RUSSIA'S FOOD RETAIL SECTOR FROM THE POINT OF VIEW OF FINNISH FOOD PRODUCERS

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Contents

Abbreviations

ACORT	Association of Companies in Retail Trade
CBR	Central Bank of Russia
CIS countries	Commonwealth of Independent States (CIS) countries
EBRD	European Bank of Construction and Development
EIU	Economist Intelligence Unit
ERDI	Exchange Rate Deviation Index
EU (15)	The 15 countries that first joined EU i.e. not the newest members in transition
EUR	Euro (currency unit of Europe)
GDP	Gross Domestic Product
Goskomstat	The Federal State Statistic Service
IPO	Initial Public Offering (i.e. issuing stocks publicly for the first time)
IRG	Interactive Research Group
JIT	Just In Time
LUT	Lappeenranta University of Technology
n/a	not available
NORDI	Northern Dimension Research Centre
M&A	Mergers and Acquisitions
PPP	Purchasing Power Parity
RUR	Russian Ruble
Sq. meter	Square meter
TE	Transition Economies
UFG	United Financial Group
USD	United States Dollar
VAT	Value Added Tax
WIIW	The Vienna Institute for International Economic Studies
YoY	Year-on-Year, i.e. compared to the same point of time in the previous year

Foreword

The Northern Dimension Research Centre (NORDI) is a research institute run by Lappeenranta University of Technology (LUT). NORDI was established in the spring 2003 in order to co-ordinate research related to Russia and other countries of former Eastern Europe.

NORDI's mission is to conduct research into Russia and issues related to Russia's relations with EU with the aim of providing up-to-date information on different fields of technology and economics. NORDI's core research areas are Russian business and economy, energy and environment, the forest cluster, the ICT sector and the logistics sector.

This report will focus on the development of the Russian retail sector and the opportunities of Finnish food producers in the growing Russian market. This work is a part of a larger research project concerning the Russian retail sector, and it concentrates on giving an overview of the retail sector now and of future trends. This report has been made in cooperation with the Finnish Food Producer association, TEKES, and five food producers.

The main part of the data used in this research has been collected from secondary information sources, such as the Internet and news items. This information has been supplemented with a round of interviews conducted in Moscow and in St. Petersburg on 24-28 January 2005. The interviewees were analysts from different investment banks, representatives of leading retail chains and a journalist of well-known and recognized magazine of economics. Some of them wished their names and positions would not be published, so the author applies this to all cases. The author used the semi-structured interview method with a questionnaire as a framework for discussion.

Since the information about the retail sector is quite contradictory and the opinions regarding the future and the development of the sector vary, the author has combined the information available and drawn conclusions of his own in order to give the best possible view of the sector. The figures presented in the report have mostly been collected from secondary sources and must be viewed critically. It must be taken into account that many studies have been conducted on the topic and many slightly different figures have been obtained with different research methods and estimations. Thus, the figures presented in this paper are estimates and merely projections of the truth.

Abstract

This research paper focuses on the Russian food retail sector and its structure and development. At the moment it is one of the fastest growing markets today with 12.1% growth last year (2004). The growth originates from high oil price, which has been accumulated to people’s wages. They are growing nominally more than 20% annually. But even though the income increases, the share of food of all retail trade has been fairly stable with only a slight decline. Thus, the consumption is shifting to products with more quality and value.

The share of modern retail outlets is low, as the Russian retail sector is still very dispersed to traditional retail outlets such as kiosks, open markets and small grocery stores. The store chains are, however, becoming more and more significant. The biggest market for retailers is Moscow but nowadays the chains are expanding rapidly into other regions. Even though the markets have not been saturated in Moscow, the best prospects for growth are in the regions. The most important factor restricting the growth in Moscow is the availability of real estate and land plots for stores.

The market is moving forward to saturation, and a consolidation process will follow. In fact, it has already started but not many acquisitions have been made so far. To this point the domestic chains have settled to form only alliances. The foreign players will be very strong in the tightening competition in the future. The problem of domestic chains is that the stores are non-standardized, which is not cost-efficient.

The chains are trying to enhance their power in price negotiations by forming purchasing alliances, introducing private label goods and using the regional expansion as a striking weapon. In order to follow the growing chains to other regions the producer must sell its products to the chains at favorable terms.

Suppliers are strong in negotiations when they have a functioning distribution network, ability to JIT deliveries, proper documentation policies, a strong brand, reliability in deliveries and a fair price. The size of the entry ticket, i.e. the listing fee may define the shelf space a producer gets in the stores.

1. Introduction

The Russian retail sector is one of the fastest growing markets in the world today. The purchasing power among the 144 million people living in Russia is growing rapidly and both domestic and multinational investors and retail chains have noticed this. The investments are growing and the retail chains are expanding rapidly. Last year (2004) the retail sector in Russia totaled officially for USD 193 billion, of which 45.6% (USD 88 billion) was spent on food. In real terms the growth was 12.1% compared to the previous year.

The communistic era left behind an insufficient number of store outlets with a huge lack of goods on the shelves of the few shops. The retail sector was also dispersed to small independent shops, kiosks and open markets. After the collapse of the state run system there was a lack of just about everything. The prices were liberated and they skyrocketed because of the shortages. The consumer price inflation was huge.

After this the economy started to recover gradually. Relative stability was achieved with a gradually devaluating managed floating regime. However, the system collapsed again in 1998 when Russia introduced a managed floating regime with set limits to currency fluctuation. Russia drifted into a crisis when the foreign investors lost their trust to the limits set for the exchange rate. The ruble collapsed, imports became highly expensive, and Russia had to resort to domestic production, which was in a fairly bad shape.

However, there has been a remarkable recovery of the retail sector in Russia, especially in Moscow. The domestic suppliers have been fairly successful in meeting the increasing demand, and thus market growth is inevitable. However, the market still remains very fragmented because there are numerous independent shops, kiosks and open markets, while the modern retail formats cover only 15-18 % of all retail trade in Russia. Not only is there lots of room for growth in the number of outlets but also the Russian consumers' purchasing power is increasing.

Market liberalization and the increasing purchasing power of Russians have made Russia's retail sector a very attractive soil for investments. In recent years heavy investments have indeed been made by both multinational and domestic retail chains and the market is growing rapidly. Investment banks and other equity investors have also been investing on retail chains, for example EBRD (European Bank of Reconstruction and Development) in Pyaterochka and Alfa Group in Perekrestok, just to mention a couple.

In addition to domestic players, there are foreign retail chains on the market today and they are likely to invest even more. The chains are racing for market shares. Possibly even more players will join the game in the near future. However, the number of players is very likely to decrease in time as the markets start to saturate and consolidation gets stronger. The saturation and consolidation will start from the Moscow markets, because it is ahead of the other cities and regions in the development.

2. Macro-economical indicators

What are the macro-economical indicators that affect the food retail market in a country? Firstly the number of inhabitants is important. Everybody has to eat something to survive. Secondly the level of income must be assessed, because the more money people the more they will spend. Because everybody needs food to survive, it can logically be concluded that the number of population and income level are the main determinants of the food retail market size. However, the food market size is not directly proportional to the income level or to the size of the retail market because the bigger one's disposable income is the smaller is the share of food from all purchases. Russia's development is similar (see table 2). It is a micro-economical fact that at certain point the demand for food reaches a saturation point when the marginal utility for one more item of food starts to decrease. Then the consumption shifts to other products i.e. non-food items and services. Of course, one cannot spend limitlessly on food. It does not make any sense. This is why also the standard of living must be taken into account when assessing the food retail market.

To assess the standard of living in a country, figures such as the GDP (gross domestic production) and average income level can and must be used, but these must be put into a right framework. The flipside of the coin must also be assessed because the price level determines what can be bought with a certain amount of currency. Thus PPP (purchasing power parity) adjustment is needed. Exchange rates and exchange rate policies affect the PPP figure and the price level of imported products. These will be discussed in more detail below.

2.1. Population and wages

According to Goskomstat there are approximately 144 million people living in Russia today, of which 73% live in urban areas. In the long run the population will be declining, however. This can be seen in figure 1, as forecasted by U.S. Bureau of the Census. The birth rates have experienced a fall after the Soviet days and in the long run the declining population will have a negative impact on the state and market size of the retail sector.

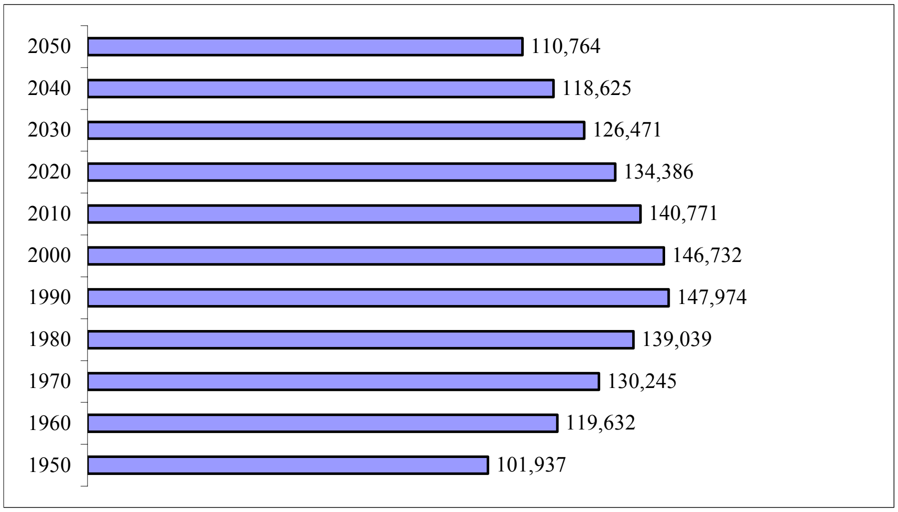

Figure 1. Population development in Russia (thousand people). Source: U.S. Bureau of the Census)

Because Russia is such a vast country and the share of urban population is high, one must always consider the concentration of population to different areas when assessing the total market of retail goods. About 10.5 million people live in Moscow city according to Goskomstat statistics (2003). In addition about 6.6 million people live in the Moscow region outside the city. St. Petersburg is the second-largest city in Russia and the population there is 4.7 million people. In the Leningrad region around St. Petersburg the number is 1.6 million. In addition to these two cities, there are 11 other cities in Russia that have a population of more than 1 million inhabitants. The differences in population, however, do not explain the whole difference in retail market size between different cities. The living standard and disposable income is much higher in Moscow than in other parts of the country, e.g. St. Petersburg (see table 3 and appendices 3 and 4). Thus there is a huge market potential for food retailers especially in the Moscow area. It is clear that Moscow is ahead of the regions in economic development. On the other hand the competition is stronger in Moscow than in the regions.

Table 1. Population in the biggest cities in Russia

Metropolises	Population (million)	Metropolises	Population (million)
Moscow	10.10	Kazan	1.11
St. Petersburg	4.67	Chelyabinsk	1.08
Novosibirsk	1.43	Rostov-na-Don	1.07
Nizhny Novgorod	1.31	Ufa	1.04
Yekaterinburg	1.29	Volgograd	1.01
Samara	1.16	Perm	1.00
Omsk	1.13		

Source: Goskomstat (2002)

The wages of Russians are growing nominally more than 20% annually (see tables 2 and 4 and appendices 3 and 4). The real growth is about 10%. This gives a good foundation to the retail market growth. Russians used 45.6% of their disposable income on food in 2004, albeit the figure is somewhat declining as the average wages are growing. In big cities the wages are higher and thus the share of food somewhat lower. Regional figures for the most important regions are presented in appendices 1 and 2.

Table 2. The development of spending in the food sector in Russia

	1998	1999	2000	2001	2002	2003	2004
The share of food of all retail spending (%)	47.0	48.2	46.5	46.2	46.6	46.3	45.6
Nominal wages (RUR/month)	1,051	1,523	2,223	3,240	4,360	5,509	6,828

Source: Goskomstat

In the Russian retail sector there is a “dual market”: a relatively thin new rich elite can afford almost everything they need, while a big part of the population is living below the subsistence level. In between, there is an emerging middle class. Table 3 presents the actual distribution of income and its development according to Goskomstat. It can clearly be seen that the group of people having a higher than RUR 4,000 monthly income is increasing rapidly. Thus it is fair to say that the middle class is growing fast and this mass of people is likely to consume more in the future.

Some experts say that 5% of the population has 80% of the country’s wealth and most of the wealth is in Moscow. In retail business this gives a good foundation for luxury chains. However, in order to get sufficient growth to survive on the market, the chains have to serve the masses.

Table 3. Distribution of income in Russia

	2001	2002	2003
Population, total (%) of which with average per capita monthly money income, RUR:	100	100	100
less than 1,000.0	12.4	6.6	3.3
1,000.1- 1,500.0	14.9	10.4	6.5
1,500.1-2,000.0	14.3	11.7	8.5
2,000.1-3,000.0	21.7	20.9	17.8
3,000.1-4,000.0	13.5	15.2	15.2
4,000.1-5,000.0	8.2	10.5	11.8
5,000.1-7,000.0	8.2	12.0	15.4
over 7,000.0	6.8	12.7	21.5

Source: Goskomstat

2.2. Economic development

Even though Russia's nominal GDP growth has shown very impressive figures in the recent years, the real growth of the economy has not been as significant. The high inflation distorts the nominal figures. However, the real growth has been clear; in 2003 7.3% and 2004 7.1%. The development of nominal and real GDP in 2000 prices can be seen in figure 2. The Russian economy has grown the recent years.

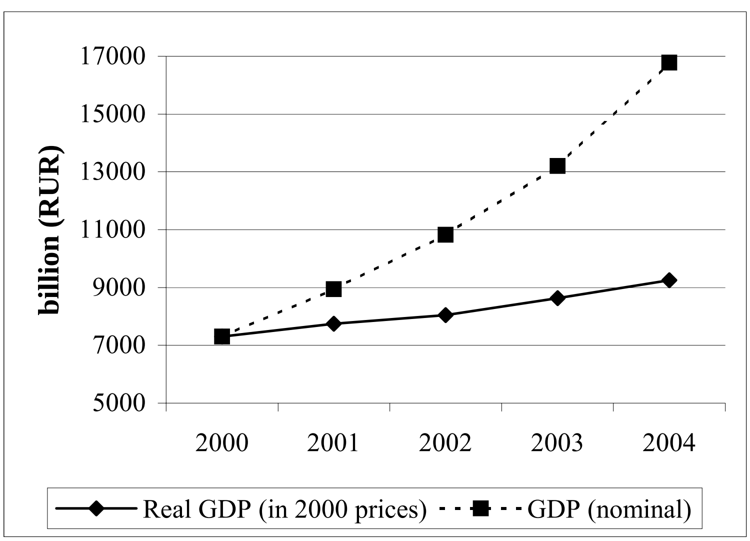

Figure 2. Nominal and real GDP growth. Source: Goskomstat

One of the most remarkable oddities of the Russian emerging market is the structural surplus in its current account (CA). In the last five years the annual CA surplus has on average been over 10% of the GDP. This means that Russia with its relatively modest living standard is a net exporter of capital.

Russia has a remarkable disequilibrium in its balance of trade (which is the most important component of the current account). In 2004 the total export in Russian visible trade was EUR 147.5 billion, while the total visible import was about half of that figure, EUR 76.3 billion. The difference between Russia's import expenditure and export income in its visible trade is striking.

Russia's current account (visible and invisible trade) had a surplus of some EUR 47 billion, which is just 10% of the GDP. This is a mirror image of Russia's net capital export: Russia finances the rest of the world with a capital injection of almost EUR 50 billion. This means that Russia could import about EUR 50 billion of goods and services a year more than it presently does without getting a penny more indebted against the outside world. Russia's total value of import is continuously below export value CA. Obviously Russia could correct this disequilibrium in its external bookkeeping easily by letting the currency to appreciate clearly.

Obviously one of the decisive background factors in the CA surpluses is the high price of oil, which in 2000 increased about threefold in comparison to 1999. In 2000, Russia's CA had a surplus equaling 18% of the GDP. In the following four years (2001-2004) the oil price was on high or very high level.

In the latter half of the year 2004 the economic growth was in decline with fourth-quarter growth of 4.5%. Thus the growth for the full year declined to 7.1% from 7.3% in 2003 according to Goskomstat. The appreciation of ruble along with political and other risk issues such as mini-crisis in the banking sector in the summer may have cost the economy part of the GDP growth, which was projected to 9.4% by EIU before. This was an estimate given the high price of oil, real effective exchange rate, the index of political stability and the inflation rate, which are the factors affecting the economic growth according to EIU (EIU, 2005, p. 7). Thus in the long run the economic growth is threatening to lag behind of president Putin's goal to double the economic growth in ten years. However, the growth of the retail sector is expected to outpace the economical growth as the new retail formats and rapid growth of income will instigate consumption.

Table 4 shows some economical indicators and the growth of the retail sector. It can be noticed that the growth of the retail sector is outpacing the real GDP growth. Inflation is still on a high level although it is gradually declining, but the wages are growing significantly more than the GDP. This causes permanent inflationary pressure on the economy.

Table 4. Economic development and retail trade in Russia

	1998	1999	2000	2001	2002	2003	2004
Nominal GDP growth compared to previous year (%)	12.3	83.4	51.5	22.4	21.0	22.0	27.1
Real GDP compared to previous year (%)	-5.3	6.4	10.0	5.1	4.7	7.3	7.1
Nominal wages growth compared to previous year (%)	-	45	46	46	35	26	24
Consumer price inflation	84.4	36.5	20.2	18.6	15.1	12.0	11.7
Retail trade in real terms compared to previous year (%)	-3.0	-6.0	9.0	11.0	9.0	8.0	12.1

Source: Goskomstat

In normal market economy with floating currency the exchange rate depreciates if the inflation exceeds the inflation of trade partner countries. The currency depreciates by the difference in inflation rates. Even though Russia has high inflation, the exchange of ruble did not depreciate nominally against euro in 2003-2004. The reason is that the Central Bank of Russia (CBR) regulates the supply of rubles on the market by buying and selling dollars and thus “artificially” manipulates the exchange rate. In fact, if the CBR would not regulate it at the moment, with ruble on the current level the ruble would appreciate despite of the high inflation, because the ruble is currently undervalued due to CBR’s interventions. This practice is so called exchange rate protectionism, with which Russia can support its domestic production by keeping the imports expensive and the exports very competitive.

The exchange rate policy used by Russia is called a “dirty” floating regime, which means that the exchange rate of the ruble is allowed to fluctuate only to a certain degree against a hard currency (US dollar) by the central bank. The exchange rate is, however, not fixed to certain accurate level as it was just before the crisis in 1998 when the exchange rate was allowed to fluctuate only +/-15%. This proved to be impossible to maintain due to the unrealistic fixed exchange rate. Today, with the currency reserves at record high level due to high oil prices, CBR can manipulate the external value of the Russian ruble against the US dollar fairly easily. Thus the ruble can be considered as a fairly stable currency at the moment. (Tiusanen, 2003, p. 29)

CBR regulates the exchange rate in order to keep it relatively stable and thus create a stable environment for investments. However, CBR has also another objective which is pursued by president Putin, and that is to restrain inflation. These two objectives are contradictory and cause uncertainty into conducting the monetary policy (EIU, 2004, p. 10). Russia is an export-oriented economy with its vast natural resources, and by keeping the exchange rate of the ruble undervalued it can make Russian exports relatively competitive. Thus exports are very profitable but the foreign money which is pouring into the economy causes inflationary pressure.

From the point of view of foreign countries exports to the Russian market are thus very clearly below expectations: Russia could potentially buy essentially more from the rest of the world than it actually does presently.

Exchange rate protectionism also erodes the productivity development of Russian industry because it does not motivate companies to do investments in better productivity. Thus stopping the managed floating regime would be harmful for Russian firms in short term, but in long term it would probably be a good thing because it would enhance the real competitiveness of Russian firms. Standard & Poor's sees that the current exchange rate policy is not even sustainable and Russia needs to move forward to real exchange rate policy without heavy interventions to the exchange rate. This would force the Russian industry to restructure itself in order to cope with competition. (Standard & Poor's, 2005) Actually Russia's Prime Minister Mihail Fradkov announced in a conference in Stuttgart in mid-October 2004 that the interference of the CBR in the exchange rate of ruble would be given up in the beginning of 2007. If this happens the ruble will float freely (SVKK, 2004, p. 7).

However, analysts consider that ending of exchange rate protectionism would have a small or no effect at all on the retail market. Some imported goods may become a bit cheaper for consumers as the ruble appreciates but on the general level it does not make a big difference for the retailers.

