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RUSSIA: READY FOR REBOUND?

Economic Reforms Could Help Lube Market

Russia is trying to diversify its economy by fostering industries such as biotechnology, information technology and nuclear energy.

BY MILIND PHADKE

A year ago, Russia's lubricant market was a wreck – like a 10-car pile-up at a train derailment. The country's lube consumption for 2009 was nearly 28 percent lower than in 2008, and this after 2008 dropped 14 percent from 2007.

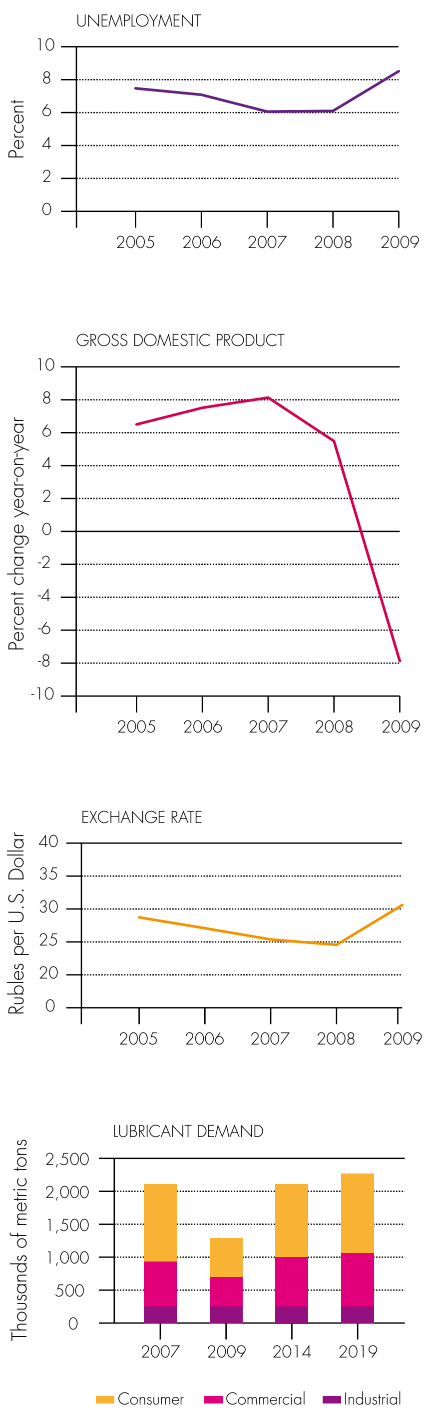
Now, however, things seem to be improving steadily. The Russian government seems to have taken some lessons from the recession and is trying to reform the economy. If it succeeds, the lubricant market could see significant improvements in quality.

RECESSIONARY IMPACT

Among major economies, Russia experienced one of the most severe contractions from the global recession of 2008 and 2009. Gross domestic product shrank by 7.9 percent in 2009 after having posted gains of 8.1 percent in 2007 and 5.6 percent in 2008. The ruble depreciated by nearly 28 percent against the U.S. dollar, and unemployment rose precipitously. General industrial production, mining and primary metal production all showed significant double-digit declines in 2009. Automotive sales declined by nearly 60 percent in 2009, compared to the year before.

The Russian government took a number of steps to alleviate the impact of the recession. Moscow rolled out a U.S.$200 billion rescue plan to increase liquidity in the financial sector and another $20 billion in tax cuts and subsidies to consumers and industries. The automotive industry, for example, received support from a "cash for clunkers" program that subsidized sales of new cars when exchanged for old. This has helped increase car sales even as car prices have started to increase. The government extended this program until 2011 due to the positive results.

RUSSIA BATTERED BY RECESSION



Sources: IMF, World Bank, Kline Group

The recession taught Russia two lessons: First, despite being clubbed with Brazil, India, and China (economists coined the acronym BRIC for large economies then thought to be fast growing), Russia is not a growth market. Second, Russia is very heavily dependent on energy exports, and this is a significant weakness in its economy.

It is now clear that Russia does not share the growth potential of other BRIC countries. It does not have a youthful, growing population that will drive its expansion as in India, nor is it an export powerhouse like China. While Russia is an export driven economy, its exports are dominated by oil, gas, metals and other precious commodities. Prior to the recession, due to high energy prices, the Russian economy was growing rapidly, even overheating. Foreign investors poured nearly $500 billion into large state firms and private companies due to the easy monetary conditions in North America and Europe and rapidly rising earnings in Russia.

With the recession, energy exports and consumer demand collapsed, and corporate profits collapsed along with them. In the wake of the recession, foreign investors withdrew from the market. The combined impact of depressed energy revenues and the slowdown of foreign direct investment caused the Russian economy to collapse in 2009. Compounding its economic woes, the significant depreciation of the ruble made the servicing of Russia's foreign debt very painful.

