

INTERNATIONAL PRODUCTION IN RUSSIAN RETAILING

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Abstract

The paper provides an overview of modern trends in Russian retailing with a special emphasis on the process of international production in the sector. The paper asserts that international production in Russian retailing is expanding despite the consequences of economic crisis. During last five years there were some news in the modes of penetrating and consolidating in the Russian market. Organic expansion of foreign retail chains to Russia proved to be difficult and costly. But Russia's retail market continued to consolidate through M&A, particularly among local and foreign companies. Due to the character of value chain we assume that in Russian retailing there is developing the form of "foreign production" with elements of internal outsourcing. Under "foreign production" foreign retailers' chains are working in Russian market as rather independent foreign affiliates. The specific feature of supply chain in modern Russian retailing is that the governance of the chain is carried out by the retailer but not by the supplier.

Keywords: international production, foreign direct investment (FDI), transnational corporations (TNCs), retailing, Russia, value-added chains.

JEL Classification: F23, M16, M37.

Introduction

During last decades international production – production made by transnational corporations (TNCs) outside national boundaries – grew rapidly and became an important trend of the world economy, even despite crisis events and some decay in foreign direct investment (FDI). International production in world retailing is not an exception. Market saturation in many mature countries attracts international retailers to look at opportunities in emerging markets, including Russia. Foreign retailers since 2000 began massive investment into the sector. This was the starting point of developing international production in Russian retailing as well as building up cross-border value-added chains with participation of foreign and Russian firms.

The paper provides an overview of the major trends taking place in Russian after-crisis retailing with a special emphasis on structure and governance of cross-border retailing value chain. In this connection the goals of the paper are as follows:

- to evaluate the scales of international production in Russian retailing before and after world economic crisis;
- to ascertain the prevalent modes of entry of foreign retailers into Russian market;
- to find out the form of international production in Russian retailing according to author's classification ("foreign production", "outsourced production", and "integrated international production");
- to identify the structure and governance in cross-border value chain in Russian retailing;
- to propose author's view on challenges and consequences for developing international production in Russian retailing.

These formulated goals have determined the research methods. We use the following ones: the method of empirical data classification, the evaluation method, and the comparative method.

The research subject of the article is relatively new and scarcely investigated in economic literature. Very often research on Russian retailing is undertaken by consulting and marketing agencies. We can find comprehensive surveys of Russian retail market in publications of such institutions as Deloitte&Touche (2012), A.T. Kearney (2007, 2008, 2009, 2009, 2010, 2011), PriceWaterhouse Coopers (2008), Infoline (2010) and others. At the same time the analysis of global retailers in Russian market was not the central point in these publications; foreign retailers were investigated mainly in the framework of comparison with domestic players. The same situation is with Russian sources. Some aspects of the topic can be found in V.V. Radaev (2009, 2011), in particular on retail formats that domestic firms adopt from foreign chains and on the conflicts between retailer and supplier. The last issue is thoroughly investigating in some other papers. The recent works of O. Tretiak and M. Sheresheva (2005), and M. Hudyakova (2009) are dealt with the supplier-retailer relationship in Russian market. At the same time the issue of international production in Russian retailing is not in the centre of mentioned works. That's why an undertaken analysis of foreign

retailers' activity in Russian market is to a certain extent new, and gives an opportunity to predict the prospects of expansion of international production that foreign chains are building up in Russian territory.

Scales of international production in Russian retailing

At the beginning of 1990s Russian retail organized market was very poor developed and there was only a few large foreign retailers in it. Nevertheless since 2000s Russian retail market was becoming more and more attractive for foreign players. Over last decade there was an impressive expansion of Russian retail market, stimulated by growing consumer spending, relatively low income tax, fast development of new retailing formats, outpacing growth of retailing operations in the regions outside Moscow and St. Petersburg. All these processes were accelerated by arrival of foreign retailers that began massive investment into the sector.

To estimate potential of the retail markets international consulting agency A.T. Kearney developed the Global Retail Development Index – GRDI (2007, p.1). Since 2002 it ranks the top 30 emerging countries on a 100-point scale – the higher the ranking, the more urgency there to enter the country. GRDI scores are based on the following four variables: country risk (25%), market attractiveness (25%), market saturation (30%), and time pressure (20%). In 2005, 2006 and 2007 Russia was ranked 2nd most attractive retail market in GRDI (2007, p.4). The windows of possibilities for foreign players were extremely large.

