

Post Recession Recovery?

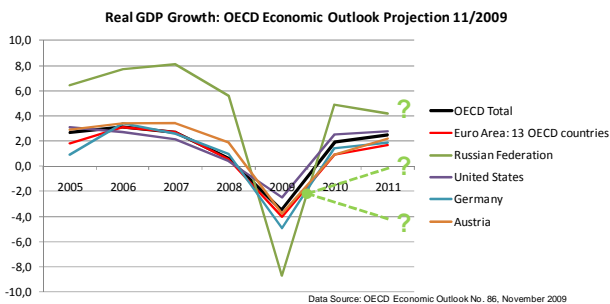
Investing and attracting Capital in Russian Pulp and Paper

By Thomas Teltscher, Alexander Wirth, Ralf Möbus and Joachim Klein

Prior to the global crisis, the Russian GDP growth significantly outpaced that of Western economies. While Western Europe had growth rates between 1-3% during the last 5 years, Russia had a GDP growth rate of 5.6% in 2008, following 10 straight years of growth averaging 7%.

However, when the recession hit, Russia was also impacted significantly harder than the Western European economies.

Interest in new investment projects in Russia was reduced heavily as demand deteriorated. Liquidity became tighter and new projects were stopped or mothballed.



While the latest consensus forecasts indicate a recovery by 2011, risks remain that growth will not be as high as before:

However, global macro-economic indicators are out of balance. Record budget deficits and huge public borrowing coupled with record low interest rates of reserve banks, restrictive lending practices, high interest rates in the private banking sector and increasing unemployment may lead to more trouble ahead. Given the risk adversity of potential investors to spend money even in markets with low volatility and economic risk it will be an even bigger challenge for an economy like Russia to attract Capital given the uncertainty about potential returns.

Within this environment StepChange Consulting conducted a survey among the participants of the 14th Annual Adam Smith Conference *Pulp and Paper in Russia and the CIS* in early November 2009 in Vienna. The intention was to conduct a survey about the participants view on the markets and their investment strategies or willingness to invest in Russia. Survey participants were from the pulp, paper and packaging industry, paper merchants, suppliers to the industry and from universities and governmental institutions. This article will summarize the results of this survey and subsequently highlight options for

Russian market participants to attract investment capital.

60% of all respondents work for companies based in the EU, almost 30% for Russian companies.

32% of respondents indicated to be a member of top management, 56% indicated to be from middle management or team lead functions.

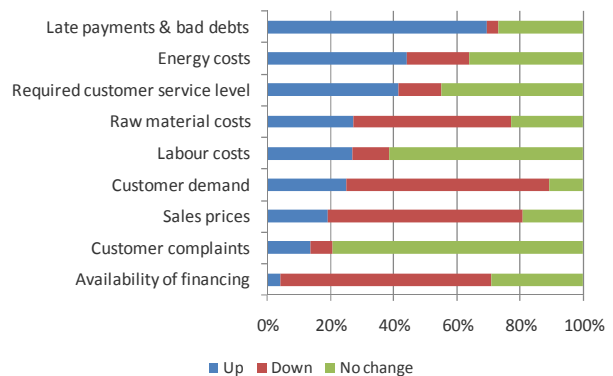
The following will summarize the results of the survey.

Managing through the crisis

The industry perception of the crisis has been homogenous with decreasing demand and decreasing prices across Europe and Russia.

Survey results indicate that the end of the downturn has been reached. Results display that demand is down for 64% of participants, prices are down for 62%, availability of financing is down for 67% of respondents, and late payments and bad debts are challenging liquidity for 69% of survey participants. In contrast the remarkable finding is that 25% of participants see an increase in customer demand.

How is the downturn impacting your company?



Survey results are surprisingly inconsistent on the cost side and reveal that suppliers of raw materials and energy have already succeeded in increasing their prices, both, in the EU and Russia. Especially energy costs in Russia were stated to rise again.

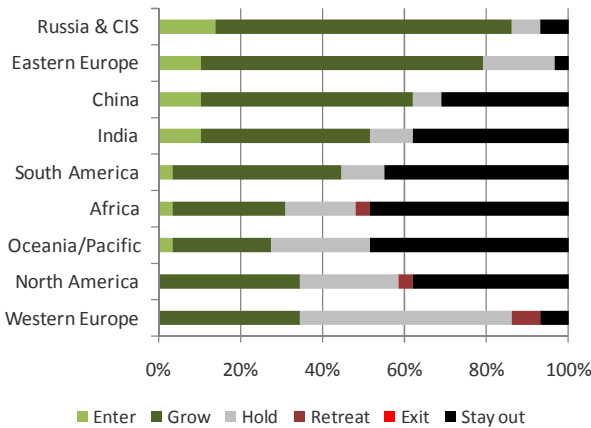
A clear divide was also detected between participants from the EU and from Russia concerning successful capacity reduction. On the one hand almost 90% of Russian participants answer they have not tried to reduce capacity, about 50% of EU participants have dealt with this topic.

