

Improving Russia's Business Climate More Than a Pipedream

The abandonment of the Shtokman Project in August highlights not only a significant challenge Russia faces in terms of reliance on a small number of high value projects in the energy sector, but also the need to embrace broader business climate reforms to attract investments in other sectors to avoid excessive risk and secure higher levels of longer term performance.

Monthly Overview

In August, Norway's **Statoil** wrote off \$ 340 mln worth of investment spending related to its interests in the Shtokman project citing rising costs and lower energy prices. The Shtokman Project, originally launched jointly in 2008 between **Statoil**, France's **Total**, and Russia's **Gazprom**, aimed to bring to market gas from one of the world's largest reserves (estimated at 3.9 tln m³) located some 600 km off Russia's north coast. The original plan, however, estimated that to breakeven the oil price had to be \$80/bbl and now, facing different market conditions, the price would have to exceed \$100/bbl making the project unfeasible under current market conditions (the current price is about \$96/bbl).

Although the full cost of this disinvestment in the Shtokman Project is not yet fully known, some preliminary figures can shed light on its significance. Developing the infrastructure to bring the gas to market was originally estimated to require an investment of \$15 bln. During the first 8 months of 2012, total new investment announcements for Russia were \$973 bln (see *Indicators* below), of which \$831 bln, or 85%, were related to the energy sector and only \$142 bln, 15%, were in other sectors. Relative in terms of size, the Shtokman project would overshadow almost any other investment announcement in any other sector including infrastructure (except one in Transportation and Infrastructure in May by **IDGC Holding**) and agriculture. Further, what this disinvestment announcement signifies is Russia's reliance on a small number of large-scale, multi-year projects in the energy sector and the risk the country faces if any one of these project fails, even if it is simply due to changing, global, market conditions beyond the Kremlin's control.

Although Russia should welcome and seek to attract these types of investment projects in energy when they are viable, it is also important for the country to adopt broader based business climate reforms to strengthen non-energy sector performance, especially given a growing consumer base, an educated population, and other valuable natural endowments, such as in agriculture.

Monthly Highlights

BCDM's highlights aim to provide a brief summary of announcements related to new investment activity that can reflect changes in the quality of Russia's business climate from one month to the next that could be overlooked in less frequent or more aggregate reports.

In August there was a noticeable increase overall in new investment announcement activity, in particular in Metals and Mining and in retail expansion.

Energy

- *Exploration and Development:* **Rosneft and Statoil** plan to drill six wells from 2016 to 2021 in four licensed areas in the Russian Arctic that hold an estimated 3.4 to 3.7 bln of ton oil equivalent with Statoil agreeing to cover 100% of the unspecified exploration costs while **TNK-BP** is planning to invest \$ 800 mln to upgrade extraction technology, geographical exploration and overall development of the Uvat oil field in the Tyumen Region in 2012 aiming to increase output of fields 18.6% to 7 mt in 2012;
- *Biogas:* Russia's **Biogazenergostroy** will invest some EUR 25 to 30 mln to construct the largest biogas station of its kind in Russia with a capacity of 4.4 MW in the Republic of

Mordovia to be commissioned by the end of 2014 while Russia's **Altenergo Company** is considering investing RUR 60 bln in building 100 biogas stations in the Belgorod Region to generate 9.6 mln KWh of electricity and 18 200 Gcal of heat per year;

- *Cost Reduction:* **TNK-BP** intends to invest over \$ 60 mln to reduce costs involved in hard-to-recover oil production in West Siberia in a three-year water shutoff technology program aiming to cut water production by 60 mcm and power consumption by 460 mKW – h by 2014;
- *Power Supplies:* In the Leningrad Region's Ust-Luga port, **Lenenergo** intends to invest RUR 1.5 bln by 2015 to increase power supplies;
- *Gasification:* To complete the gasification of the Tamov region almost fully by 2015, **Gazprom** will invest RUR 13 bln;
- **RAO Energy Systems East Vostoka** has decided to invest \$ 59.6 mln to purchase three gas turbine units from GE;
- **Rosneft** plans to invest about RUR 9.2 bln in its R&D projects in 2012.