The growth rates in Russian retailing were larger than GDP growth rates during first decade of 2000 before crisis. Moreover, retailing was one of the most dynamic sectors of Russian economy; retail sales growth was very impressive: it grew by 8.4% in 2002/2003, 12.1% – in 2003/2004, 12.0% – in 2004/2005, 18.5% – in 2005/2006, and 28.1% in 2007/2008 (Twardzik, 2011). In 2007 retail sales (according to Rosstat, 2011) equalled to 424 bln dollars (13.9 bln roubles), compared to 120 bln dollars in 2002.

In our paper (Volgina, 2008) we have identified three stages of entering foreign chains into Russian retailing. Stage I – until 2000: entry of separate chains (Stockmann, K-Rauta, Ramstore); Stage II – 2000-2006: powerful expansion of international retailers into Russian market (IKEA, SPAR, Metro Group, Auchan Group, Marktkauf, Tengelmann/OBI, REWE/Billa); Stage III – 2007-till now: a relative slow down in entering newcomers into Russian retail market (Marks&Spencer, C&A, Debenhams, Next as well as a “train” of different apparel brands).

In order to assess the scales of international production in Russian retailing before crisis we use the statistics of foreign investment in the form of foreign direct investment, portfolio investment and other investment (loans and credits). The indicators of FDI are the best ones to estimate how large is the system of international production in Russian retailing, because it is FDI that builds up the basis of international production. According to Rosstat by 2008 the stock of FDI in Russian trade (including retailing and wholesale) reached 9.8 bln dollars or 8% of whole stock of all FDI in Russian industries (Rosstat, 2011). At the same time FDI stock in Russian retailing only was about 2.224 bln dollars (1.8%). But we think that the indicator of FDI in wholesale and retail trade is much better characterized the scale of international production in Russian retailing because in reality it is very difficult to separate retail and wholesale operations of retailing companies.

Russian economy has been hit by the global financial crisis more than expected, including the consumer goods and retail sectors – e.g., market value of retail companies dropped by 70-90% in 2009 (Deloitte, 2012). Although the retail industry has grown continuously, there was a steep fall in the growth rate. The volume of retail market didn't decrease in 2009 (14,6 trillion roubles in 2009 compared with 13,9 in 2008), only the growth rates were down from 28,1% in 2008 to 4,7 in 2009 (Twardzik, 2011). In 2010, the Russian retail market recovered after the economic slowdown observed during the previous year and increased by 12.9% to 16.5 trillion roubles (543.5 bln dollars). The crisis intensified consolidation processes in retail and consumer goods markets. Foreign companies will have an excellent opportunity to strengthen their positions or enter Russian market. Some of them already started this process.

Despite recovery of Russian retailing after crisis, according to A.T. Kearney current conditions (in the retail market) are significantly less positive than they were in the early 2000s, yet Russia holds promise over the long term (A.T. Kearney, 2009, p.9-10). Additionally, there can be long lead times and a steep learning curve when building and opening stores in Russia. IKEA, for example, spent years jumping bureaucratic hurdles before opening its first Russian store. Corruption has lessened but is still prevalent. Companies entering Russia should come armed with risk-mitigation strategies, including establishing government relations, operating by strict standards and building goodwill by investing in national priority projects. In

2009 according to Global Retail Development Index™ Russia got the 2nd place (after India) with 60.0 GRDI score: +1 change in rank compared to 2008 (A.T. Kearney, 2009, table 1).

In The 2010 Global Retail Development Index™ Russia got the 10th place with 53.1 GRDI score (– 8 change in rank compared to 2009). While it dropped eight spots in rankings in 2010, Russia remains Eastern Europe's highest-ranked country. Slower GDP and retail growth rates and increasing market saturation contributed to the decline, yet the retail environment in Russia has not changed dramatically. Russia remains Europe's largest consumer market, with rising disposable incomes and an expanding middle class, and it offers massive growth opportunities for retailers with a long-term approach (Kearney, 2010, p.3).

The author comes to the conclusion that international production in Russian retailing is expanding despite the consequences of economic crisis. Russia is becoming an integral part of global retail market. Due to author's estimates by 2011 the stock of FDI in Russian retailing accounted for 2.8 bln dollars compared with 2.2 bln dollars in 2008. If we take into account not only FDI, but also all amount of foreign investment in Russian Federation the importance of international production in Russian retail trade would be even bigger. The larger share of FDI stock for the first half of 2011 – 17.5% accounted for wholesale and retail trade (for comparison the share of mineral resources was equalled to 17,2%). The inflow of foreign investment into Russian retailing in the first half of 2011 reached 3.5 bln dollars – 2,5 times much compared with the same period of 2010 (Rosstat, 2011).