2.3. Purchasing Power Parity and Exchange Rate Deviation Index

It is a commonly known fact that the real purchasing power of a currency or the standard of living cannot be estimated only with figures of the GDP at official exchange rates. The conversion into a hard currency (for example to USD or EUR) has biases. Purchasing power parity (PPP) rates are used for the measurement of the real purchasing power of a currency. The total cost of an average “basket” of goods and services in a country serves as the basis for comparison of the different countries’ currencies. PPP provides a view to what each currency can buy in real terms, providing an “alternate” exchange rate. Thus, an “alternate” GDP figure can be calculated. The Vienna Institute for International Economic Studies (WIIW) is obviously the best source of statistics linked with transitional economies (TEs).

Table 5. Nominal and PPP adjusted GDP per capita and ERDI (Euro –based) in 2003

	A	**B**	**B/A**
	GDP nominal	**GDP at PPP**	**ERDI**
Slovenia	12,407	16,874	1.36
Estonia	5,520	10,322	1.87
Hungary	7,140	13,423	1.88
Czech Republic	7,214	14,211	1.97
Poland	4,801	10,227	2.13
Slovakia	5,524	12,098	2.19
Lithuania	4,592	10,287	2.24
Latvia	3,874	9,219	2.38
Russia	**2,680**	**7,830**	**2.92**
Bulgaria	2,292	6,898	3.01
Romania	2,286	6,926	3.03
Greece		17,846	
EU-average (15)		24,279	

Source: WIIW

It can be seen in table 5 that there are biases caused by official exchange rates in different European transition economies. The different price levels of the countries have been taken into account in an imperfect manner. The GDP figures with PPP adjustment allow a standard comparison of real price levels and living standard between countries.

When the GDP figures at the PPP rate (B-figures) are divided by the original nominal figures (A-figures), an ERDI figure (Exchange rate deviation index) is obtained. ERDI values reflect differences in relative prices. If the ERDI of one country equals 2, the EU (15) has an average price level twice as high as in the country in question. Thus, twice as much goods can be bought with the same amount of money than in EU. ERDI value of Russia in the above table is 2.92. It indicates that the price level of Russia is roughly a third of that of the EU (15) average. (Tiusanen et al., 2004, pp. 14-15)

From the perspective of customers in the retailing business this means that in 2003 one could buy a consumer basket worth EUR 100 in every euro-country while the same consumer basket could be bought with one third of the sum in Russia. Of course, this applies mainly to domestic products since the imported goods are relatively more expensive. This must be taken into account when considering business opportunities of retailing and food producing in Russia.

According to WIIW, Russian ERDI was 2.54 in 2004. The previous figure for 2003 was revised from 2.92 to 2.85 in the same context. The same source mentions that Russian export increased by 22.6% in 2004 amid high oil prices. Even if the Russian ERDI value shows a decreasing tendency, it still has a rather high value, indicating that the ruble is very clearly undervalued. Therefore it can be stated that the undervaluation of the Russian currency permanently offers a clear financial incentive to invest in import-substituting activities. The same can be stated in a different form: imported foodstuffs face a strong “exchange rate protectionism”. In this context it is important to note that the WIIW figures quoted here are euro-based.

Russia’s ERDI has not an extreme value among the TEs. Ukraine’s ERDI had a very high value of 5.66 in 2004. The equivalent figure in Belarus was 3.37 and in Poland 2.07. These three TEs have long tradition of exporting agricultural products and foodstuffs to Russia (in the Soviet and also post-Soviet period). Ukraine has an extreme undervaluation of its currency: the ERDI value is more than double the Russian figure, which gives a huge competitive advantage. Belarus has also an advantage in the Russian market. The Polish ERDI is lower than that of Russia but in the euro-area comparison Poland’s exports to the Russian market are favored by the undervaluation of the zloty (Polish currency).

Wimm-Bill-Dann, the leading manufacturer of dairy and juice products in Russia, has invested in Ukrainian production units. The company has obviously started an internationalization drive in which it is looking for cost savings. Metro (Germany) has large-scale operations in Poland and Ukraine. It can be assumed that this retailing giant is seeking cheap producers for its own (private) label products in several TEs. Obviously, the relative ERDI values linked with price competitiveness are carefully taken into consideration in this context.

According to WIIW, private consumption increased by 11.3% in 2004 in real terms in Russia, while its GDP grew in real terms by 7.1%. Thus, consumption increased overproportionately, making the market very attractive from retailers’ point of view.

Russia's overall ERDI figure does not take different regions and their development into account, however. In Russia the differences between cities and regions are quite remarkable. For example the wage level in Moscow is higher than in the regions and the price level is in general higher as well. The price level is higher in some parts of Russia, such as Siberia and Kamtshatka, than in Moscow but it is due to a shortage of goods, not due to higher wages.

Due to the relatively low level of prices and wages it would be sensible for foreign food producers to invest in Russia and establish production of their own there. The market is growing all the time and the value of investments will grow along with it. Also in order to get a good position at decent market shares, tight involvement is needed. There are also other factors connected to consumer preferences that support the idea of domestic production, but they will be discussed further on.

2.4. Taxation

The government is doing its best to increase the consumption and fight the gray economy. Recently it lowered the VAT (value added tax) by 2 percentage points to 18% and totally abolished the 5% sales tax. The Russian minister of economic development and trade commented to Interfax in January 2004 as follows: "*A reduction of prices following the abolition of sales tax was not our aim. It was a promise made by the traders. The purpose of abolishing the tax was to make the retail sector more appealing by bolstering its working capital. We are reducing taxes, and the trade networks for their part ought to battle with the gray market and invest as much as possible in Russia.*" (Gateway to Russia, 2004a)

Retailers thus promised to lower their prices with that 5% to put pressure on the decision makers and to present goodwill to the state officials. Clearly the retail chains wanted the changes to happen because they want to get rid of the open markets that still exercise gray economy and thus keep the prices down. The retailers are also eager to catch the open markets' market shares. This indicates that the gray economy is still a problem in Russia.

The government is planning to lower the VAT even further. Even a 13% VAT level has been proposed. (Gateway to Russia, 2005) If this were to happen it would surely boost spending, and the market for retail goods would grow.

3. Russia's retail sector: structure and present state

In order to have a clear perspective of the Russian retail sector today and in the future it is necessary to have a quick look into the past. After the collapse of the Soviet Union in the beginning of the 90's a huge market privatization process took place. This had also a major impact on Russia's retail sector. Formerly state owned small shop outlets were transferred to private ownership, which left the whole sector very fragmented. The Soviet era left behind a large number of independent shops that were all free to choose their product range and sources of supply. Alongside with the shops there was a network of privately owned street kiosks that were selling almost everything from pet food to compact discs. (Martin, 1997, pp. 147-148)

Because of the centralized planning of grocery production and supply chains there was a substantial deficit of goods in the stores. In fact, the total number of stores was inadequate. Thus the retail trade dispersed to outdoor markets, kiosks and to the street. The Russian retail sector has been booming after the market liberalization in 1991. However, the best part of this turnover was never recorded because it was carried out through unorganized market players, which are fairly reluctant taxpayers.

In the 1998 the economic and currency crisis hit Russia and the Russian ruble was devaluated to such a low level that all imports became highly expensive for the Russians. The external value of the ruble was downgraded to roughly one fourth of what it was. Imports collapsed (see figures 3 and 4). Due to the high price of imported foodstuffs the domestic production remained as the only alternative of buying food. For importers the devaluation meant a considerable decrease of profitability because the imported goods became too expensive for average customers. Thus, the demand was shifted from imported goods to domestic ones. Despite of the recent development, the Russian retail market still remains very fragmented, although the development is fast.

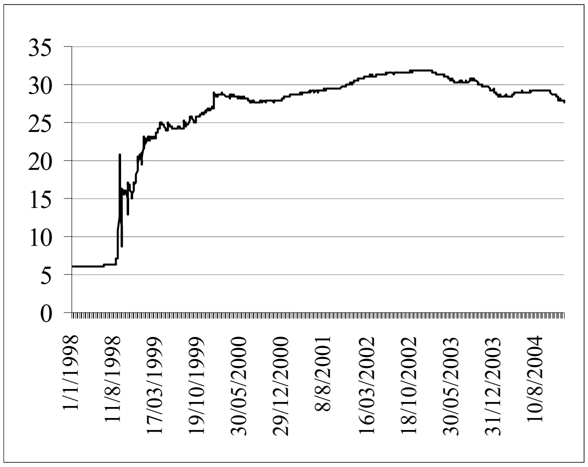

Figure 3. Development of the Russian ruble against the USD. Source: CBR

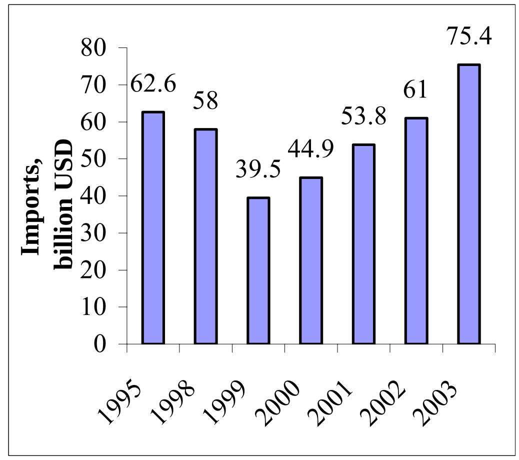

Figure 4. Development of imports in Russia. Source: Goskomstat

Figure 5 shows the official development of the Russian retail sector. It has been booming for quite some time already, in fact since the economic crisis in 1998. It can also be seen that the Russians use roughly half of their household expenditures of retail goods on food. The share of food is much higher than in Western countries. The official figure for the whole Russian retail market size in 2004 was ca. USD 193 billion but analysts think that the figure might be 20-25 % bigger since there is still gray market trade, which is unrecorded.

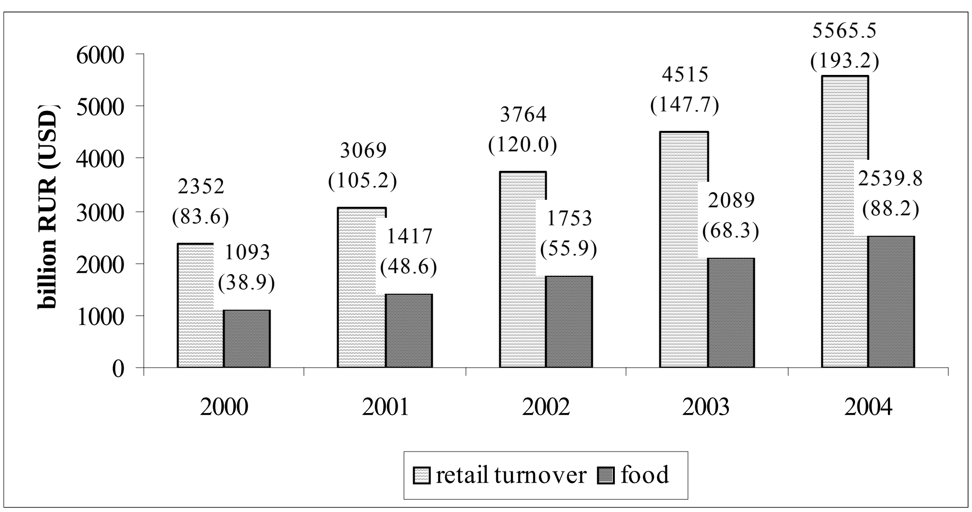

Figure 5. The development of the Russian retail sector in terms of turnover. Source: Goskomstat, (exchange rates from CBR)

The share of food of total consumption is declining (see also table 3), although it is still very high compared to western countries. As the purchasing power grows, the consumption shifts to non-food items. In the year 2004 the share was 45.6% and a year before it was 46.3%.

The distribution of the Russian retail trade and its development in recent years can be seen in table 6 and figure 6. Other products in the table comprises many small groups whose shares are quite insignificant on their own. They are: flours, groats, pasta products, potatoes, vegetables, fruits, berries, grapes, eggs, sugar, and tea.

Table 6. Structure and growth development of retail trade turnover (billion USD)

	2000	YoY*	2001	YoY	2002	YoY	2003	YoY
All goods	83.6	30.9%	105.2	25.8%	120	14.1%	147.7	23.1%
of which foodstuffs	38.9	26.2%	48.6	24.9%	55.9	15.0%	68.3	22.2%
Meat and its products	3.8	25.8%	5.4	40.4%	6.2	15.9%	7.1	14.5%
Fish and its products	1.0	30.9%	1.3	24.8%	1.3	6.3%	1.6	17.2%
Fat products (butter, margarine, oils)	0.9	0.3%	1.0	14.6%	1.1	9.8%	1.4	22.3%
Whole milk diary products and cheese	1.6	30.9%	1.9	24.4%	2.1	9.3%	2.5	19.3%
Confectionery	1.1	22.4%	1.4	20.4%	1.5	11.0%	1.8	21.9%
Alcoholic beverages	3.54	33.8%	4.4	24.9%	5.2	17.6%	7.1	36.5%
Bread and bakery products	1.5	30.9%	1.7	11.5%	1.7	1.8%	1.9	13.7%
Other	3.5	19.0%	4.0	15.1%	4.6	13.6%	5.5	20.7%

*growth figures in year 2000 are calculated in ruble terms because of the shifting exchange rate

Source: Goskomstat, (exchange rates from CBR)

Clearly the biggest groups are meat products and alcoholic beverages. It can also be seen that the group of alcoholic beverages has grown the most. Also the share of meat from all spending has increased although the confectionery, dairy and fat products had a bigger growth in 2003 compared to the previous year.

The growth of meat products is restrained by their price growth due to a meat supply crisis, which started in 2004. The government tried to hinder low cost imports and thus support the domestic meat industry by ordering import quotas for meat. This has led to serious shortages in domestic supply. (Foodqualitynews.com, 2004)

Beer is presently competing with vodka, the traditional Russian drink. As a result of this competition the overall consumption of alcoholic beverages has increased strongly. In fact, beer has replaced vodka as the favorite alcoholic beverage (The Union of Russian Brewers, 2004).

According to Ernst & Young the growth of alcoholic beverages will continue. Increased demand is also predicted for instant soups, spices, salad dressings, coffee and tea. Especially strong growth is expected for fish and shellfish products while baby food, juices and non-alcoholic beverages are the least growing groups. (Spiridovitsh, 2004c)

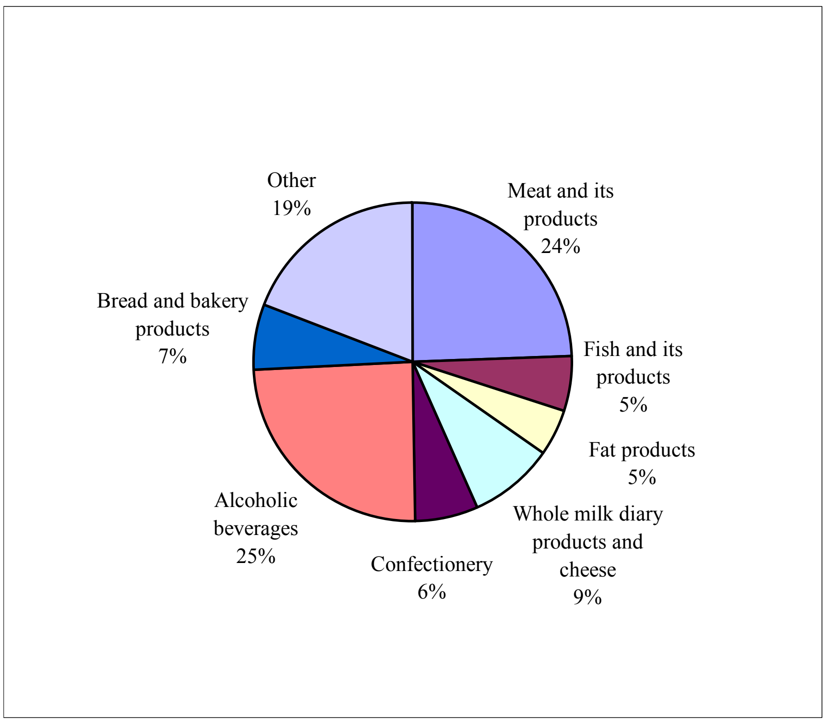

Figure 6. Structure of food retail trade by turnover in 2003. Source: Goskomstat

The changes between different product groups have been fairly insignificant. The whole retail sector is growing regardless of product groups. Because the real growth of the retail sector is so clear and the share of expenditures on food of all spending is fairly stable, it can be maintained that the consumption is evidently shifting to products with better quality and value. People cannot eat limitlessly even though some groups of people might increase their eating as well. Finpro backs the author’s assumptions (Spiridovitsh, 2004c). Thus the prospects for food manufacturers in every product group are good.

4. Regions

Regional differences are actually quite big in the retail business. Due to the great geographical distances and huge differences in the market size the Russian retail sector cannot be considered as only one market. Especially Moscow is a special case. The differences are partly explained with the size of the population and partly with the higher income level. Figure 7 presents the difference of retail trade in Moscow, Moscow region and St. Petersburg. The retail market sizes of other regions are available in appendices 1 and 2. It must be noticed that the market in Moscow region is expanding very rapidly in the suction of Moscow city (see table 7). For example St. Petersburg is falling behind and is less than 15 % of the Moscow city markets.

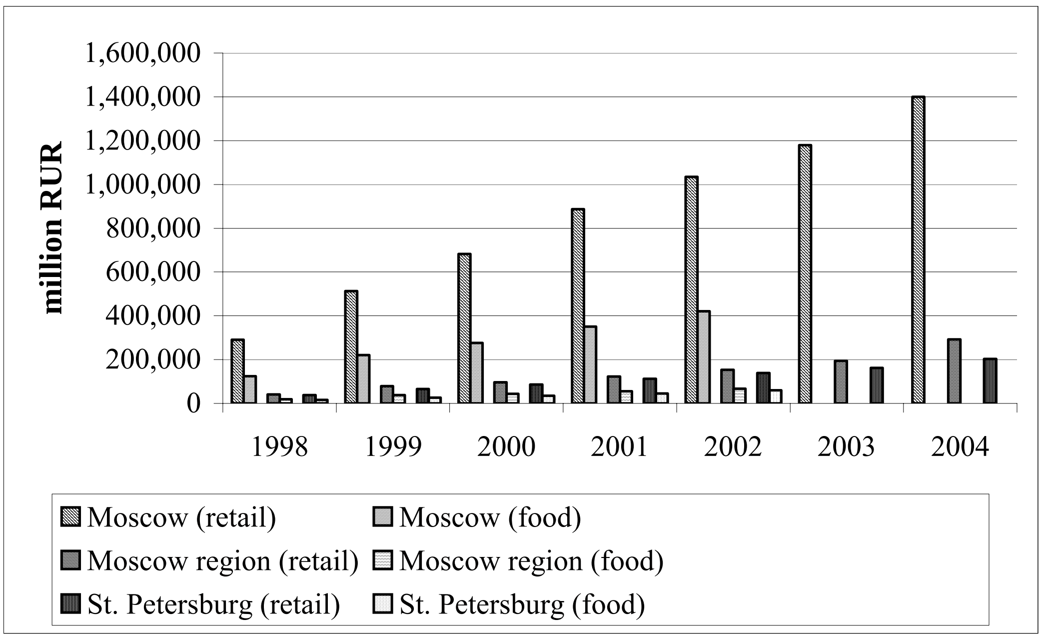

Figure 7. Retail and food retail market size in different regions. Source: Goskomstat (no statistics available for the food retail 2003 and 2004)

The growth of the retail sector has been strongest in Moscow. However, the growth is escalating in other regions. The growth figures have started to be higher there than in Moscow in relative terms. (Foodproductiondaily.com, 2004)

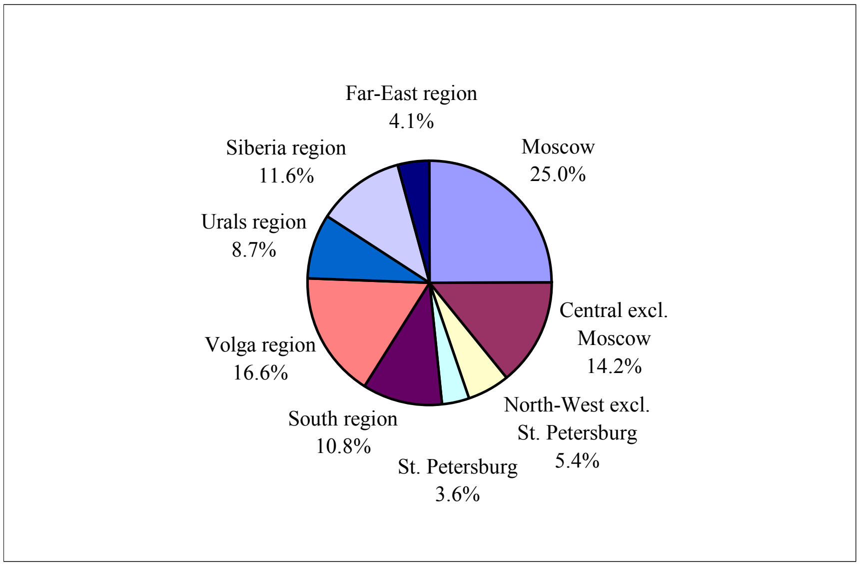

Figure 8. Distribution of retail trade in Russia in 2004. Source: Goskomstat

There are big differences in retailing between the different regions in Russia, and as can be seen in figures 7 and 8, Moscow stands out. Because of the great geographical distances Moscow has to be considered as a market of its own. However, the Moscow region can be included in the same market because it is also growing rapidly in the slipstream of the capital, and the retail chains are expanding their operations to the Moscow region especially with the hypermarket retail format.