REORIENTING AN ECONOMY

Russia's growth engine needs to change. Dependence on energy exports exposes Russia to every upturn and downturn in the global economy. Also, due to geopolitical factors, Russia's energy customers in Europe have started to look to other suppliers like Qatar and Iran.

The Russian government recognizes the need to diversify its economy. The government is soliciting investments to foster new industry clusters such as information technology, communications, biomedicine and nuclear energy. The government is also encouraging investments to develop innovative and green technologies, to improve energy efficiency in old industries, and to improve infrastructure.

To facilitate these investments, Russia has reduced the number of industries that are "strategic" and hence off-limits for foreign investors. The government is also working to improve relations with the United States and the European Union, possibly in hopes that they will ease restrictions on technology transfers. Russia is also considering eliminating its capital gains tax on long-term direct investment in these preferred industries and offering tax breaks for companies investing in innovative and green technologies.

While all of these changes are encouraging, doubts remain about the possibility of backsliding. Certainly, higher energy prices will reduce the pressure to change. Foreign businesses would also want to see some signs that Russia is tackling the three main challenges of doing business in the country: lack of the rule of law, corruption and bureaucratic red tape. The recession has brought about significant changes in the world-view of investors. Russia is unlikely to see the type of foreign-money fuelled growth that it saw in the past. To grow, Russia will have to diversify.

CHANGING FORTUNES FOR LUBES

Whether or not it diversifies, Russia has the potential to be an exciting market for the lubricants industry – in terms of both volume growth and quality improvements. This is, however, subject to overall economic recovery. Diversification will add a positive bump to the growth in high quality lubricants, especially in the industrial market.

In 2009, lubricant consumption was an estimated 1.33 million metric tons. This represented an average annual decline of nearly 21 percent between 2007 and 2009. The industrial segment was most severely affected, whereas the consumer segment escaped with a relatively minor contraction. Foreign suppliers such as ExxonMobil, Shell, BP, Chevron, and Total saw their sales contract significantly.

Foreign suppliers also saw their costs go up due to a depreciating ruble, and this reduced their ability to compete. Many of these companies depend on car dealerships, some of which were driven close to bankruptcy because of large inventories of high-priced cars that became nearly impossible to sell. Dealership troubles reduced market access of foreign lubricant suppliers, adding to their woes. Local suppliers such as Lukoil, Rosneft, Gazpromneft, TNK, ZIC and others were also negatively impacted. Besides a general reduction in demand, many of the larger local suppliers saw their business with large, state-owned industrial firms almost dry up.

In the short term, as the economy improves and idle equipment is put to work again, lubricant consumption will return to baseline consumption. This process may be fast or slow, depending on how fast the economy recovers. (Kline projects that overall lubricant consumption will not return to 2007 levels until 2014.)

The consumer and commercial segments will show strong growth, offsetting the slow recovery in the industrial segment. In the commercial segment, rebounds by construction, mining, agriculture and trucking will spur an improvement in lubricant consumption. The consumer lubricants market is projected to expand due to growth in the passenger car population. The key trend here is the growing share of foreign vehicles. Some market observers think that the share of foreign cars will grow from 33 percent in 2009 to 50 percent by 2013. This would cause growth of premium lubricants.

In the industrial segment, lubricant consumption will rise with growth in industrial production. Penetration of high-performance lubricants will be determined by the effectiveness with which the "economic diversification" mantra is implemented – or indeed, if it is implemented at all. Due to linkages with industry, the government has the ability to force its economic policy. The question is whether it has the resolve to do so.

Investments in infrastructure improvements will cause growth in many lubricant end-use industries such as construction, mining, machinery and metal fabrication. The Russian manufacturing sector uses equipment that is old, obsolete, energy inefficient and polluting. Most state industries are ripe for modernization.

In the new business environment, and with the new government ideology, there should be a growing trend to replace old equipment. This would create demand for lubricants in various capital goods industries. It would also help raise the quality of lubricants consumed. To date, synthetic and semi-synthetic industrial lubricants represent niche markets that local producers struggle to penetrate. But with accelerated equipment modernization, demand for synthetics can increase.

The Russian lubricant market seems to be showing a moderately strong recovery and is projected to achieve pre-recession levels of consumption by around 2014. The recent moves by the Russian government to reorient the economy raise interesting prospects for the growth of high performance lubricants in the industrial sector. Local suppliers are rapidly expanding their product range, improving quality, and supporting their product performance claims with international quality certifications and original equipment manufacturer approvals. Their major task now is to continue improving product development and technical services, and more importantly to change customer perceptions about quality.

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