



Forestry, Pulp and Paper in Russia

A national giant has re-awakened; one that the U.S. paper industry cannot afford to ignore.

By Clive Suckling and Loren Gerlach

Earlier this year, PricewaterhouseCoopers published a survey of viewpoints of CEOs in the forest, paper and packaging sector worldwide. Topping their concerns was overcapacity and the need for further rationalization to achieve better supply-demand balance. The Russian market is a notable exception—here the key challenge is meeting demand.

As the Russian economic boom enters its 8th year, prices for all forest products are strong, margins, for the larger players at least, are good, and if anything, the industry is now becoming supply-constrained.

However, despite having over 20% of the world's forest resources, Russia accounts for only about 3% of global supply and demand of forest products. That is going to change, and no major global player should ignore Russia in their strategic planning. International Paper has recognized this, extending its already-significant Russian presence through a planned 50% stake in Ilim Pulp, Russia's largest pulp and paper producer.

Official Russian statistics imply that the output of forest products now totals approx. \$12 billion, of which about \$7.5 billion is exported. However, this understates activity, as the statistics exclude a significant volume of

undocumented activity. Officially, Russia's output is only now getting back towards Soviet output levels of 1990—in reality, volumes are higher and the average quality of output has improved considerably over Soviet times.

A clear opportunity and business imperative exists to further increase both the quantity and quality of Russian output. Wood costs remain low (competitive with other high-volume sources). Current forestry harvests of approx. 150-200 million m³ (depending on which estimate of undocumented activity you use) could be increased by 20-40% without threatening sustainability—one of very few countries with significant reserve growth potential. Pulp and paper demand has risen by 45% since 2000 and is currently growing at 6.5% per year, with the fastest growth in higher-end, higher-margin products. Yet pulp and paper output is growing at just 1.5-3% per year, creating a growing demand gap. The Bumprom paper industry trade association estimates that \$12.5 billion of new investment is needed in the sector over the next 5 years, a figure which appears conservative considering that nearly all major operators are now operating at or near capacity.

Much of the installed manufacturing base in Russia is old, energy-inefficient, overstaffed, and in need of major overhaul. As a consequence, the sector's average return of approx. 3% is half the Russian industrial average. But the picture is different for the limited number of Russian plants that have been transformed by capital investment and global best-practice expertise over the past decade—Western investors often describe Russia as one of their most profitable markets. Thus, recent experience indicates that while the Russian pulp and paper sector's capital needs are great, well-placed investment can yield an attractive return.

For pulp and paper manufacturers facing overcapacity and tightening margins elsewhere in the world, Russia represents an important target market with robust demand and vast natural resources.

At the moment, new investment and increased output are largely constrained by two inter-related problems:

- **Infrastructure.** Forest roads (both paved and unpaved) are highly inadequate. Western companies operating there report spending significant sums on private road-building (primarily unpaved tracks) each year. Forestry activity is particularly constrained in the wet spring and autumn, when unpaved roads are largely impassable.



Russia's largest. Headquartered in St Petersburg, Russia, Ilim Pulp, is Russia's largest forest products company, harvesting 7.5 million cubic meters of wood and producing 2.5 million tons of pulp/paper products, and more than 500,000 cu./m of sawn timber, plywood, and value-added wood products annually.

- **Undocumented activity.** An unknown but certainly large proportion of forestry activity is undocumented (officially 10-20%, possibly up to 50% in some regions), with large amounts of illegal roundwood exported. Undocumented felling is typically carried out by small logging contractors operating where convenient rather than where permitted, usually employing underpaid manual laborers with inadequate regard for environment, health and safety. These producers can often deliver more cheaply than Western investors operating legally, though Westerners have generally managed to stay competitive by investing in better processes and technologies (e.g. harvester machines). Undocumented production deprives the government of tax revenue with which to invest in infrastructure, and much of the output is exported as raw roundwood, which provides little value-added income to the Russian population. The Putin Administration has declared this a priority problem for resolution and we anticipate a crackdown.

Clearly corruption and organized crime are also deterrents to foreign investment, though perception appears to be worse than reality. "Unofficial" payments for licensing or other bureaucratic procedures are commonplace in Russia. However, a recent corruption survey by the World Bank showed that the value of these payments as a proportion of economic activity is shrinking over time, and few Russian managers find them a significant impediment to doing business. For

foreign investors who aspire to succeed within the boundaries of the law, a typical route is to cultivate strong relations with local and regional authorities, investing visibly in projects and charities that are good for the locality and popular with both the authorities and the population at large. This earns respect and goodwill which pay dividends.

