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Case study on outward foreign direct investment by Russian enterprises*

Executive summary

Outward foreign direct investment (OFDI) from the Russian Federation has increased significantly in recent years. Despite the lack of specific policy in promoting OFDI, the Russian Federation is among the top five largest emerging-market investors. The majority of Russian OFDI is carried out by large conglomerates. OFDI by Russian SMEs is limited, partly because of financial constraints, concern over operations in unfamiliar territory and State exchange controls in the past. The prospect for future OFDI flows from both Russian SMEs and larger enterprises is promising in the light of the Government's recent relaxation of exchange controls.

Russian enterprises are investing abroad for various corporate strategic reasons rather than for limited reasons, such as export-supporting activities, as witnessed in the early 1990s. Their motivations have expanded to cover strengthening market positions, expanding markets overseas, internalizing control over value chains and accessing natural resources, including acquisition of strategic assets to improve competitiveness. The desire to diversify their activities out of the domestic business environment has also encouraged OFDI by Russian enterprises. These reasons have driven Russian enterprises to invest both in neighbouring countries and as far afield as Africa, Australia and the United States.

Russian resource-based enterprises in the oil, gas and metal industries are the most active with OFDI. However, manufacturing and telecommunication enterprises are also investing extensively abroad. Selected cases revealed that OFDI has contributed to increasing the competitiveness of Russian enterprises. Foreign revenues and foreign assets accounted for a significant proportion of the total revenues and assets of some Russian enterprises.

This paper is one of five case studies prepared by the UNCTAD secretariat as background documents for the Expert Meeting to facilitate discussions on enhancing enterprise competitiveness through OFDI. The paper provides an overview of the trends and motivations in OFDI from the Russian Federation. Selected cases of Russian enterprises and their OFDI activities are discussed. The paper also examines the OFDI legislative framework and how OFDI has helped increase the competitiveness of Russian firms. The paper concludes by discussing some policy options for enhancing the competitiveness of Russian enterprises through OFDI.

* This document was submitted on the above-mentioned data as a result of delays in processing.

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Outward foreign direct investments by Russian enterprises

I. Introduction

1. Outward foreign direct investment (OFDI) from the Russian Federation has increased significantly in recent years.¹ OFDI flows exceeded \$9 billion in 2004. The Russian Federation was the fifth largest emerging market investor, in terms of stock, in 2004. Russian private and State-owned corporations are contributing to the rapid growth of Russian OFDI. They are among the leading transnational corporations (TNCs) based in the Central and Eastern European region. Of the 25 non-financial TNCs from Central and Eastern Europe (CEE) in 2002, ranked by foreign assets, five were from the Russian Federation—operating in the petroleum, mining and transportation industries (UNCTAD, 2004, p. 317). OFDI by Russian SMEs is limited, partly because of financial constraints, concern over operations in unfamiliar land and the State exchange controls that existed in the past.

2. Russian enterprises are investing abroad for various reasons. Chief among them are to strengthen their market positions, expand markets overseas, internalize control over their value chains and access natural resources, including strategic assets to improve competitiveness. Increasing export revenues of leading Russian TNCs have in large part helped finance their OFDI activities, corporate expansion and acquisitions. Russian enterprises' exposure to internationalization facilitated OFDI as did the desire of these enterprises to diversify their activities abroad. Geographical proximity and historical ties also played a role.

3. Russian resource-based enterprises in the oil, gas, and metal industries are the most active with OFDI. However, manufacturing and telecommunication enterprises are also investing extensively abroad. The majority of Russian OFDI is carried out by large conglomerates, both private and State-owned enterprises. Few Russian SMEs have internationalized their activities through OFDI. The lack of statistics on OFDI by Russian SMEs also limited the analysis and understanding of the extent, geographical spread, and industry pattern of their OFDI, as well as the benefits that have accrued to them.

4. This paper provides an overview of the trends and motivations in OFDI from the Russian Federation. Selected cases of Russian enterprises and their OFDI activities are discussed. The paper also examines the OFDI legislative framework and how OFDI has helped increase the competitiveness of Russian enterprises. It concludes by discussing policy options to strengthen the internationalization of Russian enterprises, for both large companies and SMEs, through OFDI.

II. Russian OFDI: Trends and development

5. The recent statistical updates by the Russian Government confirm the previous estimations of the massive amount of Russian capital abroad. Unlike in most of the economies in transition, capital outflows from the Russian Federation have repeatedly exceeded capital inflows. The ratio between outward and inward FDI is considerably higher for Russian Federation than for any other CEE countries. The growth in Russian OFDI has contributed to this phenomenon. Russian enterprises are now investing abroad for a diverse set of corporate strategic reasons rather than for limited reasons such as export-supporting activities, as witnessed in the early 1990s (Sokolov, 1991).

¹ The larger amount of reported data on OFDI flows and stock in recent years was partly contributed by an improvement in the State's data registering system.

