Current Issues

International topics

Deutsche Bank Research

April 30, 2008

Russia's outward investment

Russia has become the second largest foreign direct investor among emerging markets and is leading among the BRIC countries. Russian outward direct investment has expanded rapidly since the beginning of the decade and Russian corporations are challenging well-established multinationals. While Russian global corporate expansion is still limited to some of the largest companies in the oil, gas and metals sector, the trend to invest abroad is gradually spreading to other sectors.

The expansion of Russian corporations started in the CIS. The expansion of Russian corporations started in the “near abroad” market due to linkages established in Soviet times and a lack of foreign investors from elsewhere. Russian ODI activities continued in developed markets and have more recently also been carried forward to Africa.

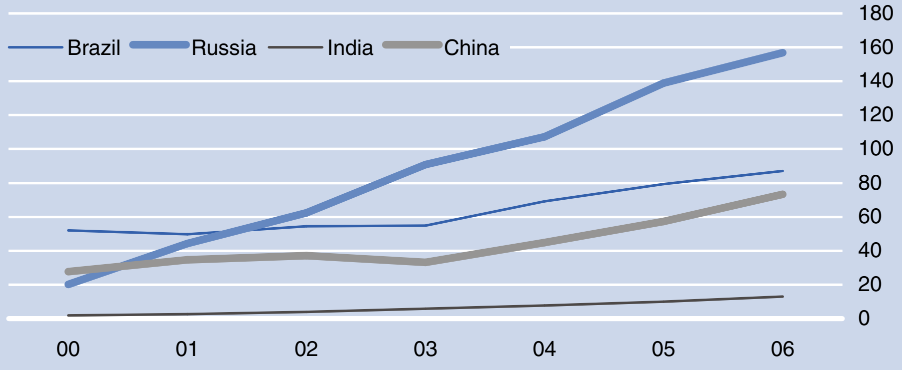
Fuel, energy and metallurgy are the front runners with regard to ODI. Large resource-based corporations not only dominate the Russian economy but are also taking the lead in terms of outward investment.

While Russian ODI is supported by the political elite, there are also strong economic reasons for expanding abroad. Gaining access to new markets and technologies, securing raw materials and obtaining a wider range of financing opportunities are among the key economic reasons for Russian ODI.

Russia will remain an important ODI source among the emerging markets. High oil prices and the booming domestic economy will continue to boost Russian ODI in the coming years.

Russia getting ahead among the BRICs

Outward direct investment stocks, USD bn



Sources: UNCTAD (2007), DB Research

www.dbresearch.com

Authors
Thorsten Nestmann
+49 69 910-31894
thorsten.nestmann@db.com

Daria Orlova
University of Mainz
dorlova@students.uni-mainz.de

Editor
Maria Laura Lanzeni

Technical Assistant
Bettina Giesel

Deutsche Bank Research
Frankfurt am Main
Germany
Internet: www.dbresearch.com
E-mail: marketing.dbr@db.com
Fax: +49 69 910-31877

Managing Director
Norbert Walter

Russia's top 25 multinationals
USD m, 2006

	Foreign assets	Sector*
Lukoil	18921	1
Gazprom	10572	1
Severstal	4546	2
Rusal	4150	2
Sovocomflot	2530	3
Norilsk Nickel	2427	2
AFK Sistema	2290	4
VimpelCom	2103	4
Novoship	1797	3
TNK-BP	1601	1
Evraz	1322	2
FESCO	1074	3
PriSCo	1055	3
Novolipetsk Steel	964	2
RAO UES	514	5
TMK	490	2
Eurochem	456	6
Gazprom	366	7
OMZ	354	7
Alrosa	294	2
ChTPZ (Arkley Capital)	244	2
Alliance Oil	211	1
Acron	200	7
Euroset	147	4
Mechel	116	2

*1 (Oil/Gas), 2 (Metals/mining), 3 (Transport), 4 (Telecoms/retail), 5 (Electricity), 6 (Agri-chemical), 7 (Manufacturing)

Sources: Skolkovo (2007), DB Research 1

What is outward investment?