Roughly a fourth of all retail trade in Russia is done in Moscow city alone. At the moment the retail market in Moscow is growing about by 8-9% annually. Also the Moscow region is growing in the drive of the capital, showing even bigger relative growth rates, 36 % in 2004. In monetary terms the growth was still larger in Moscow city and its share of the whole market in 2004 was 25%. The share is diminishing a little more than 1 percentage point yearly, however, as in 2003 the share was 26-27% and in 2000 it was 29%.

Table 7. Retail trade, price growth and wages in 2004

	Moscow city	Moscow region	St. Petersburg	Leningrad region	Russia in general
Retail turnover (billion RUR)	1,400.0	292.0	203.0	38.0	5,565.5
Growth of the turnover (in real terms compared to the same time in 2003)	8.3%	37.9%	13.9%	12.1%	12.1%
Growth of consumer prices of which	11.5%	12.3%	12.7%	14.9%	11.7%
- food price growth	10.6%	11.2%	12.7%	14.7%	12.3%
- other products	8.1%	9.6%	8.2%	9.4%	7.4%
- payable services	19.3%	19.5%	20.7%	25.7%	17.7%
Average nominal wages (RUR)	10,934	7,897	8,625	7,052	6,828
Growth (November 04 compared to November 03)	20.1%	22.1%	20.0%	17.7%	24.0%

Source: Goskomstat

It can be seen in the table 7 that the consumer prices of food have been increasing at about the same pace as the inflation rate in Russia in 2004, which was 11.7% (12% in 2003). At the same time the average nominal wages of people are increasing by more than 20% annually. As it can be seen from the general figure in Russia the rate of food price growth generally is roughly on the same level as inflation. The figures indicate also that either the food consumption in unit level is increasing more than the turnovers in real terms and/or the consumption pattern is shifting to more expensive goods in the mentioned cities and regions. This is because the food retail sector has grown nominally clearly more than the inflation rate, but the share of food of all retail trade still remains very high at 45.6% (see table 2).

As shown by table 7, there are big differences between regions in average wages. Moscow is number one again, having about 30% higher wages than St. Petersburg but even this difference is quite small when the figures are compared with the other less developed regions. Thus Moscow and the Moscow region clearly provide the greatest potential for retailers. Even though Muscovites use only 41% (in 2002) or less of their disposable income on food compared to the average of 45.6%, the market is still huge. In addition to that the wages are growing annually by more than 20% in nominal terms, which exceeds the inflation rate clearly. Thus the growth of the wages in real terms was 10.9% in Russia in 2004.

But even though the level of wages is highest in Moscow, it is still rather modest compared to those in the western world. The average salary of approximately EUR 280 per month is not much although the price level is only 39% of the western world. The figure also includes the extremely rich Russians, most of whom live in Moscow. Also the price level is somewhat higher in Moscow than in the other regions. These factors cause some “distortion” to the figure of income and purchasing power. However, it must be kept in mind that Goskomstat’s statistics are based on official records and the amount of gray economy included in them might not quite correspond with the reality. So, in fact, the income figures do not reflect the reality perfectly well. However, trends and tendencies can be seen in them.

Even though the wages are lower in the regions than in Moscow the retail chains are expanding their operations to the regions. Rostov-na-Don, Samara, St. Petersburg and Yekaterinburg are for example popular cities to expand to. Every chain is expanding because the growth opportunities are better in the regions. It is also of great benefit to be among the first in the regional market where the competition will intensify in the future. Competition in Moscow is harder even though the market in Moscow has not saturated yet. The regional expansion will be discussed more thoroughly below.

5. Store formats

The modern retail formats have not penetrated the market very efficiently yet. Depending on the source they accounted for only 15-18 % of the total retail trade in 2003 (see figures 9 and 10). The share of modern retail business has been growing every year and it will continue to do so, although all store formats fight for the customers they have. Competition is, however, at a relatively low level.

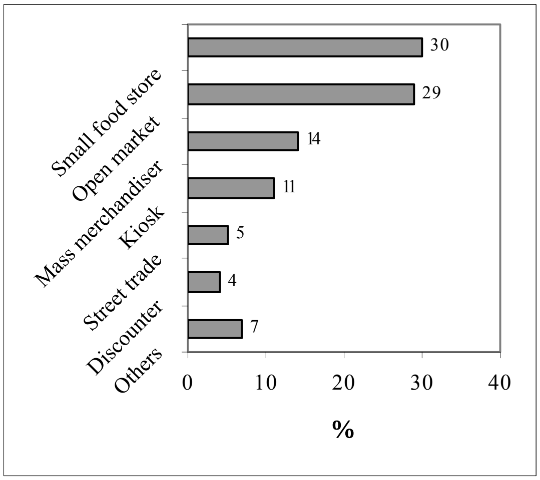

Figure 9. Retail trade by outlet types in Russia in 2003. Source: Finpro (GFK)

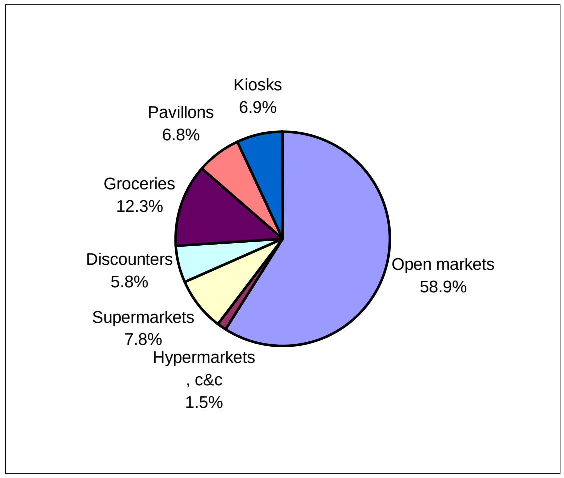

Figure 10. Retail trade by outlet types in biggest cities in 2003 (population over 1 mln). Source: UFG

According to AC Nielsen's research referred to by UFG (2005), store location close to home and the easiness of getting there are the most important factors when choosing the place where to do shopping. According to the same research, low price in most products is not the most decisive factor even though it has some significance. The customers also seem to want a wide range of quality products and brands. Even good value for money is more important than low price, which confirms the fact that the consumption is shifting towards better quality products.

In the author's opinion this might be emphasized by the fact that there are not modern stores in every street corner, not even in Moscow. Figures 9 and 10 give an overview of the distribution of the retail trade by retail format in Russia and figure 11 of the situation in Moscow.

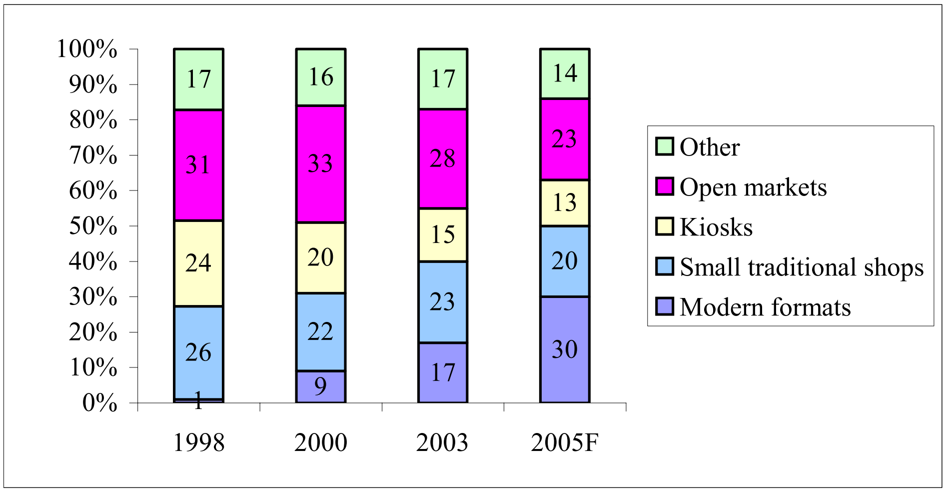

Figure 11. Distribution of retail formats in Moscow. Source: IRG

The retail chains are growing faster than the whole sector, which means that the chains are gaining market share. The chains are growing faster than the purchasing power of consumers and thus they are gaining market share from open markets and independent groceries (see figures 11, 12 and 13).

It can also be seen in the figures that the discounters were in their prime in 2003 and they accounted for most of the growth of the largest chains, as hypermarkets started to emerge and expand rapidly in 2004. Multi-format chains have steady growth figures. In 2004 the independent growth of the largest chains accounted for over USD 1 billion.

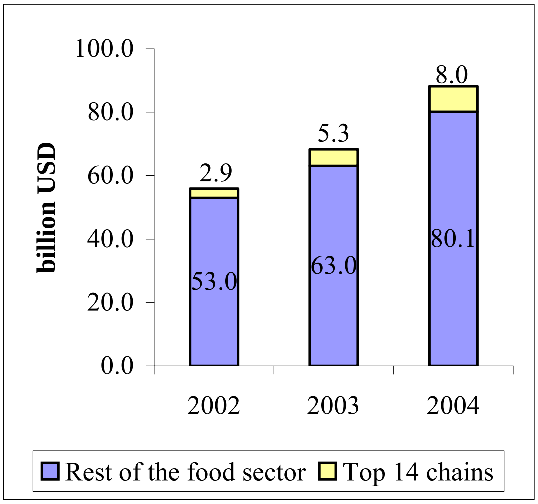

Figure 12. The share of largest chains' growth of the total. Source: Renaissance Capital data

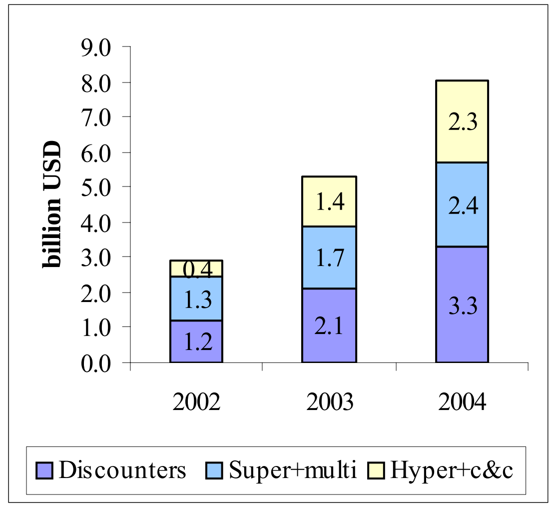

Figure 13. Growth and distribution of the largest retail chains' formats. Source: Renaissance Capital data

The modern retail formats can be categorized in 5 different groups; discounters, convenience stores, supermarkets, hypermarkets, and cash & carry hypermarkets. The formats operated by the leading chains can be seen in the table below. The definitions based on retail formats' floor area are somewhat shaky because different sources call some chains' formats differently. However, the table gives a general idea of what kind of shops are in question.

Table 8. Key players and their store formats

	Discounters	**Convenience stores**	**Supermarkets**	**Hypermarkets, cash & carry**
Size (sq. meters)	**150-1000**	**150-1000**	**1000-4000**	**>5000**
Pyaterochka	X			X
Metro				X
Perekrestok		X	X	X
Tander (Krasnodar)	X			
Auchan				X
Seventh Continent		X	X	(X) spring 2005
Ramstore			X	X
Kopeika	X		X	
Diksi (St. Petersburg)	X			
Lenta (St. Petersburg)				X
Paterson		X (supermarkets)		
SPAR (Billa)			X	
Mosmart				X
O'Key				X

Source: Finpro, company websites, IRG, interviews

Open markets and kiosks

The most common formats of retail in Russia are still open markets and kiosks. A range of different products can still be found even from the streets of Moscow, even though the capital is a special case with 30% of the total retail trade modern and 23% covered by the open markets, according to Thain (2004) (see figure 11).

Open markets have been a phenomenon of especially large cities. The greater the population, the larger is the share of this retail format. The share of open markets has diminished remarkably in Moscow in the development. Even though Moscow again is a special case with diminishing share of open markets, the share of open markets still exceeded 59 % of all retail trade in Russia's cities with population more than 1 million in 2003.

The price level is low on the open markets, but that is also due to the fact that many traders do not pay taxes. The traders on open markets rather pay the authorities and officials who do the check-ups than pay taxes. Not only are the open market traders bad taxpayers but they are also accused of selling counterfeit products and unauthorized imported goods with reduced prices, thus biasing the market signals towards the customers. (Radaev, 2004, p.6)

The retail chains as a whole possess obvious competitive advantages to off-store vending. The stores provide more comfort and a wide range of services for the customers. They guarantee that the goods are properly certified and accept reclamations from clients. Stores provide also card-based loyalty schemes and some of them even organize transportation of goods. The employees can give expert advice to the customers. The modern retail formats are pushing the open markets aside but the process has been surprisingly slow so far. The open markets still attract customers with their low prices. Thus, the modern retailers are demanding the state to intervene because it is clear that the share of open markets will not diminish with traditional competitive operations.
(Radaev, 2004. pp. 6-7)

Moscow city government has done its fair share in getting rid of the open markets by conducting several administrative attacks against them because it prefers to support modern retail formats rather than open markets in hope for greater tax revenues (Radaev, 2004, p. 7). According to Colliers, referred by UFG, there were 120 open markets in Moscow in 2004. They were expected to diminish to 110 by the end of the year due to government actions and remain stable till 2007. A bigger fall in the number of open markets was in 2002 when the total number diminished from ca. 230 to ca. 170 open markets. (UFG, 2005)

In medium term the open markets will lose their significance in the food sector if similar hygiene regulations are pursued in Russia than in the rest of the former Eastern Europe, i.e. new EU members. These kinds of regulations restrict the food business of open markets, and eventually the regulations will support the retail chains.

Discounters, convenience stores and small independent shops

The present author considers discounters and convenience stores more or less the same thing. There is a fine line between them, which sometimes is not very clear. They compete on the same market for the same customers and their average floor space is fairly similar. In fact, small supermarkets correspond to large discounters by size, for instance Paterson's supermarkets. Thus the borderlines are quite blurred and there are differences in classifications presented by different sources. Logically thinking the difference should lie in prices and assortments, but then it is hard to tell what the difference between a convenience store and a supermarket is. Nevertheless, independent shops must also be considered as rivals for these retail formats. The key to success of the modern formats (including supermarkets) is providing customers retail outlets which are conveniently near the customers, e.g. in residential areas and they are easy to get to.

Discounters developed during the financial crisis of 1998 and the largest representatives of this retail format are Pyaterochka, Kopeyka, Diksi and Tander with its Magnit stores. The average store size is still very small (e.g. Pyaterochka 650 and Kopeyka 1,000 sq. meters) but the size of new stores is growing. For example Pyaterochka's new outlets are approximately 1,100 sq meters in size. This exceeds Paterson's and Seventh Continent's average store sizes.

Discounters seem to be the most promising of these retail formats at the moment, but there is also room in the convenience store sector as the purchasing power of the consumers continues to grow. At the moment there is a demand for convenience stores, but the ridiculously high rents and prices of the real estate slow down the growth. However, in the future the convenience stores will get more market share with the expense of the open markets. This will be a slow but organic process.

The author sees that the success of discounters is hugely dependent on the right product and brand choices in their assortment in the areas where there are other shops as well, because discounters have a narrower product range than supermarkets and convenience stores. But if one can find everything needed in discounters, there is no need to visit a supermarket or a convenience store to pay more for the same products. Of course, if there is only one store nearby it does not make any difference whether it is a discounter or a convenience store unless the customer's upper class prestige is in jeopardy.

The strength of the discounter format is that it does not take much capital to open one. For this reason it is also easy to franchise and thus get profits for even less money. Franchising offers the chains a possibility to expand their store networks with very small input. If the franchised business is looking good and profitable there is also a chance to redeem the stores to the chain.

Another strength of convenience stores at this point is that there are a lot of independent shops in Russia which can be fairly easily integrated to a large chains' network of convenience stores. However, as the independent shops are not standardized in any particular form the foreign players do not have much interest in them. This might be an advantage to domestic retailers. This matter will be discussed more thoroughly below.

Supermarkets

The first supermarkets emerged in Russia in the early 90's, pioneered by Seventh Continent and Perekrestok. According to UFG (2005) there were ca. 1,300 supermarkets in Russia in mid-2004, of which only a couple of hundred were operated by the top 14 retail chains. The average selling space of supermarkets is 630 sq. meters and the assortment varies from 10,000 to 30,000 products, 70% of which are food items. The modern retail boom started with supermarkets, but at the moment, the growth of this format is slower than that of discounters in terms of turnover. The recent boom in the hypermarket segment will also put this format to the test. Excluding Paterson, no chain is concentrated only on supermarkets and even Paterson's supermarkets are small and comparable to discounters in that sense. In 2004 the leading multi-format chains managed to slightly outpace the growth of the leading discounters but considering the growth in the last two years the multi-format chains are clearly lagging behind. Also with hypermarket segment booming, a part of the growth of multi-format chains has evidently come from hypermarkets. However, in monetary terms the discounters grew more in 2004 because they had already achieved the size of the multi-format segment due to Pyaterochka's huge success. According to

Renaissance Capital, the supermarket chains in Moscow compete mainly on the basis of location, prices, product quality and variety, service and store condition. Thus, supermarkets have to compete against discounters and convenience stores and thus they have to position themselves to upper-scale market providing a wide assortment and service. That is not serving masses.

Hypermarkets and cash & carry

Hypermarkets and cash & carry outlets resemble each other in many ways. The average floor space for them is ca. 9,000 sq. meters, but the average floor space is increasing as new hypermarkets arise because the store sizes are growing in all segments. The assortment of these outlets is ca. 40,000 products, of which 60 % is food (UFG, 2005). They are very efficient in generating turnover (especially Auchan) but suffer from the lack of good construction sites for new ones at least in Moscow and partly also in St. Petersburg.

The difference between hypermarkets and the cash & carry format is that cash & carry outlets also acts as wholesalers for small businesses. In fact, Metro Cash & Carry is targeted solely for business clients, but truthfully it is quite easy to get the customer card which is needed to do shopping in Metro. Hypermarkets often provide services such as cinema, restaurants etc. depending of course on the size of the building. The first company to introduce the hypermarket format was Auchan in 2002. Other major players operating either one of these retail formats are Lenta, Ramstore, O'Key, Mosmart, Perekrestok, Marktkauf and the already mentioned Metro. In December 2004 Pyaterochka opened its first hypermarket under the name of Karusel in St. Petersburg and has plans for further 100 hypermarkets. Seventh Continent also plans to open a hypermarket of its own in the near future. O'Key has announced an objective of opening 30 hypermarkets nationwide. Mosmart has plans to build 100 hypermarkets all around Russia. Metro has plans to open 20 Rewe hypermarkets in a couple of years. Auchan doubled the number of its hypermarkets in 2004 to 6. Ramstore is doing its fair share of building new hypermarkets as well. German Marktkauf is planning to increase its number of hypermarkets to 10 till the end of 2006 or 2007 (MMR, 2003). Thus, the hypermarket segment is booming at the moment.

In fact, it is very sensible for the leading chains to build hypermarkets because it is a segment with a low level of competition. Only the leading companies have them. They are more efficient in generating turnover than any other format, due to their size. Building a hypermarket requires significant investments, however; the largest hypermarket investments can exceed USD 20 million. Thus, capital must be available to reach high turnover.