Westerners' perceptions are often colored by gangland-style shoot-outs and killings—these peaked in the early 1990s and then rapidly declined. While a small number of high-profile contract killings of Russian journalists and officials in recent years have made Western headlines, these are now quite rare. Westerners living in Russia do not report feeling threatened by this and as to normal street crime, most feel safer on the streets of Moscow or St. Petersburg than major U.S. cities.

The following is an excerpt from a presentation by Dmitry Chuiko, Ilim Pulp's Director for Development of Logging and Woodworking Facilities, at the Plenary Meeting of the 6th International Forestry Forum, October 2006, in St. Petersburg, Russia:



DMITRY CHUIKO

“So far, production growth in Russia's forestry sector fails to impact the performance and development of the global markets. We mostly ramp up the existing facilities to their rated capacity and implement local projects. This trend cannot be

turned around and the sector cannot develop further without a proactive industrial policy on the part of the Government, mostly in terms of establishing a favorable investment climate. Indeed, expert estimates put capital intensity of modern-day pulp-and-paper operations at € 1,100 per ton of annual capacity, which implies multi-billion investment amounts with a payback period of 10 to 15 years.

“Nowadays, Russian and international investors see two key benefits of pursuing forestry projects in Russia, namely a prime forest base for source wood and relatively low costs. If we fail to capitalize on this potential, then, at a later time, as our cost advantage over competitors erodes, the rate of exploiting our resource base and developing the wood-processing facilities will assume crucial importance.”

WHAT TO INVEST IN

Russian production is currently concentrated in lower-end products. Russia exports a large proportion of its market pulp, newsprint, corrugating materials and B-grade & Y-grade business papers. In these products, Russia has a good deal of manufacturing experience, scale in many of its plants, and a cost advantage conferred by low labor costs as well as natural gas prices held by government edict at well below world levels.

By contrast, Russia is an increasingly important importer of a variety of higher-end products such as coated papers and board (there is no coated manufacturing in Russia at present), and A-grade business papers, which domestic plants cannot produce to the necessary quality specifications. This raises a number of issues and opportunities for global operators:

- In the near term, Russia is an attractive target for foreign investors wishing to produce high-volume commodity products, for both domestic sale in Russia and export. The industry remains fragmented and offers a number of brownfield investment opportunities largely in the form of undercapitalized, inefficient producers that could do better with an infusion of Western capital and practices. It should be noted, however, that Russia's operating cost advantages are likely to shrink over time. Russia is under increasing pressure from the World Trade Organization to raise domestic natural gas prices. And wage inflation is currently about 6-9% per year and exacerbated by a strong ruble. Therefore, foreign investors need to think ahead about labor-saving and energy-saving investments in anticipation of higher input costs in future.
- Russia is also attractive as an import destination, particularly for high-end products, which are likely to see robust demand growth for the foreseeable future. The Putin Administration has given some indication that in the future it intends to treat forestry, pulp and paper as a strategic industry. The government might take actions to benefit “favored” firms over “disfavored” ones, and enact laws, regulations and import/export tariffs that incentivise domestic production and import substitution. Over time, Russian domestic producers can be expected to move up the value chain with higher-end products. However, it will be a long time before Russia could feasibly produce all the products that it requires. A savvy Western producer should be able to sustain an attractive (if increasingly niche) import business over the long term—all the more so if they simultaneously invest in domestic production of other goods.

WHERE TO INVEST

Russian forest products activity is concentrated in about 12 of Russia's 89 regions and autonomous republics. These fall into four basic geographic groupings:

1. **South-central Siberia**, particularly along the two parallel trunk lines of the trans-Siberian railway. Output here is primarily either used domestically or exported to China. The major operator in this area is Ilim Pulp.
2. **The Northwest District**, encompassing most of European Russia north of Moscow. Output here is particularly tied to European export, although St. Petersburg and a few other provincial capitals are important domestic markets as well. Major investors include Mondi and International Paper.
3. **The Far East**, which is heavily oriented toward round-wood exports to Asia.
4. **The Central (Moscow) and Volga districts**. Although the smallest of the four in terms of forestry reserves, this area has a high concentration of packaging and other value-added plants, targeting the disproportionate share of national wealth that resides in Moscow and the prosperous provincial capitals along the Volga.