Is investing in Russia still attractive?

To get an answer to this question, participants were asked about their company's strategy for different regions. The outcome shows a clear picture: 86% of all participants respond with "enter" or "grow" as the main option for the Russian and CIS markets - 62% of these opinions come from non-Russian compa-

nies. Only very few survey participants from EU companies indicated that they do not want to increase their engagement in Russia.

What is your company's strategy for the following geographical markets?

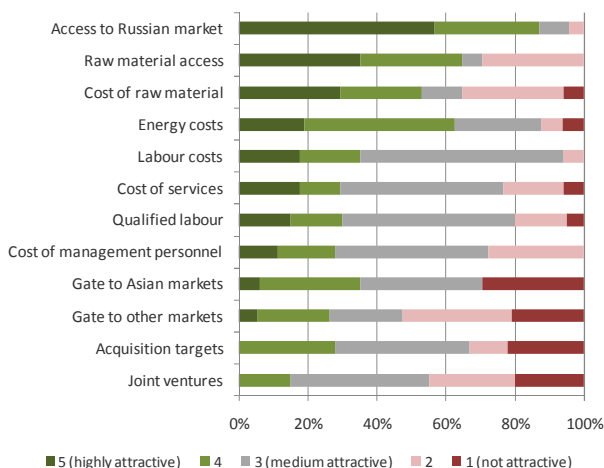


Filtering results by respondents from the pulp and paper industry, very few answer that for the near future they do not have any plans to enter the Russian market.

It can be concluded that the Russian market has not lost its attractiveness for the international pulp and paper industry despite the crisis.

The question remains however, what attracts potential investors to Russia or augments interest to increase existing engagements. To understand this in more detail, participants were asked how they assess the attractiveness of the Russian market against a list of specific criteria.

How do you rate the following with regards to the attractiveness of the Russian market for your company?



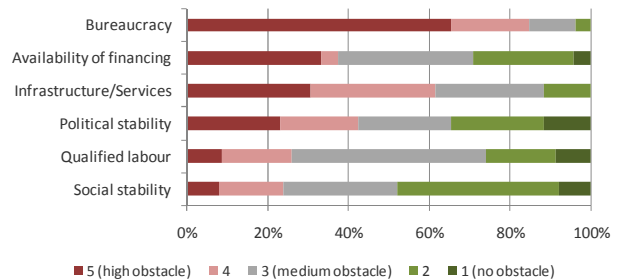
The majority of respondents replied that it is the access to the Russian market itself that has the highest attractiveness, followed by access to raw materials, costs of raw materials, energy and labor.

For the pulp and paper manufacturers the preferences vary by country: While all producers value Russia as a gate to the domestic market, especially producers from the EU are attracted by the raw material access and the low cost base.

Also for suppliers to the pulp and paper industry and merchants the access to the domestic market is the main attraction of Russia.

After receiving a better view about what attracts investors to Russia it was also asked which potential obstacles exist to investments in Russia.

How do you rate the following as being obstacles to investments in the Russian market for your company?



The main finding is that Russian and non-Russian investors uniformly agree that bureaucracy is the main investment obstacle.

The availability of financing and infrastructure/services was also considered to be a significantly obstacle. Infrastructure was mostly mentioned by non-Russian companies.

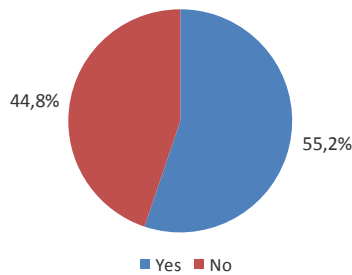
While respondents agree that social stability is not considered a major obstacle, more than half of the non-Russian company representatives are concerned about political stability when it comes to assessing an investment in Russia.

Some Russian participants also mentioned corruption in the commentary fields as a potential obstacle to further expansion plans.

Investing in Russia

The answers above reveal that Russia is considered an attractive market for the industry in general. Furthermore participants were asked specifically "do you plan to invest in Russia?". 55% of participants answered "yes". Of the pulp and paper producers and overwhelming 82% state to have investment plans.

Do you plan to invest in Russia?



Analyzing results by country, Russian survey participants display the biggest commitment to investments in Russia followed by Europeans. Respondents from outside Europe and Russia appear to have a lower inclination to invest in Russia.