Shopping centers and malls

A new wave of retailing has begun as the store outlets become bigger and better. Recently, building of huge shopping centers and malls has started. Ramstore was the first retail chain that built a whole shopping center with cinemas and restaurants, cafés etc. It has been followed by Ikea which already has built two big malls named Mega I and Mega II. Because the Ikea Group could not find an existing regional mall project to anchor, it built its own. Mega I is an approximately 93,000 square meter mall in Moscow, but Mega II is already a 195,000 sq. meter mall. Ikea is expected to build two more stores in Moscow within five years and is striving for a total of 22 in Russia by 2020. (Bodamer, 2004)

There have, however, been some problems. The opening ceremonies of Mega II were interrupted twice by the authorities. The official explanation was that the road leading to the mall was built on a gas pipe. Eventually the mall got opened in the turn of the year 2005. Along with Auchan, the Finnish Stockmann is also present there with about 14,000 sq. meters of floor space (Cushman & Wakefield, Healey & Baker, 2004). The German Marktkauf opened a shopping center to back the operations to its first 8,000 sq. meter hypermarket in Moscow in February 2003 (AVA, 2003). Paterson has also opened a shopping center of its own in the Moscow region. It has 8,000 sq. meters of retail space, of which 1,000 sq. meters is occupied by the Paterson supermarket. (Retail.ru, 2004b) It seems that the retail chains have found a new way to establish stores. They are involved in establishing of shopping centers in which they take exclusive rights for food retail on the premises.

In fact, the biggest hypermarkets such as Mosmart start to resemble shopping centers because there are also additional shops such as book and clothing stores, restaurants and cafés in the same building.

6. Key players on the market

The author chose 14 largest retail chains under deeper evaluation in his research, because among them are the most probable survivors when consolidation starts. In order to assess the performance of companies and evaluate their chances, some historical data must be examined. Table 8 shows the size and development of the top retail companies.

Table 8. The largest players on the market (in million USD)

	2004E	YoY	2003	YoY	2002	YoY	2001	YoY	2000
Pyaterochka (combined)	1,425	50%	950	90%	500	136%	212	183%	75
Metro	1,059	61%	658	101%	328				
Perekrestok	771	72%	448	32%	339	35%	252	53%	165
Pyaterochka (Moscow only)	741	93%	384	54%	250	136%	106	83%	58
Tander (Krasnodar)	894	45%	617	89%	327	54%	213		
Auchan	640	61%	398						
Seventh Continent	600	46%	412	37%	301	54%	196	51%	130
Ramstore	550	22%	451	51%	298	54%	193	48%	130
Kopeyka	518	97%	263	45%	182	57%	116	93%	60
Diksi (St. Petersburg)	490	60%	306	49%	206	94%	106		
Lenta (St. Petersburg)	476	55%	307	207%	100				
Paterson	280	100%	140	65%	85	113%	40	48%	27
SPAR	180	88%	96	20%	80	33%	60		
Mosmart	160	129%	70						
Petrovsky (acquired by Seventh Continent in 2004)	N/av		145	24%	117	17%	100	72%	58
Prodmak	N/av		48	20%	40	14%	35		
Total large chains	8,043	52%	5,308	83%	2,902	91%	1,523	136%	645
Total large chains (ex. Metro)	6,984	50%	4,650	81%	2,574	69%	1,523	136%	645
Total large chains in Moscow	5,499	57%	3,512	74%	2,019	84%	1,098	75%	628
Total large chains in Moscow (ex. Metro)	4,440	56%	2,854	69%	1,691	54%	1,098	75%	628
Russia's Total Food Retail, USD billion	88	29%	68	23%	55	15%	48	26%	38
Total Large Chains as % of Russia's Food Retail	9.2%		7.8%		5.3%		3.2%		1.7%
Total Moscow Large Chains as % of Moscow Food Retail	27.3%		22.2%		14.9%		9.0%		5.9%

Source: Renaissance Capital

There is a number of different strategies on the market, which will be discussed in chapters 7 and 8, but there is one trend that the author would like to point out right away. That is how the chains have priced themselves, because there are two groups that can be identified. The reader should keep in mind that the figures are merely based on people's perceptions of quality and price. The results are only approximations and do not reflect the absolute truth. E.g. the perceptions of quality varied a lot among the interviewees. Despite of this, the figure 14 gives an idea of the situation on the market.

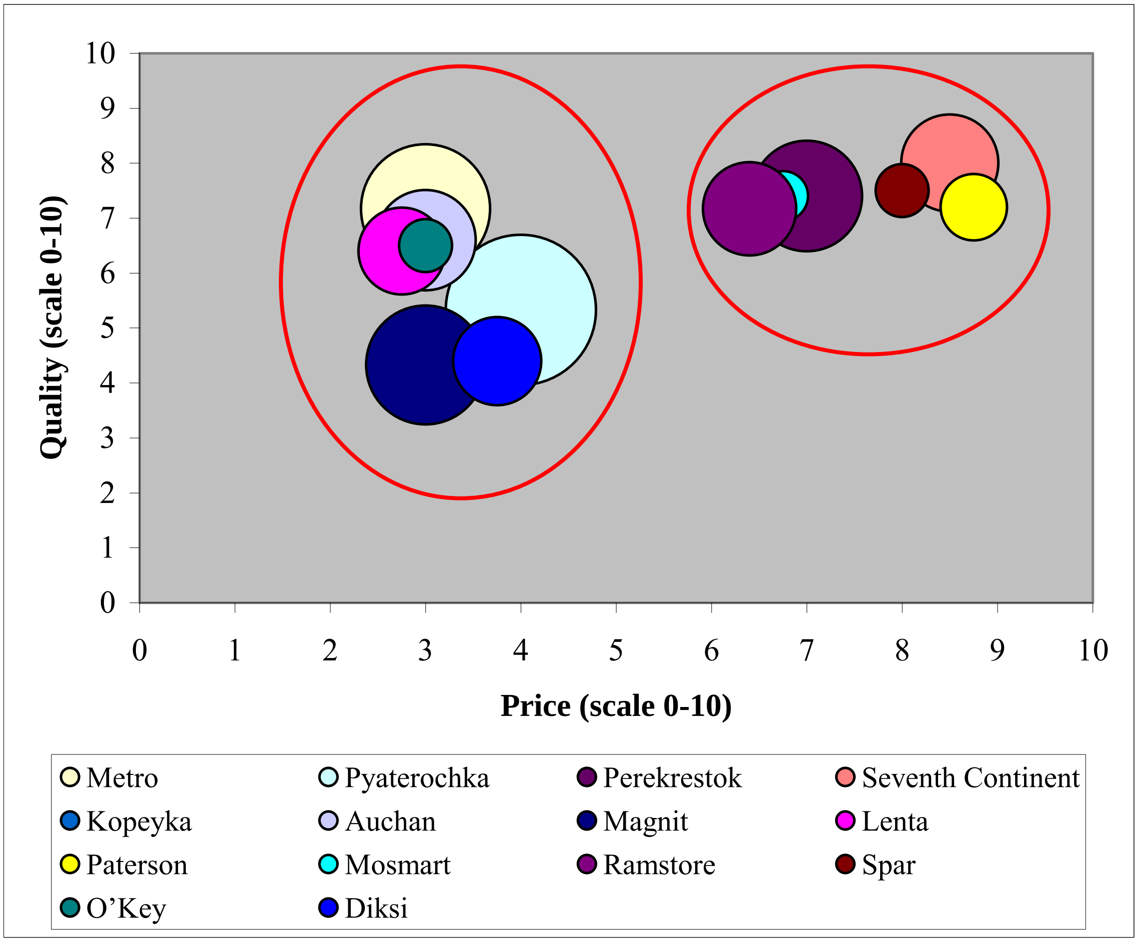

Figure 14. Positioning of the retail chains by size, price and perceived quality

Clearly two different segments can be found in the above figure; a segment of high price stores and a segment of low price stores. In the year 2003 the top players in the high price segment clearly lost to the top low price segment companies. The growth rate for the cheap chains reached 112%, while the growth of the more expensive chains reached only to 47%. However, in the year 2004 the growth was 57% in both segments. Nevertheless, the growth has been more outstanding in the low price chains than in the high price chains in the last two years. In monetary terms the growth is bigger in the lower price segment.

About half of the large players are in the segment of the upper scale stores. The recent decline in this segment has been noticed by the top players and they are all seeking ways to enhance their growth. Along with Perekrestok, Seventh Continent has practically all the retail formats covered when they open their first hypermarket in the first quarter of 2005. Ramstore has also hypermarkets in addition to supermarkets. Perekrestok has hypermarkets, supermarkets and discounters although it is concentrating on the development of hypermarkets at the moment. Paterson is the only exception. A consultant company advised Paterson to stick to one retail format only, which in this case are the supermarkets.

The present author's research on the price level is based on the personal opinions of a few experts but there is one research report available. Vesti magazine's research backs the perception of the interviewees (see figure 15). The research was conducted using a certain "basket" of goods, which were compared between different retail chains. The basket contained the following items:

- 1 loaf of bread,
- 200 g of butter,
- 1 liter of edible oil,
- 1 liter of UHT milk,
- 1 kg of sausage,
- 1 kg of beef,
- 0.5 liters of vodka,
- 0.5 liters of beer,
- 100 grams of instant coffee,
- 1 liter of orange juice
- 1.5 liters of drinking water,
- 1 kg of lemons, and
- 125 grams of flour-based cookies.

The brands of the products varied in different stores. The results are quite similar to the author's research; Kopeyka and Perekrestok are surprisingly expensive in this comparison although they have a low-price image.

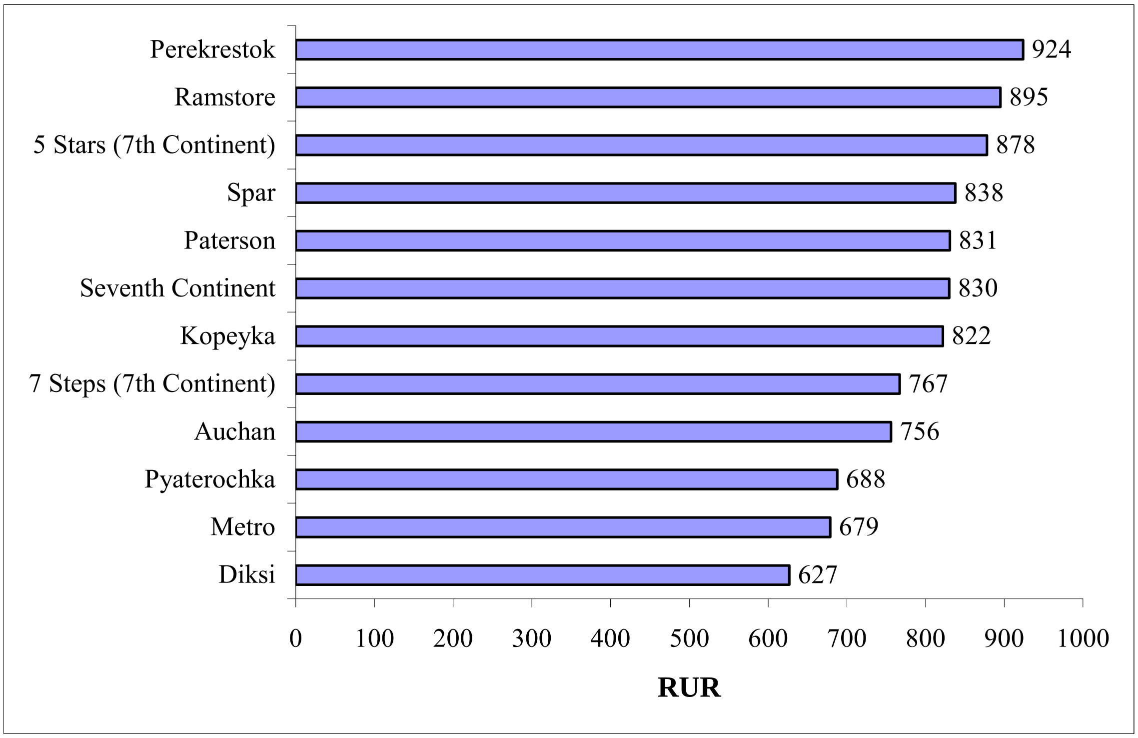

Figure 15. Price of an average basket of goods in different stores. Source: Vesti magazine, UFG

The cheap stores are often regarded as low quality stores. Pyaterochka, Diksi and Magnit stores are clearly on a lower quality level than the others according to the author's interviews (see figure 9). High quality level makes a store a prestigious place to do shopping at, and for people of the upper-middle class it might be quite unthinkable to do shopping in a chain store, which is regarded as low of quality. The customer segments are clearer in Russia than in Finland due to the bigger class differences.

The store formats differ a lot when it comes to the average customer or the segment to which it is targeted. In hypermarkets and especially in cash & carry –outlets customers buy lots of goods during one visit because they usually come to the store by car and can buy large amounts of food and other goods for a longer time period (see figure 16). Metro is in this comparison superior but the reader has to bear in mind that Metro is mainly targeted to businesses.

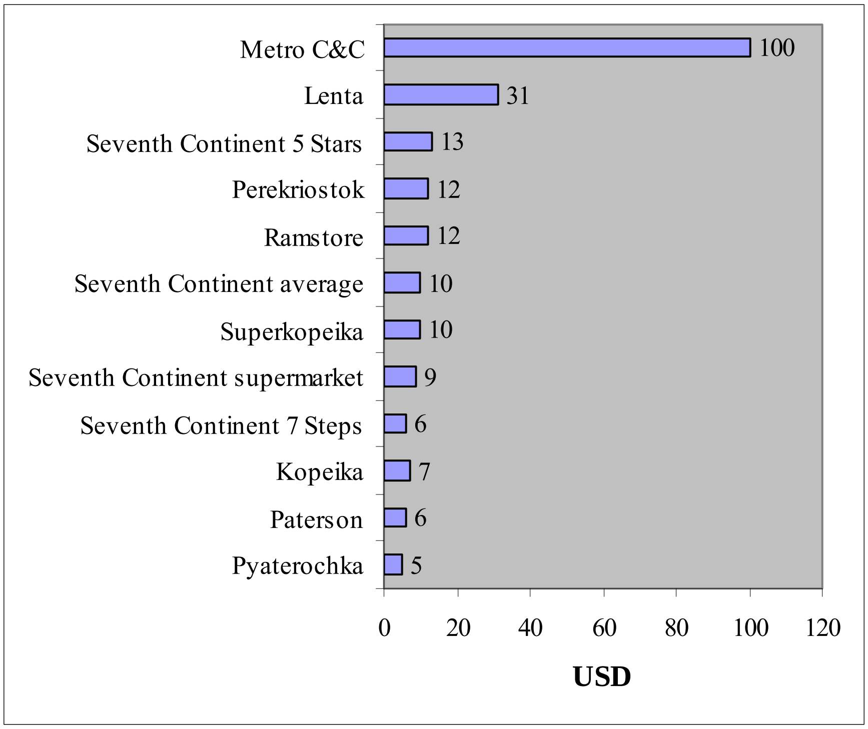

Figure 16. Average value of purchases in different stores, USD. Source: UFG

7. Profiles of key players

Pyaterochka

Source: www.e5.ru

Pyaterochka is the leading domestic retail chain in Russia. It has been expanding rapidly mainly in the Moscow and St. Petersburg areas but also in other regions like Voronezh, Chelyabinsk, Ufa, Perm, Yekaterinburg, Ulyanovsk, Saratov and Volgograd. In order to gain market share as fast as possible it uses also franchising outside Moscow and St. Petersburg. The chain operates mainly in the discounter retail format, but there are also plans to open 30 Pyaterochka shopping centers and 5 hypermarkets with a very similar format as Lenta has in the Leningrad region (Deckmann Media, 2005b). An agreement on this was recently signed with the regional governance of the Leningrad region (spring/summer 2004). In the next 5-6 years Pyaterochka is planning to open ca. 100 hypermarkets under the name of the above-mentioned Karusel. The first one was opened in December 2004 in St. Petersburg.

In 2004 Pyaterochka invested USD 220 million in the expansion of the chain. In addition it invested USD 35 million in the construction of a distribution center in Moscow and USD 10 million in the expansion of the distribution center in St. Petersburg (Spiridovitsh, 2004a). Pyaterochka is now expanding heavily to the Leningrad region. This acts as a pilot project for large-scale expansion to regions. So far the company has concentrated on cities with population over 1 million, but the results have been promising. Pyaterochka has now (in the beginning of 2005) approximately 450 shops and in the following 8 to 10 years the number of shops will reach 1000 according to the plans of the management. In 2004 Pyaterochka was supposed to open 155 shops out of which 100 outside Moscow and St. Petersburg. In 2003 the overall turnover of the company was 933 million USD and for the year 2004 a turnover of USD 1.4 billion was predicted (Spiridovitsh, 2004a).

Pyaterochka announces its key factors to attract customers to be convenient store locations, competitive prices, guaranteed quality of products, well-chosen range of products, and always-in-stock. The most important factor is a strong customer orientation. Because Pyaterochka's stores are smaller than 1,200 sq. meters each (excluding the Karusel hypermarket), there is not even much room for wide assortments of products. This is why Pyaterochka and also the other discounters must choose the products carefully. The author was told that the products in the

Pyaterochka assortment should be present in 70% of all retail outlets, including kiosks and open marketsm, before they can be added to Pyaterochka's assortment.

An average purchase in Pyaterochka stores is RUR 150-160, which is ca. USD 5.5. The figure has risen from previous USD 4.5, which was announced on their web pages. Pyaterochka stores are targeted for middle and lower middle class people.

Source: www.e5.ru

Pyaterochka procures about 90% of its goods domestically. This is not just because of the fact that the consumers prefer domestic products, but also because the customs operations are not very stable. There can be surprising regulations of importing certain products. Just in recent years there have been regulations against e.g. meat and dairy product imports.

Pyaterochka's strongest competitors are Kopeyka, Diksi and Magnit along with supermarket chains. Pyaterochka's pace of growth has been very impressive in recent years. It serves masses in convenient locations and is therefore very strong in the competition. Its logistics are also organized better than it is with many of its rivals. In the beginning of 2005 Pyaterochka made a bid for Kopeyka (Retail.ru, 2005e). This proves that Pyaterochka is very strong against its competitors.

Metro

The German based Metro Group is one of the largest retail chains in the world in terms of turnover, and it has gained a significant foothold in the former Eastern Europe countries, including Poland and Russia. In fact, it is the number one chain in central Europe. Metro operates with a cash & carry format in Russia so it serves also wholesale customers. In fact, Metro is a wholesaler for businesses and professionals: individual entrepreneurs, commercial and institutional customers, hotels, restaurants and cafes as well as small and medium-sized enterprises.

Metro has six stores in Moscow, two in St. Petersburg and one each in Kazan, Krasnodar, Samara, Rostov-na-Don, Volgograd, Yaroslavl (Metro, 2005). It also plans to open stores in Chalyabinsk and Togliatti, two more in Moscow and 6-7 shops in other regions, mainly in the biggest cities of the Volga and Ural regions, one in Perm and one in Yekaterinburg in 2005

(Spiridovitsh, 2004a). Metro's stores are bigger than average hypermarkets, up to 18,000 sq. meters. (Metro, 2005)

One must be a registered card-holding customer to be able to do shopping in Metro. The presem author considers that to be a part of its segmentation strategy. Metro buys only directly from manufacturers and has out-of-town stores with low overheads. Therefore, Metro's price-quality relation is the best in business, perhaps along with Lenta. Because of Metro's minimum cost policy the Metro stores are not in very convenient locations for people without cars, but that may be the company's intent and strategy. People with cars probably possess more purchasing power than customers without them. Also they will probably buy a lot of products at one visit because of the distances. For customers it pays off to come to Metro from a distance because of the low prices, but not several times a week. The company wins because it sells lots of goods to each and every customer. Thus the operating efficiency is great. The Metro Group has also announced building 20 hypermarkets under the name of Real in Russia in the next 5 years. All the stores will be located in residential areas (Spiridovitsh, 2004b). Metro has its own private label called Aro. (Metro, 2005)

In secondary sources it is told that the Metro store in Samara purchases 25-30% of the products sold from the same region. In Perm the planned figure is at least 20% (Spiridovitsh, 2004b). The present author supposes that this kind of activity will be normal in other regions as well.

Metro's strongest competitors are Auchan, Mosmart and Lenta in St. Petersburg. It poses a significant threat also to all wholesalers in the regions in which it has and will build its stores because its prices are approximately 10% lower than the wholesalers' (Spiridovitsh, 2004b). This will put many wholesalers out of business.

Perekrestok

Trading House Perekrestok is the fourth largest retail chain (Metro included) in Russia, but it was number one in 2001. This means that Perekrestok's star is declining. Pyaterochka has chased it down in terms of turnover also in Moscow but it is still the leading chain with supermarkets.