Autos and Aviation

- *Engines and Spare Parts Shops:* **Kamaz** is planning to open another 12 shops in other Russian regions by the end of 2012 featuring its own original spare parts after opening three outlets in Stavropol, St Petersburg, and Irkutsk while **Volkswagen** will invest EUR 250 mln to construct an engine producing plant in the Kaluga Region with an estimated annual capacity of 150 000 engines;
- *Capacity Expansion:* **GM** plans to invest an additional \$ 1 bln in Russia to expand the capacity of its plant in St Petersburg to 230 000 cars per year; and to 120 000 in Togliatti in its joint venture with **AvtoVAZ**;
- *Aircraft Service Center:* **FL Technics Ulyanovsk**, a subsidiary of Lithuania's Avia Solutions Group, will invest RUR 800 mln to construct an aircraft service center in the Ulyanosvk Port Special Economic Zone to be commissioned by 2019;
- *Airlines:* **Tatarstan Airways**, **Ak bars aero** and **Mordavia Airlines** plan to invest an unspecified sum in a joint managing company with each airline retaining their own brands aiming to increase passenger turnover to 3 mln within two years;
- *Buses:* Russia's **GAZ Group** is planning to invest RUR 4 bln in the bus production division in 2012-2017 split with RUR 1.33 bln in the modular construction of Unimax buses and the remainder for upgrades of facilities aiming to bring engines up to the Euro IV standard requirements;
- Russia's **Derways** plans to launch a RUR 4.3 bln car plant in the Stavropol Region city of Nevinomyssky in 2014 with an annual capacity of 100 000 units of medium-sized crossovers and cars.

Metals, Minerals and Mining

- *Dry Construction Materials:* Belgorod-based **ZhBK-1** intends to invest RUR 500 mln to build a concrete units plant in the Voronezh Region to be commissioned in 2014, France's **Saint-Gobain** plans to launch a gypsum pit by 2014 requiring an investment of EUR 10 – 15 mln and a drywall producing plant in the Republic of Bashkiria by 2015 worth EUR 65 mln while Russia's **UNIS Group** will invest RUR 800 mln to build a dry structural mixed plant in the Ulyanovsk Region with a planned launch in October 2013;
- Russia's **Urals Mining and Metallurgical Company (UMMC)** intends to invest RUR 12.9 bln into the reconstruction and development of its Gaisky GOK ore mining and processing plant

by 2017 and an additional RUR 10.6 bln to construct a new mine at the Podolskoye copper and zinc deposit in Bashkortostan;

- **Coal Terminal: Coalmar** plans to build a coal terminal to be commissioned in 2015 in Muchka Bay in the Khabarovsk Region;
- **Korund-Tsian**, a chemical producer, plans to invest up to RUR 6.7 bln to construct a sodium cyanide plant in the Nizhni Novgorod region with the first stage of production scheduled for launch in September, 2012, and the second a year later, with the capacity of each stage at 40 000 tons while its parent company, **United Petrochemical Company**, plans to invest an additional \$ 5 bln on the construction between 2013 and 2017;
- **Metalloinvest** plans invest \$ 850 mln to launch the construction of a third line at its Lebedinsky iron ore production facility;
- Russia's **TechnoNIKOL Corporation** plans to invest an estimated RUR 3 bln to commission the first line of a mineral insulation plant in the Rostov Region in March 2015;
- **Mitsubishi Corporation** is planning to invest an undisclosed amount focusing on modernizing of equipment and machinery for its mining interests.

