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Russian outward FDI and its policy context

by

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Outward foreign direct investment (OFDI) from Russia often surprises outside observers by its landmark deals. One of them was the purchase in September 2009 of a 55% stake in General Motors' German affiliate Opel by a consortium of the Canadian car maker Magna and the Russian state-owned bank Sberbank. The latter is the largest creditor of the Russian car maker GAZ, and may represent its commercial interests in the contract. With this deal, Russia has bought into the industrial heartland of the world economy and could potentially access more advanced technology. This acquisition hints at the growth of Russian OFDI in general, which has prospered despite fears in many host countries that the investors are subject to Russian political interference, a fear that recently announced Russian policy intentions may allay.

Trends and developments

A decade ago, following the disintegration of the Soviet Union and the deep post-transition fall in output, Russia seemed to have become an economy of secondary importance. Since 1999, however, the Russian economy has staged a spectacular comeback thanks to various favorable international factors, such as the consistently high prices of its main export products, and is now again a major player in the world economy. One clear expression of this reality is to be found in its direct investment abroad.

Country level developments

OFDI from Russia in recent years has been much deeper than the pre-transition OFDI of the 'red multinationals', which had focused mostly on trading relations rather than on productive facilities.[1] It has also been a strikingly fast-growing phenomenon. Indeed, Russia produces three different data sets on OFDI, measuring it in different ways,[2] and each set of statistics indicates a major rise in Russian OFDI in

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[1] See G. Hamilton (ed.), *Red Multinationals or Red Herrings? The Activities of Enterprises from Socialist Countries in the West* (London: F. Pinter, 1986).

[2] FDI statistics collected by the *Bank of Russia* and international organizations such as *UNCTAD* register transactions on a net payment basis; cross-border M&A data from UNCTAD are recorded mostly on a gross value and announcement basis; the statistics of *Rosstat* are based on company surveys of investment intentions. Even though there are a number of steps between investment intentions and cash flow, Rosstat data are useful for the

recent years. For example, while from 2001 to 2005, Russian OFDI averaged USD 7 billion a year on a balance-of-payments basis, over the next three-year period, 2006–2008, this average jumped to USD 34 billion.[3]

Because of this rapid expansion of Russian MNEs abroad, Russia now has the second largest stock of direct investments abroad among the emerging economies (USD 203 billion in 2008), behind the special case of Hong Kong (China) (USD 776 billion in 2008). Russian MNEs hold more FDI assets than Brazil (USD 162 billion), China (USD 148 billion) and India (USD 62 billion) (annex table 1). Between 1995 and 2007, Russia's OFDI stock was growing more rapidly than the OFDI stock of the other emerging economies mentioned. However, as a result of the global financial crisis, a sharp downward revaluation of Russian assets held abroad reduced Russia's lead vis-à-vis other large emerging economies by the end of 2008 (annex table 1).

Detailed data on Russian outward FDI are not available, but given the large role played by foreign takeovers as the mode of their expansion abroad, features of the dynamics of Russian OFDI can be gleaned from data on cross-border mergers and acquisitions (M&As).[4] In the period January 2005–June 2008, such M&As increased by more than ten times compared with the period 2001–2004, from USD 5.5 billion to USD 56.8 billion. Most of these cross-border purchases were in the primary sector, which accounted for 59% of M&As in January 1997–June 2008 (annex table 2). Within manufacturing, which accounted for 23%, machinery, metals and motor vehicles were the three most important industries. The share of services was 18%, of which telecommunications was much the most important industry.

As to the geographical distribution of acquisitions abroad, the data show that Russian firms have generally targeted developed country firms, especially in Europe and North America (annex table 3 and section on companies below). One part of the world that has been particularly open to Russian investment is the Commonwealth of Independent States (CIS). Most CIS countries have close relations with the Russian Federation. Benefiting from these historical ties and from a deep knowledge of the local business environment, Russian FDI in these countries is relatively large and has been growing. Rosstat data show that Russian investment in the CIS economies (including FDI, portfolio and other foreign investment) grew rapidly from 2000, in which year it was USD 130 million, to 2008, when it was well over USD 10 billion (annex table 4). The leading CIS destinations in 2008 were Belarus and Ukraine, followed at some considerable distance by Kazakhstan and Armenia. For some of these countries, Russia is a major source of inward FDI.