Outward investment can be divided into three categories:

(1) Direct investment refers to investment expressing a lasting interest in another country and comprises for instance greenfield investment and stakes in other companies above 10%. **(2) Portfolio investment** can occur in the form of debt or equity investment, the latter for equity stakes below 10%.
(3) Other investment comprises in the case of Russia e.g. trade credits, bank deposits, loans and other credits.

In this report, unless explicitly mentioned, outward investment refers to direct investment.

Sources: IMF Balance of Payments Manual, Rosstat, DB Research

Introduction: Russia's expansion abroad

In recent years, emerging market multinationals have increasingly expanded abroad to enhance their competitiveness, i.e. the ability to survive and to grow while maximising profits.[1] This is achieved by saving costs, improving efficiency, applying new technologies as well as gaining access to new markets and resources.

As a consequence, emerging markets' share in global outward direct investment (ODI) rose to 12.8% in 2006 from 10.7% in 2003.[2] Russian corporations have played an active role in this process and Russia's ODI stock became the second largest among emerging markets in 2006. Russian ODI has in particular been boosted by rising volumes of cross-border mergers and acquisitions.

The majority of Russia's ODI is concentrated in the oil, gas and metals sector.[3] However, companies from the telecom, financial and retail sector are also expanding abroad. To what extent these companies can be classified as "multinationals" is not clear-cut. The Boston Consulting Group, for example, includes only six Russian companies as "global challengers" based on their revenues (must be over USD 1 bn) and selected indicators such as international presence, overseas investments, etc.[4] A broader definition considers as "multinationals" companies with sizeable foreign assets (see chart 1).[5]

In any case, unlike in China, there is no specific "going global" programme[6] for Russian companies, although there is outspoken support by the political elite for corporates' expansion abroad[7]. The bulk of Russia's foreign investment is accounted for by private companies[8] and it mainly reflects economic considerations such as obtaining higher profit margins, increasing companies' growth potential and securing access to raw materials. Foreign engagement also allows access to new technologies, thereby helping to modernise the Russian economy. In addition, foreign activities, especially in developed markets, force Russian companies to increase transparency and to improve their corporate governance structures.

Russian ODI flows are expected to remain high in the coming years and, in this respect, Russia is likely to remain an important player among emerging markets.[9]

---

1 See Sauvant (2005, p. 641).
2 Note that the share of emerging markets in global ODI was 14.8% in 1997 before falling to 10.7% in 2003.
3 See UNCTAD (2005, p. 6). Also note that the ODI share of developed markets fell to 95% from 99% in 2000 in extractive industries such as metals, oil and gas. See UNCTAD (2007, page xxi).
4 For comparison, there were 34 companies from China, 20 from India and 13 from Brazil. See BCG (2008).
5 Skolkovo (2007). Note that total foreign assets include portfolio and other investment in addition to direct investment (see box).
6 Sauvant, (2005, p. 663). The Chinese strategy focuses on the development of national champions and accessing natural resources by implementing an investment-friendly policy framework, direct and indirect subsidies and preferential financing. See Lunding (2006, p. 5-6).
7 Evidenced for instance by recent public statements of the new Russian president Dmitry Medvedev. FT (2008, p. 1).
8 Skolkovo (2007, p. 3).
9 EIU (2007, p. 172).

Source: DB Research 2

Local data sources for Russian ODI

	Rosstat	Central bank
Coverage	Non-financial corporations	Overall economy
Based on	Reports from non-financial corporations	Rosstat data, bank reports, estimates on reinvested earnings and real estate operations
Break-down	By top 10 destination countries, by individual CIS countries and by industry	By country group (CIS or non-CIS). Some details on banking sector

Sources: DB Research, CBR, Rosstat 3

Top 10 ODI sources in EM

ODI stocks, 2006

	USD bn	% of ODI from EM
Hong Kong	688.9	39.1%
Russia	156.8	8.9%
Virgin Islands	123.5	7.0%
Singapore	117.5	6.7%
Taiwan	113.9	6.5%
Brazil	87.0	4.9%
China	73.3	4.2%
South Korea	46.8	2.7%
South Africa	43.5	2.5%
Mexico	35.1	2.0%

Sources: UNCTAD, DB Research 4

Russian corporates invest abroad…

… to obtain higher profit margins. In some sectors, profit margins have been comparatively low as a consequence of selling products at the lower end of the value chain.[10] Hence, Russian outward investment has begun to target higher value-added production facilities. Russian corporations are also trying to widen their profit margins by accessing end-customer markets outside Russia.[11]

… to increase their growth potential. Global consolidation pressures raise the need for Russian companies to grow outside Russia in order to retain a strategic position in the domestic market and to withstand global competition.[12] In addition, expanding abroad may open new growth opportunities in case of limited domestic growth potential.