Transportation and Infrastructure

- Railways: Russian Railways **RZhD** plans increase its overall investment plan for 2012 by RUR 31.7 bln to RUR 460.1 bln and will invest RUR 2.7 bln in core strategic projects in 2012, a further RUR 10 bln in 2013 and RUR 13.4 bln in 2014, while its passenger subsidiary, the **Federal Passenger Company**, plans to invest RUR 42 bln to acquire rolling stock between 2012 and 2015;
- **Social Infrastructure: Transneft** plans to fund the construction of roads and apartment blocks near the Eastern Siberia – Pacific Ocean pipeline (which is also being built by the company) in the Amur Region with an investment of RUR 3.3 bln over three years into the development;
- Sea Port: **Avtodor-Holding** will invest an estimated EUR 3 bln to build a sea port in the Kaliningrad Region comprising the port and 21 auto plants to meet the needs for the auto-cluster currently being created there;
- Russia's **Transmashholding** and Finland's **Wartsila Corporation** are investing around RUR 1.8 bln to establish a joint venture to design and manufacture diesel engines for railway and marine transportation as well as stationary use;
- **TNK-BP** plans to invest RUR 600 mln to modernize the Koltsovo airport fuelling complex by 2014;

Agriculture

- **Pig and Soy Production:** Canada's **Genesis** and Russia's **Argo-invest** will invest RUR 800 mln to build a pig breeding center in the Ulyanovsk Region to be commissioned at the end of 2013 while **Rusagro** plans to invest \$ 1 bln into new agricultural projects involving the creation of eight pig farms with a capacity of over 100 000 animals each in the Samara Region by 2016 and will co-invest in soy production facilities;
- In the Penza region, Russian milk company **Rusmoloko** will invest \$ 800 mln to construct a milk processing complex with a projected output capacity of 46 000 tons of milk per annum;
- Russia's **Magnit**, a retailer, intends to invest EUR 350 mln to develop its own agricultural production facility in the Krasnodar Region.

Tourism

- Russia's **Gorno-story**, a developing company, plans to invest RUR 300 mln to build a hotel complex in the Altay Special Economic Zone with the first stage to be completed in August, 2013 and the remaining by the end of 2014;
- **Starwood Hotels and Resorts Worldwide** is planning to open five hotels in Russia by 2015 to be located in Moscow (a 10-storey hotel near Sheremetyevo airport), St Petersburg, Kaluga, Rostov-on-Don and Perm.

Non-energy sector investment activity

- *Pharmaceuticals:* **R-Pharm** and **ChimRar** are investing RUR 1 bln to construct a pharmaceutical production facility in the Yaroslav Region with the first line to be commissioned in 2013 and the second in 2015 while **Pharmstandard** is planning to invest RUR 2 bln in product promotion in the second half of 2012;
- *Medical Services:* **Alfa Insurance** invested RUR 250 mln to open a medical center in Rostov-on-Don and plans to increase the number of similar clinics to 60 over the next few years from the current 11 located in Ekaterinburg, Kirov, Moscow, Murmansk, Nizhni Novgorod, Perm, Samara, Saratov, Tyumen and Yaroslav;
- *Fast Food:* **Starbucks** has invested in opening its first cafes outside Moscow with plans to open several in St Petersburg by the end of Q3, 2012, **Quiznos**, a US fast food chain, is planning to invest about \$ 4 mln to develop its Russian franchise and open its first outlet in St Petersburg by the end of 2012, **Nandos**, a South African restaurant chain, plans to invest an estimated \$ 10 mln to open 20 restaurants in Moscow and St Petersburg over the next 2 years, and **Amrest Company**, a franchisee of Kentucky Fried Chicken, plans to invest \$ 11 mln to open 11 restaurants in Kazan and Nizhni Novgorod by 2014;
- *Microchips:* **Rusnano** and the Netherland's **MAPPER Lithography** will each invest EUR 40 mln to develop the production of lithographic equipment used to produce microchips while **Angstrom**, a Russian microchip producer, intends to invest RUR 6 bln to construct a technological site to produce military communications equipment in the Alabushevo Special Economic Zone in the Moscow Region;
- *Credit Services:* **Renault-Nissan** and **UniCredit** intend to invest jointly to launch a bank focused on automobile lending under the license of Sibir Bank, located in Omsk;
- Sweden's **East Capital** plans to invest an estimated \$ 500 mln to create East Capital Russia Domestic Growth Fund aiming to invest initially in 10 to 20 locally oriented companies;
- Russia's **Gloria Jeans**, a footwear and accessories producer and retailer, plans to invest over RUR 450 mln in production facilities in the Volgograd Region;
- Russia's **Rusalox** is planning invest RUR 200 mln to double the production capacity of its circuit plates plant in Vladimir by 2015;
- *A number of investment plans in consumer retail were announced:*
 - The UK's **Debenhams**' Russian franchisee will invest an undisclosed amount to open its second the third 8000 m2 department stores in 2014 and is considering five to seven more in Moscow over the next five years;
 - After investing over \$1.6 bln during the past 10 years in Russia, **Auchan**, an electronics retailer, is planning to invest in launching a drive self service that will allow customers to shop online and pick up purchases at issue points;
 - **Mitsubishi Corporation** is planning to invest an undisclosed amount to build a chain of supermarkets in the Primorye Region;