СЕТЬ УНИВЕРСАМОВ
ПЕРЕКРЕСТОК

Source: www.perekrestok.ru

Perekrestok's operations are mainly concentrated in Moscow area, although it has stores also in St. Petersburg, Samara, Togliatti, Volgograd and Nizhny Novgorod. Perekrestok also acquired a 75% stake of the Spar Middle Volga from Delta Capital in the end of 2003. Spar Middle Volga has the license to Spar brand name in the Volga region and thus Perekrestok has access to those markets. The target group of Perekrestok is the middle class (Spiridovitsh, 2004a). Perekrestok's product assortment is 18,000 items in supermarkets and 35,000 items in hypermarkets. Perekrestok's average basket size is USD 35 (UFG, 2005).

The Perekrestok chain comprises approximately 100 stores, which include also a hypermarket in Otradnoye and 8 discount stores - Mini Perekrestoks. By the end of 2005 the figure is planned to be 140. All the stores are located at the crossings of busy main roads and in densely populated areas of the city. 75% of the assortment in Perekrestok stores is food. Even though Perekrestok's main market segment is clearly upper middle class, it still tries to serve also the people with low or medium income. Pensioners and handicapped people get 5% discounts from the Perekestok stores (Perekrestok, 2004). Despite of this it still ranks to be the most expensive retail chain in the top 14 (see figure 8).

Perekrestok has also started its regional expansion. It leased 3 stores from the local chain Vavilon in Rostov-on-Don in the turn of 2005. It will also open its first supermarket in Krasnodar in March (Retail.ru, 2005b). In addition to horizontal expansion, Perekrestok has expanded vertically. In the end of 2004 it had 30 mini-bakeries, 36 sections (shops) producing meat cookery and 29 sections producing fish cookery inside its stores. In meat and fish production they are concentrating on semi-finished goods such as fillet steaks, stuffed chicken breasts, meat loafs, stuffed and natural (alive) fish etc. Perekrestok has also an Internet home delivery service. (Perekrestok, 2004)

There are rumors that Perekrestok would be preparing itself for IPO, but at least according to their website the time is not ready for it just yet. The owners possibly want more profits for the sales of the shares.

Perekrestok has been involved in many strategic alliances. Currently it is in a purchasing alliance at least with Kopeyka and Lenta.

Perekrestok's strongest competitors in the supermarket segment are Ramstore, Seventh Continent and Paterson, but the discounters have to be taken into account as well. Perekrestok has a distribution center in the Moscow region and other supermarket chains do not. Perekrestok is introducing its own label goods at the moment and plans to increase their share to 10-12% of total sales. (Oilworld.ru, 2004)

Tander (Magnit)

Magnit stores are owned by a wholesale operator called Tander. Tander is the biggest retail chain in Russia in terms of number of stores, even though its stores are quite small, 300-500 sq. meters. Similarly to Pyaterochka, Tander operates discounters but its average floor space is much smaller and product range narrower, max. 2000 items (Oleynik, 2004). Tander has over 1000 stores all around Russia, of which only a small fraction is in Moscow (Retail.ru, 2004d). It has further plans to expand the chain to 2500 stores by 2008 (Oleynik, 2004). Thus Tander is indeed concentrating on regional expansion. The company's home base is in Krasnodar. There are a lot own label goods in Magnit stores (Retail.ru, 2005d).

Seventh Continent (Sedmoy Kontinent)

Seventh Continent is originally a supermarket chain, with the longest history along with Perekrestok. Nowadays the chain has also elite class supermarkets called 5 Stars and out-of-city-center supermarkets with a somewhat narrower and cheaper product range and discounters called 7 Steps. In October 2004 it had about 57 stores, operating these three different formats. At the moment it has already 78 outlets: 5 Stars (20 outlets), supermarkets (27 outlets), 7 Steps (31 outlets) (Retail.ru, 2005a). The chain started its business with the upper scale supermarket format, which were and still are targeted to middle and upper middle class customers. Because this single segment did not provide the company enough potential for further expansion, they had to expand their operations to other niches as well. Seventh Continent has the widest variety of different retail formats of all retail chains. It has even Internet home delivery service.

Source: www.deckmannmedia,fi

Recently, a lot has been happening with Seventh Continent. In August 2004 it acquired its rival Petrovsky chain in Moscow. The company leased its 17 shops in Moscow and they all started to operate under the name of Seventh Continent till the end of 2004. The deal indicates that Petrovsky chain was more inefficient in its operations because Seventh Continent was able to offer a little bit more than they would have got from the retail business. Otherwise the deal would not have made any sense. The owners of Petrovsky got a fair price for their investments, and Seventh Continent managed to increase its market share, even though the contract might have not been very profitable for the company.

The acquisition may not have been a surprise for the analysts, because in table 3 it can clearly be seen that Petrovsky was lagging behind in growth figures and it was just a matter of time when it would be acquired.

In November 2004 Seventh Continent announced its IPO as the first Russian retail chain and managed to raise USD 80-90 million with the procedure of selling 13% of the share capital. The total value of the whole company can be calculated from these figures to be about USD 640 million.

Seventh Continent is building also its first hypermarket in South-East Moscow near the city center. The hypermarket is expected to be smaller than average and have 5,200 sq. meters of floor space, and it is planned to be opened in the first quarter of 2005. The company has decided to develop a separate brand (Nash) for its hypermarket partially because it is a trial project, which is supposed to show whether the company can generate decent returns with this new format. Actually Seventh Continent has experience of planning hypermarket activity because it took part in the development of the Mosmart chain in its early stage, but then surprisingly Seventh Continent decided to pull out from the project and announced that it would build hypermarkets of its own in the future. The good relations with Mosmart did not change, however, because at present they are in a cooperation alliance together. The alliance combines their purchasing, advertising and distribution functions. The goal of these two companies is a common turnover of USD 1 billion in 2005. (Spiridovitsh, 2004a and UFG, 2005)

In the discounter format the strongest competitor of the company are Pyaterochka, Magnit, Kopeyka, Diksi and the Mini-Perekrestoks. The 7 Steps format is fairly competitive, and it resembles Pyaterochka's and Kopeyka's formats a lot although the stores are a little bit smaller; on average 600 sq. meters. In the segment of supermarkets it competes fiercely with Perekrestok, Ramstore and Paterson. A bit surprisingly the company seems to be the cheapest of these supermarket chains (see figure 8). By entering the hypermarket segment it will face competition from every hypermarket operator in Moscow. However, Ramstore is the strongest opposition in this segment because it has managed to get land plots from Moscow city center for its hypermarkets, where also the hypermarket of Seventh Continent is located. The 5 Stars format will generate high profit margins but does not provide too much growth. The company is planning to introduce its first own label goods during spring 2005 at about the same time as the first hypermarket is opened. (Deckmann Media, 2005a)

Auchan

The French-based Auchan was the first who introduced the hypermarket format to Russians in 2002. Nowadays it has 6 shops, which are all located in the outskirts of Moscow. Auchan has announced that its main rival is actually the open markets and it settles its price level according to that idea. The prices are 10-15% lower than in supermarkets on average. Auchan is very efficient in generating turnover with its hypermarkets. Three stores were opened in 2004, 2 in the end of the year and one in the middle. Thus only with an average of 4 stores it managed to achieve estimated USD 640 million of revenues in 2004. That means sales of roughly USD 160 million per outlet, which is significantly higher than in the case of the domestic hypermarket chains, Mosmart and O'Key, whose outlets are about the same size. In fact, it beats even Metro Cash & Carry in this comparison.

Auchan has been slow to expand its network before but now it has started to against competitors. It is planning to open 4-5 hypermarkets in Moscow in the coming 2-3 years. This will take Auchan investments of USD 300 million (Spiridovitsh, 2004a). Auchan will be very strong in the future competition, as it has strong experience also from other countries in transition. It for example bought Billa from Poland already in 2001.

Ramstore (Ramenka)

The Turkish Ramenka has been operating on the Russian market since 1997, and it was the first foreign chain to enter Russian markets. Ramenka's Ramstore chain is the second-largest foreign chain in the market in terms of turnover. Ramstore is a multi-format chain along with Perekrestok and Seventh Continent. It has 6 hypermarkets and 16 supermarkets on Moscow market. It also has been a pioneer of shopping malls. In December 2003 it opened a trade and entertainment center Ramstor-City in St. Petersburg with 72 000 sq. meters of floor space and 130 other shops along with one Ramstore. The mall contains also a cinema and 15 restaurants. At the same time Ramstore opened another mall in Podolsk, Moscow region. The first hypermarkets outside Moscow and St. Petersburg were opened in Krasnoyarsk, Kazan and Nizhny Novgorod in 2003. Further hypermarkets have been opened in Rostov-na-Don, St. Petersburg, Novosibirsk and in most towns in the Moscow region. The company has further plans in Rostov-na-Don, as it plans to build 4-5 super- or hypermarkets and 1-2 shopping centers in the upcoming years.

Source: www.ramstore.ru

Ramstore has a wide range of goods in its stores, approximately 35,000 items. The prices are clearly for the upper scale segment (see figure 8), but also the service is on the level of Western Europe. Ramstore was the first company who introduced the private label goods in their assortment. (Spiridovitsh, 2004a)

Analysts think that Ramstore can afford to drop its prices when the competition becomes harder. The strongest competitors of Ramstore are Perekrestok and Seventh Continent, but it differentiates itself from them by building hypermarkets and malls. Later both of these have followed Ramstore to the hypermarket segment.

In 2004 the growth of the Ramstore chain was worryingly slow. The growth of the retail sector outpaced Ramstore's estimated 22% growth by 7 percentage points (see table 8). This could be a sign of Ramstore's weakening position on the market. On the other hand, Ramstore could also catch up this year (2005) with implementing the ongoing expansion plans. This remains to be seen. However, if the growth does not improve, Ramstore will find itself in the same situation as the Petrovsky chain last year and be acquired.

Kopeyka

Kopeyka was originally a wholesale operator supplying imported goods to local distributors. Later it evolved into a no-frills discount store with functional layouts, enabling the customer to shop quickly and at the lowest prices. The stores are slightly larger than Pyaterochka's, but in fact the floor space of Pyaterochka's new stores are at the same level as Kopeyka's. Kopeyka offers 2,500 different products in its assortment, except for its Kopeyka Super –stores which have 6,000 products. Also the stores are much bigger, 2,500-3,000 sq. meters. 20% of the assortment in the regular discounters are non-food items while in Kopeyka Super –stores the figure is 40%-50%. No other leading retailer has this kind of retail format, a discount superstore. However, 75 % of Kopeyka's turnover still comes from traditional discount stores. Kopeyka begun franchising its operations in 2001. (UFG, 2005)

Low price, high quality private labels are part of the company's strategy; it sells them under a number of controlled brands that consumers do not perceive as being owned by Kopeyka (UFG, 2005). It has plans to have 50% of its assortment private label goods by the end of the year 2005 (Interfood, 2004). This is the most aggressive private label strategy in Russia at the moment.

Kopeyka's strategy is to focus in the medium-term on the most dynamic markets, such as Moscow and satellite regions, and opening stores in towns with population over 50,000. (UFG, 2005)

Along with Pyaterochka, Perekrestok and Diksi Kopyka is the only retailer that has a distribution center. With the strategy Kopeyka is conducting, a distribution center's service zone would eventually cover 60 towns with a total population of 20 million. (UFG, 2005)

The company has plans to acquire 4 rival companies in Moscow, Samara and Yekaterinburg. It had a plan to increase the number of its outlets to 100 by the end of the year 2004. (Spiridovitsh, 2004a) Pyaterochka made a bid for Kopeyka in the first quarter of 2005. It was turned down, however.

Paterson

Paterson is the only domestic top 14 food retailer that operates purely in the supermarket format. In fact, it has been advised to do that by consultants. Paterson's focus group is clearly the middle and upper-middle classes (see figures 8 and 9).

The company has been succeeding in its strategy better than the average. It has grown remarkably in the last 3 years, by 600% (see table 8). Despite its rapid growth Paterson has some problems with its logistics because it has a wide assortment of goods in relatively small shops and it does not even have a distribution center. The transports to its stores are not as effective as they could because the trucks actually have to queue for their turn to unload.

Source: www.paterson.ru

Paterson was the first Moscow based chain to expand its operations to St. Petersburg in 2002. The same year it expanded also to Tver. The last two years have been a time of regional expansion for the chain. It has opened new stores in Lyberca, Juznoje Butovo, Kurkino, St. Petersburg, Ufa, Kazan, Penza, Stavropol, Sochi, Togliatti, Krasnodar, Chelyabinsk, Samara and Ukraine as the first Russian retail chain. It was also the first big chain to open stores in Southern Russia, in Stavropol and in Krasnodar (Spiridovitsh, 2004a). In the end of 2004 Paterson operated 22 stores in Moscow and 23 in St. Petersburg, Tver, Samara, Togliatti, Kazan, Penza, Ufa, Stavropol, Krasnodar, Sochi and Chelyabinsk. (Retail.ru, 2004b) Till the end of 2005 it intends to open 60 more stores in Russia and 30 in other CIS-countries. In St. Petersburg there are currently 9 stores and further 11 stores are planned. Thus, Paterson enhances its competitive position against the market leaders Lenta and Pyaterochka there. In Moscow Paterson focuses on expanding to residential areas and to the region (Paterson, 2004).

The stores of Paterson are 800-1000 sq. meters, so they are no bigger than the discounters operated by Kopeyka and Pyaterochka (new stores). However, its assortment is many times bigger than those of the other two reaching 25,000 items.

Mosmart

Mosmart is the first domestic chain concentrating purely on the hypermarket format and the only one in Moscow. O'Key is the other domestic chain of hypermarkets, but it has shops only in St.Petersburg and one in Rostov-na-Don. The Mosmart chain was originally launched as a joint venture by Seventh Continent and Gipertsentr (a developer), but due to differences in the views of the owners on the development of the chain and financial issues the alliance broke up. Before Seventh Continent withdrew from Mosmart in 2003, the chain had plans to open 100 hypermarkets in 10 years all around Russia but they are lagging behind in the objectives already. The forecasted turnover of USD 200 million did not come true, obviously due to the fact that the third Mosmart hypermarket was supposed to be opened in the spring of 2004 but was actually opened in the fall of 2004. Thus, the chain suffered from the disbanding of the joint venture in short term. Mosmart's store format resembles Carrefour's store layout a lot. Even the goods display is exactly like in Carrefour's stores. Thus Mosmart's format would fit perfectly to Carrefour for a possible acquisition. Actually even the CEO of Mosmart, Eric Blondo, used to work for Carrefour. He earned his spurs in the Polish market before he was hired by Mosmart.

Mosmart plans to open 2 stores in Moscow and one in Nizhny Novgorod in 2005. It plans to open 8 more stores in the following year three of which will be located in the Moscow region. Outside Moscow it will be using the name Rosmart. Volgograd, Voronez, Yekaterinburg, Izevsk, Kazan, Krasnodar, Perm, Rostov-na-Don, St. Petersburg, Samara, Saratov, Togliatti, Tjumen, Ufa, Chelyabinsk and Jaroslavl have been named as possible locations. Mosmart plans to get financing for its expansion from banks and foreign investment funds. There is also the possibility of issuing bonds. IPO is not relevant yet. (Mosmart, 2005)

Mosmart chooses its suppliers by assessing the suitability of the products to their assortment and uses marketing research to define that. The supplier also has to be inexpensive, with good reputation and willing to operate according to the principles of the chain, which include reliability of deliveries, norms for deliveries and documentation. Mosmart names Auchan as its main competitor. (Mosmart, 2005)

Lenta

Lenta is the leading retailer in the St. Petersburg area with 7 cash & carry outlets. Lenta has an average assortment of 8,000 items and the average store size is increasing all the time. In the competition with its main rival Metro, the latest stores are already 20,000 sq. meters large when the older outlets are a lot smaller. The stores are located close to main highways. The price level is slightly lower than in Metro in St. Petersburg.

Source: www.lenta.com

Lenta might be the only domestic operator who keeps its margins at the same level as the foreign competitors. In July 2004 Lenta got a loan of EUR 30 million from EBRD to open 4 big retail outlets in St. Petersburg. By the end of 2004 the company was supposed to comprise 12 stores. (Spiridovitsh, 2004a)

Lenta's strongest and probably only direct competitor is Metro because these two are the only ones on market with the cash & carry format. However, Metro concentrates more on serving business clients when Lenta serves also regular customers. O'Key is the strongest competitor in this segment.

O'Key

The first O'Key hypermarket was opened in 2002 in St. Petersburg, and it has been followed by 3 additional hypermarkets since, the latest in December 2004. The stores are all located in St. Petersburg. The company has plans to expand its network of stores up to 30 stores by 2007 in Russia (Retail.ru, 2005c). This will cost the chain USD 700 million of investments. The O'Key stores have an average floor space of 15,000 sq. meters, which is clearly bigger than the average floor space of hypermarkets in general. The average store size is to exceed 20,000 sq. meters if the plans become materialized. The first hypermarket outside St. Petersburg will be opened in the beginning of 2005 in Rostov-na-Don.

Rewe (Billa)

Rewe is the second-largest retailer in Germany after Metro. In summer 2004 Rewe entered the Russian market by establishing a joint venture with Marta Holding, which was operating 20 Spar stores in Moscow and got the Spar outlets, which started to operate under the name Billa. Rewe owns 75% and Marta Holding 25% of the newly established joint venture. Rewe plans to invest USD 500 million in Russia. Rewe's entry strategy was to choose a local partner because it considered the expansion to be easier and faster that way than by itself. From Marta it got the expertise of the market and access to good real estate. In the beginning the expansion will concentrate in Moscow and the Moscow region, but the chain intends to expand to regions as well in a couple of years. By the end of 2008 the chain believes it will be among the 5-8 top players in Russia and have 150-250 stores. Billa competes in the same market as Seventh Continent and Perekrestok. (Spiridovitsh, 2004d)

Spar

Spar has been operating with franchising contracts in Russia since 2000. The Spar brand was formerly split to two organizations. The possessor of the franchising permit in Moscow was Spar Retail and in the Volga region Spar Middle Volga. Spar Retail was owned by Marta Holding and Spar Middle Volga mainly by Delta Capital. In 2003 Delta Capital sold its 75% share of the chain to Perekrestok. The other owner is OOO Sladkaya zhizn. In the summer 2004 Marta Holding formed a joint venture with Rewe and turned its stores to Billa outlets. Spar Middle Volga will continue its expansion in the regions.

Diksi

Diksi is probably the cheapest retail chain in Russia at the moment. It operates hard discounters with a floor space of 800 sq. meters and assortment of 2,500 products. In the fall 2004 the number of its stores in Moscow was 60 (UFG, 2005). By keeping a narrow range of products it can cut costs but at the same time it is cutting profits by keeping its prices down. It is hard to say what its margins are but in order to expand heavily it needs profits, because most of the domestic chains have to finance their expansion by themselves. A newly established distribution center in Moscow will help Diksi in its task to cut the costs down. The center was completed in the end of 2004 (Olex Holding, 2004). The company considers its main rival to be Pyaterochka, and Diksi prices itself at a discount of it. Diksi has managed to establish a good foothold in Moscow markets, in addition to St. Petersburg where it is based. Diksi's management and a group of private equity funds own the company.

According to some news articles (Lorentz, 2004, p. 76) Diksi was looking for a strategic investor in 2002. For some reason nothing has happened yet. However, this is an indication that Diksi might be willing to sell its operations forward to foreign investors, and thus similar development might be possible as in the case of Rewe (Billa chain) and Marta Holding. The German Tengelmann showed its interest already in 2000. It is presumable that their offer was not good enough for the growing Diksi then.

8. Competition and consolidation

According to the author's research, the most important factor restricting the growth of retail chains in Moscow and in St. Petersburg is the lack of suitable sites for the retail chains. It is very hard to find a proper real estate e.g. for convenience stores, because they are ridiculously expensive due to the huge demand. Pharmacy chains, retail banking, retailers of mobile services etc. also need the same kind of real estate as the chains need for their convenience stores. The cities are also trying to get the best possible prices for the land plots. Everyone is after the same land and real estate. The high rates of real estate will put many single standalone stores out of business, unless they have a long-term contract or they own the real estate already. At the moment the chains are actually competing for land plots and real estate rather than with prices, advertising and other normal market actions.

The global chains try to avoid this problem by building their stores at the outskirts of cities (Gateway to Russia, 2004b). Another way of avoiding this problem is to establish a hypermarket or a supermarket in a shopping center built near the city center. As mentioned above at least Ramstore and Paterson of the food retailers have done that already.