… to gain access to technological and management know-how. Investing abroad allows fast access to new and more advanced technologies. In addition, foreign investment can help to broaden management skills and to improve risk control capabilities.

… to secure access to raw materials. Despite possessing a vast amount of natural resources, global resource scarcity and growing demand for commodities have sparked off competition with regard to securing access to natural resources. In addition, the exploitation of e.g. oil and gas reserves has become more difficult and costly in the domestic market. As a consequence, Russian oil and gas companies are trying to access raw material sources abroad; for example, they are increasingly expanding in Africa.[13]

… to reduce capital costs via better governance and diversification. Foreign activities, especially in developed markets, will force Russian companies to increase transparency and to improve their corporate governance structures. In addition, international diversification of a firm's operations and activities can improve its risk profile. As a consequence of the above, the cost of attracting capital may be reduced.

… to benefit from a more favourable investment climate. Limited domestic investment opportunities and political uncertainty may have contributed to capital outflows. The comparatively difficult business and institutional environment in Russia might also have pushed Russian capital abroad.[14]

Russian outward investment in perspective

Against the background of high commodity prices, Russia's ODI stock increased nearly eightfold to USD 157 bn at the end of 2006 from only USD 20 bn in 2000.[15] During the same period, Russia's share in emerging markets' ODI stock increased to around 9% from 2.5%, becoming the second largest ODI source in emerging markets

[10] Russian companies have mainly delivered raw materials and have hardly participated in the processing, refining and finishing of the products. See RUSAL/EIU (2006) and NZZ (2007).

[11] Lukoil for instance undertook downstream investments in the USA, Western Europe and Eastern Europe. See FT (2007, p. 3) and company website.

[12] More than 50% of sales of Lukoil, Novoship, RUSAL, Primorsk Shipping and Mechel came from foreign sales in 2003. See UNCTAD (2005, p. 9).

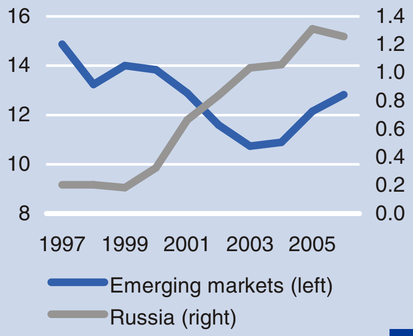
[13] See Euromoney (2007), Global Insight (2007), The Moscow Times (2007, p. 7).

[14] Russia only ranked 106th out of 178 countries in the 2008 World Bank Doing Business survey.

[15] UNCTAD (2007). Note that UNCTAD data is based on central bank data on Russian FDI. See box on p. 3 and http://www.cbr.ru/eng/statistics/credit_statistics/print.asp?file=iip_cis_e.htm.