- **MGTS**, the Moscow telephone network, is planning to invest an estimated \$575 000 to \$1.38 mln to transform its outdated service centers and open 23 client oriented shops in 2012 operated jointly with **MTS**;
- **Idexe**, an Italian children's clothes producer, is planning to invest \$ 12 mln to open 60 outlets in Russia over the next five years;
- **Lenta**, a retail operator, plans to open about 7 new hypermarkets in different regions of Russia by the end of 2012, financial figures were not disclosed;
- **Okey**, a retailer, intends to invest \$ 500 mln to launch a chain of 100 discount shops between 2014 and 2016 in the Moscow Region;
- Russia's **Ideas4retail** plans to invest RUR 600 mln to develop and open a retail chain, Cook House, for kitchen appliances targeting the opening of 50 stores within 3 years.

Outward New Investment Announcements

Outward new investment announcements in August were primarily in energy-related activities, but with a noticed announcement in consumer retail

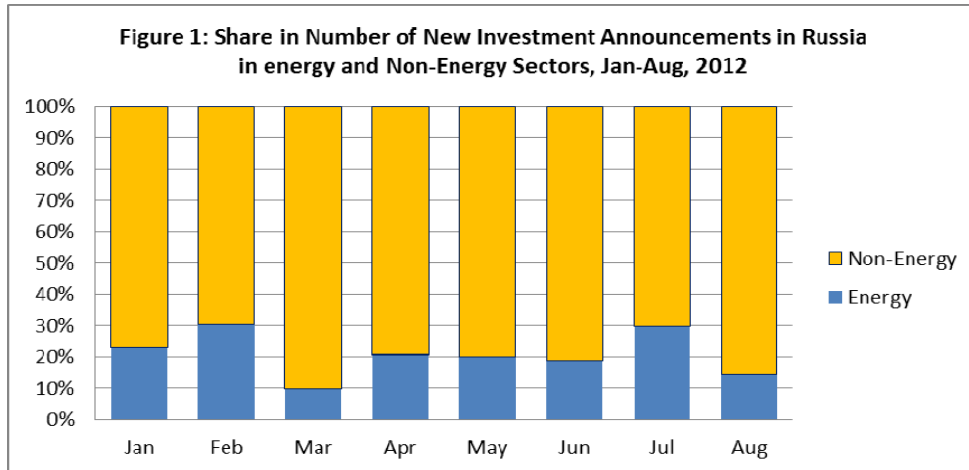
- Russia's **Ideas4retail Holding** has been granted an exclusive franchise to open Spain's Imaginarium brand shops and will invest EUR 12 mln to open about 50 shops by 2014 starting in Germany with future expansion plans into in Denmark, Norway, Sweden and Finland;
- To construct a new complex at its Lukoil Neftochim Bourgas oil refinery in Bulgaria that will help produce 1.2 mt of Euro-5 diesel fuel as well as stopping the production of high sulfur residual fuel oil, **Lukoil** will invest and estimated \$ 1.1 bln;
- Gazprom Neft's Serbian subsidiary **NIS** aims to become a regional leader with a capitalization of \$ 10 bln by 2020 and plans to invest over EUR 2 bln into development by 2015 and over EUR 3 bln by 2020;
- **TNK-BP** plans to invest in a gas collecting station in Ukraine to be launched in October to sell LPG to filling stations and boost sales efficiency targeting a doubling of LPG sales in Ukraine in 2013.

