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MAIN

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IN OUR OPINION

FROM PROBLEM TO SOLUTION

OUR NEAREST NEIGHBORS

MARKET BREAKDOWN

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CULTURE & CUSTOMS

WINTER OLYMPICS IN SOCHI

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RS → [Market breakdown](#) → Investing in Russian agriculture: where there's a will there's a way

Investing in Russian agriculture: where there's a will there's a way

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Russia's agro-industrial complex has always been a somewhat risky business: low levels of profitability are exacerbated by losses brought about by corruption, and the sector boasts very few qualified experts. But in spite of these difficulties, experts predict that we are going to see growing interest in Russia's agricultural industry now that the country has joined the WTO and agreed to play by the rules in force around the world.

In August it will have been a year since Russia became a member of the World Trade Organization, after spending 18 years striving to attain member status. Despite its long preparation period and the country's strong desire to become a member of the WTO, only a handful of sectors have been able to derive a benefit thus far. The majority of the key sectors of Russia's economy are faring badly and only seem to be getting worse, and the biggest victim turned out to be agriculture, in which the constraints were removed in one go, rather than gradually.



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It must be said that the level of state support for agricultural manufacturers is significantly lower than in Europe. Whereas in Europe it's possible to get a loan at 3-4% interest, in Russia the interest rate is likely to be at least 15-16%. At present, most of the subsidies that people in the agricultural sector receive go towards covering their debts and paying their lease.

Almost every branch of the agricultural industry has felt the impact of the blow either directly or indirectly. Pig farming has suffered as a result of a reduction in tariffs to zero. Cheap import prices, which cannot now be limited by protective dues, have put a whole raft of businesses in central Russia - a key area for Russia's pork industry - under threat.

Why did Russia need to join the WTO? That is the question still bothering both consumers and the companies on the market

The dairy sector has been affected almost as badly: imports of butter have risen by 80%, cheese and tvorog - by 8%, and milk - by 14%. Russian manufacturers have lost a total of 20% of the dairy products market, and their profits have fallen by 10% by comparison with 2012. According to experts from the National Union of Milk Producers, 'Soyuzmoloko', milk production fell by more than 10-15%.

Russia had been so eager to join the WTO, but turned out to be completely unprepared

for the opening of its borders to imports. Government-approved programs have been set up to train 400 WTO experts a year. That is not nearly enough: when China joined the organization, it already boasted 25,000 experts, including 6000 lawyers.

Loans and leases: the pillars of the agricultural industry

Prior to Russia's membership of the WTO, a sufficient flow of funding was ensured by state support, under the agriculture development program. Mikhail Losev, the deputy director of the Department of Economics and State Support for the Agro-industrial Complex, at the Ministry of Agriculture, told RS that at the end of 2012 the total amount of investment in the sector stood at over 1.8 trillion roubles. For every rouble of state support in the form of investment loans, there were over 5 roubles of private investment in main capital. The biggest flow of investment was seen in the first year of the state program's implementation, in 2008: 11 roubles of investment for every rouble from the state.

Loans and leases also played their part. In the space of 5 years, Rosselkhozbank provided 667 billion roubles-worth of loans for investment projects, while Sberbank provided over 503 billion roubles for project financing. Rosagrolizing provided agricultural manufacturers with approximately 40,000 pieces of machinery, with a total value of over 65 billion roubles, and also supplied over 266,000 animals for breeding, with a total value of approximately 16 billion roubles.

Be that as it may, the plan for the agricultural industry that was supplied by the government was left unfulfilled: in 5 years, the volume of agricultural production rose by 116.8% rather than 121.7% as stipulated by the plan, plant production rose by 114.6% rather than 115.9%, and animal breeding rose by 114.9% (as opposed to 127.7%).

The fact that the targets were not met could be put down to "unfavourable weather conditions and a shortfall in financing for particular measures". "There were years when the harvest was good and years when it was bad. In 2008, the grain harvest and the harvest of leguminous cultures reached the record level of 108 million tonnes, whilst in 2010 only 61 million tonnes were collected, and in 2012 - 70.9 million tonnes," Mr Losev explains.