6. OFDI stock from the Russian Federation has risen rapidly since 2000, from \$20 billion to \$72 billion in 2003 (table 1). The significant increase in OFDI stock was partly attributed to an improved data registering system and an increase in OFDI flows during the period. In comparison with other CEE countries, Russian OFDI is considerably larger.

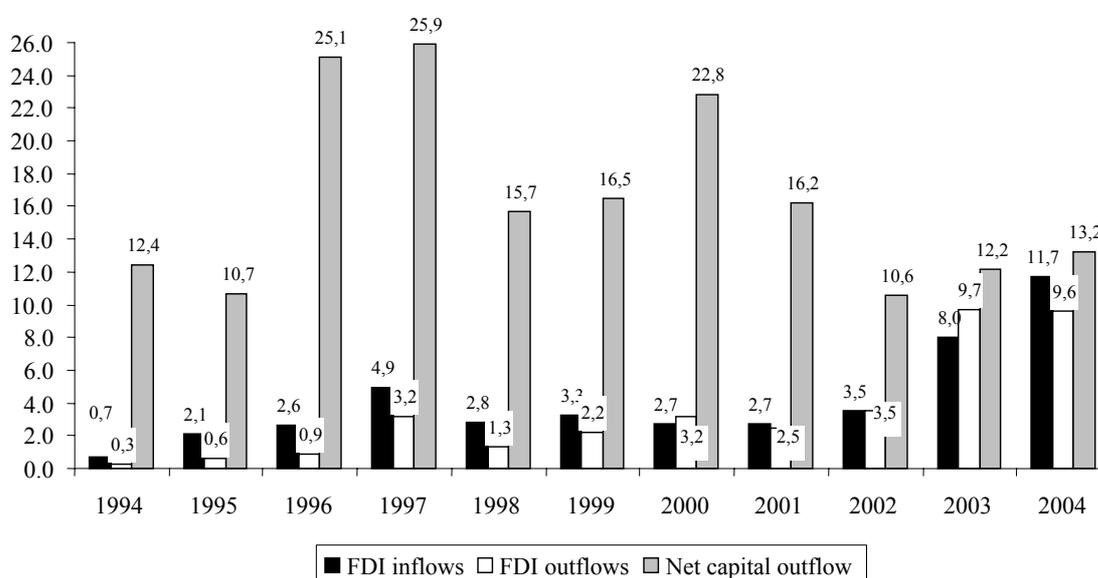
Table 1. Russian Federation: OFDI stock, 2000-2003
(Millions of dollars)

	2000	2001	2002	2003
Direct investments abroad	20 141	32 437	54 608	72 273
Equity capital and reinvested earnings	18 470	30 384	50 616	67 931
Other capital	1 671	2 053	3 992	4 341

Source: Bank of Russia (<http://www.cbr.ru/eng/statistics>).

7. Although there is widespread controversy concerning the total amount of Russian OFDI and capital abroad, it is widely acknowledged that the actual figures are considerably higher than suggested by the official data (European Commission, 2004; Buiters and Szegvari, 2002; Loungani and Mauro, 2000; Grigoryev and Kosarev, 2000; Tikhomirov, 1997). The Bank of Russia reported that the net capital outflow of non-financial enterprises and households from the Russian Federation amounted to \$181 billion between 1994 and 2004 (figure 1). With this amount, the Russian Federation ranks among the 10 largest investors and capital-exporting countries in the world (Kalotáy, 2005; Central Bank of Russia, 2005). This figure, however, reflects conservatively the magnitude of Russian capital abroad.²

Figure 1. Russian Federation: FDI flows and net capital outflows, 1994-2004
(Billions of dollars)



Sources: Bank of Russia (<http://www.cbr.ru/eng/statistics>); UNCTAD (<http://stats.unctad.org/fdi>).

² Various estimates are provided on additional capital flight from the Russian Federation. The non-recorded capital flight from Russia totalled \$245 billion in 1992-2002 (European Commission, 2004).

8. Russian OFDI is mainly in the traditional neighbouring host countries such as the Commonwealth of Independent States (CIS), Europe and CEE. OFDI in non-traditional locations such as Australia, Africa, the European Union and the United States is increasingly visible. About half of Russian OFDI stock is believed to be in the European Union, while the CIS and the United States each accounted for about a one-fifth share (Kalotáy, 2003).³ This development is highlighted also in UNCTAD's data on cross-border mergers and acquisitions (M&A) by Russian enterprises (table 2). Although greenfield and cross-border M&A purchases are market entry strategies adopted by Russian enterprises, the latter has been increasingly notable in recent years. Over half of the Russian M&A purchases took place in the CIS region. M&A purchases in developed countries are increasing, especially in Lithuania, the Czech Republic and Latvia.⁴ The majority of the M&As by Russian enterprises in 1995-2004 took place in the past five years, a fact that suggests a growing interest by Russian firms in internationalizing through OFDI, particularly through M&As. The recent OFDI trend indicates an increasing geographical spread of OFDI activities by Russian companies.