The data set on cross-border M&As also allows us to measure the size of round-tripping transactions in OFDI, under which foreign affiliates of Russian firms, typically established in offshore financial centers such as such as Cyprus, the Netherlands and the British Virgin Islands (annex table 5), invest back to the Russian Federation: such deals amounted to almost $7 billion over January 1997–June 2008, accounting for 10% of the total (annex table 3).[5]

The corporate players

Some 50 to 60 MNEs account for a large part of Russian assets abroad, with OFDI among this group dominated by such behemoths as Gazprom, Lukoil, Sberbank, AFK Systema, Norilsk Nickel, Evraz, Rusal, and Severstal, all of them global players, some of which in turn are part of larger and looser business groups (e.g. Rusal is part of the Basic Element Group).[6] The majority of Russian MNEs operate in four major industries: oil and gas, metallurgy, finance, and telecommunications. Despite the concentration of OFDI among a limited number of large MNEs, the total number of Russian firms investing abroad probably exceeds 1,000.

In particular, the 10 largest announced M&A transactions in January 2005–December 2008 mainly involved Russian resource-based firms (e.g., Norilsk Nickel, Evraz Group, Gazprom, Lukoil)

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information contained on the geographical composition of OFDI, something that balance-of-payments data do not currently provide. All these sources have difficulties with registering complex flows passing various borders.

[3] According to UNCTAD's FDI/TNC database (http://stats.unctad.org/fdi/) and the balance-of-payments data of the Bank of Russia (www.cbr.ru/eng/statistics/?Prtid=svs).

[4] These data need to be treated with some caution as they register announced deals, whose payment could take place over various years, and in some other cases could be canceled.

[5] This measurement is possible because the data base records both the immediate and the ultimate buyers and sellers.

[6] See Alexei V. Kuznetsov, "Russian companies expand foreign investments", *Russian Analytical Digest*, 2008, No.34 (www.res.ethz.ch).

targeting purchases mostly in Canada, Italy and the United States (annex table 6). So far, the largest transaction has been Norilsk Nickel's full acquisition of Lion Ore Mining in Canada in 2007.

The state has played an important role in the emergence of Russian OFDI. State-owned enterprises, such as Gazprom, possess a set of advantages (financial capabilities, access to loans from the central bank, administrative support, etc.) that facilitate their internationalization. At the same time, even in fully or partly privatized enterprises, state influence remains, sometimes directly (for example through residual ownership, as in Rosneft) and sometimes indirectly, through State support and other measure of State influence. When it comes to companies in the energy sector, the law makes Russian – state or private – majority ownership mandatory.

Russian OFDI has been driven by various motives, including a desire of managers and private equity owners to mitigate the economic and political risks still inherent in their home market through holding a large portion of assets offshore (a variety of post-transition "capital flight" related to "system-escape" motives, which decreased sharply after 1999 but bounced back during the global crisis). Expected profitability of FDI has been another primary driver. However, there is no clear evidence as to what degree the expectations of Russian firms about the ease and low transaction cost of M&A purchases facilitating vertical integration and increasing control of the value chain of products (from the extraction of natural resources at home to the processing and distribution abroad) have materialized. Aspirations for better global recognition and an improved image abroad have also been among the drivers of Russia OFDI.

Effects of the current global crisis

The dynamism of Russian OFDI has weakened lately, in part due to the onset of the global economic and financial crisis. From 2007 to 2008, it still grew, but only by about 15% (from USD 46 billion to USD 53 billion). In the first quarter of 2009, however, OFDI fell by 15% (from USD 16 billion to USD 13 billion) on a year-to-year basis.[7] These data, as compiled by the Bank of Russia, differ from the OFDI data of Rosstat, the Russian statistical agency, which show Russian OFDI jumping in the first quarter of 2009 to nearly USD 10 billion, an increase by a factor of eight over the first quarter of 2008.[8] The discrepancy between the two data sources reflects fundamental differences between the statistical methodologies of the two agencies.[9]

The sharp downward revaluation of Russian assets held abroad in 2008 (annex table 1) could indicate major problems at the international affiliates of Russian MNEs, although reliable reports on eventual downsizings or closures are impossible to find for the moment. It seems that, despite their mounting difficulties, the financial crisis has not stopped Russian companies from seeking to expand internationally, although it may have made it harder, as the prices of their commodity exports decline and their market capitalization shrinks. Through the first quarter of 2009, however, there were no signs of the repatriation of Russian financial assets abroad, from international financial centers such as Cyprus, the Netherlands, the British Virgin Islands, and Gibraltar, which partly serve as tax havens for Russian firms as well. These locations still figured prominently (first, second, sixth, and eighth positions) in the OFDI flows of Russia in the first quarter of 2009 (annex table 5).