Russia increases share in world ODI stock

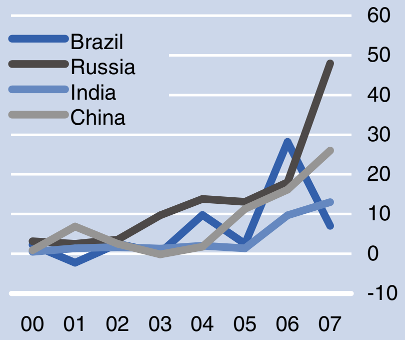
% of worldwide ODI stock



Sources: UNCTAD, DB Research **5**

Russia getting ahead

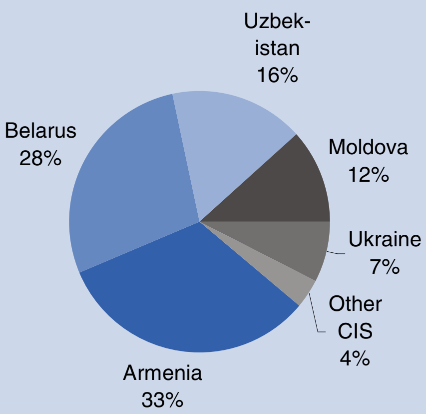
ODI flows, USD bn



Sources: UNCTAD, EIU, DB Research **6**

Armenia & Belarus lead among CIS

% share of Russian ODI flows to CIS, 2000-2006



Sources: Rosstat, DB Research **7**

after Hong Kong[16] (see chart 4). Its share in worldwide ODI stocks, meanwhile, rose to 1.2% from 0.2% in 1999 (see chart 5). For comparison, Russia's share in world GDP was around 2% in 2006.[17]

Regarding ODI flows, Russia has outperformed the other BRIC countries since 2002, reaching an all-time high of USD 48 bn in 2007 (see chart 6).[18] The only exception was in 2006 when Brazilian corporations invested larger sums abroad.[19] Russian ODI flows appear sizeable even when compared to flows from industrialised countries.[20] Overall, Russia's ODI flows were placed in rank 30 out of 128 countries in UNCTAD's most recent Outward FDI Performance Index, which measures the share of a country's outward FDI in world FDI as a ratio of its share in world GDP.[21]

From CIS to developed markets and Africa

The expansion of Russian corporations started predominantly in the member countries of the Commonwealth of Independent States (CIS) in the 1990s, moving on to developed markets and continuing in Africa more recently. Russian corporations established a prominent position close to their home market due to linkages already in place in the Soviet Union as well as a lack of foreign investors from elsewhere.[22] Armenia, Belarus and Uzbekistan have accounted for the bulk of the Russian FDI flows to the CIS (see chart 7).[23] Examples of Russian investment in the CIS include state-owned energy supplier RAO UES, which has invested in energy distribution chains in Armenia, Georgia, Moldova and Ukraine.[24] In addition, Gazprom controls infrastructure assets in Kazakhstan and Moldova.[25] Furthermore, Russian mobile telecom services providers are competing for the leadership in the CIS, having invested USD 1.38 bn in M&A since 2001 and accounting for 40% of the CIS cell phone market.[26]

However, the proportion of Russian direct investment flows to CIS member states shows a downward trend: it fell to 12% on average in the period 2004-2006 from 59% in 1997-99 (see chart 8). At the same time, the figures should probably be taken with a grain of salt, since they have been quite volatile. In 2004, Uzbekistan received 85% of total investment to the CIS, while Armenia accounted for 78% in 2005. In 2006, FDI flows seem to have been more equally distributed, with Tajikistan accounting for 39%, Kazakhstan for 33% and Ukraine for 26% of total CIS investment. In general, strong economic growth in the CIS should make them an attractive market for Russian direct investment in the future.

---

[16] UNCTAD (2007). Hong Kong plays an important role in round-tripping investment flows to China and as a financial offshore centre, hence its ODI stock is likely overestimated. Similar issues apply to Russia's ODI statistics: A large part of ODI is e.g. directed to Cyprus, an offshore centre from which a significant amount may return in the form of FDI to Russia. See more below.

[17] Based on the IMF's World Economic Outlook database as of April 2008.

[18] For more on Russian ODI in comparative perspective see e.g. Gammeltoft (2008) and Sauvant (2005). For case study-based evidence see Liuhto (2005).

[19] This reflects a USD 17.6 bn acquisition in Canada which accounted for 64% of Brazil's 2006 ODI.

[20] Within the EU, only ODI flows from France, Germany, the UK, Spain and Belgium were above Russia's 2007 figure. See WIR (2007, p. 251).

[21] See http://www.unctad.org/Templates/WebFlyer.asp?intItemID=3241&lang=1.

[22] RUSAL/EIU (2006, p. 11).

[23] Note that data on ODI flows by country have gaps. In terms of overall outward investment Ukraine (56%) is the leading country followed by Belarus (21%) and Kazakhstan (8%).