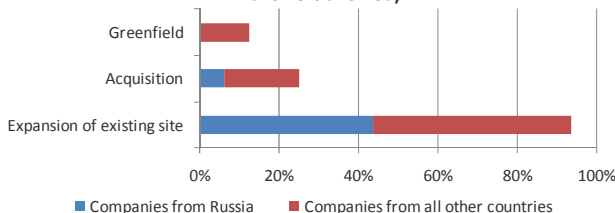
Participants who indicated to have plans to invest in Russia were asked what type of investment they are planning.

The vast majority of respondents clearly confirm to have plans for expansion of existing sites.

Only 13% have plans for greenfield investments and about 25% indicate that they intend to expand through mergers or acquisitions.

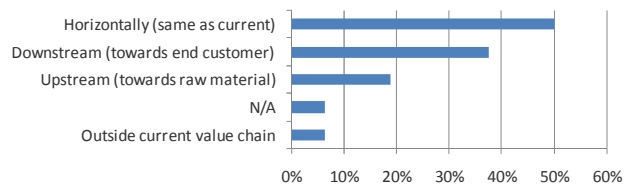
In a follow-up question the preferred deal structure was asked from the participants. Results show that the preferred deal structure is either 100% ownership or a majority share.

What type of investment are you planning? (multiple answers allowed)



In the next question it was asked where in the value chain investments will be targeted. Options were upstream (into the direction of raw materials), downstream (into the direction of the customer) or horizontally (expansion of existing capabilities). Half of the respondents indicate that they have plans for horizontal investments. Almost 40% also plan downstream investments and only 20% plan upstream investments (multiple answers were allowed). This is a remarkable result as it shows that investors are not only after the raw material base. The result is also consistent with the responses received from the earlier question where 86% of respondents answered that they value a presence in Russia for the access to the domestic market.

Where do you invest in the value chain? (Multiple answers allowed)



Analyzing the responses from this question by country origin the results show that for the majority of Russian investors downstream and horizontal investments are in focus, while European companies also consider upstream investments.

What is the impact on future investment activities?

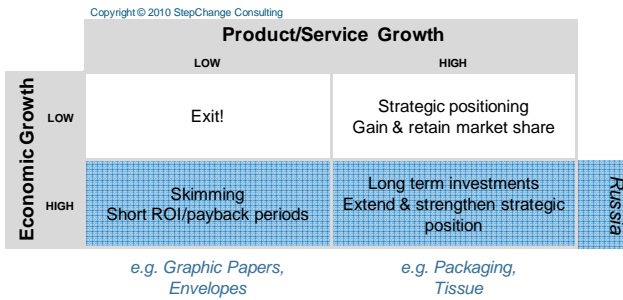
While there is evidence that global economic development has improved during the last months, there are many opinions and forecasts that predict further turbulences. Especially for the Russian economy which requires large investments and which still relies heavily on energy and other raw materials, trust needs to be strengthened and bureaucracy needs to be contained in order to attract investors.

According to the results of the survey one can expect that the Russian market remains attractive for investors from the pulp and paper industry. Nevertheless, there appears to be an intention to contain and minimize the risk of planned investments as participants indicate to rather expand existing sites and grow horizontally than to invest Greenfield. Should the Russian economy and growth rate get back on track, investors may increase their risk affinity as a potential reward will increase as well.

In any case, containing risk will remain key to attracting capital and managing investments. The diverse segments in the pulp and paper industry are each in a different stage of their lifecycle and each stage requires a unique assessment of opportunities and risks. The starting point for each major investment initiative therefore needs to include a thorough evaluation of the respective position in the lifecycle curve. This will help to estimate the growth prospects and help calculate payback periods.

Combining the lifecycle assessment in a second step with the overall economic growth figures of an economy, leverages the concept and will help decide on generic strategies for potential investments.

The matrix illustrated below combines the lifecycle concept with the overall outlook on economic growth.



In the upper left quadrant with low economic growth and low-growth of the respective product or service, there are no rewards to be expected – the standard strategy for this quadrant would be to not invest at all.

For the two quadrants on the lower left and the upper right, investing selectively may pay off. If the economic growth is low and a product is expected to face a dynamic growth, a strategic positioning is recommended to gain and retain market share. If the economic growth is high but the product or service has a low growth or decline on the life cycle curve, it makes sense to “skim” the profits, provided that payback periods for the investments are short.

Investment is highly recommended if there is a high projected economic growth combined with overall growth of the market segment selected – at a given combination of risk and return. This quadrant characterizes the Russian economy. Nevertheless, investors are hesitant to invest in Russia in the current situation which points to a perceived imbalance of risk vs. return.

Managing Risk and Return – Attracting Capital

While Russia is a potential target country for investment it is still crucial to convince investors that financing activities in Russia pay off.

