Consortium

Russky Textile

Garments from fiber to end user

Executive Summary

Russky Textile is a financial-industrial group composed of restructured textile and clothing interests of Rosprom and a bank. It has a unique vertically integrated technological and marketing scheme. From fiber to end user!

The fiber is **high–modulus viscose fiber**, developed and produced in Russia.

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Consortium Russky Textile

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General

SINCE 1991 RUSSIA HAS BEEN PAINFULLY MOVING FROM A CENTRALLY PLANNED ECONOMY to a free market, striving to be reintegrated into the world community. The intervening years have seen deep economic, political, psychological, and social transformations of the country, with virtually every aspect of life affected by those dramatic developments. What other nations have achieved through centuries Russia has had to grasp in a matter of years, sometimes months. And so everything in the country is extremely dynamic and fluid.

The former USSR

The former USSR was a closed centrally planned economy. It had close ties with the former CMEA countries, many industrial sectors in the former Central European Socialist countries serving the needs of the Soviet economy.

The Soviet central planning system, with its emphasis on heavy industries and collectivized agriculture, favored cumbersome huge production associations and had centralized distribution mechanisms. There were virtually no horizontal relationships among enterprises.

Everything centered around the so-called Plan, a production target that was valued above all other considerations. Planning targets were delivered from the center and production results analyzed at the year-end. This practice **resulted in a very low worker motivation, little prospect of job loss, low productivity and competitiveness.** Both sale prices and costs of production were never an issue for the enterprise manager to justify, and **marketing and advertising did not exist** at the enterprise level.

Transition to a market economy

In the last five years Russia has been one of the most resolute countries of the former USSR in moving to a market economy. The Soviet Union was run with objectives and assumptions so qualitatively different to those prevalent in a market system, that the transition has been an extremely difficult task. And it still is.

To begin with, the Government initiated a large privatization program, removed the infamous “iron curtain,” and reduced its intervention (both subsidies and protection) since 1991. The transition, when considered at two levels, (1) national and (2) corporate, has for a prospective foreign investor two main implications:

1. **Russia is well equipped** in terms of natural resources, industrial development, infrastructure, and skilled labor force to quickly become a major global competitor;
2. Some Russian companies found themselves in a sort of paralysis due to the sudden change of the economic environment: the main challenges they face are the development of adequate managerial and marketing skills to successfully compete in the market environment.

Privatization

The privatization process proceeded so quickly that in 1994 the private sector made up about 50% of both GDP and employment, and the public sector share of GDP in 1994 was only 30%, a lower percentage than in most developed countries.

Removal of "iron curtain"

Although in Russia it was nothing as spectacular as the pulling down of the Berlin Wall, the opening of the Russian borders makes itself felt in virtually every aspect of life. One sees many foreign-made goods in Russian stores, Russian businessmen are free to travel and visit places the world over, Russian students win scholarships at foreign colleges, majoring basically in economics, business, marketing, and law. This is all extremely beneficial psychologically and educationally for young Russian managers, who are extremely receptive to advanced business practices. This is not the case with "old guard" ex-beens, who unfortunately are the mainstay of management at newly privatized factories.

Reduced state intervention

Virtually overnight most factories, which used to be just production units, found themselves in a situation where jobs are not guaranteed by the state, raw materials are no more delivered at fixed prices, industrial activities are severed from social services. To become real market-oriented production companies they have now to understand that to compete in the new environment they have to develop managerial, marketing and advertising skill, that output quality (not just quantity to meet the "plan" target) comes to the fore, that a new motivation scheme is needed. To survive they have to adept to the situation. Most important, many factories, textile included, found themselves **cut off from traditional sources of raw materials and components.**

Psychology

Before 1917 Russia was one of the fastest developing economies in the world, its growth rate in 1914 being higher than that of the United States. It boasted Europe's largest fair at Nizny Novgorod. By the way, the exhibition commanded most of European prices, specifically in cotton and textiles.