Indeed, a number of large transactions were announced in the first quarter of 2009; notably, the Russian company Surgutneftegaz purchased 21% of the shares of MOL Hungarian Oil and Gas Plc. (bought from Austria's OMV Group) and TNK bought 49% of the shares of the US manufacturer of steel pipes NS Group Inc. In another notable case, Lukoil paid €852 million to Italy's ERG to acquire a 49% share in the joint venture refinery ISAB in Sicily. The crisis has had also some positive impacts: it has cut down the prices of foreign assets that some Russian companies intended to acquire. For example, at the end of 2008, Severstal saved USD 302 million (from an original price of USD 1 billion) when purchasing the Canadian coal-mining firm PBS Coals,[10] and NLMK saved USD 50 million (from an

[7] According to the Bank of Russia (www.cbr.ru/eng/statistics/?Prtid=svs).
[8] www.gks.ru/bgd/free/b04_03/IssWWW.exe/Stg/d02/29inv24.htm.
[9] As noted in footnote 2, the Bank of Russia registers a transaction only when it is fully paid for, so its statistics are very sensitive to events affecting the financing of MNEs such as the current crisis. Rosstat, on the other hand, reports transactions when intentions to undertake them are announced by companies and thus points to resumed dynamism in the future.
[10] www.reuters.com/article/mergersNews/idUSN2526880020081026.

original price of USD 400 billion) when purchasing the US steelmaking firm Beta Steel,[11] both as a result of declining asset prices.

A full evaluation of how the crisis continues to affect Russian OFDI is not yet possible. The financial difficulties of the natural-resource-based MNEs may however indicate that these companies need to slow down or cancel their investment plans in the future. Alternatively, they may rely more on State help, including financing obtained from State-owned banks. The crisis may have also altered the political context of Russian OFDI, especially the bilateral relationships of Russia with its main partners (the EU and the United States). It also remains to be seen to what degree "covert" FDI protectionism[12] will gain influence in those partner countries and to what degree that may result in additional obstacles to Russian OFDI. These factors together could potentially change the Russian OFDI landscape, resulting perhaps even in the disappearance of some of today's FDI giants.

The policy scene

One idiosyncratic impediment to Russian investment abroad is the perception in certain countries that Russian companies, especially some of Russia's largest companies, are more subject to political interference than MNEs in general. One sign that the perception exists was cited by the vice-president of Lukoil, Leonid Fedun, who told the *Financial Times* that Russian investors have started to withdraw from countries such as Poland and Lithuania because of political antagonism.[13] Also, according to Fedun, Lukoil was interested in purchasing two oil refineries belonging to the Polish power concern PKN Orlen, but the Polish government saw the "long hand of the Kremlin" behind the deal and feared the misuse of market power for political ends. Another case of putative political antagonism concerned the aforementioned purchase by Surgutneftegaz of the Austrian oil company OMV's holdings in MOL, the Hungarian power company.[14] MOL, although privately owned, is seen as strategic by the Hungarian government, and OMV had itself been accused of being a front for Russian interests in 2007. Although the transaction went through, it was a source of political concern in Hungary.[15]

Anxieties about Russian OFDI have also been expressed by authorities in other European countries, for example in the Czech Republic and Spain. Not all such concerns are over security or possible political interference. Some relate to other factors common to emerging-market OFDI generally, such as the quality of corporate governance or actions that do not meet professional standards. In practice, nevertheless, such concerns are often outweighed by the crisis-generated need for additional equity capital and financial inflows to cover balance-of-payments deficits.

Conclusions

Despite various difficulties, Russian direct investors are continuing to penetrate foreign markets. The one thing perhaps lacking is a carefully thought out government policy that recognizes the economic benefits of OFDI, in particular, for competitiveness. Such a policy would also have to convince potential host countries that Russia's government will eschew political interference in Russian MNE operations. It could also support Russian OFDI in a systematic way, as is the practice of many other countries, especially in promoting investment in developing countries (political risk insurance, support for pre-investment studies, etc). It may be that this is changing, as President Medvedev has recently announced the intention of supporting outward investors from Russia.[16] If carried through, this can only promote Russian OFDI and intensify the internationalization process of Russian firms.

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[11] http://expert.ru/news/2008/11/17/nlmkotkaz/.

[12] See UNCTAD, *World Investment Report 2009: Transnational Corporations, Agricultural Production and Development* (New York and Geneva: United Nations, 2009).