We have mentioned largest foreign retailers that were working in Russian market. Here we try to assess their positions in Russian retail market from the point of view of sales values. According to ranking «Infoline&Retailer Russia Top100» (Infoline, 2010), based on interviews retailers working in Russian market, we can identify positions of foreign retailers compared with main Russian players. According to Infoline gross sales of 100 largest retailers accounted for 2557.7 bln roubles in 2010. First 10 retailers accounted for 50% of sales (1324.2 bln roubles). First two leaders are Russian companies – X5 Retail Group (342,6 bln roubles) and Magnit (236,2 bln roubles.). In the first 10 ranking companies there are French Auchan (third place with 178,1 bln roubles of sales). All foreign retail chains accounted for 21% of the market of retail sales in Russia (for 100 largest retailers). In 2010 the top 20 retailers accounted for about 11% of the country's total retail sales value. The three largest players (the X% Retail Group, Magnit and the Auchan) controlled almost 5% of the market (Twardzik, 2011).

Modes of entry of foreign retailers into Russian market

In our paper (Volgina, 2008) we have identified three key strategies, that foreign players chains used penetrating Russian retail market. They are as follows: opening foreign subsidiaries via greenfield FDI (Metro, Auchan, IKEA, Stockmann, etc.), purchase of Russian chains (Rewe, SPAR, etc.) and franchising via Russian and foreign franchisee (OBI, BHS, Marks & Spencer, C&A, other department stores). Foreign subsidiaries and franchising proved to be more effective methods of entering Russian retail market in the 1990s and beginning of 2000s. There are some examples of joint ventures (supermarkets Billa, owned by German Rewe and Russian Marta).

During last 5 years there were some news in the modes of penetrating and consolidating in the Russian market. According to A.T. Kearney (2010), foreign retailers such as Auchan and Metro Group are driving the development of big-box stores, and some have established smaller stores in cities to increase penetration. Organic expansion in Russia, however, is difficult, costly and slow. Carrefour struggled with its entry and expansion, eventually selling the leasing rights of its two hypermarkets and withdrawing from the market. But, as Auchan has shown with its 40 Russian hypermarkets, endurance can pay off. The remaining attractive retail M&A targets are limited mainly to geographic niches.

At the same time Russia's retail market continues to consolidate through mergers and acquisitions (M&As), particularly among local companies. We expect this trend to continue, with the largest domestic chains acquiring both national and medium-sized regional players. For foreign companies, entry via M&A has proven difficult (though quite attractive) as local companies have strong lobbying advantages. Entering Russia requires understanding and adapting to local operating conditions, including logistical challenges. Lines at borders and ports, poor service quality, infra- structure issues and long distances between large cities cause delays and make the supply chain a strategically crucial function. Additionally, there can be long lead times and a steep learning curve to build and open stores in Russia. IKEA, for example, spent years overcoming bureaucratic hurdles before opening stores in Russia. Nevertheless, it is possible to overcome these hurdles and be successful in the market. Multinationals such as Metro Group and Auchan have

operated in Russia for years, understanding the rules of the game and continuing to grow through expansion. (A.T. Kearney, 2011, p. 9).

Forms of international production in Russian retailing

International production is expanding not only in its quantitative scales; it is changing its nature as well. In the previous research (Volgina, 2011) we have formulated a concept of quality evolution of international production and identified its three forms – «foreign production», «outsourced production», and «integrated international production» (IIP). The basis of this identification was the notion of cross-border value-added chain: distribution of different parts of the chain in different geographical locations all around the world means that production is becoming international by its nature.

Key criteria for identification of the forms of international production forms are: TNCs' organization strategy for entering foreign market, including special character in geographical fragmentation of production; the degree of functional integration in cross-border value chain; the level on integration of the economy (where the parts of the chain are located) into the world economy. Below we give a short overview of these forms.

The specific feature of «foreign production» is that main organizational strategy of TNC aims at establishing stand-alone foreign affiliates, that works mostly as independent entity in the country acquiring foreign investment. Foreign affiliate abroad looks like miniature replicas or as a duplication of parent firm. As for geographical strategy in the framework of “foreign production” – the most popular are so called multi-country strategies. It means that foreign affiliates (miniature replicas) of a parent firm are located in different countries and very poorly linked with each other if linked at all. Under these strategies foreign affiliates supply with their products mainly host country market while parent TNC controls these affiliates in different regions, countries or locations.