Russian industrialists and merchants were a match to their foreign counterparts. But after 70 years of so-called socialism **psychology and business thinking of Russian operators are now so different from those prevailing in the West**. What is second nature to a Western businessman is sometimes unheard of by Russian directors. This is what potential foreign investors should take into account when establishing their presence in Russia on the basis of an old-style newly-privatized company.

To be sure, Russian businessmen, especially the younger ones, are learning on the fly and it is only a matter of time when they will catch up with the rest of the world. There is ample evidence of this already. One example is **Russky Textile.**

Personnel

The main problem of this incipient market culture is **the shortage of managers, marketeers** and other operators, who make a market economy tick. The Soviet system had millions of party and industrial bureaucrats, who used to be extremely good at "passing on the buck." Good decision-makers and analysts were in short supply. Old-style chair-polishers are still too slow in giving way to the "young turks." On the other hand, intellectual and educational potential of the population is extremely high.

When private enterprise became legally possible in this country, most would-be entrepreneurs had to begin from scratch, by trial and error. This accounts for the high mortality rate among young Russian companies earlier on and for the fact that the most successful are young Russian businessmen who have been educated in the elements of business, some of them in the West.

Russia's international trade pattern

The geographical pattern of Russia's international trade has shifted from CIS and former CMEA countries towards Western countries. In 1994, 65.2% of exports and 67.4% of imports were with OECD nations.

As to textiles and apparel, Russia is one of the main markets for EC: Russian **imports from EC amount to $580 million**, whereas its **export is only $140 million** because EC has import **quotas for Russian textiles and clothes**. At the moment Russia is renegotiating the situation and considers raising import duties on fabrics and apparel, which will make direct imports of those goods to Russia less profitable.

Prospects

The natural resources, the size of the market and the high level of education of its population provide Russia with a **basis for stable growth**. On the other hand, until fairly recently, speaking

about Russia, international experts used to mention political, ethnic and religious instability, ever changing government policies and legislation, high taxation and interest rates, currency repatriation restrictions, even the risks of expropriation, nationalization and confiscation of assets.

It would be a bit of overstatement to maintain that all of the difficulties are out of the way. At the same time, it would be safe to say that now that the nation and its young market economy have accumulated some experience, its bicameral parliament has had its share of growing pains, and especially with the presidential elections past us, there are **positive indications of drastic political and economic stabilization and improvement**. Mr. Eltsin's resounding victory goes to prove that the reform process in Russia is irreversible. Other positive developments are the **end of the war in Chechnia** and resolute measures undertaken by the Government to fight crime in Russia.

The 1996 CEER's annual survey[1] expresses **cautious optimism for the Russian economy**. This panel of economists were asked to rank 26 counties on the basis of a number of factors affecting business, including overall growth prospects, price and currency stability, infrastructure and legal safeguards for investments. They ranked Russia 14, its **most favorable factors being banking system, ease of portfolio investment and currency stability (now inflation in Russia is almost nil.)** The Panel speak of a **"mental turnaround" in 1996**.

Kapital, No. 083, 4-10 September 1996, a Russian-language paper published by Independent Press in Moscow, says that individual companies feature a growth rate of 30% or better.

This indicates that Russian companies,
if properly restructured,
can yield unparalleled growth!

[1] "The Great Growth Race," *The Wall Street Jounal Europe's*, Central European Economic Review, Vol. 3, No. 10, December 1995-January 1996 (CEER panel is composed of top economists from major companies, such as Solomon. Brothers International, JP Morgan, Deutsche Bank Research, and Vienna Institute for Comparative Economic Studies).