[13] "Russian investors face 'antagonism'", *Financial Times*, April 9, 2009, p. 2.

[14] "OMV closes sale of 21.2% of MOL to Russia's Surgutneftegas for EUR1.4 bln", *Interfax Russia & CIS Oil and Gas Weekly*, April 15, 2009.

[15] "Hungary's new PM opposed to Russian takeover of MOL", Reuters, April 19, 2009, www.reuters.com/article/rbssOilGasRefiningMarketing/idUSLJ45152820090419.

[16] "Medvedev dvinet bizness za granitsu", February 4, 2008, http://businnestalk.ru/content/view/1180/28/.

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The Vale Columbia Center on Sustainable International Investment (VCC), led by Karl P. Sauvant, is a joint center of Columbia Law School and The Earth Institute at Columbia University. It seeks to be a leader on issues related to foreign direct investment (FDI) in the global economy. VCC focuses on the analysis and teaching of the implications of FDI for public policy and international investment law.

Statistical annex

Table 1. Outward FDI stock of selected economies, various years (USD billion)

Economy	1995	2000	2005	2007	2008
United States	1,363.8	2,694.0	3,638.0	5,228.0	3,071.2
Hong Kong, China	78.8	388.4	471.3	1,011.2	775.9
Russian Federation	3.3	20.1	146.7	370.2	202.8
Brazil	44.5	51.9	79.3	136.1	162.2
China	17.8	27.8	57.2	95.8	147.9
India	0.5	1.9	10.0	44.1	61.8

Source: UNCTAD's FDI/TNC database, http://stats.unctad.org/fdi/ and United States, *Survey of Current Business*, September 2009 and 2006.
Note: In 2008, the decline in OFDI stock of certain countries reflects a sharp downward revaluation of assets held abroad due to the global financial crisis.

Table 2. Cross-border purchases by Russian multinationals, by sector/industry, January 1992–June 2008 (USD million)

Sector / industry	1992–1996	1997–2000	2001–2004	2005–2008
All sectors / industries	511	1,700	5,498	55,850[a]
Primary	45	1,098	2,980	33,485
Agriculture, forestry, and fishing	-	-	5	-
Mining, quarrying and petroleum	45	1,098	2,976	33,485
Mining and quarrying	-	-	1,546	15,742
Petroleum	45	1,098	1,430	17,743
Secondary	451	146	661	13,430
Food, beverages and tobacco	-	90	9	2
Wood and wood products	3	-	-	34
Oil and gas; petroleum refining	-	7	161	589
Chemicals and chemical products	-	-	164	113
Metal and metal products	-	31	306	2,914
Machinery	6	-	17	7,575
Electrical and electronic equipment	-	2	-	453
Electronic equipment	-	2	-	217
Communications equipment	-	-	-	143
Transportation equipment	442	15	-	1,537
Motor vehicles	200	15	-	1,537
Services	15	456	1,857	8,935
Electricity, gas, and water	-	177	60	1,042
Construction firms	-	-	100	1,637
Hotels and casinos	-	-	2	468
Trade	-	235	536	350
Transport, storage and communications	15	13	1,106	3,880
Telecommunications	-	10	1,021	3,637
Finance	-	23	30	1,773
Business activities	-	2	23	116
Business services	-	2	19	250
Community, social and personal services	-	7	-	888

Source: UNCTAD, cross-border M&A database, http://stats.unctad.org/fdi/.
[a] Excluding unspecified industries.

Table 3. Cross-border M&A purchases by Russian multinationals, by host country/region, January 1992–June 2008 (USD million)

Country / region	1992–1996	1997–2000	2001–2004	2005–2008
World	511	2,211	5,498	56,794
Developed economies	511	2,151	3,962	44,287
Europe	311	1,749	2,766	30,575
European Union	311	1,749	2,566	30,160
Austria	-	-	4	1,662
Belgium	-	90	-	-
Bulgaria	-	816	37	-
Cyprus	-	-	-	511
Finland	45	45	-	276
Greece	-	-	-	806
Hungary	6	6	-	177
Italy	-	-	-	1,280
Luxembourg	-	-	-	1,660
Netherlands	245	245	-	-
Romania	-	300	121	-
Slovakia	-	-	72	-
Slovenia	-	-	-	50
Sweden	-	-	-	4,652
United Kingdom	-	211	2,273	19,016
North America	-	170	1,195	13,247
Canada	-	-	68	7,937
United States	-	170	1,127	5,310
Other developed countries	200	232	-	465
Australia	-	2	-	461
Japan	200	200	-	-
Developing economies	-	-	-	3,210
Africa	-	-	-	250
Nigeria	-	-	-	250
Asia and Oceania	-	-	-	2,945
Turkey	-	-	-	2,006
China	-	-	-	786
Malaysia	-	-	-	92
South-East Europe and the CIS	-	61	1,536	9,297
Southeast Europe	-	-	303	257
Bosnia and Herzegovina	-	-	-	157
Croatia	-	-	76	-
Serbia and Montenegro	-	-	225	59
Commonwealth of Independent States (CIS)	-	61	1,233	9,039
Armenia	-	-	27	423
Kyrgyzstan	-	-	-	150
Russian Federation	-	47	990	5,614
Ukraine	-	13	199	2,769