As for the types of links in the cross-border value chain – parent company controls foreign affiliates mostly by ownership as well as by inflows of long-term capital and transfer of technology. Parent company exercises only fragmented control and governance over their foreign affiliates, and a degree of integration in cross-border value chain is rather low. It follows that the level of integration of host country (where the affiliates are located) into the world economy are poor as well. Moreover the influence of TNCs on the host country economy is limited with exception of the situation when the produce of foreign affiliate accounted for a large part on a special segment of domestic market.

Beginning from 1970s we can observe the expansion of international production which takes a form of «outsourced international production». It is closely related with the phenomena of cross-border outsourcing and regional fragmentation of production. The main distinction of cross-border “outsourced production” from the previous “foreign production” is that only fragments of firm's production (value chain) are moving abroad compared with the miniature replicas of parent companies. It means that the value chain takes the cross-border form, and links between countries and firms are becoming tighter, location of production is transforming from national into regional one. Companies of host countries (foreign affiliates and independent domestic firms) are embedded into cross-border value-added chain, becoming integral part of international production. There emerged relations on interdependence between host and home countries companies, though the latter still possess the control over the functioning of the cross-border value chain.

The form of “integrated international production” (IIP) is developing very fast during last 15-20 years. And though more simple forms of international production (like “foreign production” and “outsourced production”) are still dominating in the world economy, IIP is gradually expanding and most probably in the future will be the phenomenon that to a greater extent is determining configuration, nature and main directions of world economy development.

In the framework of IIP regional fragmentation of production is supplemented by global fragmentation of production; regional outsourcing is transforming step-by-step into outsourcing that is global in its scale. Moreover, for IIP vertical and horizontal integration of production processes are supplemented by functional integration of globally integrated value-added chains. Different production functions (including services) are carried out by parent TNCs, foreign affiliates, and independent firms for the system of international production as a whole. Control over the global value-added chain is exercised by equity mechanisms over foreign affiliates and non-equity links (contracts) over independent firms, which are working like regional or global outsourcers. The integration of this type is characterized by deep integration of national economies into the world economy.

Taking into consideration the character of value chain in Russian retailing we assume that in Russian retailing there is developing the form of “foreign production” with elements of internal outsourcing. Under “foreign production” foreign retailers’ chains are working in Russian market as rather independent foreign affiliates. Foreign retail chains (for example, Auchan Group, Metro Group) are at the same time miniature replicas of parent Auchan or Metro in their own markets in France and Germany.

Structure and governance in cross-border value chain in Russian retailing

In order to confirm the hypothesis that Russian retail has elements of internal outsourcing let’s examine the structure of value chain in Russian retailing, paying special attention on supplier-retailer relationship. Value-added chain in retailing includes suppliers, distributors responsible for different logistic activities, retailers and clients of retail stores. Product in retail is a special service of supplying final customers with different kinds of goods. To research the «zone» of interaction between supplier and retailer we need to identify typical model of organization of retail logistics in Russia which can be depicted as three-layer pyramid that includes operator 1PL, 2PL and 3PL.

1 PL model (first-party logistics) – is an autonomous logistics, when independent agent makes all the operations. A 1PL operator can be a manufacturer, trader, imposter/exporter, wholesaler, retailer or distributor. Anyone having goods moved from their place of origin to their new place is considered to be first-party logistics provider. The scheme is widespread in Russian retailing, especially when the retailer is rather small and has limited number of retail shops. The level of integration in the supply chain is not high.

2 PL model (second-party logistics) – is a traditional logistics, when logistical services are partially carried out by 2PL providers – transport companies, forwarders, custom brokers, etc. It means that all the functions that in 1PL model, were made by retailers, are now on outsourcing.

3 PL model (third-party logistics) – is so called contract logistics, when almost all main logistics functions are made on the basis of outsourcing. 3 PL provider is wholly responsible for logistic functions for the client (retailer), it is carried out transportation, warehousing, distribution and management of the whole supply chain in retailing. It is widely spread in competitive markets of FMCG (fast moving consumer goods), where suppliers are responsible for SCM – supply chain management.

4 PL model (fourth-party logistics) – is an integrated logistics, when logistic operators use system approach to the management of business processes, including building-up of effective supply chain and exchange of data among agents of the chain in real time format on the basis of modern information and communication systems. 5 PL model (fifth-party logistics) – electronic logistics, is used rather poor even in mature retail markets.