9. Russian TNCs possess considerable assets abroad. OFDI from the Russian Federation is driven by large industrial conglomerates, especially in the natural-resource-based industries, particularly oil, gas and metal. Their foreign assets are widely diversified in different geographical locations. Among the leading Russian investors abroad, measured by foreign assets, three are non-natural resource-based enterprises (Novoship, Primorsk Shipping Corporation, Far Eastern Shipping). They are in the transportation industry.

³ Russian OFDI to the United States could be considerably larger than what has been reported in various other studies. In view of a few large-scale investment projects by the Russian firms in that host country. The actual amount of Russian investments in the CIS could be considerably higher if round-tripping and transhipped FDI are taken into account (Kalotáy, 2003).

⁴ These countries are now members of the European Union.

Table 2. Russian Federation: Cross-border M&A purchases by Russian enterprises, by geographical distribution, 1995-2004

Economy	(Number of deals)							1995-2004
	1995-1999	2000	2001	2002	2003	2004	2000-2004	
Total world	32	12	22	21	31	25	111	143
Developed countries	14	4	12	10	10	13	49	63
Lithuania	-	2	-	3	2	2	9	9
United Kingdom	1	1	1	1	1	1	5	6
United States	-	-	1	1	1	3	6	6
Czech Republic	1	-	-	-	-	4	4	5
Germany	1	-	1	2	1	-	4	5
Latvia	2	-	1	-	1	-	2	4
Netherlands	1	-	2	-	-	1	3	4
Developing economies	-	-	-	2	1	1	4	4
Mongolia	-	-	-	2	-	-	2	2
Turkey	-	-	-	-	-	1	1	1
China ⁵	-	-	-	-	1	-	1	1
Transition economies	18	8	10	9	20	11	58	76
Ukraine	3	7	2	6	3	4	22	25
Armenia	-	-	-	-	6	2	8	8
Belarus	2	1	3	-	-	1	5	7
Uzbekistan	-	-	1	1	3	2	7	7
Bulgaria	3	-	1	1	1	-	3	6
Georgia	3	-	1	-	-	-	1	4
Kazakhstan	1	-	1	-	-	2	3	4

Source: UNCTAD cross-border M&A database.

10. For many Russian enterprises, the CIS region is the first region for them to be involved in internationalization (Pchounetlev, 2000). Russian natural resource enterprises in many cases have a strong grip on certain segments of the CIS markets and over time they have diversified beyond the CIS countries. Their manufacturing and telecom counterparts are following suit and are making their presence felt in the region. The assets controlled by Russian enterprises in the CIS countries tend to be strategic in nature, in such industries as energy and infrastructure. Russian enterprises are dominant players in several CIS countries (Zashev, 2004; Heinrich, 2003; Pelto et al. 2003, Liuhto 2001, 2002), whereas in the developed countries they often have smaller market shares and leverage on their product and corporate strengths (Vahtra and Lorentz, 2004). Finance and resource-based Russian enterprises (oil, gas, and metal) are particularly active Russian outward investors (table 3). A large proportion of Russian OFDI is accounted for by a few industrial giants, often facilitated by their strong export revenues. Oil and gas industries accounted for nearly 60 per cent of the value of OFDI by Russian enterprises. The ferrous and non-ferrous metals industries accounted for about a quarter of shares. Aside from traditional natural resource-based industries, the Russian telecommunication enterprises have recently been actively investing abroad, especially in the neighbouring CIS countries, to expand market and seek assets.

⁵ Intensifying energy co-operation between the Russian Federation and China is likely to lead to increasing investment flows by Russian companies to this vast energy-consuming market, including infrastructure and downstream projects.

11. Russian OFDI is predominantly by TNCs. The role of small and medium-sized enterprises (SMEs) in internationalization has been limited. Their OFDI motivations differ from those of the larger enterprises. Operational characteristics, size and financial resources explain the differences. While Russian TNCs frequently use cross-border M&As to improve their global market positions, the Russian SMEs are more niche market-oriented in their internationalization process. Market- and technology-seeking investments dominate the international expansion of Russian SMEs. Their relatively low internationalization experience and limited financial resources have impacted on their location decision. As a consequence, Russian SMEs tend to operate closer to home, in the CIS and CEE markets.

Table 3. Russian Federation: Cross-border M&A purchases by Russian enterprises, by industry distribution, 1995-2004

(Number of deals)

Industry	1995-1999	2000-2004	1995-2004
Total industry	32	111	143
Primary	-	3	3
Agriculture, forestry, and fishing	-	1	1
Mining	-	2	2
Secondary	18	49	67
Food, beverages and tobacco	2	7	9
Oil and gas; petroleum refining	3	11	14
Chemicals and chemical products	3	7	10
Metal and metal products	2	13	15
Services	14	59	73
Electric, gas and water distribution	2	6	8
Trade	1	8	9
Transport, storage and communications	1	10	11
Finance	7	25	32
Of which:			-
Commercial banks, bank holding companies	6	14	20
Insurance	-	7	7

Source: UNCTAD, cross-border M&A database.