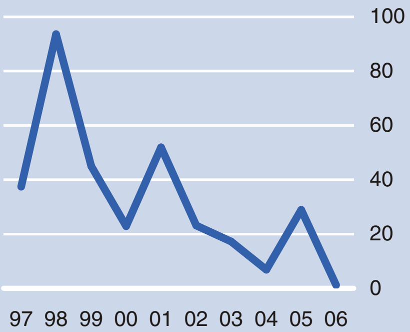
[24] UNCTAD (2006, p. 135).

[25] Company data.

[26] iKS-Consulting (August 2006) at http://www.iksconsulting.ru/eng/engpdf/3.pdf.

Share of CIS is falling

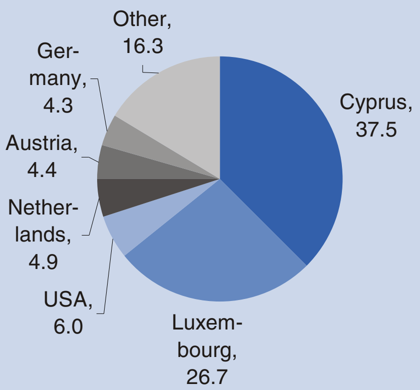
% share of total Russian ODI flows



Sources: Rosstat, DB Research **8**

Russian ODI flows are concentrated in a few destinations

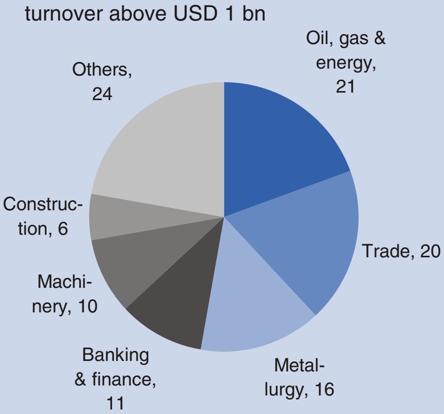
% share of total Russian ODI flows, 2006



Sources: Rosstat, DB Research **9**

Energy & metals dominate economy ...

No. of companies with yearly turnover above USD 1 bn



Sources: Rosstat, DB Research **10**

Russian total ODI flows have been fairly concentrated, with only two countries, Cyprus and Luxembourg, accounting for 64% in 2006 (see chart 9). Given that these are offshore financial centres, part of these investment flows might return as investment to Russia or be redirected to other countries.[27] Unfortunately, it not possible to establish this from the data, which captures only the first capital-exporting action. Further insights can be gained by looking at survey data. A recent survey among the top 25 Russian multinationals listed in chart 1 above for instance shows Western Europe as the leading destination, accounting for 52% of foreign assets, followed by the CIS with 22% and Eastern Europe with 11%.[28]

As mentioned above, Africa has emerged as a new destination for Russian investors.[29] Examples include Alrosa, a Russian state-owned diamond company controlling a quarter of the global market, which owns mining facilities in Angola[30], and large metallurgy companies, such as Norilsk Nickel, which hold raw material reserves in South Africa, Gabon, Guinea and Nigeria.[31] Moreover, Russian oil and gas companies are participating in greenfield investment projects. For example, Sintezneftegas acquired a 70% stake in an oil-exploration project in Namibia in 2006.[32] Apart from resource-based companies, Russian financial companies are also pushing into Africa and leading Russian telecommunications firms are also expected to expand in the African continent.[33]

Fuel and metal companies dominate outward investment

Large fuel, energy and metallurgy corporations have a major presence in the Russian economy, so it is not surprising to see that these sectors also dominate in terms of outward investment. Out of 108 companies with annual turnover over USD 1 bn, 37 belong to the energy and metals sector (see chart 10). At the same time, fuel and metallurgy sectors accounted for about half (45%) of outward investment (see chart 11).[34]

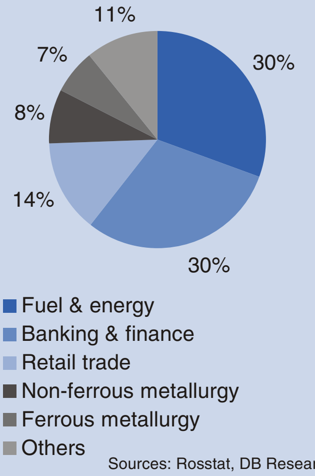
Cross-border M&A activity also shows the predominance of Russian fuel and metallurgy giants (see chart 12). For instance, in 2007 the Russian companies RUSAL and SUAL merged with the Swiss Glencore to create the world's largest aluminium and alumina company[35]. At the same time, smaller players such as Novolipetsk (metallurgy) or Mirax Group (hotels) are entering the acquisition fray (see chart 13).