What kind of logistics is prevailing now in Russian retailing? For some subjective and objective reasons Russian retailing companies are demanding for services of 1-2PL providers. They “give” on outsourcing only separate operations, such as warehousing, transportation and distribution of shipment. Russia stands behind other countries in using 3PL operators. In 2007 the share of contract logistics in European countries was 81%, in the USA – 56% and in Russia – 23%.

But recently in Russia there emerged a range of retailers that demand services of 3 PL operators, contract logistics. These are large Russian retail chains (X5 Retail Group, Magnit) as well as foreign retailers, which got accustomed in their home markets to 3 PL logistics and are moving this practice to Russia. Foreign retailers bring their established supplier relationships with them to Russia. Foreign retailers and processors impose all elements of the “Western” supply and quality chain management in Russia. For example, Auchan, BAT, Danone, IKEA, Mars, Metro Cash&Carry, Kodak, LG, Nestle Food, Pepsi, Procter&Gamble, Wriggles, Sony, HP, Unilever use model 3 PL in Russian market. The positions of 3 PL operators in Russian market are occupied by foreign logistics companies. Thus, French FM Logistic is one of large foreign operators in Russian logistics market. It works in Russia since 1994 in the segments of retail, electronics and high tech, food products, hygiene, cosmetics (from FMCG to luxury products) and provide the whole supply chain services (customs, warehousing, transport and co-packing) to a range of companies, including Auchan, Real, Mars, Nestle, L’Oreal, Seldico, Henkel, Bat, Bosch and others (FM logistics, n.d.).

It is very important to assess the nature of supplier-retailer relationship in Russian retail market. According to our research we can stress that the specific feature of supply chain in modern Russian retailing is that the governance of the chain is carried out by the retailer but not by the supplier.

This author’s conclusion is confirmed by the findings of other researchers who have dealt with the topic. In their work O. Tretyak and M. Sheresheva (2005) pointed out that in recent years there has been major growth in the retail sector in Russia. The Russian retail market has undergone numerous changes, with

retail chains becoming increasingly powerful. This process was clearly accelerated by recent arrival of foreign retail “heavyweights” known for their aggressive marketing strategy and the successful implementation of modern business practices.

Z. Pall, M. Sheresheva and J.H. Hanf (2005) also confirmed that supplier-retailer relationships are now of growing importance in the Russian retail sector. Most local companies in the Russian retailing still consider selling firms as adversaries, not collaborators, and therefore prefer to emphasize on optimizing single transactions instead of creating win-win situations and building long-term connections.

M. Hudyakova (2009) stressed that inter-relations between retail chains and suppliers are very contradictory. During 2000s the sufficient part of market power was shifting gradually from suppliers to retailers, including foreign ones. Retailers, as a more powerful side of contractual relations, pursue a policy aimed at imposing on suppliers unequal terms of the contracts.

Conclusion

The paper provides an overview of the major trends taking place in Russian retailing with a special emphasis on the process of international production in the sector. Russia is becoming an integral part of global retail market. The author comes to the conclusion that international production in Russian retailing is expanding despite the consequences of economic crisis. Due to author’s estimates by 2011 the stock of foreign direct investment FDI in Russian retailing is accounted for 2.8 bln dollars compared with 2.2 bln dollars in 2008.

During last five years there were some news in the modes of penetrating and consolidating in the Russian market. Organic expansion in Russia of foreign retail chains proved to be difficult, costly and slow. Russia’s retail market continued to consolidate through M&A, particularly among local companies. For foreign companies, entry via M&A has proven also difficult as local companies have strong lobbying advantages. Nevertheless large foreign retailers used M&A as an effective instrument for market consolidation.

Taking into consideration the character of value chain in Russian retailing we assume that in Russian retailing there is developing the form of “foreign production” with elements of internal outsourcing. Under “foreign production” foreign retailers’ chains are working in Russian market as rather independent foreign affiliates. Foreign retail chains (for example, Auchan Group, Metro Group) are at the same time miniature replicas of parent Auchan or Metro in their own markets in France and Germany.

As for the models of logistics, the author’s finding is that Russian retailing companies are demanding for services of 1-2PL providers. But recently in Russia there emerged a range of retailers that demand services of 3 PL operators, so called contract logistics. These are large Russian retail chains (X5 Retail Group, Magnit) as well as foreign retailers, which got accustomed in their home markets to 3 PL logistics and are moving this practice to Russia (Auchan and Metro). According to our research we can stress that the specific feature of supply chain in modern Russian retailing is that the governance of the chain is carried out by the retailer but not by the supplier.

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