III. Drivers and motivations of Russian OFDI

12. Recent developments suggest increasing variation in OFDI motivations among Russian TNCs and between industries (table 4). At the initial stage of internationalization, OFDI was closely related to export-supporting activities and access to natural resources (Bulatov, 1998; McMillan, 1987; Hamilton, 1986). In the later stage of internationalization, the motives for OFDI became more diverse and strategic (Vahtra and Liuhto, 2004). Russian OFDI was traditionally driven by the motives to diversify risk through reducing exposure of the domestic business environment. Russian enterprises are acquiring assets abroad to strengthen their market positions, expand their global reach and access natural resources. In this regard, OFDI has in general helped increase the competitiveness of Russian firms, particularly those in the resource-based industries.

13. A strategy to improve the competitiveness of Russian oil enterprises is to undertake OFDI to internalize or control the value chain internationally. By acquiring refineries and sales outlets abroad, Russian enterprises have achieved better control over foreign demand, processing oil in their own refineries and selling the products via their own petroleum stations. In the oil sector, the infrastructure assets are of vital importance and Russian oil enterprises have gained control of several strategic infrastructure assets in the CEE countries, including seaports and oil pipelines

delivering crude oil and products to the European and the United States markets. Acquisition of Lithuanian Mazeikiu Nafta and Slovak Transpetrol by Yukos is an example. In addition, Lukoil possesses a wide infrastructure network in the Baltic and several CEE countries. For example, the company acquired the second-largest petroleum retailer in Finland, Teboil, and its sister company, Suomen Petrooli, for \$270 million in early 2005. The acquisition provided Lukoil with a strong foothold not only in Finland, but also in the Scandinavian petroleum markets. Through these acquisitions, Lukoil is capable of altering the competitive structure of the Finnish market with the introduction of its own petroleum products.

14. Resource-seeking Russian enterprises (metal and mining activities) such as Norilsk Nickel are extending their global reach in accessing natural resources through overseas M&As. The recent acquisition of a 20 per cent stake in Queensland Alumina (Australia), the world's largest alumina refinery, by RusAl for \$460 million in 2005 is another example. The acquisition increased RusAl's raw material stock and strengthened the company's position in the world aluminium markets.

15. Russian enterprises are investing abroad to expand their markets and for long-term growth. While the oil and other natural-resource-seeking enterprises (e.g. Severstal) invest both near and far to expand markets, Russian enterprises in the telecommunication industry tend to concentrate on expanding markets to neighbouring countries through both greenfield and M&As (e.g. MTS, VimpelCom). Russian TNCs in the transportation industry (Novoship, Primorsk Shipping Corporation, Far Eastern Shipping Co.) have a noticeable presence abroad, with a considerable share of their assets and revenues emanating from overseas (UNCTAD, 2004, p. 317).

16. An important aspect of Russian OFDI is connected with the international activities of State-owned enterprises. By supporting the active expansion of the State-owned energy giants (Gazprom, RAO UES), the Russian Federation strengthened its cooperation with countries in the region.

Table 4. Motivations of Russian OFDI

Motivations	Corporate examples
Efficiency-seeking motivations (e.g. compulsion to control the entire value chain)	E.g. oil companies' acquisitions of retail assets, petrol stations in the CEE, United States and Baltic countries.
Strategic asset-seeking motivations (e.g. securing infrastructure functionality abroad)	E.g. acquisitions by Yukos of Mazeikiu Nafta in Lithuania and Transpetrol in Slovakia; Severstal's acquisition of Rouge Industries in the United States.
Resource-seeking motivations (e.g. accessing natural resources)	E.g. oil companies' upstream acquisitions in the Middle East, South America and the CIS. Acquisition by RusAl of Queensland Alumina (Australia) and Norilsk Nickel's acquisition of Gold Fields (South Africa).
Market-seeking motivations (market expansion in neighbouring countries and further afield)	E.g. telecommunication companies' acquisitions of mobile operators in the CIS

Source: UNCTAD.

IV. OFDI and competitiveness of Russian enterprises

17. OFDI has contributed to the increase in sales and assets of Russian enterprises. For instance, more than 50 per cent of sales of Lukoil, Novaship, RusAl, Primorsk Shipping and Mechel in 2003 came from foreign sales (table 5). Other large Russian TNCs include Gazprom, Severstal and Rosneft. OFDI, through M&A purchases, has helped Russian enterprises strengthen their global market position, accessed to new markets and natural resources supply, increase the value chain and follow their customers abroad, as the cases below indicate. In this regard, these benefits of OFDI have contributed to the competitiveness of Russian enterprises and the extent of their internationalization.

