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Investment in Russia: Risks and Opportunities

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Russia is seeking foreign investment to boost its flagging growth rate, but its difficult investment climate deters many potential investors. Some sectors, such as energy and high technology, are particularly high-risk. But others, such as retail, transport, infrastructure, and software, display promising investment opportunities. Polish companies have some inherent advantages, and can expect good returns from investing in Russia if they do so with an awareness of the risks and insight into the opportunities available.

Investment Risks. At the Davos forum in January, Russian Prime Minister Dmitry Medvedev stated that Russia was seeking large-scale foreign investment to help it achieve its goal of a 10% annual investment growth rate, in order to push economic growth above 4%. However, Russia's investment climate presents a serious barrier: Russia ranks 112th out of 185 countries for ease of doing business and 117th for protecting investors. The Russian Central Bank estimates that, as a result, capital flight from Russia exceeded $65 billion in 2012.

Russia's economic and fiscal policy is not investor-friendly. The tax code is overly complex, and Russia ranks among the worst countries for ease of paying taxes. Russia also has a distinct penchant for protectionism: despite its WTO accession, it continues to unpredictably implement levies, tariffs and bans on hundreds of imports. Tight relations between business and politics are highly detrimental to the business environment. President Vladimir Putin's "strong political vertical" has created a lack of accountability for many officials, particularly at the local level. Despite the government's "war on corruption," business surveys suggest corruption has increased since 2000. Property rights are widely perceived to be contingent on political connections, and intimidation of businesses by the FSB and police for political and financial ends is frequent. Red tape stifles innovation, and lack of transparency makes adequate partner due diligence elusive. The judicial system is also problematic: legislation implementation is broadly unpredictable and the independence and integrity of Russian courts is deeply flawed.

Technical factors present a different kind of risk to investors. Russia's huge territory and decrepit infrastructure complicate supply chain management. The quality of Russia's labour force (at 36% and 72% of the productivity of the U.S. and Chinese labour forces, respectively) increases costs for businesses. Strike rates have been growing (although admittedly from low levels) and potential further increases—due to declining economic performance and inequitable income distribution—create functional and reputational risks for investors.

High-risk Sectors. Direct investment in Russian energy is only—if at all—for majors: even multinational giants like Shell and BP have found operating in Russia to be a challenge. Energy assets are seen as strategically important, and state companies increasingly dominate the sector, making expropriation of assets a real threat. Portfolio investment is also risky, as companies part-owned by the state are likely to serve government interests before those of private shareholders. Moreover, reputation risk is high as Russian oil and gas companies are implicated in serious environmental disputes.

Russia's high-tech sector presents a different kind of risk to investors: low returns. Russia inherited the USSR's prestigious scientific education establishment, and universities continue to provide valued scientific degrees. But state domination and interference is a serious hindrance to development. Despite good theoretical research and huge spending, the nanotechnology industry is not commercially successful because it is dominated by state-owned

Rusnano, which is ineffective due to extensive government intervention (in 2009, it had to transfer half its funds to help cover the federal budget deficit, and political pressure affects the company's decision-making). Moreover, Russian research and development is lacking: expenditures are low and dominated by the state, and the number of personnel has been shrinking since 2000.

Investment Opportunities. Russia's retail sector presents opportunities for foreign investors. Russia has Europe's largest population, and its middle class is booming (Russians' real disposable income growth was among the world's highest in the 2000s), but modern retail saturation is low. The luxury sector—in particular Russian fortes such as fur, caviar and diamonds—also exhibits potential for growth, given rising appetites in Asia and the uptick in Russian consumption since 2010. However, potential investors must be prepared to navigate red tape: importing a single container to Russia requires 36 days and 11 documents (compared to two in France, for example).

Opportunities for investment in Russian transport and infrastructure are growing. Russia's transport sector is expected to boom as the trade benefits of entering the WTO kick in, and transport assets have been selling well. Upcoming sporting events, such as the 2014 Sochi Winter Olympics and 2018 football World Cup, create investment opportunities for engineering, procurement and construction firms: stadiums, hotels, and transport facilities will have to be built or upgraded. Here too, investors should expect and mitigate bureaucratic obstacles (Russia ranks 178th for ease in obtaining construction permits) and a strong state presence in the sector.

Russia's software industry—the only Russian high-tech industry not dominated by the state—is very successful: annual export growth rates exceed 20%. It benefits from low government regulation, improving intellectual property rights enforcement, high technical skills and close integration into the global economy. It is the only high-tech industry that offers real opportunities for foreign investors.

Current Polish Investment in Russia. Russia is regularly among the top 10 destinations for Polish foreign direct investment (FDI), and accumulated Polish investment in Russia in 2011 was $704 million. But this is just a small fraction of total accumulated foreign investment in Russia ($347 billion), and only 2% of total Polish FDI (almost $45 billion). Nevertheless, in terms of the frequency of investment (i.e., the number of investors), Russia ranks fourth (after Germany, Ukraine and the Czech Republic) for Polish investment.

Currently, the main destination for Polish investment in Russia is the processing industry ($39 million in the first half of 2012), in particular in the food, drink and tobacco sector ($25 million). Financial services attract the second largest amount of Polish investment ($27 million), followed by wholesale and retail trade, and transport, household and consumer product repair ($23 million), then mineral extraction ($11 million). Polish investors are much less present in sectors such as real estate, construction, transport, and hospitality.

Polish investment in Russia is concentrated in three regions: 82% of all Polish investment in Russia goes to the Moscow, Leningrad and Kaliningrad regions, with their 26 million consumers. This means most Polish investment misses out on 117 million consumers in the rest of Russia, many of whom have big consumption potential, and are concentrated in large cities and rich towns such as Sochi, Kursk and Perm.

Conclusions and Recommendations for Polish Companies. Polish companies have several competitive advantages for investing successfully in Russia. First, they can benefit from the good reputation that Polish goods and services enjoy on the Russian market. Second, most Polish companies are smaller than their Western counterparts, and many experienced the wilder economic climate during Poland's democratic transition in the 1990s. This gives them a lead over larger Western companies on the Russian market, which requires quick decision-making and the ability to function in a less stable and auspicious institutional and administrative environment. Third, conditions for Polish FDI in Russia are increasingly favourable, following Russia's WTO accession and the entry into force of the Local Border Traffic regulation in 2012, which facilitates Polish trade with Kaliningrad.

Polish companies can use these advantages in several investment areas in particular—and some already are. Retail giant LPP has opened clothing stores in Moscow, and Bella, a major exporter of cosmetics, has invested $13 million in building a logistic centre in Novosibirsk. Other Polish retail companies, including supermarket and drugstore chains, could find similar investment opportunities. Polish investment in Russian transport and infrastructure is growing (UNIBEP and Trasko-Invest were among the top Polish investors in Russia in the first half of 2012, and PESA delivered its first tramway to Kaliningrad in December 2012). Others, particularly companies involved in building the infrastructure for Poland's Euro 2012 football championships, could use their know-how for upcoming sporting events in Russia (utilising the Polish government project "From the European Cup to the World Cup"). Polish technological companies and portfolio investors could benefit from investing in vibrant Russian software SMEs and startups, which seem to suffer less than other sectors from red tape, corruption and state intervention. Polish companies that are successful with their investments in Russia can further benefit from increased access to other markets, such as Kazakhstan, which was recently designated as a particularly promising market by the Polish Economy Ministry.