Foreigners in Russia's agricultural industry: the odd ones out

"There aren't all that many foreign investors in our agricultural industry," asserts Evgeny Ivanov "There are practically none in the beet and sugar industry, for example." The companies Cargill and ED&F Man Sugar were recently forced out of production entirely in Russia. Admittedly the former still has its glucose and treacle plant in Efremov, so they are still in the market for sugar alternatives and starch sugars (No.1 in this market). Moreover, a plethora of international traders have brought their sugar operations in Russia to a close, according to the expert. Only a handful remain, and they no longer have any sugar-related assets in Russia - all they have is their trade itself, a small office and a rented warehouse.

The French company Sucden acquired several sugar plants in Russia in the 2000's, and built three production areas covering 75,000 hectares, which provided approximately 30% processing capacity. According to the company's financial director Gleb Tikhomirov, the company has already poured \$60 million into the agricultural project, and now plans to invest \$7 million a year. Tikhomirov cites the low cost of renting land as one of the advantages of working in Russia, whilst the drawbacks include the shortage of experts and the constant need to struggle against theft.

On the whole, food production is less attractive to foreign investors than food processing. But many processing companies are turning into de facto producers. The French company Bonduelle decided to construct a jam factory near Krasnodar, along the same lines as its factories in Hungary and Italy: the company purchases produce

from the farmers, who supply sweetcorn and peas to the firm. But outsourcing of raw materials production has suffered a setback, despite the efforts that were put in over three years. The recommendations made by French technical experts were not put into effect, and imported machinery was not used for its intended purpose. Ultimately, Bonduelle had to alter its strategy and rent over 3000 hectares in order to grow its own vegetables.

Food production is less attractive to foreign investors than food processing

You can count the number of successful companies on the Russian market that have received foreign investment on the fingers of one hand.

The company Russian Farms, which belongs to someone who, though born in Russia, is a US citizen - Andrei Danilenko - began to do business back in the mid-'90s, with small pilot projects involving the rearing of large, horned cattle and the planting of food crops and vegetables. It is now a business with a turnover of 1 billion roubles, with assets in the Belgorod and Moscow Regions and in the Stavropolsk Territory.

CECAB Group, one of Europe's leading players in the production and processing of conserved and frozen vegetables, launched the firm "Conserves of Kuban" in the Krasnodar Region. The Danish company "DAN KUB" is implementing a project in the same place, involving the refurbishment of a pig farming complex to incorporate 2,600 sows, with a capacity of 60,000 animals a year.

Incidentally, there aren't many foreign investors in the meat industry either, particularly in pig farming. The high risks in the industry can be put down to African swine fever, an epidemic which first reared its ugly head in the country years ago and refuses to go away. Outbreaks of ASF among wild boar have now been recorded in 15 regions. The acting Director of the Veterinary Department at the Ministry of Agriculture, Svetlana Dresvyannikova, accounts for this by saying that private farms feature heavily in Russian pig farming. 33% of all pig farming takes place here, and the risks of contracting and passing on the virus are between 67 and 100%, Dresvyannikova says that what further complicates the issue is the fact that there is as yet no cure for the disease. And in addition to swine fever, there is also a need to battle against foot-and-mouth disease.

The market that is most attractive to investors is the dairy market. It includes Nestle, Danone-Unimilk, Armann, Valio and Kampina. A supply system was set up in Russia in the early 2000's, followed by food production. Admittedly, in the last few years some of these companies have implemented an aggressive policy, buying up existing farms rather than building new plants, something that has been frowned upon by local residents.

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Plant of the company 'Danone' in Chekhov District, Moscow region

At the end of last year, as a result of an overall reduction in consumption, leading foreign companies have seen their share of the dairy and juice markets in Russia fall, but their market-share remains impressive. By way of example, Danone-Unimilk's share of dairy products fell from 23% to 21.6%.

The dairy market holds the greatest appeal for investors

Alexander Korbut, vice-president of the Russian Grain Union: "In the field of grain production, there are relatively few foreign investors, but there are some." "There are also

farmers who have come in from other countries, foreign investors, and companies which have bought up bundles of shares from a range of processing companies and grain elevator companies, and are now increasing their capacity and their production of the produce for which demand is high." In 2012, the Japanese company Mitsui & Co purchased 10% of the 'Sodruzhestvo' group, a minority share in which had been acquired by the World Bank's International Financing Corporation (IFC). The daughter company of the Singaporean company Olam - "Outspan", which obtained the core production facilities "Azov grain terminal" last year, was among the top three suppliers in terms of grain exports. The amount of grain exported in the current agricultural year stood at 1.33 million tonnes, or 9% of the total volume of supplies in Russia.