Table 5. Russian Federation: Top 8 Russian TNCs,^a ranked by foreign assets, 2003
(Millions of dollars and number of employees)

Companies	Industry	Assets		% of foreign assets	Sales		% of foreign sales	TNI ^b (Per cent)
		Foreign	Total		Foreign	Total		
Lukoil JSC	Petroleum and natural gas	7 247	26 574	27	16 260	22 118	74	36.7
Norilsk Nickel, OJSC/MMC	Mining	1 518	5 916	26	1 518	11 253	13	13.6
Novoship Co.	Transportation	1 107	1 213	91	317	395	80	57.6
RusAl	Metals mining services	691	6 085	11	3 660	4 509	81	33.7
Primorsk Shipping Corporation	Transportation	382 ^d	442	86	104 ^e	134 ^f	78	71.3
Mechel	Metal and metal products	121	1 835	7	1 048	2 050	51	24.2
Far Eastern Shipping Co.	Transport	52 ^d	160	32	57 ^e	180	32	22.8
Arosa	Non-metallic mineral mining	46	4 630	1	886	1 955	45	15.4

Source: UNCTAD, *World Investment Report 2005*.

^a Based on survey responses and annual reports.

^b TNI is calculated as the average of the following three ratios: foreign assets to total assets, foreign sales to total sales and foreign employment to total employment.

^c Foreign employment data are calculated by applying the share of foreign employment in total employment of 2001 to total employment of 2003.

^d Foreign assets data are calculated by applying the share of foreign assets in total assets of the previous year to total assets of 2003.

^e Foreign sales data are calculated by applying the share of foreign sales in total sales of the previous year to total sales of 2003.

^f 2002 data.

^g Foreign employment data are calculated by applying the share of foreign employment in total employment of the previous year to total employment of 2003.

18. **Gazprom** is the largest Russian corporation and taxpayer, and the world's largest natural gas producer and exporter. The company is the most transnationalized Russian corporation in terms of foreign assets, foreign sales and the spread of its international operations. Gazprom has operations in 17 European countries, involving natural gas distribution and processing activities. It also has operations in nearly all of the CIS countries (table 6). Foreign acquisitions by Gazprom largely follow its natural gas export markets. Gazprom is the sole provider of natural gas in the Baltic States, Finland and several CIS countries. In the light of its internationalization strategies, Gazprom's competitiveness was enhanced by its ability to strengthen its traditional export markets, exploit new market opportunities and internalize its value chain of business activities. OFDI has helped the company to achieve a strong international presence, which has provided Gazprom with substantial leverage, both economically and politically, in several of its key markets and in the CIS region in particular.

Table 6. Gazprom: Selected foreign subsidiaries and affiliates abroad (2004)

Country	Company	Activities	Gazprom's share, %
Armenia	Armrosgazprom	Gas distribution	45
Austria	Gas und Warenhandelsgesellschaft	Sale of gas	50
Bulgaria	Overgaz	Gas distribution	23
	Overgaz Incorporated	Investing	50
	Topenergo	Gas distribution	100
Cyprus	Leadville Investments Ltd.	Investing	100
Czech Republic	Gas Invest	Investing	n.d.
Estonia	Eesti Gaas	Gas distribution	37
Finland	Gasum	Gas distribution	25
	North Transgas OY	Gas transportation	50
France	Fragaz	Gas trading	50
Germany	Wingas	Gas distribution	35
	WIEE	Gas distribution	50
	WIEH	Gas distribution	50
	ZMB	Gas distribution	100
	ZBM	Gas distribution	100
Greece	Prometheus Gas	Foreign trade	50
Hungary	Panrusgaz	Sale of gas	40
	Borsodchem	Petrochemical production	25
	DKG-EAST Co. Inc	Gas trading	38
	TVK		14
	General Banking and Trust	Investing	26
Italy	Promgas	Gas distribution	50
	VOLTA S.p.a	Gas trading	49
Kazakhstan	KazRosGaz	Gas distribution	50
Latvia	Latvijas Gaze	Gas distribution	34
Lithuania	Lietuvos Dujos	Gas distribution	34
	Stella Vitae	Gas distribution	50
Netherlands	Gazprom Finance B.V.	Investing	100
	Blue Stream Pipeline Co	Construction, gas transportation	50
	West East Pipeline Project Investment	Construction, investing	100
Poland	EuRoPol GAZ	Gas distribution	48
	Gas Trading	Sale of gas	16
Republic of Moldova	Moldovagaz	Gas distribution	50
Romania	Wirom	Gas distribution	25
Serbia and Montenegro	Progresgaz Trading Ltd.	Gas distribution	25
Slovakia	Slovrusgas	Gas trading	50
	Slovenský Plynárenský Priemysel	Gas distribution	16
Slovenia	Tagdem		n.d.
Turkey	Turusgaz	Sale of gas	45
United States	Gazprom UK Trading Ltd.	Gas distribution	100
	Gazprom UK Ltd	Investing, banking	100
	Interconnector (UK) Ltd	Gas trading	10
	HydroWingas	Gas distribution	50

Source: Gazprom (www.gazprom.ru).