Business Climate Indicators

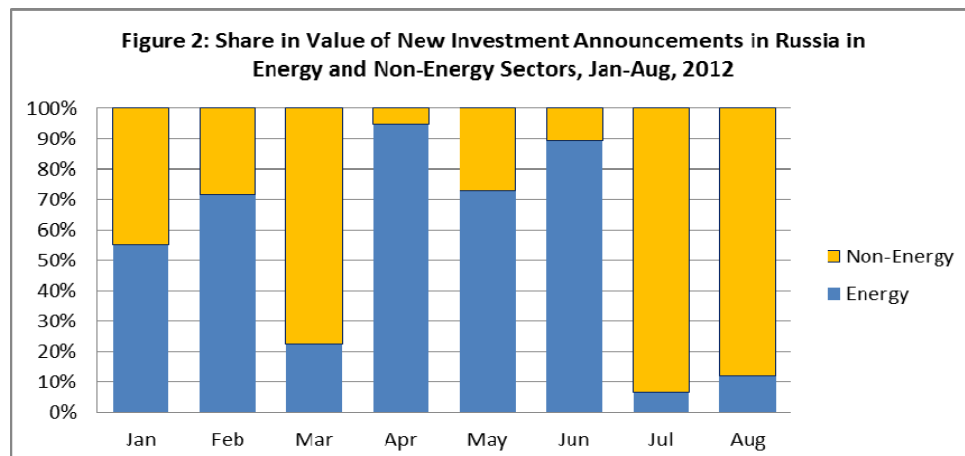
BCDM's indicators aim to provide a monthly snapshot reflecting important trends, challenges, and changes related to Russia's business climate.

Despite a high volume and number of new investment announcements in Russia during the first 8 months of 2012, a small number of large scale multi-year projects in the energy sector have dominated the scene overshadowing other sectors as well as the need to embrace broader business climate reforms to help the economy diversify.

- During the first 8 months of 2012, there have been 299 new investment announcements in Russia with a total value of \$973 bln for those for which figures were disclosed.
- 61 of these announcements, 20%, however, were in the energy sector which accounted for \$831 bln, 85%, of the total value.
- **Figure 1** shows the share in the number of new investment announcements by month between energy and all other sectors. Generally, the number of new investment announcements in energy represented at most 30% in any given month and as low as 10%. By number, this suggests a high level of activity taking place in Russia which is consistent with the monthly breakdown of investments in retail, autos, minerals and mining and agriculture.



- **Figure 2** shows the share in value of new investment announcements in energy and non-energy sectors during the same period. Despite the low portion by number, in value terms the energy sector dominates and in particular, in several months they almost completely overshadow all other investment activity.
- In April and June, three large scale investment announcements by Exxon and Rosneft accounted for \$720 bln, or 74% of the total value tracked so far this year.



Note on Data : New investment announcements are tracked monthly and totaled in USD only for those announcements for which figures were disclosed. The monthly edition of the BCDM discloses both announcements for which figures were and were not disclosed, but nevertheless tracked. Disclosed sums in other currencies were converted for each month using European Central Bank figures for the last day of the month of the announcement. New investment announcements do not capture all investment intentions nor do they represent actual investment expenditures made. They represent only the total amount disclosed in the month of the announcement.

Although there are signs of diversification in terms of new investment announcements in Russia across sectors when activity is broken down by number, the domination of a small number of high value, multi year, investments in the energy sector indicate the country's high level of dependence and risk on a few projects. Broad based business climate reforms are needed to not only help secure performance in energy, but also to improve the country's ability to attract more, diverse, investment activity in other sectors.

Next Issue

Upon going to print, the **World Economic Forum** has released its *2012-2013 Global Competitiveness Report*; Russia's overall ranking has slipped one place from 66 to 67 this year. More details will follow in the next *Monthly* and *Quarterly* editions of the **BCDM**.