It is a known fact that when the markets start to saturate, a consolidation process will begin. In this case this means that the successful retail chains will start to acquire the less successful ones, taking their share of the market to themselves. At the moment the domestic retail chains are settling for joining forces to be able to compete with large foreign players and possible new market entrants by forming alliances. This issue will be discussed below.

The Russian retail market still remains very unconsolidated, as only 4.2% of the total food retail sales are controlled by the top 5 players on the market. The same figure for example in France is 88% and in another transition economy, Czech Republic, 17-27% (UFG, 2005). In Finland only three main retailers cover over 80% of the total market (USDA, 2003).

Consolidation in a massive scale would require significant changes in the retail sector. At present the retail business is very profitable and the chains can keep up to 30% gross margins for their products (UFG, 2005). At present there is not much pressure on the market, but the situation is gradually changing. Such a profitable business takes a lot of money to acquire and the bigger the chains are, the higher is the price. To acquire a chain, one has to offer more than the acquired chain can generate in profits. The acquirer must basically be able to extract more from the shops acquired than the former owners. Efficiency counts.

Because the domestic chains are not always very efficient due to the non-standardized stores and lack of logistics schemes, the global players are not necessarily very interested in them at the moment. It would require a lot of resources to make the shops efficient, if that is even possible. The domestic chains are becoming better, however, by copying the operation methods from their rivals and other western chains.

Regardless of the poor concentration of the Russian retail business, the first signs of consolidation can be seen. In table 9 all the major acquisition activities in recent years can be seen.

Table 9. Major deals in the retail sector

Date	Buyer (chain)	Target	Number of stores	Target sales, million USD	Transaction, million USD
Dec-01	BIN (Petrovsky)	Magnolia	6	n/a	10-12
May-01	Tander (Magnit)	Nesterovsky	15	n/a	6.5-7
Aug-03	Marta (Spar)	Stolitsa	6	37	20
Dec-03	Perekrestok	Spar Middle Volga	7	30	14-16
Jul-04	Rewe (Billa)	Marta (Spar)	21	95	75:25 JV
Aug-04	Seventh Continent	Petrovsky	17	90	n/a

Source: UFG

Forecasting the consolidation process is not an easy task. Anything can happen. But what can be seen are the growth rates and store formats of the chains which act as indicators for figuring out the development.

* *Growth is projected to 2005 given the same annual growth as year 2004, because there was no decent data from year 2002.*

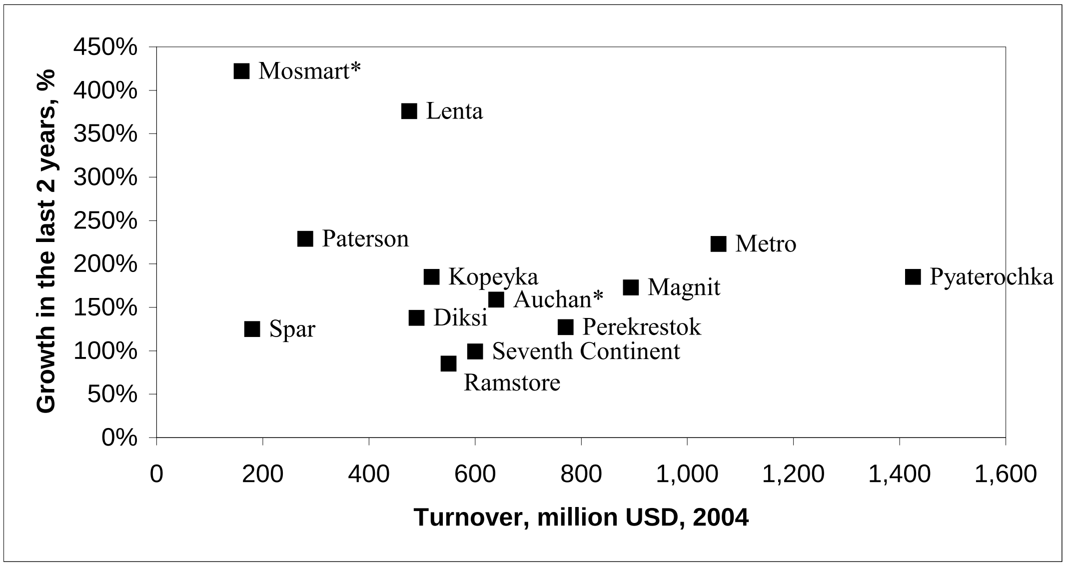

Figure 17. Growth rate and size of turnover

Figure 17 above can be used in assessing the companies that are lagging behind in growth and thus the most probable targets for future acquisitions, as well as the "stars" that are moving towards bigger market shares. The truth is that today nothing is very evident. Only Pyaterochka distinguishes itself with its size from the rest of the discounter chains. The hypermarket and cash & carry formats give the best growth figures as well, although the growth of all these companies is very impressive. Only Ramstore's and Seventh Continent's rather modest growth compared to the others is a little bit worrying from their point of view.

However, so far the chains have been more interested in expanding to the regions than in acquiring the rival companies, because being first on a market has a huge significance for being successful. Thus they have rather concentrated on investing their available capital in the regions. At least that is the case with the biggest ones and those that will survive in the competition.

Considering this, the major boom consolidation will not take place before the price competition starts. Actually at this point it would not even make any sense to lower the prices, because as mentioned above, the customers will buy anyway.

As part of this research the author conducted a study on the probabilities of certain events happening in the consolidation process in 5 years. The interviewees were asked how probable they would see certain M&A (mergers and acquisitions) activity happening between the domestic and foreign retail chains in 5 years. The analysts were very unanimous in that new players will enter the market with greenfield investment and the bigger chains will eat some small chains in the time frame.

"Maybe when 50% of the market is covered by the chains and there are 10 foreigners on the market and the capacity is 5 times larger than now… Maybe then they would kill the price on a daily basis. But right now it does not make any sense."

The above sentence by one of the interviewees contains a lot of information about the characteristics of the competition and the speed of consolidation in Russia. Price competition will not start very soon and before that there will not be many massive acquisitions performed, at least not by foreign companies. The market situation might force the foreign chains to make acquisitions if the domestic retailers start to merge but as long as the domestic companies walk their own way, the foreigners will continue their expansion with greenfield investments, excluding the chains operating purely in the hypermarket format.

However, at some point the consolidation process will start in a more massive scale than currently. It can be seen in figure 18 how different or similar the chains are regarding their stores. If acquisitions will take place, it would be very logical that the consolidation would start with chains with similar store formats, because the acquired stores are easily branded and integrated to match the buyer's system of operations. The analysts support this idea by stating that multi-format chains probably are not the most efficient ones in the business and that in time the multi-format companies would choose the format which suits them the best. Another option is of course to brand the different stores separately from the company's main brand. That leaves a possibility to sell the different stores to some other operator without harming the main brand if the stores prove to be unprofitable.

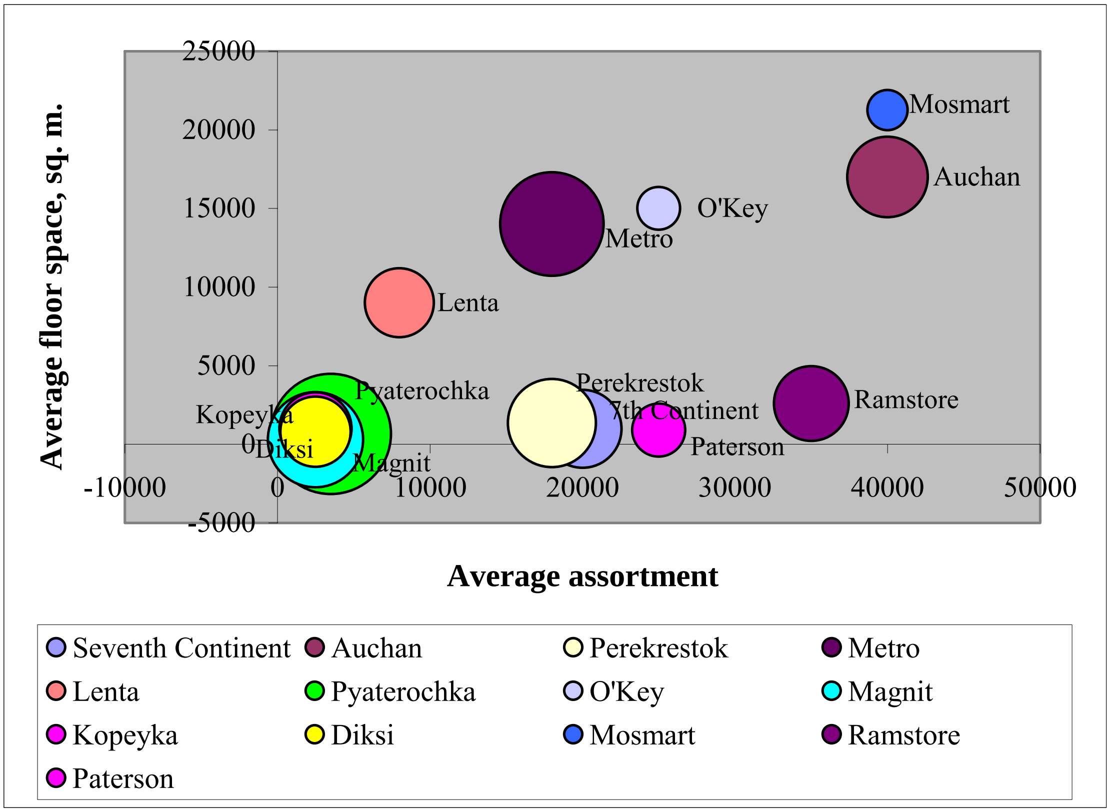

Figure 18. Average assortment and floor space of the chains

If the similarity of store format is considered to be an important criterion for acquisitions and mergers, it is easy to see from the above table which are the chains that will merge. The truth is that Pyaterochka, Kopeyka, Diksi and Magnit are very similar in terms of assortment size and in floor space, and thus they are possible chains to merge. By merging they would get a considerably large market share and sales volumes, which would improve their position clearly. Pyaterochka is of course the strongest one of these. In fact, it has already made a bid from Kopeyka. (Retail.ru, 2005e) This bid was turned down, however, but this indicates that acquisitions between the large chains are quite possible in the near future.

By merging the multi-format chains like Seventh Continent, Perekrestok and Ramstore could get considerable market shares as well. But because the supermarket format, on which these chains are based, is in decline changes can happen sooner in this segment. However, it is hard to think that the supermarket format will die out, no matter what happens. Paterson's stores could be acquired by either multi-format or discounter chains. In hypermarkets the most evident similarity is between Mosmart and Auchan. Auchan is the more efficient one of these, as mentioned above.

Because the margins are so high, there is always a possibility that new entrants will come to the market. Rewe's market entry with the Billa concept and Metro Group's plans of establishing Real hypermarkets in Russia are a living proof of this. In this sense the consolidation might go even slightly backwards at first. There have been speculations about Wal-Mart entering the market, and it has already announced several times that it will enter Russia soon. There have been rumors about Wal-Mart having a recruiting office already in St. Petersburg and about the construction of the first hypermarket there. Carrefour has tried to enter the Russian market several times but the plans have for some reason backfired. Tesco is also one possibility, because it has managed to establish a strong business in the Central European transition economies. However, the author did not encounter any articles concerning Tesco and Russia during the whole process of research.

Personal matters are not to be excluded when considering the factors affecting the consolidation. The analysts see mergers as joint ventures unlikely because the owners of the chains have too big egos.

The biggest retailers will conquer the regions in the long run, but there are also problems in entering them. For example it is hard to find skilled work force in distant regions. There will also certainly be difficulties with management and logistics. Everything must be built from scratch. There might also be resistance from local trader companies and municipal public officials against newcomers, despite it being against anti-monopoly legislation. (Radaev, 2004, p. 13)

8.1. Domestic vs. global retail chains

The Russian retail sector has experienced an invasion of global retailers in the last couple of years. IKEA, Metro Cash & Carry, Auchan, Marktkauf have all entered the market with big store formats. Wal-Mart and Media Markt are expected to enter the market shortly as well (Radaev, 2004). According to expert opinions there is still room for both domestic and foreign newcomers in the Moscow market as well as in the regions. However, the best growth prospects for investors are in the regions. According to AT Kearney (2005), Russia is the most attractive investment target in retail business today.

There are a number of competitive advantages the global players possess in comparison to the domestic chains. Firstly they have great financial capacity and economic sustainability because the level of their sales normally exceeds that of domestic chains by roughly a hundred times.

They also have access to long-term credit from international banks, which allows a lot of greenfield investments and lets them operate with low level of profitability for the start-up period. None of the domestic companies could make a business plan to be profitable only after 4 years like IKEA in 2000 when it entered the market. (Radaev, 2004, p. 8)

Domestic chains suffer from a lack of investment resources. They have to use their own accumulated capital and profit to finance their expansion because they do not have an access to long-term credit like the global players do. They could get bank loans, but the terms would be rather unfavorable. Loans are provided mostly for a one-year period or less and there is a deficit of credits for long-term investments, although the situation is gradually getting better (Radaev, 2004, p. 8). For example Pyaterochka’s development plan for the years 2002-2005 was partly financed by its owner at that time EBRD (European Bank of Reconstruction and Development). From the total USD 216 million only USD 36 million was from the bank. The rest was financed with Pyaterochka’s internal cash flow (EBRD, 2002). This was a long-term loan, but it was only 16.6% of the total sum and it came from the owner. Thus it is fair to say that when assessing the future success of retail chains, it is worthwhile to check who the owners of the chain are, because it affects the availability of capital, even though it is also the mission of EBRD to support firms in emerging markets.

“*The role of investment banks has so far been somewhat insignificant. The growth has so far been financed by private money but now the chains are achieving the point where they face the problem that also external capital is needed to finance the growth. In order to sustain the growth the chains can either collect capital by issuing bonds or let investment banks in as equity owners.”* (Renaissance Capital, 2005)

Domestic chains could finance their expansion through stock markets but so far only one of them has done so, Seventh Continent. It was able to raise USD 80-90 million by selling 13 % of the company in November 2004. The analysts think, however, that the price of the shares was overvalued in comparison to the results of the company. The lack of retail stocks on the market created a demand for them, however. Pyaterochka and Kopeyka are planning IPOs and are potential followers. There are some rumors about Perekrestok as well. Another way of financing expansion is commodity credits, but it presumes a high level of trust between the suppliers and the chains, and the entry tickets i.e. listing fees are eroding that trust (Radaev, 2004, p.14).

Another advantage for the global players is their effective systems of logistics and storage management. They are also able to sign contracts directly with world brand producers and thus save on distribution costs (Radaev, 2004, p. 8). In fact, due to their efficiency they can also pay high rents and taxes if needed, and they are ready to do that (Yevnevich, 2002). The Russian chains try to respond to this strength by forming e.g. purchasing alliances as mentioned above, and negotiating about discounts. In any case, together they are more powerful against the suppliers. Apparently they have been fairly successful in getting discounts.

Global retail chains have modern store layouts and arrangements and they can handle a cut-price approach. Everything is standardized, which leads to efficiency. They exploit the advanced technologies of merchandising that stimulate customers' purchasing activity, including those inducing to impulsive purchases (Radaev, 2004, p. 9). The domestic chains are doing their very best to copy the operation methods of their global rivals, but the problem still is that the stores are fairly non-standardized and it is not easy to standardize them. They are also not quite certain what store type they should concentrate on. Thus many of the domestic chains have a multi-format strategy, as e.g. Perekrestok and Seventh Continent. Even Pyaterochka is expanding to the hypermarket segment even though it has succeeded to rise to the leading position in the Russian market with discounters. Ramstore is the only foreign chain with multi-format strategy, although Metro will present its Real hypermarket chain to the market in the near future.

There are pros and cons in pursuing a multi-format strategy. Because the market is open for newcomers and the competition is not fierce yet, the domestic chains can experiment on formats and see which format suits best for their expertise and which generates the highest profits. Possibly in the future they will decide on the right format for the chain. E.g. Seventh Continent had to expand to other niches because originally it positioned itself in the niche of upper-scale supermarkets. This segment does not offer the growth the company needs to expand further. It needs to move to convenience stores or to hypermarkets to ensure future growth. In fact, Seventh Continent will open a hypermarket in Moscow soon.

The prospects for newcomers in the Moscow market are not as great as they would have been 5 years ago, but there is still room for them. The large margins in the business speak for this fact. There will, however, be price competition between the chains.

According to expert opinions, ownership by an investment banks or similar equity investors is clearly a benefit for a domestic retail chain. The banks are trying to shape the corporate structure to a more transparent one. They offer their help in e.g. marketing issues and provide loans for the chains. There are some good examples. Alfabank and Perekrestok are owned by the Alfa Group and Perekrestok has been very successful. A minor stake from Pyaterochka was bought by EBRD in 2001. In the summer 2004 it retrieved its profits and got its investment back 4.5 fold. At the same time, Pyaterochka rose to a leading position in the whole Russian market.

The Russian retailers have an association attending to their interests called ACORT (Association of Companies of Retail Trade). Originally the association was founded by 17 food and non-food retailers in Russia and its purpose is to ascertain that the legislation of retail trade is harmonized to correspond reality and to enhance the equality of the foreign and domestic retailers. (Oilworld.ru, 2004) ACORT is clearly an advantage to Russian retail chains because the legislation is far from the European level and there are no proper rules for competition. It also enhances the competitive situation of Russian chains against the multinationals. In fact the association can be a factor promoting the forming of alliances, but of that one cannot be sure.

8.2. Possible strategies for domestic chains

In the tightening competition the domestic chains must somehow cope and adapt to the pressure coming from the global retailers. At this point they have only a few strategies they can pursue to be in a competitive situation in the future.

Escaping to regions

One possible scene is that the domestic retailers divide the market niches with the global operators. It has been argued that large global players will be attracted first and foremost to the huge capital of Moscow with its great purchasing power, leaving the market in other regions for the local companies for at least three or four years. After all, the large domestic chains left the markets in the regions for small shops and micro-chains before the turn of the millennium. There are a lot of growth opportunities in the regions, and the domestic operator could succeed by being the first mover and occupying semi-periphery districts of Russia before the global operators get there. This strategy is very hard, however. The domestic chains need to generate profits for expansion and the average profit in the regions is twice as low as in Moscow. However, the domestic operators have already started expanding their networks to the other big cities as well, even though the market is not yet saturated in Moscow (Radaev, 2004, p. 12). But they are not alone. Metro and Ramstore have also expanded to the regions and Spar is still operating in the Middle Volga region, albeit it is 75% owned by Perekrestok. The foreign companies have also noticed the great growth potential in the regions and they want their share of the cake.

Selling one's business

At the moment no company is thinking about selling its profitable business away because the margins are huge and the market continues to grow. The buyer would have to offer something extra to what the acquired company thinks it can extract from the market. But of course it might be possible that a chain is preparing its business for an acquisition and is looking for a buyer pursuing for increasing its market share. With a reasonable offer the deal is done.

For an average Russian it would not matter which firms, domestic or foreign, operate in the market because the western chains would work with Russian suppliers and hire local employees anyway. Local customers would get better quality for less money and the state would get more revenues from customs duties and taxes. (Radaev, 2004, p. 11)

However, the author is somewhat skeptical about this development at least in the short term. The foreign companies clearly favor greenfield investments in increasing their market share. The reason for this might be that the Russian companies should have to have more standardized shops, so that it would be possible to integrate them easily with the methods of the western firms. The author's perception is that Mosmart and O'Key along with Lenta are the only domestic chains that could be acquired by global chains in short term, even though some discounter chains, especially Pyaterochka, are in very good shape. The reason is that global chains have so far been more interested of the hypermarket segment. The domestic hypermarket chains are achieving great results at the moment, however, and are probably reluctant to sell their business. Losing their trademark and business does not sound a very lucrative option for the domestic chains because the value of the business is rising all the time. However, the Russian chains are making improvements continuously by copying the modes of operation from the market leaders, and they will become more and more attractive for foreigners in time.