19. **Lukoil** is a leading private Russian TNC. It possesses substantial foreign assets around the world (table 7) and more than 80 per cent of the company's revenues were generated abroad in 2004. In upstream production activities, the company has a strong presence in the resource-rich Middle East region and the CIS countries, whereas the company's downstream assets are concentrated near its main export markets, namely the European Union and the United States. Lukoil operates an extensive network of petrol stations in the Baltic States, several of the CIS countries, new EU members and the United States. In addition, the company operates three oil refineries in Eastern Europe, which supply the key export markets such as the European Union. In upstream activities, Lukoil's foreign production ventures serve to extend the company's hydrocarbon resource base and to partially cover the depletions of its domestic resources. Lukoil has made a number of recent strategic acquisitions abroad, which have helped the company secure a prominent presence in some of its key markets. In 2004, Lukoil expanded its retail network in the United States by purchasing 795 petroleum stations from ConocoPhillips for \$266 million. The recent acquisition of the second-largest Finnish petroleum retail chain provides Lukoil with strategic possibilities to enter the Finnish market with its own petroleum products and to considerably alter the competitive structures of the market. Lukoil further strengthened its ownership of the Bulgarian refinery of Burgas in 2005, and acquired additional petroleum stations in Hungary. These OFDI activities have increased the competitiveness of the company by

extending its resource base, and strengthening its market position in several CEE countries, as well as in the United States, and its ability to control the value chain internationally.

Table 7. Lukoil: Selected OFDI activities abroad (2004)

Activities	Countries
Oil & gas production and exploration	Azerbaijan, Colombia, Egypt, Islamic Republic of Iran, Iraq, Kazakhstan
Petroleum retailing	Bulgaria, Cyprus, Czech Republic, Estonia, Finland, Greece, Kazakhstan, Latvia, Lithuania, Poland, Republic of Moldova, Romania, Serbia-and Montenegro, Turkey, Ukraine, United Kingdom, United States
Petrochemical production	Bulgaria
Investing & services	Bulgaria, Canada, Colombia, Cyprus, Denmark, Egypt, Kazakhstan, Lithuania, Netherlands, SaudiArabia, United Kingdom, Ukraine, United States, Yemen

Source: Lukoil 2005 (www.lukoil.com), Troika Dialog 2005 (www.troika.ru), Petroleum Argus 2005.

20. **Russian Aluminium** (RusAl) is the country's largest non-ferrous metal producer and the largest primary aluminium producer in the world. The main reason for of RusAl's OFDI is resource-seeking and market expansion. The company has the third-largest foreign assets among the Russian TNCs. RusAl controls an extensive network of production outlets worldwide, from the neighbouring CIS countries to Australia and Africa. Owing to insufficient domestic raw material reserves, RusAl has expanded its raw material base by acquiring bauxite mines in Guinea and, more recently, a majority share in the world's largest alumina refinery in Australia (table 8). It possesses two additional giant alumina refineries in Ukraine. The company has been able to improve its competitiveness through expansion of its raw material base, increase the value-added of its aluminium production and strengthen its market position as a leading producer of aluminium in the world.

Table 8. Russian Aluminium: Selected OFDI activities abroad (2004)

Country	Company	Activities	RusAl's share, %	Estimated value \$ mn
Armenia	Rusal Armeal	Foil mill	100	n.d.
Australia	Queensland Alumina	Aluminium production and refining	20	475
Guinea	CBK	Bauxite mining complex	100	250
	Alumina Company of Guinea	Aluminium production	>50	200
Kazakhstan	Eurasian Aluminium Company	Alumina refinery & smelter (under construction)	50	1 500
Romania	Cemtrade	Alumina refining	n.d.	n.d.
Ukraine	Nikolayev Alumina Refinery	Alumina refining	100	75

Source: RusAl 2005, Rustocks.com (<http://www.rustocks.com>).

21. **Norilsk Nickel** is the world's largest producer of several strategic metals, including nickel and palladium. The company is one of the largest industrial producers and mining enterprises in the Russian Federation. Norilsk Nickel has established representative and sales offices in Europe and the United States to strengthen its market position, and export and distribution channels. It expands internationally through acquisition of strategic assets abroad and has a group within the company that deals exclusively with M&As. The company recently acquired a majority stake in Stillwater Mining (United States), which is the world's fifth-largest producer of platinum group metals (PGM), and a 20 per cent stake in Gold Fields Ltd. (South Africa) for \$ 1.2 billion (section III and table 9). In this regard, OFDI has helped increase the company's competitiveness by strengthening its international market position and ensure access to natural resources.