Investing in Russia

WHATEVER COULD BE SAID ABOUT SOME INSTABILITIES AND DEFICIENCIES IN THE RUSSIAN political, economic, legal, and administrational climate, at the moment **Russia is quite attractive for investors**. International businessmen came to trust the reforms currently under way in Russia after the country had **joined the International Monetary Fund, International Bank of Reconstruction and Development, and International Finance Corporation.**

According to observers of the US State Department, **Russia meets all the requirements** in terms of state finances, taxation and legal basis for international investments imposed by the International Trade Organization. They also believe that quite soon Russia will become member of the ITO, a fact that is bound to strengthen Russia's position in the international financial market. During his last visit to Moscow the **Secretary of Commerce** of the United States said that **the USA plan to invest into the Russian economy up to $45 billion.**

In the opinion of Luxemburg's **Diffusion Finance** and other international investment authorities the shares of Russian companies on the market are generally **undervalued relative to their counterparts** in more developed stock markets, including a number of Russia's Eastern and Central European neighbors. This makes Russian stock market quite attractive.

Late in 1995 the OPIC expanded its insurance operations, credits and guarantees in Russia up to $1.5 billion. Morgan Stenley, Solomon Brothers, Goldman & Sax, and Pain Vebber also plan to expand their operations in this country.

The European Bank of Reconstruction and Development establishes in Russia **regional funds to support investments** in the regions. In April 1996 the Board of the EBRD approved 63 investment projects in Russia totaling **$7.4 billion**.

In 1995 the EC Council initiated a technical assistance program for CIS countries (**TACIS**), which is called upon to help Russian companies in restructuring, technical modernization, training of personnel and project managers, etc.

According to analysts at the Russian Government, in the nearest future foreign investments to various sectors of Russian economy will be:

1996	**— $4–6 billion**
1997	**— $7–8 billion**
1998–2000	**— $10–15 billion a year**

Legal aspects

The legal basis governing foreign investments in Russia includes more than **30** laws and presidential decrees. These can broadly be divided into:

- laws pertaining to **fundamental concepts** (property, companies, entrepreneurial activities, customs, land, etc.);
- laws pertaining to **foreign investments** *per se*.

Among the latter, of fundamental importance is the **Law on Foreign Investments in the RSFSR** of 1 September 1991. Together with later amendments, the Law is a basis for foreign investing in Russia. It guarantees legal **protection of foreign investments**, and makes **privileged taxation** of foreign investments possible.

It should be noted that with most of major capital exporting nations Russia has made agreements to encourage and mutually protect investments. Among other things, the agreements stipulate measures to settle possible investment conflicts.

The legal basis for foreign investments is being continually strengthened. The latest developments can be summarized as follows:

Companies with foreign investment may have under certain conditions their import **customs duties halved.** And if investments are made into top-priority sectors of Russian economy, they are subject to **more lenient taxation**.

Investment restrictions

Foreign investment in Russian companies is, in certain cases, restricted in constitutional documents of the company. **Russky Textile has no such restrictions**.

Prospects

Prime-Minister Victor **Chernomyrdin** has recently said in an interview that in the nearest future foreign investors in Russia can receive **further privileges**. Among other things, they can be **exempt from profit tax for five years**, their leases will enjoy top priority to be extended up to 99 years.

In late 1995 the **Law on Production Sharing Agreements** was adopted by the State Duma. Unfortunately, the Law attracted much criticism from various quarters, and, according to some sources, it awaits some amendments and improvements.

Under Russian legislation on Russian financial-industrial groups foreign **investors into FIGs enjoy significant privileges and guarantees**. Russky Textile *is* a FIG (see later chapters).

Foreign investments in Russian textiles

Out of $2 billion invested in 1995 into Russian industries (mostly oil & gas, timber, and telecommunications) textiles accounted for only $20 million, about 1%. According to some estimates this share is bound to grow. So in the opinion of **Cast Management Consultants,** who were commissioned by TACIS to conduct an in-depth research into the Russian textile and clothing industries as part of the TACIS project "Support for the Restructuring of Selected Companies in the Textile Industry" (Project No. PRRUSUS 9401):

> *"The* **opportunities** *for foreign capital in the qualitative development of the Russian textile and clothing industries are* **almost unlimited**. *The vast unsatisfied market and cheap labor force offer advantages to foreign entrepreneurs. Some obstacles should be removed in order to increase foreign investment in the country."*

Among the pioneer investors in the Russian textile and clothing industries are, among others, USA's **Du Pont**, Japan's **KobeSteel** and **Nisho Iwai** (polyester fiber production), South Korea's **Daewoo** Group, Germany's **Felina** (production of swimwear and underwear).