Getting a good enough evaluation of one's business from the investors might also be a problem for companies thinking of selling their business. If the evaluation is not good it will be hard to get a satisfactory compensation from the business. Traditionally the Russian companies have not been very transparent in their operations. In the years of economic reform a significant share of Russian companies' transactions were carried out in shadow economy because by doing so they could avoid taxes and other payments. (Radaev, 2004, p. 11)

Getting closer to customers

This strategy has clear advantages for the Russian chains. As the foreign chains are concentrating on building hyper- and supermarkets in the periphery of the cities, it will leave space in the market in the niche of convenience stores. Due to the high rental rates they are not attractive for the foreigners, and actually the municipal authorities will not even allow them to enter the downtown areas in most cases. Not all the people have cars to drive to hypermarkets and many car owners do complementary shopping in local stores, too. (Radaev, 2004, p. 13)

Expanding fast

The strategy of expanding fast is something that every retail company is doing at the moment. Even though the Moscow market is not yet saturated, the chains are moving towards the regions, where there are better growth perspectives and the market situation is different. The difference to the "escaping to regions" –strategy is that the domestic company boldly faces the competition also in Moscow. To be the first on the market is a great benefit for the chains, although every leading chain is expanding to regions at the moment. The objective of this strategy is to expand as much as possible so that the value of the company would be grow to the extent where it is questionable whether the company is worth acquiring or whether the risk is too big to take. Sufficient growth clearly improves the possibilities of domestic chains to survive.

The crucial factors in implementing this strategy are obviously the above mentioned retail chains' access to capital and their ability to generate cash flow for expansion. The investments needed to build a store are, however, a lot smaller than in Moscow. On the other hand, so are the profit margins as well.

At the moment it does not matter much why the companies are expanding their networks of stores. Only if they expand they have a chance to survive. But if they do not survive by expanding their businesses, they are making sure that they will get large revenues for their investments. They are increasing the value of their chains anyway.

Mergers, takeovers and alliances

So far the retail chains have settled for the softest kind of cooperation, leaving the autonomy of decision making for themselves. They are e.g. forming strategic alliances. As mentioned above, the domestic firms are forming for example purchasing alliances to cut down product costs. Also other kinds of cost-cutting forms of cooperation exist. However, the author expects this situation to change in the future when the real competition for market shares begins. M&A activity will play a great role in the development as the chains look for more synergy benefits that come from joining forces. These kinds of improvements include for example synergy benefits in logistics and warehousing, advertising and in negotiation power towards the suppliers. Mergers might also make it easier to get access to long-term capital.

Joint ventures are one possible option, as Rewe's and Marta Holding's deal showed, but between domestic companies it is an unlikely direction of development. The joint ventures are much harder to establish and to sustain with different points of view in decision-making organs. There are some examples. The oil company Yukos failed in its investment when it acquired a 51% stake from Kopeyka in 2002. The alliance lasted less than a year because of the different opinions of the managers. Finally, the stock was moved to the investment company Nikoil. The joint venture to build Mosmart hypermarket chain between the chain's current owners and Seventh Continent failed also for the same reason and Seventh Continent withdrew from the project.

However, when the real consolidation starts the foreigners are again very strong because they have previous experience from acquisitions and they have learned how to create value from acquisitions. The domestic chains are fairly "green" in this sense and thus there is a risk of overestimating the value of the acquisitions and overpaying for them. Their advantage, however, is that their learning on the subject will probably start sooner than the foreigners'.

Summary of strategies

At the moment every domestic retail chain can be seen to implement all the above strategies at the same time. They are expanding fast to the regions even though the market in Moscow is not yet saturated. They are forming alliances with each other and some acquisitions have already taken place. The domestic chains are imitating the operations of the foreign chains and will at some point reach the level where they will become attractive also for the foreign chains to acquire. The domestic chains are dominating the convenience store sector, and they are all expanding to the segments of the foreign hypermarkets as well. Some chains might even think about selling their business if they feel to be lacking efficiency and quality. Nevertheless, they do not admit it at this point, and thus they will continue to implement the other strategies as well in order to increase the value of their chains. All in all, it does not make any difference what the ultimate goal of the different companies is at this stage because they are all in a race for bigger market shares in order to get better profits from the chains either by selling or by staying in the business.

For food producers the expansion to the regions means that they have now a chance to enter the markets of the regions as well. The best growth figures are there. The perishable nature of certain food products sets some restrictions for this is, as the quickly perishable goods cannot be transported very far from the production facilities. The future consolidation process will mean that the producers must probably start to sell their products for the merged chains according to the most favorable terms, which are negotiated with whichever member of the merger. Perhaps even lower prices are possible, because when the retail chains grow, they have more negotiation power towards the producers. This, however, does not make a big difference to the situation at the moment because the purchasing alliances and ACORT make sure that the producers must have more or less the same prices for every chain.

8.3. CEE experience

To forecast the pace of the consolidation, one can look at the history data of the other transition economies in Europe and try to find analogies in the development cycles. After the collapse of communism the starting point for these economies were more or less the same. The characteristics of retail trade were similar. However, due to regulations set by the Russian government and the second economic slump in 1998-1999, foreign retail chains started to enter the Russian market much later than in the CEE-countries. Thus, Russia is lagging behind in development.

The development trends of the retail market in the CEE-countries are presented shortly as follows:

1990

- Poor state owned retail chains
- Large number of independent small groceries
- Bazaars, street vendors

1995

- First international chains start opening their outlets in biggest cities
- The number of traditional retail outlets decreases
- Legal regulations limit the freedom of bazaars

2000 –

- International retailers strengthen their market position
    - Hypermarkets operate in all major cities
    - Discount stores are opened in smaller towns
- Strong price competition among retail chains and between chains and traditional outlets
- Traditional outlets organize groups/chains to compete with international retailers

It can be seen that the foreign chains are very strong in the CEE-countries' retail markets. In 2002 the clear market leader was Metro. It was leading Tesco by over EUR 2 billion (see table 10). Metro is expected to be very strong in Russia, too because it has an early mover advantage on the Russian market against other foreign chains, excluding Auchan. In addition, it already is the second-largest chain there. Thus Metro has been very successful in all of the European transition economies.

Another trend that can be seen in table 10 is that there are only a few domestic chains among the top 15 retailers in the CEE-countries. Only 4 Hungarian companies are fighting against the global players. There are no chains from Poland or the Czech Republic. It would be bold to say that the development in Russia may follow this same pattern, although there are clear similarities in these countries. One must bear in mind, however, that Russia is in its vastness different geographically. The size of the population is also over four-fold compared to Poland. Thus the changes may take longer than in other transition economies. However, if the market will change at the same pace as in the CEE-countries, the consolidation will be on the level of the situation described by table 10 in 5 years. This means that at that time the foreign retailers will have already taken the market leadership and the domestic chains' market share is diminishing. However, the author thinks that some leading Russian chains have a chance to survive in the market. Pyaterochka is one of them, and depending on the direction of development, others could be found as well. It is fairly easy to forecast that the price competition will start at some point soon and the competition will probably be as fierce as in the CEE-countries.

Table 10. Market leaders in Poland, the Czech Republic, Hungary and Slovakia in 2002

Pos	Company	Origin	Turnover, billion EUR
1	Metro AG	Germany	5.165
2	Tesco Plc	UK	2.916
3	Rewe Zentral AG	Germany	1.938
4	Tengelmann Group	Germany	1.796
5	Ahold N.V.	the Netherlands	1.643
6	Carrefour S.A.	France	1.424
7	CBA Kereskedelmi Kft.	Hungary	1.409
8	Groupe Auchan	France	1.369
9	JMR Jerónimo Martins Retails SA	Portugal	1.284
10	CO-OP Hungary Rt.	Hungary	1.233
11	Schwarz Group	Germany	1.083
12	Cora / Louis Delhaize	France	0.883
13	Honiker Kft.	Hungary	0.616
14	Reál Hungária Elelmiszer Rt.	Hungary	0.608
15	Globus Holding GmbH & Co. KG	Germany	0.508

Source: Mai Piac / Moderni Obchod / HANDEL / LZ|NET 2003

9. Supplier relationships and brand development

In the pursuit for better profits, the retail chains are trying their best to cut down the costs of their operations. As the infrastructure is still in poor shape and the logistics have proven to be very difficult to improve in a short time, the chains are trying to enhance their position against the food producers in order to get better deals from them. This is possible because the chains do not use intermediaries much but tend to do business directly with the producers, excluding a few foreign big producers who always use wholesalers in their distribution chain.

In order to enhance the negotiation power the chains have a variety of methods to cut down the cost of products. They are:

- Introducing private label products (i.e. own brands, such as Kesko's "Pirkka" in Finland)
- Forming alliances with other retail chains
- Offering the possibility for the supplier to sell its products in other regions as well, if they agree to lower their prices

The chains introduce own label goods and form alliances with other chains in order to get discounts for products. The regional expansion of the biggest retail chains enhances their negotiation power. Only manageable suppliers are allowed to follow the chains into the regions. Regional expansion has become a good striking weapon in negotiations. Suppliers are interested in regional expansion along with the retailers, and only some retailers can provide access to the regions where the best growth prospects are. In order to get that access, suppliers might have to grant discounts for their products, or otherwise the retailers will drop the supplier from their list. But even though the retail chains are becoming more and more powerful, the suppliers can still have some power of their own if they have a well-known brand and good distribution net. But if a supplier does not have these, it will be more or less at the mercy of the chains. Even the biggest suppliers have suffered from the alliances.

Cheap price is not necessarily the main factor the chains are looking for when selecting their suppliers. What the chains need is good quality brands that attract customers with JIT-deliveries with documentation according to standards. Bar codes are very important as well. Naturally the chains are trying to push the prices down but it is of advantage to producers if they have these things taken care of. These producers are in better position than many competitors because good distribution is profitable also for the retailer. Because the producers usually handle transportation of the goods to the stores, having an effective logistics scheme can lead to large savings. The chains with distribution centers distribute some of the goods by themselves to the stores, but not all. For example Pyaterochka distributes about 60% of the goods by itself.

It was mentioned above that Russian people prefer to buy domestic food products because they are considered to be healthier than imported ones. But because Russia is such a vast country with huge geographical distances, it needs to be asked whether the region of origin of goods really matters to consumers. According to the author's interviews it does. People prefer to buy products that are known to be from the same region, and some of the chains, if not all of them know this fact. For example 60% of Pyaterochka's assortment is produced locally. The case with hypermarkets could be somewhat different because they can afford to offer a wider assortment of goods due to their large floor space, but still over 50% of O'Key's assortment is locally procured.

In the interviews it was stated that the brands affect the buying decisions of consumers, but some of the chains have not realized this yet. Some of them still might think that they can sell anything. For example, an average Russian considers the domestic products to be better and healthier because the domestic products do not contain much food additives. Russians also want to support domestic production, in fact quite similarly as in Finland. There are some famous and successful domestic brands which look and sound like western ones such as J7 juice from Wimm-Bill-Dann, but these brands were introduced at the time when foreign products were considered to be better than domestic ones. Recently also Wimm-Bill-Dann has used only Russian brands. The interviewees also seemed to think that it is recommended to use a Russian brand when entering Russia's food market as a producer of food articles.

However, the consumers are not only aware of brands of different products, they also recognize the brands of different stores. Thus they are forming brand loyalty towards the chains as well. As mentioned above, the cheap stores are also often considered to be low in quality as well and this should be taken into account when thinking about the proper distribution channel to the produced goods. The brand loyalty is stronger in upper-scale supermarkets, while the customers doing their shopping in discounters and hypermarkets are more price-sensitive. People are also used to buying products from open markets, and in fact they are still the most popular form of retail in Russia. The situation is changing, but slowly.

Imported goods are often regarded as expensive alternatives almost by definition. This fact must be taken into consideration in groceries, which are frequently price-sensitive items. Locally made foodstuffs are widely regarded as superior in comparison to imported goods. Under the present circumstances Western investors in the Russian retail sector must obviously try to maximize the locally made contents of groceries offered. The pressure in this context is two-fold: locally made products are highly likely to be cheaper, and foreign alternatives in foodstuff do not necessarily have any higher prestige value. The situation is not necessarily the same in consumer durables and in consumer electronics. In these two spheres, foreign products enjoy high prestige and image of high quality. In some consumer durable products price sensitivity is obvious. IKEA's basic idea is to offer good value for money, and thus, it develops local supply chains everywhere in TE's – with success. This strategy obviously takes time and effort; however, it might be a must in the grocery store business segment. Probably this rather difficult route explains the so far rather thin involvement of foreign retailers in the Russian market in which several local companies already have the size and scope to compete.

9.1. Private label

It is already an established fact that the concept of own brand i.e. private label business has landed in Russia and in other TE's. One way of enhancing the chains' position in price negotiations is developing own brands for the products to be sold. In Finland Kesko's Pirkka is probably the most famous private label. In Russia they are often called with the same name as the chain. For example there is Perekrestok milk, Perekrestok French fries and Perekrestok juice.

Private labels give the chain the freedom to choose its suppliers and it can look for cheaper products. Changing the supplier does not have any effect on the product loyalty because the brand will stay the same. The own label development in Russia has just recently started. At least Perekrestok, Ramstore, Metro, Pyaterochka and Kopeyka have them. Seventh Continent is about to establish its own when it opens its hypermarket in the spring 2005. According to the interviewed analysts the chains that have their own label goods are pushing to increase their share. This has to be taken seriously. Kopeyka has a goal of even up to 50% by 2005 and Pyaterochka by 2008 (Interfood, 2004). Perekrestok has set their objective, increase their share to 10-12% in the near future. Now they have 3-4% (Oilworld.ru, 2004). Also Paterson is planning to introduce its own label products in the near future (Spiridovitsh, 2004a). These figures confirm what one of the interviewees also mentioned that better margins can be obtained from own label goods than conventional products. Private label products are beneficial also because the own brand gives a Russian image to the product and the Russians prefer such products.

Because the low price alternative is the very core of the private label concept, potentially expensive imports (of private label products) are by definition excluded. Thus, the concept as such is likely to advance local manufacturing.

9.2. Development of alliances

The bargaining power of the chains is increasing. Suppliers' possibilities to determine a price of their own for each customer has deteriorated because of the strategic alliances Russian companies have formed. The first alliance of this sort was formed by Perekrestok, Kopeyka and Diksi and in the spring 2001. At first the alliance was set up against Wimm-Bill-Dann, the largest producer of dairy products in Russia. It was considered to have unfavorable sales terms and that is why the retailers joined their forces. The scheme worked so well that soon the alliance squeezed discounts from 30 different producers. (Oilworld.ru, 2004)

The second similar alliance between Perekrestok, Seventh Continent and Kopeyka was launched in the fall of 2001. This alliance was designed to resist Metro Cash & Carry's good position. At that time some of the suppliers had special low prices for it and the domestic chains joined forces to resist that kind of trade. The retail chains put all the producers that had special prices for Metro under boycott. (Oilworld.ru, 2004)

Perekrestok formed a purchasing alliance again with Kopeyka in the spring 2004. Soon after that the largest hypermarket chain in St. Petersburg, Lenta, joined the alliance. The alliance is supposed to cut down the purchasing costs of goods by using the common negotiation power of the members of the alliance towards the food manufacturers. The manufacturers have to work directly with the chains and discounts are demanded for certain product groups. The members share information on their prices, discounts, etc., and thus discounts negotiated by a member chain benefit every chain in the alliance. Together the total turnover of these three companies exceeded USD 1 billion in the year 2003 and it was expected to rise to USD 1.6 billion in 2004. According to Renaissance Capital estimates the total turnover was even greater, USD 1.765

billion. The overall turnover of the three chains is to approach USD 2 billion in 2005. The manufacturers cannot afford to ignore these kinds of sales volumes. (Retail.ru, 2004a)

Starik Khottabych, SportMaster, MVO, Avtokei, Seventh Continent and M-Video have formed a somewhat different alliance. The alliance is geared toward implementing a unified marketing and advertising policy, as well as executing joint ventures such as the retail outlet complex currently under development in the city's suburbs about 26 km from MKAD (Moscow city ring road). The alliance is called Seven Sevens Alliance (Kenneth, 2002). The alliance has been successful so far. Seventh Continent cooperates also with Mosmart in advertising and purchasing schemes (Spiridovitsh, 2004a).

9.3. Warehousing logistics and infrastructure

The demand for modern warehousing facilities is clearly bigger than the supply in Russia. Even though there has been some development the supply has grown slower than planned. For example in 2004, the building of approximately 300,000 sq. meters of warehousing space was completed in Moscow when the planned figure was 500,000 sq. meters. Especially, the retail business, along with car and computer industry, the producers of commodities, and logistic firms suffer from the situation. The problem is not the lack of interest of investors but the lack of suitable land plots at the outskirts of metropolises and long bureaucratic and corrupted application processes for building permits. In the Moscow area alone the deficit of high-class warehouses (A and B class) is 400,000-500,000 sq. meters, whereas the deficit in the whole Russia is 2.5-3.0 million sq. meters. (Spiridovitsh, 2005)

The retailers face the same problems in improving their logistics as in expanding their store networks in large cities. Because of the lack of warehousing space, the rents from existing warehouses are very high as well. In Moscow they are already close to the level of London. Warehousing costs are lower even in Paris and in Frankfurt. In St. Petersburg the deficit of A- and B-class warehouses is so huge that the prices reach the Moscow level. (Spiridovitsh, 2005)

One solution to the warehousing and other problems in the infrastructure is to establish a distribution center. So far only a few of the retail chains have done that, such as Pyaterochka, Kopeyka and Perekrestok. Diksi joined this group recently by establishing a distribution center in Moscow (Olex Holding, 2004). The problem of the poor infrastructure is quite severe in this sense. Another way is to have proper relations with distributors, but it is a very challenging task since the distribution is mainly the responsibility of producers. The chains must keep the producers on a very tight leash. The distribution centers not only improve the companies' efficiency, but also the level of quality (Deckmann Media, 2004b).

As the producers usually must distribute their goods to the shops themselves, a well-planned and -implemented logistic scheme can lead to savings in costs. The producers should be prepared for JIT deliveries because they are a huge benefit when the chains choose their suppliers. Firstly one must see that every city has its own peculiarities in the distribution of goods. For example, in St. Petersburg the trucks are allowed to cross the bridges over the river Neva only at certain time of the day. The producers must find out these peculiarities before establishing any kind of production in the cities. The producers must see that only Kopeyka, Pyaterochka, Diksi and Perekrestok of the domestic retailers have distribution centers of their own and not all products are distributed through them. Thus, more of this kind of activity will be expected in the future.

10. Other trends

In addition to the trends already presented, there is a number of factors affecting the retail trade in the long or medium term. These trends affect investors' willingness to invest on the retail business, the consumers' purchasing power and ability to use money, and the growth of the chains.

10.1. Investor ratings

The GRDI (Global Retail Development Index) is an index for the attractiveness of investing in the retail sector, published annually by a global consulting firm AT Kearney. In 2004 Russia was for the second time in row number one followed by India and China. This can also be seen in the recent investment rate on the Russian retail sector. The factors used for measuring the attractiveness are the perceived economical and political risk, the level of retail saturation, and the difference between gross domestic product (GDP) growth and retail growth (AT Kearney, 2005). This indicates that the Russian retail sector is not considered very competitive because there is lots of room even for new entrants.

Moody's Investor Service, Fitch Ratings Ltd. and Standard & Poor's are companies that provide credit and bond ratings, research and risk analysis. They assess whether it is safe to buy the bonds of different countries. Encouraging investors, Moody's Investors Service lifted Russia's credit rating to the investment grade for the first time in September 2004. Both Fitch Ratings Ltd. and Standard & Poor's were expected to follow. Fitch in did it in November and Standard & Poor's in the turn of February 2005 (EIU, 7.2.2005). As the risk levels subside, investors are getting a clearer picture of Russia and might get more confidence on the Russian economy and thus increase their investments (Bodamer, 2004).

10.2. Improving standard of living

In the past people used to shop daily and get the daily goods from the shops and market places nearby. Today people's habits are shifting more and more to weekly shopping. One reason to this is the growing number of cars. Bigger and better store formats that were never seen in the communist era, for example super- and hypermarkets, can keep their prices low because they sell large volumes of goods. However, especially the hypermarket and cash & carry chains do not have enough building space in the city centers and they must build their shop outlets outside the city center. Consumers that want to benefit from their low prices must drive to their store and do all the week's shopping at one time. This competitive and changing situation sets new challenges and opportunities for the food producers. The purchasing volumes grow, but at the same time the price might become lower.

The bad housing situation is an ongoing trend, which may in the long run affect people's consuming habits by lowering the share of food from disposable income. The apartment buildings of average Russian citizens are deteriorating because nobody has a responsibility to fix and maintain them. After the communism the apartments were practically inherited from the state, and the living has therefore been practically free of charge ever since. However, nobody is responsible for the maintenance of the buildings themselves, and so they are deteriorating all the time. In order to be able to maintain the buildings organizations similar to the Finnish housing corporations must be founded. This will channel people's consuming and usage of money from retail trade to housing costs.