Table 9. Norilsk Nickel: Selected OFDI activities abroad (2004)

Country	Company	Activities	Norilsk Nickel's Share, %	Estimated value, \$ mn
USA	Stillwater Mining	Metal mining and production	55.5	275
South Africa	Gold Fields	Gold mining and production	20	1 000

Source: Norilsk Nickel 2005 (www.nornik.ru); Aton Research 2005 (www.aton.ru), authors' calculations.

22. **Mobile TeleSystems** (MTS) is the top non-natural resource-based company among the leading Russian enterprises. It is the Russian Federation's largest mobile operator and has successfully entered the CIS markets in recent years with substantial investments. MTS adopts an aggressive market-seeking strategy by having operations in virtually all the countries in the CIS region. The company's presence is strongest in Ukraine, where it has a fast-growing subscriber base. MTS owns the majority share in Ukraine's largest mobile operator, UMC. It also controls the largest operator in Uzbekistan, UzduNorbita, and has a minority ownership in the largest operator in Belarus. It has a substantial telecommunication infrastructure assets in the region. The growing and unsaturated CIS markets provide vast possibilities for Russian telecom operators and, thus far, MTS has outperformed its domestic competitors in the race for these lucrative markets. The company has emphasized further acquisitions in the region to strengthen its market position, given the low mobile penetration rates and growth potential in CIS countries. The key drivers for MTS OFDI are rapid economic growth in CIS region, investment opportunities, geographical proximity and historical ties with the region. Several large corporate clients of MTS had entered the CIS markets and the need to follow them to these markets has become an important factor driving OFDI. MTS's competitiveness has improved with its strategy of overseas market expansion and increase in customer base.

23. **Severstal** is one of the largest steel producers in the Russian Federation. Apart from several representative offices and marketing units abroad, Severstal acquired **Rouge Industries** (United States) in 2003 for \$360 million. Severstal follows an aggressive internationalization strategy and has plans to acquire several steel producers in the CIS countries, Europe and North America. In 2005, the company acquired **Lucchini** (Italy), a bankrupt steel producer. Severstal's recent international expansion through strategic asset-seeking investments is aimed at strengthening the company's position among the world's top steel producers. Acquisitions of underperforming production assets in strategic markets such as the United States and the European Union provided Severstal with opportunities to increase production capacities and gain market access through local production and distribution outlets. The internationalization strategy of Severstal thus contradicts that of many other Russian TNCs, which have started their expansion from the neighbouring CIS markets. Instead, Severstal follows an aggressive expansion strategy in developed markets through acquisitions. OFDI through acquisition has increased the competitiveness of Severstal because of its access to a number of key steel markets, including in the United States and EU. The internationalization strategy has considerably strengthened the company's position in the world steel industry.

24. **Alrosa** is one of the world's leading diamond mining enterprises, responsible for over 25 per cent of the world's raw diamond output. The company has a strong market position in diamond production in the Russian Federation. Alrosa has a 33 per cent share in a diamond mining company in Angola. The corporation has several financial units overseas and plans to carry out further resource-seeking investments, targeting additional mining assets and projects in Africa. Most of the OFDI projects are to strengthen the company's global market position and access to the mining of diamonds. Alrosa also controls additional production units in the CIS countries.

25. **OMZ** is the largest heavy engineering corporation in the Russian Federation. It has established a strong international presence through OFDI in production, marketing and financial units overseas. The company controls a 25 per cent share of the world market for equipment for atomic power stations and has a strong international market position in highly specialized product segments. OMZ has affiliates and subsidiaries in the CIS countries, Western Europe and the United States (table 10). OMZ acquired three units of Skoda Holding (Czech) (i.e Skoda JS division, Skoda Steel consortium, and Hut and Kovárny) in 2005 for \$200 million. The acquisition provided the company's competitiveness with improved access to the Eastern European markets.

Table 10. OMZ: Selected OFDI activities abroad (2004)

Country/economy	Company	Activities	OMZ' share, %
Armenia	OOO OMZAR	Investing	100
British Virgin Islands	UHM Investments Ltd.	Investing	100
	Shiplely Trading Ltd. BVI	Investing	100
Czech Republic	Skoda Kovarny	Steel production	100
	Skoda Hute	Steel production	100
	Skoda JS	Nuclear equipment production	100
Netherlands	Friede Goldman Marketing	Engineering services	75
	United Heavy B.V.	Investing	100
	UHM Investments NV	Investing	100
Romania	UPET S.A.	Production of metal equipment	66
Ukraine	OAD CBK Korall	Services for shipbuilding industry	94.3
USA	BioLink Technologies Inc.	Biometric products	39
	FGL Buyer LLC	Naval architecture	75
	OMZ Investments Co.	Investing	100
	Friede Goldman United Ltd.	Financial services	75

Source: OMZ, company information.