Germans are especially active in the Russian market. In 1991 **Puma** opened an office in Moscow and started selling textiles, sportswear and footwear for hard currency. The leading German lingerie manufacturer **Triumph International** has 15 years of experience in Russia. It has a shop in Moscow and produces lingerie in Minsk and has plans to produce in Russia. In 1995 the German-Chinese couturier **Lecano et Hemant** announced his intention to start production and sales in Russia. Another good example is **Steilmann**. This German company set up a system to produce 600,000 pieces of garments a year and distribute through its Moscow office to traders and wholesalers in the country.

Outward Processing Trade (OPT)

Outward processing trade of textiles in Russia has grown dramatically in recent years. Western OPT traders are attracted to Russia by its low cost of skilled labor, relative proximity (compared with the Far East) and the lack of quotas under the MFA. OPT contracting is especially popular in garment making: in 1994, for instance, 3700 tons of clothing imported into the EU from Russia was "outward processed." Western companies normally provide the fabrics, designs, and accessories.

An 1995 study of the German **Ifo–Institute** predicted that German clothing and knitwear manufacturers will shift their OPT contract from the Mediterranean countries to Eastern Europe.

Although OPT seems to be a fairly cheap way of having garments produced, the scheme in Russia is not without its drawbacks, the main one is having to set up one's own distribution network.

Russian textile industry

At THE TURN OF THE CENTURY RUSSIAN TEXTILES COMPETED SUCCESSFULLY IN THE WORLD markets. The names of Morozovs, Ryabushinskys, Baron Knop and other Russian textile operators were household names in Russia and widely known in Europe. After the revolution of 1917 textiles were among the first modern industrial sectors to emerge from the country's industrialization process.

At the end of the 1980s the textile industry in the USSR represented 9% of the country's total industrial potential, more than in other East European communist states. Only in China textiles accounted for 16% of the national industry output.

During the early 1990s, after the disintegration of the Soviet Union, the Russian textile industry faced a sharp crisis because of:

- **uncontrolled imports** of cheap but fashionable textiles from Asian and some East European countries;
- **break–up of wholesale and retail networks** as links between Russian textile companies and garment makers;
- **lack of managerial capabilities, absence of marketing/advertising skills and tools;**
- **dated technologies;**
- **raw material shortages**, mainly of cotton and flax, caused by the demise of the Soviet Union;
- **lack of cash** to meet the required advance payments for the supplies of yarn, chemicals, and spare parts;
- **loss of some markets** after the break-up of the USSR and CMEA;
- **weak state support** for the Russian textiles.

As a result, the output of the Russian textile industry dropped by 60-80% in the years 1990-94, and the share of this industry in the total volume of production went down to 4-5%.

Industry size

Textiles still remain the largest sector of the Russian consumer goods industry in terms of output and employment. According to EIU (Economist Intelligence Unit), there are about **1,700 textile and clothing manufacturers in Russia**. Russian official statistics put the total number of plants at almost **2,000**.

Raw materials

Since the disintegration of the Soviet Union, the production and supplies of traditional raw materials (cotton, silk, wool, flax, and some man-made fibers) in Russia dropped significantly, the reasons in each case being different.

High-modulus viscose fiber

At the same time Russia is a major source of high-modulus viscose fiber produced of softwood pulp. It **compares favorably with cotton and other natural fibers** in terms of consumer qualities. It is extremely **good for tropical climates** (see Addendum 2). This unique material was developed in the late 1970s in Russia. It is now produced at Sibvolokno in Krasnoyarsk, Siberia.

Sibvolokno is a member of **Russky Textile** group, which guarantees adequate supplies of this excellent material to any reasonable specifications.