The geographical distribution of M&As varies with the acquiring sector: over the past few years CIS member states have prevailed as targets in the telecoms sector, while large metallurgical companies have purchased assets in industrialised countries as well

[27] Cyprus accounted for 28% of FDI in Russia in 2006.
[28] Skolkovo (2007). For information on Russian ODI in Germany, see Russland-analysen (2007), Zeit (2006) and Spiegel (2008).
[29] This investment is still too small to feature in official statistics (Rosstat only lists the top ten outward investment locations) but there is plenty of anecdotal evidence from press reports as well as Russian company websites.
[30] Company data and Euromoney (2007, p. 338).
[31] RUSAL/EIU (2006, p.14).
[32] Company data.
[33] Renaissance Group has established a securities and research presence in Nigeria, Kenya and Zimbabwe, while VTB Bank opened a bank in Angola. See Euromoney (2007, p. 340/341).
[34] The figures refer in this case to total outward investment as data for direct investment have significant gaps. Source: Rosstat.
[35] See UNCTAD (2007, p. 64).

... as well as overseas investment

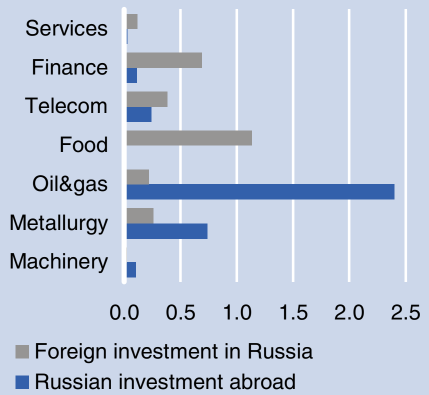
% of overseas investment, 2004



Sources: Rosstat, DB Research 11

Major differences of break-down in sectoral of cross-border M&A

USD bn, as of 2005



Sources: Sliyaniya i Pogloshenıya, DB Research 12

as Africa. Companies from emerging Asia seem not to be on the shopping list yet, but this may start to change. For instance Altimo, the telecom arm of Russia's Alfa Group, has stated that it wishes to establish a long-term presence in Vietnam and other South-East Asian countries.[36]

Summary and conclusion

Russia has become one of the leading foreign direct investors among emerging markets in the last decade. The Russian expansion abroad started in the CIS and has moved forward to industrialised countries as well as Africa. While resource-based industries continue to dominate outward investment, financial, telecom and retail trade companies are also venturing abroad.

Expanding abroad provides Russian companies with access to new technologies, know-how and resources. In addition, higher revenues and lower funding costs achieved by investing abroad support the build-up of the capital stock and infrastructure investment within Russia. Thus, overseas investment will help to modernise the local economy and thereby contribute positively to long-term economic growth.

We expect that Russia's ODI flows will continue to grow in the future and that Russia will remain a major source of outward direct investment among emerging markets in the coming years.

Thorsten Nestmann (+49 69 910-31894, thorsten.nestmann@db.com)
Daria Orlova (dorlova@students.uni-mainz.de)

[36] Company data.

