict. In addition, additional American sanctions must always be reckoned with. The resulting uncertainty is burdensome for companies, especially those with significant activity in the United States.

Some companies therefore completely abstain from business in Russia. One example is that of a German real estate company, which had considered the acquisition of properties in Moscow and St. Petersburg. After much deliberation, the company has refrained from entering the Russian market, expressly referring to risks from possible future US sanctions.

### What feedback do you receive from your clients on the impact of the sanctions on their Russian business?

Unfortunately, in the public debate in Germany - and, incidentally, in Russia - several topics are mixed on a regular basis, which in fact should be considered separately from each other.

First, there are the Western sanctions. These are directed against transactions with certain Russian industries, the export of certain products and transactions with specifically listed persons and institutions. In addition, there are Russian counter-sanctions, which mainly prohibit the import of food from Western countries.

At the same time, the Russian government is pursuing a policy of import substitution. In summary, it is about reducing the import of goods to Russia and getting companies to produce in Russia.



**Christian Tegethoff**  
Managing Director  
CT Executive Search

In my view, import substitution has a greater impact on the business activities of European companies than is the case with sanctions. Ultimately, the import substitution program is a package of protectionist measures. It puts foreign suppliers at a disadvantage against local competitors during tender processes under state participation.

There is surprisingly little criticism from European companies and trade associations on import substitution. Instead, it is often vociferously demanded that Western sanctions be withdrawn, with their detrimental effects on German and European economies estimated at billions.

For me, it is questionable whether these figures, which are largely based on companies' own accounts, differentiate carefully between sanctions and losses resulting from import substitution and the generally weak economy in Russia.

It is unclear whether the Russian government would abandon the import substitution policy if the sanctions were withdrawn. Personally, I have doubts here.

### **What factors influence the Russian market currently?**

In addition to import substitution and sanctions, it is above all the weak rouble that has shaped the business environment in Russia in recent years.

Compared to 2013, the rouble has lost almost 40 percent against the euro and the dollar. This led to a massive increase in the price of imported goods for the Russian customer, who has since turned more and more to local producers.

The competitiveness of Russia's economy has increased significantly in recent years from a cost perspective. In view of lower wage and other factor costs, production in Russia has become more attractive. Of course, foreign companies also benefit from this if they decide to localize.

A rather inhibiting factor is the slow pace of economic growth. In the first quarter of 2019, the economy has grown by only 0.5 percent; for the full year, the Ministry of Economic Affairs expects 1.3 percent. These are weak numbers for Russia; In the short term it is not clear where impulses for higher growth rates should come from.

Nevertheless, resource-rich Russia offers a multitude of opportunities that every company should consider for themselves. The overwhelming majority of international companies did not leave Russia during the turbulences emerging in 2014, but continue to work on realizing the potential that the market has to offer.

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## „INTERESTING MARKET DESPITE CHALLENGES“

### How is Symrise's business in Russia affected by the sanctions?

Our products are not subject to any Western sanctions, but to the Russian counter-sanctions on agricultural products, which incidentally also include salt.

We used to import our raw materials from Europe and the United States, but this is no longer possible. Today we buy globally or, if possible, locally. This is not easy, because many suppliers do not provide the quality we require or the processing levels needed.

For a long time, for example, we did not find any onion powder with the appropriate grinding and taste. This is a crucial factor: If you are planning a football evening or serve your date potato chips with pea-sized pieces of garlic, then the event can be over quickly!

Today we buy onion powder in China and import salt from Belarus and other countries. In addition to the grain size, salt also depends on the form of the chlorides. If these do not fit, there will be chemical problems, and you end up with a lemon-yellow paprika chip.

### What positive or negative impacts do the sanctions have?

In principle, localization in the food sector is to be welcomed. Why should a country like Russia not feed itself? Local food production is certainly a step in the right direction.

But I would also like to say clearly that we invested in Russia before sanctions were imposed. Political conditions are not a stable factor. When it comes to investment decisions, we do not focus on the political weather, but on the market potential and real business opportunities. If the business plan is not right, the general conditions will not help either.

Although localization has become a national-patriotic dogma in Russia, the bottom line is that investing is the right approach. However, products made in Russia are now sometimes even more expensive than the formerly imported goods.

This is one of the downsides of sanctions - they have removed competition from the market, and less competition means higher prices very quickly. Even the Russian government cannot just override the laws of the market.

### What other factors hinder business activity in Russia?

Clearly bureaucracy and corruption. We are confronted with numerous audits by vari-



### Stephan Schulte

Schulte is Managing Director of the Russian subsidiary of Symrise AG. The M-DAX company is engaged in the production of fragrances and flavours, which are mainly used in food and hygiene products. Symrise operates a production facility near Moscow and employs around 125 people in Russia.

ous control organizations, which deal with partly contradictory legal regulations. As a result, companies often do not know exactly where they stand.

Corruption is still a huge business. In my opinion, it tends to increase rather than decrease, in spite of all the pawn victims. As a German company one should not necessarily hope for milder treatment by the authorities.

### **How do you assess the potential of the Russian market for your company?**

We continue to regard the market positively, people have to eat even in times of crisis. Localization policy and sanctions put pressure on our customers to produce in Russia. Compared to the European market, per capita consumption in our segment is still relatively low. In combination with the pressure to localize this provides us a growth potential that is more interesting than in the traditional saturated markets.

In any case, despite ongoing political turmoil, we are continuing to invest - on July 11, we will commission a production line for liquid aromas.