Russian clothing industry

THE COMING OF A MARKET ECONOMY ALLOWED COMPANIES TO HAVE DIRECT ACCESS TO UPstream and downstream activities, but also forced them to compete in an unprotected market. The final consumer market has developed in two broad segments: lower end and upper end. At both ends of the market foreign competitors entered with products that are comparatively lower priced and of superior quality.

Lower–end market

It encompasses **90–95% of the Russian population**. This segment is mainly served by **Russian garment makers** and the **imports of cheap fabrics and finished goods** from Asia and Eastern Europe. Almost every stage of the production chain is influenced by a rapid development of international trade. Russian manufacturers use mostly Russian and Asian fabrics (from India, China, Pakistan, and Turkey). Imports from these countries are managed by independent traders and by a large number of small **"shuttle" traders**.

These latter import goods in small volumes, which are often within the free baggage allowance or below the minimum taxable value and therefore tax exempted. This accounts for the fact that their goods are generally cheaper priced. Shuttle traders make up a **huge street markets** of garments in Moscow and other cities.

The number of European textile and clothing companies producing in Russia for this segment of the local market has been increasing.

Market attitudes

At the lower end, **price is an extremely important competitive factor**, followed by durability, as expressed in resistance to washing. Nevertheles, fabric quality, design and fashion are becoming more and more important.

There is, however, **one aspect of the evolution of the market attitude to apparel that normally escapes the attention of Western analysts**. The fact of the matter is that in the Soviet Union there were many fashion houses, which would virtually every year win some fancy international awards. A man in the street knew about it, just as he knew that Soviet-made garments offered to him in the stores used to be a far cry from those high-fashion pieces. On the other hand, apparels imported, even from East European nations, were better quality and more fashionable, and so the Soviet consumers normally went for imported products. They still do.

When a tide of cheaper apparel, imported legally and illegally to Russia from Asia, hit the market,

at first they took fancy of the Russian market because of their wider assortment and better design. Now one hears **complains about their low resistance to washing and other deficiencies**. This disenchantment with imported apparel coincided with a similar change in attitude to imported food stuffs, with their bright packing and all.

By the way, this shift has been revealed in a **monitoring exercise** conducted at the sale exhibition of the so-called Fashion Laboratory, a group of Moscow fashion masters that includes Tanya Fedorova who designs for **Russky Rextile**.

This does not mean to say that a "Buy Russian" movement is round the corner, but to ignore the development would be a folly. But it is a sure indication of growing interest of Russian consumers in home-made garments.

Russian garment makers

At the lower end, there are two types of Russian garment makers now. More often than not they procure raw materials from traders, but some of them managed to by-pass these actors and establish a supply network of their own.

Advanced garment makers

Their practices resemble those of operators in more advanced market environments. So they analyze final consumers' and distributors' needs and adjust their supply and sales policies accordingly. They have been developing networks of privately owned shops. To penetrate the distribution they can offer **preferential payment conditions** to shopkeepers, who are reluctant to build up stock and usually request products **on consignment**.

Traditional garment makers

These suffered the most from the economic U-turn, because they could not adept to the new situation and develop market-oriented competencies. They lack a product development system and distribute through the state retail networks and own shops. Their role is declining.

Upper–end market

Demand in this segment is on **high–quality, fashionable goods**. Price is not a competitive issue, high price is thought to be indicative of fabric quality, good workmanship, and fashion.

This segment is characterized by the **strong presence of foreign–labeled goods**. Goods imported from Western Europe and the United States are of high quality and expensive. A new trend has emerged recently: foreign fashion groups begin to manufacture in Russia apparel with foreign labels and develop their own retail networks.

Western garment makers

They import quality goods and distribute them through fashionable retail stores mostly in Moscow and St.Petersburg. Their customers are new Russians. Although prices are extremely high, most of them are making good business.

Russian garment makers

They produce of behalf of foreign companies on commission basis. It is estimated that a growing percentage of **goods made in Russia** on commission remains within the country and is distributed through foreign and Russian owned retail networks.