Although northern Siberia and the northern Far East contain vast tracts of virgin forest, they are uneconomic to harvest for numerous reasons; inadequate population, no rail access, and a severe climate that results in very low wood yields. The opportunity to increase output is primarily within the regions that are already active.

Clearly an investor's strategy will influence where they invest. Those targeting Russia's rapidly growing middle class and commercial sector may consider locating in the Central and Volga federal districts. Those who, in addition to the growing domestic market, wish to export to EMEA may consider the Northwest. Those who wish to export to the rapidly escalating Chinese market may prefer Siberia or the Far East. Those who pursue a broad, multi-faceted approach may invest in multiple regions.

KEY ISSUES WHEN INVESTING

Despite the significant economic growth and wealth creation of the last eight years, Russia remains a challenging place to invest and do business. Key issues include:

Rail access. Proximity to Russia's rail network is essential. Service is slow by American trans-continental rail standards and can be disrupted in summer due to scheduled maintenance. But overall, the service is remarkably reliable given



Papermaking in northern Russia. Mondi Business Paper Syktyvkar mill operates a board machine and three paper machines. Total production capacity is over 750,000 tons per year. The mill complex includes a wood yard, a pulp mill with a capacity of 720,000 tpy, and a power plant with generation capacity of double the total mill demand. In addition, the company controls 13 logging operations in the Komi Republic that supply wood to the mill.

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the tough climate and geography. The rail network is quite comprehensive throughout European Russia, but in Siberia and the Far East it consists mainly of two trunk lines running near the southern border. Investors should consider managing their own fleet of rail cars for at least part of their output, as the economic boom has created a shortage of state-owned rail cars.

Limited road infrastructure. Investors should expect to build forestry roads. Beyond that, some Western investors have put satellite navigation units into their vehicles to better track and manage their own in-house forestry activities.

Availability and cost of skilled management and labor. Soviet enterprises were routinely overstaffed, perhaps by 10-20 times, and excessive staffing remains an increasingly costly legacy with some Russian firms. Right-sizing the staff is politically sensitive, but can be done. New hiring may also be necessary as existing staff (particularly older staff) sometimes find it very difficult to adapt to Western practices. In turn, this may require paying wage premiums and relocation costs to get workers with the right skills to the forestry-producing



A natural for papermaking.

Syktvykar, located on the Sysola River, offers water and timberlands. The town is located near the point where the Sysola River joins the larger Vychegda River. These rivers are navigable and are a major transport route of forestry products from the region.

areas. Labor shortages may increase over time, as Russians (particularly males) have a low and falling life expectancy and the nation is experiencing negative population growth. Some Western investors have made employees' health a very public priority, instituting free, regular, mandatory health checkups and actively encouraging healthier lifestyles.

Condition of brownfield facilities to be acquired. Many Russian pulp and paper assets are old and inefficient. Plants were designed in the Soviet era under the "bigger is better" principle, with little regard for quality or efficient flow—to a Western eye, the layout may make little sense. Since 1991, some Russian managers have made clever incremental improvements with limited capital to address these issues. Key questions for a foreign investor are: what is the fastest and cheapest route to make a given plant economically effective? ...and, does the current management have the ability to deliver that with proper funding and guidance?

Attitude of the authorities. The Russian government is taking an increasingly interventionist role in seeking to shape industrial development in ways that it considers beneficial. Any investor should ensure that their strategic plans find favor with the relevant authorities before committing significant funds—depending on the size and political sensitivity of the investment, regional authority support may be enough, or Federal authority blessing may be necessary.

The greatest opportunities are in regions where the industry is already well established, meaning that the relevant regional authorities understand the industry and generally perceive when a proposed investment will benefit their area. Clearly, however, some governors are better than others and

no investor should commit capital without a clear understanding of the vision and desires of the relevant regional administration.

IN SUMMARY

For pulp and paper manufacturers facing overcapacity and tightening margins elsewhere in the world, Russia represents an important target market with robust demand and vast natural resources. It also offers a well-established industry with a large complement of trained workers, yet also a great deal of room to grow and improve in partnership with Western capital. It is an increasingly important production and export base for certain products, and a rapidly growing import destination for others.

At the same time, no one should underestimate the challenges arising from a harsh climate, extraordinary distances, inadequate infrastructure, or corruption. Further, the need for good relations and mutual understanding with the authorities cannot be overstated. Investors must carry out thorough due diligence on their target plant, their target locality and its government, and on wider infrastructural, demographic and strategic issues in order to manage the risks and capture the significant opportunities presented by this unique market. ■

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