Source: UNCTAD, cross-border M&A database, http://stats.unctad.org/fdi/.

Table 4. Russia's investment flows[a] **to the Commonwealth of Independent States, commitment data, 2000, 2005, 2007 and 2008** (USD thousand and %)

	2000		2005		2007		2008	
Country	USD thousand	% of total	USD thousand	% of total	USD thousand	% of total	USD thousand	% of total
Azerbaijan	26	0	6,734	1.1	8,994	0.3	20,034	0.2
Armenia	5	0	138,185	22.3	3,907	0.1	444,676	4.3
Belarus	77,238	59	102,438	16.5	1,314,092	48.7	5,945,951	58
Georgia	133	0.1	60	0	433	0	3,924	0
Kazakhstan	3,453	2.6	204,314	32.9	445,068	16.5	762,159	7.4
Kyrgyzstan	7	0	1,247	0.2	207,718	7.7	386,029	3.8
Republic of Moldova	31,224	23.8	4,904	0.8	4,248	0.2	22,377	0.2
Tajikistan	-	-	496	0.1	105,683	3.9	171,962	1.7
Turkmenistan	2,934	2.3	-	-	0,4	0	6,357	0.1
Uzbekistan	929	0.7	6,968	1.1	93,040	3.6	96,823	0.9
Ukraine	15,032	11.5	155,176	25	513,580	19	2,397,847	23.4
Total to CIS countries	**130,981**	**100**	**620,522**	**100**	**2,696,763**	**100**	**10,258,139**	**100**

Source: Rosstat, www.gks.ru/bgd/regl/b08_11/IssWWW.exe/Stg/d03/24-13.htm

[a] Included are not only FDI, but also portfolio and other foreign investments.

Table 5. Russia's OFDI flows, commitment data,[a] **first quarter of 2009** (USD million)

Main destinations	**Amount**
Cyprus	12,559
Netherlands	11,065
United States	4,944
United Kingdom	2,045
Belarus	1,943
British Virgin Islands	1,298
Switzerland	1,181
Gibraltar	1,000
Germany	107
Ukraine	102
Total outward foreign investment flows	**38,454**

Source: Rosstat, www.gks.ru/bgd/free/b04_03/IssWWW.exe/Stg/d02/91inv21.htm.

[a] Included are not only projects that have been paid for, but also FDI that is in the phase of announcement or approval.

Table 6. Ten largest M&A deals by Russian MNEs, 2005-2008

Year	Acquiring Russian company	Target company	Target industry	Target country	Shares acquired (%)	Estimated/ announced transaction value (USD mn)
2007	Norilsk Nickel	LionOre Mining	Gold	Canada	100	6,287
2008	Evraz Group	IPSCO – Canadian operations	Steel pipes and tubes	Canada	100	4,025
2007	Gazprom	Beltransgaz	Natural gas distribution	Belarus	50	2,500
2008	Evraz Group	Sukhaya Balka GOK	Iron ore	Ukraine	99	2,189
2008	Lukoil	ERG SpA – ISAB Refinery	Oil and natural gas	Italy	100	2,098
2007	Evraz Group	Oregon Steel Mills	Steel works	United States	90	2,088
2005	Lukoil	Nelson Resources	Gold	United Kingdom	100	2,000
2007	Rasperia Trading (Basic Element)	Bauholding Strabag	Industrial buildings	Austria	30	1,637
2005	Alfa Group	Turkcell	Telecommunication	Turkey	13	1,602
2007	Basic Element	Magna International	Motor vehicles	Canada	18	1,537

Source*:* UNCTAD, cross-border M&A database, http://stats.unctad.org/fdi/.