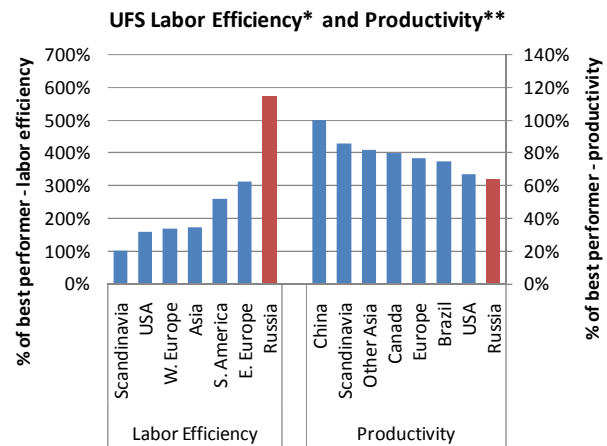
In general, there are two levers that determine the attractiveness of an investment: risk and return. Both of these need to be taken into account when making investment decisions.

There is a clear correlation between risk and return: At any projected rate of return investors are only willing to accept a maximum level risks combined with that investment.

The lower the risk of an investment, the lower the return it needs to pay and vice versa - the riskier an investment is, the higher the expected return needs to be. As a result, the net present value of an investment, based on its expected return including a risk premium, needs to be positive to be a potential target for capital.

One may wonder why Capital is short for new investments in Russia. Typically this means that the

risk of investments is considered too high in relation to the expected return. Therefore the ratio between risk and return needs to be improved. The following graph highlights one of the issues very well. While the external risks in Russia are already quite significant there are additional internal risks that are representative for the Russian economy. Extremely low efficiency and productivity are heavily impacting returns and make other countries more attractive to global capital.



* man hours / ton (integrated mills only). Source: IP
** tons per day per inch. Source: IP

Risk can be classified into several groups: while there are risks specific to the investment, such as completion or technology risks, there are also country-specific risks. These country & market risks include inflation risk, currency risks, political risk, legal risk etc. Capital markets rate Russia as a high-risk market. Since capital markets expect a premium for the additional risk, the expected return from an investment in Russia needs to be attractive. According to the survey, there are several aspects that make Russia attractive as an investment target, especially access to the domestic market and to raw materials. However, there are also clear inhibitions to attractiveness such as relatively low labour efficiency & operational productivity combined with a poor infrastructure and challenging stakeholder relations.

Consequently, there are two opportunities to increase the attractiveness for capital investment: reducing risk associated with Russian investment opportunities or increasing prospective return.

Firstly, companies looking for access to capital need to understand and manage all risks attached to an projects. Risks associated with inflation or exchange rates can be tackled using financial instruments. Political risk can be managed through cooperation with central and local government and interest groups. Not only can this reduce political risk, but it can also significantly increase attractiveness of an investment opportunity. Improving these relations and offering

benefits for the local community, such as additional infrastructure investments, may help to secure raw material access through long-term contracts.

Secondly, weaknesses of the Russian economy such as low labour efficiency and productivity need to be tackled. Improvement programs need to be planned before and executed in conjunction with an investment in order to ensure operational excellence. Business projects with focus on increasing productivity, reducing costs, improving the Supply Chain and creating an effective organizational structure will help to improve returns of an investment. Another area of focus should be Human Capital development to create a culture of continuous improvement.

Thirdly, the planned investment needs to be documented in an overall business plan summarizing all areas of risk and return. This plan required clear targets, benefit estimates and execution timelines. The plan will serve as a mirror to monitor if all areas have been addressed and should also serve as a marketing plan in order to attract the capital required.

The results from the survey show, that Russia remains an attractive market despite uncertainties about the overall economic development and hesitations with respect to the specifics about doing business in Russia. Investing in Russia will not pay off by itself – companies will need to be clear and selective about their investment strategy and ensure they have a convincing business plan. To attract investments, risk and return need to be managed. While thorough analysis and a methodological approach offer decision support and thus help to minimize the risk of failure, it will never be possible to exclude all risk. Doing business will require risk-taking to capture potential rewards. However, in the capital restricted environment concerning Russian investments, it is required to work on improving potential returns while containing risk through active management and collaboration with external stakeholders.
No pain, no gain, no risk no reward.

Thomas Teltscher is Consultant at StepChange Consulting.

Alexander Wirth is Consultant at StepChange Consulting.

Ralf Möbus is Senior Project Manager at StepChange Consulting.

Joachim Klein is Founder and Managing Director of StepChange Consulting.

About StepChange Consulting

StepChange is an industry focused and independent management consulting company with a proven track record in supporting clients to achieve sustainable value. StepChange provides support to top tier organizations in the industry from strategy development to implementation of operational improvements. With an international team of industry experts StepChange can hit the ground running. StepChange provides innovative and yet pragmatic solutions, placing an emphasis on delivering measurable business results.

For further inquiries and comments regarding this Point of View please contact us at leapfrog@stepchange.com