### **When do you expect a withdrawal of mutual sanctions?**

I am always surprised by the nagging that the sanctions are ineffective and therefore must be lifted. Either one generally accepts them as a political instrument; the current American president obviously uses it as an economic weapon. Or one rejects them – that is a question to be argued about. However, there are rarely winners when sanctions are being imposed. Consequently, alternatives are needed in dealing with each other, and somebody has to take the first step.

However, history has also taught one thing: sanctions have an impact, if only on a long-term basis, as the examples of South Africa and Iran have shown. But these were other times and we should expect from the politicians quite more imagination and creativity to settle political differences in other ways.

The preconditions for a withdrawal of the sanctions are constantly repeated by the West. Things should move in the direction of Minsk-2, the situation in eastern Ukraine is currently the main issue. Russia, but not only Russia, certainly holds the key to the solution. If both sides are not moving, then it will probably take some more time before the sanctions fall.

Despite all the challenges, Russia is an interesting market - with the right strategy, the potential can be realized.

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## „EVERYBODY SHOULD RETURN TO SENSIBLE COOPERATION“

### How does the Russian business go in times of sanctions and import substitution?

All in all, our sites are currently well utilized. We mainly sell to the glass industry and foundries. Other interesting target industries are the construction materials sector and the plastics industry. In the last two years, demand has improved. We are even considering expanding our production capacity.

However, the market prices for our raw materials are at a level that makes long-term asset preservation difficult. The prices would have to be significantly higher for necessary investments in products of high quality.

We have learned to live in Russia with high volatility over the past ten years. By 2009, growth rates looked promising. After the crisis, many companies initially experienced a relatively rapid market recovery.

As of 2014, also caused by the conflict over Ukraine, some economic upheavals emerged. However, things improved again, partly due to targeted support measures by the government. At the moment we are living in a period of uncertainty about the further development – which is due, among other things, to sanctions. We have to wait and see how things go on.

In the short term, I am not overly optimistic. In the medium and long term, I believe that Russia will realize its potential. If we were not optimistic, we would not have commissioned our fourth production facility in the Vladimir region in 2018.

### How do the sanctions impact Quarzwerke in Russia?

We are not directly subject to sanctions because we produce locally with our Russian operations. Thus, in the Russian view, we are considered a domestic company. Our loyalty is greatly appreciated.

In the longer term, however, as a consequence of protectionism and sanctions, I expect reduced economic growth - by the way, not only for Russia, but for all sides. Our customers in Russia are reluctant to invest in much-needed refurbishments of their plants. Also, they currently have limited access to financial and technological sources.

This slows down general growth, and we will ultimately be affected by this, being positioned at the beginning of the supply chain. I therefore hope for reasonable thinking on all sides and a quick return to normality.



### Jens-Uwe Klemens

is Managing Director of Quarzwerke GmbH, based in Frechen/Germany. The medium-sized family business has been mining mineral resources for 135 years, processing them and trading the processed and refined products. The Quarzwerke have been active in the Russian market for more than ten years, operate four plants in Russia and employ almost 500 people there.

## **What are positive and negative impacts of the sanctions on your business?**

In the short term, protectionist measures appear beneficial for some companies, because the weaker domestic industry is initially protected from competition and receives a new impetus. Some believe that this will contribute to rapid development. Maybe that's the way it is.

In the long run, however, protectionism does not work because there will be no innovations and technological leaps. Competition is known to strengthen market participants.

Today, Russia achieves an annual economic growth of 1-2 percent, but would need 5 percent or more. Ultimately, this is unsatisfactory for companies, employees whose salaries do not grow, and the state - in short, all stakeholders. The economy is not picking up. In the medium to long term, sanctions and market foreclosure have a negative impact.

## **What other factors hinder business activity in Russia?**

I regard this question from the perspective of a company. Clearly, there are regional differences. However, the market is often not transparent. The administration is not efficient in many areas. The infrastructure could be improved in many places. Overall, I would like to see a more liberal economic system with a stronger focus on development.

Another issue is the availability of skilled workers, especially outside the large cities. The level of education is satisfactory as far as the theoretical basis is concerned. However, education does not focus enough on the real needs of the economy. However, there are some good initiatives, some of them driven by member companies of the German-Russian Chamber of Commerce.

I would like to emphasize positively the Central Bank's financial policy, which has apparently found clever ways to stabilize the rouble exchange rate and inflation. In terms of financial policy, Russia is on a solid foundation, in my opinion.

## **How do you assess the potential of the Russian market for Quarzwerke?**

We would not have invested in Russia if we did not see opportunities here. In the long run, I see the huge potential of the country with all its resources.

However, Russia needs modernization and greater efficiency in all areas. This requires, among other factors, an end to protectionism and sanctions. Russia needs a fair connection to the world market for mutual benefit.

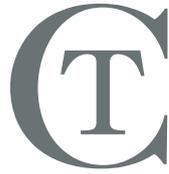
## **When do you expect the mutual sanctions to be lifted?**

You should pose this question to the politicians! Let us not fool ourselves - at the moment, the view on Russia seems to be very one-sided. Some of the conditions attached to the sanction regime do not seem realistic to me. Here, other possibilities for improving the relationship have to be developed.

Parts of German politics are not logical in my view. However, the newly signed letter of intent for a German-Russian „Efficiency Partnership“ or the Nord Stream 2 project have set some right impulses.

I think the sanctions will not disappear in the short term. I would like to appeal to all sides to lower the bar for a solution. In my opinion, all those involved should return to sensible cooperation as soon as possible, from which all sides will benefit.

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## EXECUTIVE SEARCH

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