26. **Rosneft** is the Russian Federation's largest State-owned oil company and the second-largest oil producer in the country, following its purchase of the main production subsidiary of the embattled Russian oil giant, Yukos. Rosneft's experience in international operations dates back to the Soviet era, and the company is now engaged in various foreign ventures based on intergovernmental agreements. Besides its extensive export activities, Rosneft participates in several foreign upstream ventures, including oil and gas production in Algeria, Colombia and Kazakhstan. In addition, the company controls upstream assets in Afghanistan.

V. OFDI by Russian SMEs: Main challenges

27. Owing to limited statistics, analysis of OFDI by Russian SMEs has been considerably constrained. However, available information suggests that Russian SMEs seldom possess the capital and market knowledge needed for extensive foreign expansion (World Bank, 2004). Their relatively weak financial positions and limited access to financing facilities are among the main hindrances to OFDI. Russian SMEs also lack the experience associated with international business operations. The additional risks associated with operating abroad, in an unfamiliar environment, have also contributed to the limited OFDI by Russian SMEs. Domestic market size and growth potential are factors that encourage Russian SMEs to invest and operate at home rather than abroad. Given their limited resources and capital for business expansion, Russian SMEs are inclined to stay at home.

28. The lack of international networks remains a discouraging factor for many Russian enterprises especially in the manufacturing sectors where business networks are traditionally build around large domestic conglomerates.

VI. Policies that contribute to OFDI

29. The low level of real sector investments in the Russian economy and massive capital outflows are among the main challenges faced by the Russian Government. The new regulatory framework on capital exchange, enacted in 2003, is expected to ease the problem by increasing transparency and legitimize capital movements. This new regulation, known as the Currency Law, regulates cross-border currency and capital transactions, including direct investments (Ernst and Young, 2005). Under this new regulation, capital exchange control is relaxed; this is expected to have a positive impact on OFDI in the future.

30. OFDI by Russian enterprises is essential for both the individual enterprises and the Russian economy as a whole. It is imperative that Russian enterprises become more internationalized with a view to increasing their ability to compete in the global market. Competition at home — through imports, inward FDI and non-equity forms of participation — is likely to increase once the Russian Federation becomes a member of the World Trade Organization. In this regard, Russian enterprises should be encouraged to go abroad and the Government could consider improving the regulatory framework, including offering institutional support.

31. A number of specific policy options could be considered for the purpose of supporting future OFDI by Russian enterprises, if OFDI is deemed important and is viewed as a way to strengthen the economy and enhance enterprise competitiveness. For example, any administrative OFDI requirement such as OFDI approval should be easy to comply with and encourage internationalization by Russian enterprises, including SMEs. Facilitation activities such as outward investment missions to target host countries could include SMEs in such missions or in the missions of high-level delegation visits to a host country. Provision of market information and investment opportunities in target host countries by the Russian Government could help. More importantly, transparency for OFDI could be encouraged through regularization and legalization of such overseas investment activities and assets. Consideration could be given to the establishment of public-private sector forum to provide a platform for the exchange of views and experiences of Russian enterprises with regard to internationalization through OFDI.

32. To the extent possible, the Government could consider providing investment guarantees and financing support. This facility is particularly important for SMEs, which often face limited access to finance and are more concerned about operating risks.

33. It is important that due consideration be given to improving the national statistical system to collect data on OFDI by Russian enterprises, particularly with respect to SMEs. Improvement and availability of such comprehensive statistics will help increase the understanding of OFDI by SMEs, including how such enterprises can benefit from investing abroad, and formulation of appropriate policies to further strengthen the competitiveness of Russian SMEs, through internationalization.

34. The enterprises could take a number of measures. Russian enterprises, particularly the SMEs, could increase their knowledge and understanding of the challenges and risks associated with internationalization through OFDI. They could strengthen their capacity and capability through a private sector dialogue or industry club, sharing experiences with other SMEs that have invested abroad. To this end, the Russian business schools could play a role in providing programmes to support capacity building and development of management skills in

internationalization. Increasing expertise in respect of managing cross-border transactions, cross-cultural issues and international laws are important aspects that deserve attention, as would

understanding how to obtain and utilize information to operate effectively abroad. Russian enterprises, including SMEs, should observe good corporate governance and while investing abroad should strive to contribute to the development of the host countries.

VII. Conclusion

35. The Russian Federation is an emerging outward investor, with significant recent OFDI flows. While most of its OFDI is dominated by large Russian enterprises, particularly resource-based and transportation companies, OFDI by SMEs and manufacturing and telecommunication firms is increasingly visible. The cases of internationalizing Russian firms presented in this paper confirm that OFDI has helped increase enterprise competitiveness through strengthening their global market position, expand the natural resources base, gain better control over the value chain, and increase global sales and the acquisition of strategic assets abroad.

36. The future prospects for OFDI from the Russian Federation are promising despite the lack of specific policies promoting it. The recent relaxation of exchange control is expected to contribute to this trend as well as increasing competition from within and outside the country.

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