The share of foreign capital in the meat industry has been, and remains, very modest. No less than \$20 billion has been put into poultry farming and pig farming in the last 10 years, but according to the National Meat Association, foreign investment in animal rearing and the meat industry accounts for no more than 4-5%. "Several years ago, foreign investors were more than happy to put resources into acquiring shares or constructing new venues in all three of the main sub-industries: poultry farming, pig farming, meat production from large horned cattle, and the meat processing industry," according to Sergei Yushin, chairman of the board of the National Meat Association. "The investors also came from a wide range of countries: the USA, France, Brazil, Germany, Spain, Denmark, India, China, Thailand, Finland and several other countries." In recent years, some investors, primarily Americans, have decided to cash in when they have reached maximum growth, and have sold their poultry farming assets - with considerable success, according to Yushina. Some people, such as the French, decided that the Russian market was not for them, and left for this reason. Others found that their business was coming up against real difficulties, and cancelled the projects they were working on. But as the expert says, there have also been those who believe in long-term future growth and have even stepped up their investment, despite current losses and the lack of clarity after Russia joined the WTO and the Customs Union was set up.

The pluses and minuses of working in Russia

Mr Korbut acknowledges that the scale of direct foreign investment is clearly insufficient to meet the needs of Russia's agricultural sector, or to strengthen the country's position in the global agricultural production market. One clear plus point is the active backing of the state, and its readiness to promote Russian products in the domestic markets.

Andrei Danilenko, the owner of Russian Farms and chairman of the Governing Board of the National Union of Milk Producers "Soyuzmoloko", asserts that the milk market also has good potential for growth and is therefore attractive to investors. "The level of consumption of milk and dairy products in Russia currently stands at around 250 kg a year per head of the population, and could grow by 300-330 kg over the next few years," claims the expert.

A factor which could limit growth in foreign investment, as he sees it, is the shortfall in raw materials, i.e. the deficit in the supply of untreated milk to the market. The situation has been exacerbated in the last year as a result of the drought, Russia's admittance to the WTO and the altered terms of support for the sector from the state.

As a result, untreated milk production fell by 5%, and imports rose. Investors decided not to invest in the sector due to the high risks and the extended period of time required to make projects profitable: over 15 years. And unfortunately the problem with raw materials may in the long-run impact negatively on the investment appeal of the milk industry.

Alexander Korbut highlights the lack of development in the institutional environment as the main drawback in the grain sector. The lack of regulation of land ownership disputes, and the lack of clarity in administrative procedures, also have a role to play. "These are drawbacks for any investment in Russian agriculture, not just in the grain sector," the expert explains. The specific nature of the problem is that there is a lack of transparency in the state's policy with regard to agro-industrial exports, and for foreign investors, that is something they look for: being able to sell produce in global markets that are clear and transparent. Incidentally, in 2012-2013 the state indicated to the market that it would not interfere in regulating grain exports without good reason - and that is a positive "message" both for the market and for investors.

The meat sector is not popular among investors either. Firstly, there are plenty of countries where meat production makes greater economic sense, countries with clear competitive advantages in the shape of a modern production-processing-distribution chain. "Everyone has heard about the plans of Chinese pork producers to buy up the American company Smithfield, the world's biggest meat producer," says Sergei Yushin, the chairman of the board of the National Meat Association. "The Brazilians, particularly JBS, have been buying up shares in beef production practically throughout the whole world. American companies have entered the EU market with varying degrees of success."



An important factor has been the shortfall in local, qualified staff, the expert notes. The unfavourable situation with regard to animal diseases is becoming an ever more significant factor in terms of the analysis of the potential for investment in animal rearing in this country. Moreover, Russia has very limited prospects with regard to bringing its production to external markets, and that has had a significant impact on future profitability.

The lack of developed infrastructure and the poor quality of the roads - all this puts the major foreign players off coming to Russia. Mr Yushin cites the advantages as well, however: the poor competition. A large amount of production still takes place at relatively outdated firms, at times in violation of legislation regarding protection of the environment and of animals. High-tech companies are getting ahead of the competition from the outset, they certainly have good prospects due to the combination of lightweight goods and dangerous production techniques. And we are talking about hundreds of thousands, if not millions of tonnes a year.