Another trend that is due to the rising living standard, is the establishment of Internet stores. Some major domestic retail players in the foodstuffs sector have already done so (e.g. Seventh Continent, Perekriostok) and there are also other players in that small niche. The number of Internet users is increasing as the growth of the standard of living continues. Until 2002 such efforts had been targeted mainly at the Moscow market. (PWC Global, p. 94)

10.3. WTO

At the moment Russia is negotiating on WTO (World Trade Organization) membership. Russia is a major oil producer, but the policies they drive in selling oil to other nations are against the principles of WTO. The Russian oil and gas companies sell energy at much cheaper prices to domestic customers than to foreign customers (Mäkinen, 2005, p. 23). Russia has at this point negotiated an agreement with the EU that it can continue doing this in the future, but Russia is required to change the prices gradually in any case. In the long run Russia is required to set the prices on the same level with other WTO members, and this might have an effect on people's use of money. The share of money used in retail goods of all income will thus be reduced. On the other hand, the higher energy prices might encourage Russian industries to develop their production to be more effective. (EUROPA, 2004)

For Finnish food producers the membership would mean a lot better exporting possibilities, as the custom duties would be diminished significantly and goods could be transported easily over the border. The analysts say that Russia's WTO membership might come true in the beginning of 2006 (Mäkinen, 2005, p. 23).

10.4. City authorities

Because Russia is a vast country and the markets are separate, the conditions of doing business vary around different large cities. The regional governments want to support local production and jobs. The governments might demand that a certain share of the products sold by a retail chain must become from local producers, and they actually have that power. Otherwise the retail chains would face difficulties in getting land plots and construction sites for their business. For example Metro has this kind of agreements at least in Samara and Perm.

In fact Metro, Lenta and O'Key were invited to meet the Council for Economy Development, Industrial Policy and Trade (CEDIPT) official Youri Rakov who implied to the retailers that too much of the chains' assortment comes from Moscow and they should be more loyal to St. Petersburg suppliers. The officials can use the argument of not giving land plots to these retailers, but it also can imply that the city is negotiating with several foreign chains to enter the market in St. Petersburg. Thus the city can use this kind of "civilized" extortion and pressure to support its producers (Retail.ru, 2004c). Thus, a great share of goods is expected to be purchased from the same region because the above mentioned amount of 50% at O'Key is apparently not enough for St. Petersburg officials. This fact is something what the food producers should take into consideration when thinking about setting up production facilities in Russia.

11. Conclusions

It is easy to say what the origin of the success of the top 5 retailers in Russia is. E.g. Pyaterochka's stores are very convenient to get to because they are located in densely populated areas. The company has been successful in getting good spots for its stores. The stores and the average purchases are small but they are so easy to get to that one can go there several times a week. Pyaterochka is also able to offer a good assortment of products at a low price. In Russia the income of majority of people is quite low and Pyaterochka targets its actions to this particular group. Volumes count. They have carefully selected the goods in their assortment so that a customer rarely needs to go to another shop to search for a certain product. EBRD's 3-year ownership clearly helped the company to rise to number one chain in Russia.

Metro Cash & Carry's success factor is clearly the best price-quality relation. It is inexpensive, but the quality of the products is very good. The assortment of goods is also wide, so practically everything can be found at Metro. The second factor is the cost managing approach. Metro can offer decent value for money for its customers because it has been able to control its costs partially because its stores are located far from city centers.

Magnit has met the needs of people with less money in the regions (mainly south) with its hard discounter format and managed to be the first in many markets, at the same time when the others were battling for market shares in Moscow. Tander, which owns the Magnit chain, is originally a wholesaler, and it has a long history of dealing with suppliers. It must have helped creating the Magnit discounter chain.

Perekrestok's and Seventh Continent's advantage of being the first in the Moscow market is gradually diminishing. Their main format supermarkets are being attacked by the hypermarket and discounter formats. Supermarkets are caught in between and they have not been able to expand fast enough to respond to these other formats. However, the author sees that by joining forces the domestic multi-format chains will be able to match the pressure of the other companies and become even the largest players in Moscow.

Pyaterochka has been the most successful of the Russian retailers but there are also rising stars. It is interesting to see how well Paterson will succeed against its rivals. In addition to existing competition, there is still room for new players in the market. The market is far from saturated. However, it will not be easy to enter the market, and it is almost impossible for a new domestic chain to establish business and survive. Because the domestic chains have to finance their expansion with their own cash flow, the companies that are big now are highly likely to survive in the competition. Small chains will be eaten.

All in all, the chains with the discounter format will be strong because there is a lack of investment capital available in the market. The chains have to finance their expansion mostly by themselves and the discounters are very cheap to establish. They are also easy to franchise. Thus, new stores can be built with a small input, even though there is not very much capital available.

The hypermarket segment is booming, but it does not compete with discounters at all because the hypermarkets are targeted for a different market segment, i.e. people with cars. In addition, they are usually located somewhere at the outskirts of the cities near the main highways and thus they do not compete for location as severely as discounters and supermarkets do. It is enough to be near the highways. One can find practically everything from hypermarkets and they are less expensive than supermarkets. It pays off for the customers to do their weekly shopping in hypermarkets. Thus, they are very efficient in generating revenues. The down side is that the hypermarkets need fairly large investments to establish.

The ability to establish new stores in the regions and thus take market share is of high importance in the competition. The best growth prospects are there nowadays. Even though Moscow is ahead in development, the regions are following behind and with time the difference will to a certain degree even out. The markets will saturate first in Moscow and just after that in the other regions. In fact, at the moment the retail sector's growth in Moscow is already slower than the overall growth in Russia (see table 7). The author considers it to be likely that the large chains will evidently conquer the regional markets as well, despite of the opposition from regional governments and chains. Their size is beginning to be a clear advantage. Thus it is fair to say that the market survivors from the current players are among the top 15 retailers.

It was mentioned above that the Russian retail sector permanently has a high profit margin. According to the very basic market rule, sectors with high profits will attract supplementary capital from internal and external sources. Therefore, it can be predicted that there will be continuous dynamism in the Russian retailing in the foreseeable future. At the same time, it is obvious that the core of the Russian boom is in the export of energy bearers, such as oil and natural gas. Thus, there is rather high volatility in the Russian economic development, which is probably hindering an outright invasion of foreign retailers.

The new market entrants will cause tightening in the competitive environment when they come to Russia. However, it will not be easy to find success on the Russian market anymore, albeit there is still room for new players. The current players enjoy the advantage of being first in the market. They have gathered experience and learned how to do business in Russia. They know how to deal with corruption. They have also established a significant number of stores at important locations of the biggest and most promising cities. Thus the newcomers would have to seize customers from existing companies and that will not be easy without a functioning distribution net. At this point the author expects only big multinationals to enter the market, as it will take significant investment inputs to establish or to buy a critical mass of stores to be successful. The author will not rule this out, but considers new domestic players unlikely to enter the market. There is more room for market entrants in the regions, but the problem is that the margins might also be lower due to the lower wages in the regions and the operations thus less profitable. The second half of this decade will be interesting to observe: there is still plenty of leeway for intensified competition in the Russian retail sector.

Expanding to regions is the most important trend in the Russian retail sector today. Even though the Moscow markets are not saturated yet, the leading chains are expanding their operations to the regions. This is partly because the land plots for store construction and real estate are very expensive in the capital, and partly because being among the first in the regions gives good growth prospects and competitive advantage against other chains in those markets. In fact, in order to grow fast enough chains even have to enter the regions. The consolidation process will follow when the growth slows down. St. Petersburg is not necessarily the best place to expand to, even though the size of the population is great, because there is already competition in that market and the development of wages is not better than in the other regions.

The consolidation of the food retail sector has started but remains fairly undeveloped. Moscow is ahead of the regions in this respect. At first the larger chains will start to acquire small chains and independent shops. They will be compensated well for their business. As the competition gets tougher, the chains have to give up their huge margins and start to compete with prices. Those who have created good logistic schemes and implemented them are more efficient and thus generating more profits. If necessary, they can also pull the prices down and be profitable still.

The heavy mergers or acquisitions will start then and, according to analysts, the end-result will be that there are 5-10 players in the market. The estimated time frame for this development is 3 years in Moscow and 5-7 years in the regions. However, the growth will continue clearly at least for 10-15 years.

The overall retail sector will continue its growth for some time with the increasing purchasing power of customers, before major changes in the environment will take place. Because the consumers have more money than before they will demand more and better products for their money in the future. The food producers should bear in mind that the price level in Russia is, however, significantly lower than in developed countries, and thus they have to sell 2.5 fold more of same products in Russia to achieve the same turnover as in EU (15) –countries. Therefore, the producers must keep their utilization of production capacities high to achieve the best profits. On the other hand, the large number of people in the biggest cities makes long production series possible.

The growing income and the upcoming WTO membership of Russia make it possible for Finnish food producers to continue doing business with Russians by exporting. However, in order to get significant market shares, and above all, make decent profits in the Russian market, FDI is the best alternative. Brownfield investment would probably be a preferable method for entry because the local companies have already established working relationships with the suppliers of the scarce raw materials. Thus it would be difficult for a foreigner to start from scratch.

Exchange rate protectionism is an attraction to produce in Russia in comparison to direct export: it makes import-substituting activities potentially profitable. With a weak US dollar and thus weak Russian ruble (RUR is regulated against USD), it would be the right time to invest now because EUR is very strong against USD at the moment. More can be obtained with less investments. At the same time the value of investments will grow along with the market growth if the business is well taken care of. Also, the longer you wait, the tougher the competition gets. If the ruble is allowed to float freely in the future, the appreciation of the ruble will bring investors bigger profits also in euro terms.

When entering the Russian markets, foreign food producers have to consider the location they want to establish their products in. Moscow, the Moscow region or at least immediate proximity to these areas provide the best prospects for business, compared to other regions in Russia, because the retailers buy a lot of goods locally and the market size in Moscow is huge. Especially perishable goods ought to be produced near the markets. On the other hand, also the toughest competition and pressure from the retailers are there, but by offering quality products with a functioning distribution net, the companies can be included among the strongest food producers in the business. Those suppliers who can deliver goods with high quality in right time, reliably and with proper documents are in a good position when retail chains are thinking about choosing suppliers.

However, the decision process starts with choosing a product and then the supplier. The retail chains will buy what the customers need and buy. Thus a proper market research is recommended before investing for food production in Russia. The food producers should also plan and implement logistics schemes carefully before entering the market. The same rules would also apply to everyone in Moscow, although corruption still exists. The wages are also on a higher level in the capital than in the rest of Russia.

Producers entering the market might also have to use Russian brands because the consumers prefer Russian food products. One solution is to acquire a strong brand from Russian markets, as this will raise the negotiations with the retail chain to a different level. If a producer possesses a strong brand, it is possible for it to negotiate favorable sales terms for it.

All in all, it is fair to say that Russia offers a fairly stable and profitable environment for investments in food production, and the success factors are clear. There is potential in the market waiting for someone to take the chance.

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Appendix 1.

Retail trade and food retail in the most important regions for retailers
RUR (million)

	1998	1999	2000	2001	2002	2003	2004
Central Federal District							
Moscow retail	290,148	512,946	682,439	886,390	1,034,743	1,178,970	1,400,000
of which food	124,620	219,909	275,847	350,268	420,177	n/a	n/a
Moscow region retail	40,242	78,196	96,770	122,302	153,803	194,375	292,000
of which food	19,035	37,534	43,929	55,300	67,371	n/a	n/a
Tver region retail	6,570	11,707	14,533	18,047	22,410	28,152	40,500
of which food	3,679	5,803	6,919	8,344	10,696	n/a	n/a
Yaroslavl region retail	7,590	11,847	14,143	17,664	21,727	25,568	31,000
of which food	3,803	6,250	7,296	8,920	10,951	n/a	n/a
North-West Federal District							
St. Petersburg retail	37,966	65,274	86,493	112,330	139,303	161,878	203,000
of which food	16,111	26,170	35,173	44,683	59,381	n/a	n/a
Leningrad region retail	7,329	12,461	15,854	21,578	26,653	30,633	38,000
of which food	3,780	7,371	8,915	13,248	15,910	n/a	n/a
South Federal District							
Krasnodar territory retail	23,990	45,121	62,145	82,886	109,908	130,497	157,000
of which food	10,592	21,294	30,049	40,481	52,757	n/a	n/a
Rostov region retail	23,337	44,956	60,588	80,619	101,952	122,568	152,000
of which food	10,168	21,000	27,543	36,472	46,201	n/a	n/a
Stavropol territory retail	12,705	22,570	30,418	39,461	49,904	60,488	79,900
of which food	5,477	11,166	14,266	18,038	22,730	n/a	n/a
Volgograd region retail	12,752	22,605	29,938	39,185	50,198	61,837	80,000
of which food	6,042	11,242	15,294	19,801	25,522	n/a	n/a
Privolzhsky (Volga) Federal District							
Samara region retail (Samara and Togliatti)	38,368	69,339	84,411	107,059	127,798	147,999	178,000
of which food	15,011	31,809	38,011	46,691	57,208	n/a	n/a
Republic of Bashkortostan retail (Ufa)	21,361	38,689	49,400	65,663	82,048	103,785	134,000
of which food	11,369	21,396	25,256	33,999	42,583	n/a	n/a
Republic of Tatarstan retail (Kazan)	19,296	34,096	44,815	61,218	74,577	96,314	118,000
of which food	10,313	19,349	25,299	34,773	41,243	n/a	n/a
Nizhny Novgorod region retail	17,982	33,657	43,163	57,513	74,759	92,013	115,000
of which food	8,632	16,232	20,815	29,249	36,616	n/a	n/a
Perm region retail	20,492	31,536	40,460	54,225	68,144	83,796	101,000
of which food	9,976	16,415	20,492	27,504	34,919	n/a	n/a
Ural Federal District							
Sverdlovsk region retail (Yekaterinburg)	26,367	42,978	58,665	80,787	107,718	134,139	174,000
of which food	13,711	22,091	30,442	41,484	55,259	n/a	n/a

Source: Goskomstat

Appendix 2.

Retail trade and food retail in the most important regions for retailers

USD (million)

	2000	2001	2002	2003	2004
Exchange rate used	28.128725	29.175301	31.360773	30.572359	28.808037
Central Federal Disrict					
Moscow retail	24,261.28	30,381.52	32,994.82	38,563.27	48,597.55
of which food	9,806.59	12,005.63	13,398.17	n/a	n/a
Moscow region retail	3,440.26	4,191.97	4,904.31	6,357.87	10,136.06
of which food	1,561.71	1,895.44	2,148.26	n/a	n/a
Tver region retail	516.66	618.57	714.59	920.83	1,405.86
of which food	245.98	286.00	341.06	n/a	n/a
Yaroslavl region retail	502.80	605.44	692.81	836.31	1,076.09
of which food	259.38	305.74	349.19	n/a	n/a
North-West Federal District					
St. Petersburg retail	3,074.90	3,850.17	4,441.95	5,294.91	7,046.64
of which food	1,250.43	1,531.54	1,893.48	n/a	n/a
Leningrad region retail	563.62	739.60	849.88	1,001.98	1,319.08
of which food	316.94	454.08	507.32	n/a	n/a
South Federal District					
Krasnodar territory retail	2,209.31	2,840.96	3,504.63	4,268.46	5,449.87
of which food	1,068.27	1,387.51	1,682.26	n/a	n/a
Rostov region retail	2,153.95	2,763.26	3,250.94	4,009.11	5,276.31
of which food	979.18	1,250.10	1,473.21	n/a	n/a
Stavropol territory retail	1,081.39	1,352.55	1,591.29	1,978.52	2,773.53
of which food	507.17	618.26	724.79	n/a	n/a
Volgograd region retail	1,064.32	1,343.09	1,600.66	2,022.64	2,777.00
of which food	543.71	678.69	813.82	n/a	n/a
Privolzhsky (Volga) Federal District					
Samara region retail (Samara and Togliatti)	3,000.88	3,669.51	4,075.09	4,840.94	6,178.83
of which food	1,351.32	1,600.36	1,824.19	n/a	n/a
Republic of Bashkortostan retail (Ufa)	1,756.21	2,250.64	2,616.26	3,394.73	4,651.48
of which food	897.87	1,165.34	1,357.84	n/a	n/a
Republic of Tatarstan retail (Kazan)	1,593.21	2,098.28	2,378.03	3,150.36	4,096.08
of which food	899.40	1,191.86	1,315.11	n/a	n/a
Nizhny Novgorod region retail	1,534.48	1,971.29	2,383.84	3,009.68	3,991.94
of which food	739.99	1,002.53	1,167.57	n/a	n/a
Perm region retail	1,438.39	1,858.59	2,172.91	2,740.91	3,505.97
of which food	728.51	942.72	1,113.46	n/a	n/a
Ural Federal District					
Sverdlovsk region retail (Yekaterinburg)	2,085.59	2,769.02	3,434.80	4,387.59	6,039.98
of which food	1,082.24	1,421.89	1,762.04	n/a	n/a

Source: Goskomstat, (exchange rates from CBR)

Appendix 3.

Average monthly nominal accrued wages of the employed in the economy (Most important regions for retailers)
RUR

	1998	1999	2000	2001	2002	2003	2004
Central Federal District							
Moscow	1,522.3	2,355.5	3,229.3	4,924.2	6,388.4	8,156.5	10,934.0
Moscow region	1,036.1	1,579.8	2,269.3	3,450.0	4,802.6	5,996.7	7,897.0
Tver region	768.0	1,109.3	1,574.5	2,343.2	3,306.5	4,306.0	5,559.0
Yaroslavl region	888.3	1,290.1	1,905.8	2,830.6	3,889.5	4,925.3	6,317.0
North-West Federal District							
St. Petersburg	1,147.9	1,687.3	2,511.5	3,695.3	5,434.7	6,864.6	8,625.0
Leningrad region	960.7	1,443.7	2,178.8	3,258.4	4,527.5	5,699.4	7,052.0
South Federal District							
Krasnodar territory	800.3	1,191.2	1,697.6	2,495.3	3,365.4	4,197.5	5,517.0
Rostov region	645.5	931.9	1,360.5	2,092.2	3,002.1	3,916.7	5,093.0
Stavropol territory	668.3	984.0	1,438.4	2,098.7	2,837.4	3,562.5	4,780.0
Volgograd region	817.1	1,127.0	1,690.4	2,392.5	3,132.7	3,904.4	5,068.0
Privolzhsky (Volga) Federal District							
Samara region (Samara and Togliatti)	1,160.7	1,622.9	2,214.0	3,157.3	4,228.0	5,161.5	6,413.0
Republic of Bashkortostan (Ufa)	879.2	1,239.6	1,932.9	2,836.8	3,717.9	4,534.7	5,606.0
Republic of Tatarstan (Kazan)	949.1	1,293.0	2,010.2	2,936.1	3,735.6	4,534.4	5,692.0
Nizhny Novgorod region	819.1	1,272.0	1,697.6	2,508.2	3,404.1	4,271.7	5,416.0
Perm region	1,137.0	1,658.1	2,433.7	3,421.9	4,286.6	5,286.6	6,496.0
Ural Federal District							
Sverdlovsk region (Yekaterinburg)	1,086.7	1,534.1	2,273.8	3,246.1	4,473.1	5,643.5	7,488.0

Source: Goskomstat

Appendix 4.

Average monthly nominal accrued wages of the employed in the economy
(Most important regions for retailers)
USD

	2000	2001	2002	2003	2004
Central Federal Disrict					
Moscow	114.8	168.8	203.7	266.8	379.5
Moscow region	80.68	118.3	153.1	196.1	274.1
Tver region	55.97	80.31	105.4	140.8	193
Yaroslavl region	67.75	97.02	124	161.1	219.3
North-West Federal District					
St. Petersburg	89.29	126.7	173.3	224.5	299.4
Leningrad region	77.46	111.7	144.4	186.4	244.8
South Federal District					
Krasnodar territory	60.35	85.53	107.3	137.3	191.5
Rostov region	48.37	71.71	95.73	128.1	176.8
Stavropol territory	51.14	71.93	90.48	116.5	165.9
Volgograd region	60.1	82	99.89	127.7	175.9
Privolzhsky (Volga) Federal District					
Samara region (Samara and Togliatti)	78.71	108.2	134.8	168.8	222.6
Republic of Bashkortostan (Ufa)	68.72	97.23	118.6	148.3	194.6
Republic of Tatarstan (Kazan)	71.46	100.6	119.1	148.3	197.6
Nizhny Novgorod region	60.35	85.97	108.5	139.7	188.0
Perm region	86.52	117.3	136.7	172.9	225.5
Ural Federal District					
Sverdlovsk region (Yekaterinburg)	80.84	111.3	142.6	184.6	259.9

Source: Goskomstat, (exchange rates from CBR)

Appendix 5. Map of Russia

Source: PLC, 1993