Large M&A projects with Russian corporates as purchaser*

Purchaser	Sector	Target	Country ISO code	USD m
2005				
Alfa Group	Telecom	Turkcell	TR	3,300
Lukoil	Fuel & energy	Nelson Resources	BM, KZ	2,130
Severstal	Metallurgy	Lucchini	IT	511
Evraz Group	Metallurgy	Vitkovice Steel	CZ	287
VimpelCom	Telecom	URS	UA	231
Amtel	Chemical	Vredestein Banden	NL	201
2006				
Purchaser	**Sector**	**Target**	**Country ISO code**	**USD m**
Evraz Group	Metallurgy	Oregon Steel	US	2,300
Novolipetsk Steel	Metallurgy	Duferco	US, EU	806
Evraz Group	Metallurgy	Highveld Steel	ZA	678
VimpelCom	Telecom	Armentel	AM	496
Rusal	Metallurgy	Eurallumina SPA	IT	420
Norilsk Nickel	Metallurgy	OMG nickel assets	AU, FI	408
Rusal	Metallurgy	Alscon	NG	250
Interros	Fuel&energy	Plug Power Inc.	US	241
VimpelCom	Telecom	Unitel	UZ	207
2007				
Purchaser	**Sector**	**Target**	**Country ISO code**	**USD m**
Norilsk Nickel	Mining	LionOre Mining	CA	5,234
RUSAL	Metallurgy	SUAL, Glencore	CH	3,600
Gasprom	Fuel&energy	Beltransgas	BY	2,500
Renova	Energy	Energetic Source SPA	IT	700
Titan Acquisition Sub Inc. (Evraz Group)	Metallurgy	Claymont Steel Holdings Inc.	US	564
Lukoil	Fuel & energy	Jet Petrol Stations	CZ, PO, HU, FI	560
Global Information Services Holding	Machinery	Altis Semiconductor	FR	449
MTS	Telecom	K-Telecom	AM	434
Mirax Group	Hotels	Sungate Port Royal	TR	340
Severstal	Mining (gold)	Celtic Resources Holdings Plc	IE	315
Evraz Group	Metallurgy	Highveld Steel and Vanadium	ZA	238
Novolipetsk	Metallurgy	Winner Steel INC	US	212

*Note: Only stakes above 10% and deals over USD 200 m included

Sources: Magazine Sliyaniya i Poglosheniya, company data, DB Research 13

References

BCG (2008). The 2008 BCG 100 New Global Challengers. The Boston Consulting Group.

Die Zeit (2006). Aufbruch im Land des Bären. November 23, 2006.

EIU (2007). World Investment Prospects. Economist Intelligence Unit, 2007.

Euromoney (2007). It's the resources, stupid. September 2007: 336-341.

FT (2008). Medvedev urges push to invest in foreign companies. Financial Times. European Edition. February 1, 2008, p. 1.

FT (2007). Lukoil extends its reach across Europe. Financial Times. European Edition, January 23, 2007, p. 3.

Gammeltoft, Peter (2008). Emerging multinationals: outward FDI from the BRICS countries. International Journal of Technology and Globalisation. Vol 4, No. 1: 5-22.

Global Insight (2007). Russia increases engagement in Southern Africa. March 19, 2008.

Liuhto, Kari (2005). Expansion or Exodus: Why do Russian corporations invest abroad? International Business Press.

Lunding, Andreas (2006). Global champions in waiting. Deutsche Bank Research. Current Issues. August 4, 2006. Frankfurt am Main.

Skolkovo (2007). Russian multinationals bullish on foreign markets. Release of the SKOLKOVO – CPII 2007 ranking of multinational enterprises by the Moscow School of Management and The Columbia Program on International Investment. Moscow and New York. December 2007.

Sauvant, Karl P. (2005). New sources of FDI: The BRICs – Outward FDI from Brazil, Russia, India and China. The Journal of World Investment & Trade. Vol 6 No 5: 639-709. October 2005.

NZZ (2007). Russlands Firmen müssen sich globalisieren. Neue Zürcher Zeitung. March 14, 2007, p. 15.

RUSAL/EIU (2006). The Russians are coming. Report by RUSAL in co-operation with the Economist Intelligence Unit.

Russlandanalysen (2007). Russische Direktinvestitionen im Ausland. Forschungsstelle Osteuropa. Deutsche Gesellschaft für Osteuropa-kunde. Otto Wolff Stiftung. No 144. October 12, 2007.

Spiegel (2008). Märchenhafter Reichtum. Der Spiegel. No. 14, 2008, pp. 74-76.

The Moscow Times (2007). Russia hopes for African mega deals. March 19, 2007.

UNCTAD (2007): World Investment Report 2007. United Nations, New York and Geneva, 2007.

UNCTAD (2005): Case study on outward foreign direct investment by Russian enterprises. November 8, 2005.

Printed by: HST Offsetdruck Schadt & Tetzlaff GbR, Dieburg

ISSN Print: 1612-314X / ISSN Internet and e-mail: 1612-3158