Institutional problems at the Ministry of Agriculture

Mikhail Losev from the Ministry of Agriculture highlights seven key problems in Russia's agriculture industry. Firstly, the sector does not have sufficiently stable financing, due to market instability, price fluctuations and the shortfall in private investment. Secondly, manufacturers of agricultural products have limited access to sales markets. The infrastructure is outdated, and with each passing day the monopoly enjoyed by the major retail networks grows stronger. Thirdly, agriculture has fallen off the pace from the technical and technological standpoint, due to the manufacturers not having enough profits at their disposal with which to carry out modernization. We are therefore seeing stagnation in machine-building for agriculture, and in the food production industry.

The fourth point is that the pace of social development is slower in agricultural areas. The fifth point is that there is a shortage of qualified workforces in all the agricultural production and processing branches within the sector. The sixth point is that practically all beef in Russia comes from milk-producing herds, which require high production costs, and food costs are twice as high as normal. The seventh point is that there is practically no system of land-improvement works whatsoever. Essentially, that means that Russia has to build everything from scratch, and even to train its own experts.

"The problem boils down to the relatively high risks and the low profit levels," according to Mr Ivanov. The picture is made more complex by the agricultural industry's high dependency on state regulation (especially with regard to sugar, rice and meat) - dues, quotas and subsidies, which often change, plus a customs regime that is far from watertight for many products - it is hard to forecast profitability or how long it will take to get a return on long-term investment projects. Sometimes, those investing in the agricultural industry therefore opt for Ukraine rather than Russia, despite higher levels of corruption, the expert adds.

The greatest drawback, Mr Losev concludes, is the sector's low level of profitability. Agricultural producers have grown used to hiking up their results for lending organizations. But if we look at the proportion of agricultural organizations that attract investment loans each year, it's around 20%. At the same time, the number of agricultural organizations that are profitable has increased over the last five years by only 2%, reaching 80%.

Ultimately, without subsidies, agriculture proved to be unprofitable in 3 of the 5 years between 2008-2012. In 2012, profitability in Russia stood at 4.8% on average in Russia, and taking the subsidies into account it rose by an average of 14.6%. To make the sector more attractive, and ensure that it remains attractive, profitability must reach 25-35% regardless of the direction of production and the investment project, but for the time being this does not even come into the equation.

Tomorrow will be a brighter day

Mikhail Losev asserts that the Ministry has decided to attract investors to the sector by stimulating not only the production of raw materials, but of a high-quality end product, and by focusing less on providing subsidies (on which 70% of resources were spent under the old State program) and more on direct payments to the producers of agricultural products (subsidies per hectare of arable land, per kilo of milk produced). Moreover, the Ministry of Agriculture promises to pay more attention to structural issues within the sector and to put resources into developing the territory's infrastructure and bringing in innovations.

Subsidies have been promised for the dairy sector, which has been in an ever worsening condition. According to Vladimir Labinov, the Director of the Department of animal rearing and breeding at the Ministry of Agriculture, they will only be given to producers of finest quality milk. The state programme will see the state subsidizing interest on loans, financing programs aimed at developing animal rearing for dairy products, and reimbursing insurance costs, up until 2020.


"Once Russia entered the WTO, Russian producers began to pay more attention to the quality of their products, because at present that is the main advantage that Russian products have over their rivals," asserts the General Director of the Institute of Agricultural Marketing, Elena Turina. "Russian consumers are paying more and more attention to content, freshness and the quality of the product. This has even enabled them to increase sales to Russian producers."

Russian agriculture has its plus points, including low levels of competition

"Before we entered the WTO, it was often said that our companies were afraid of competition," explains the deputy speaker of the Union of Federations, Ilyas Umakhanov. "It is

not the competition that scares them, but the lack of a level playing field. We simply can't provide them with exactly the same amount of sunshine and humidity that they have in Holland, so we have to find other ways of evening things up."

Evgeny Ivanov from the Institute of Market Studies for the Agricultural Industry is determined to be upbeat. "Russia's admittance to the WTO and its probable admittance to the Organization of Economic Cooperation and Development gives us cause to hope that we will see greater interest in Russia: the country will begin to play by the rules in effect throughout the world." "In addition to that, the rebalancing of state support for agriculture in accordance with the WTO's rules, will mean that different conditions will be in effect as early as 2014-2015."

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