Supply Chain Challenges in Russia

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As Western markets are starting to become saturated, companies are looking for new growth opportunities. Countries that used to be targeted for low-cost sourcing are now changing into attractive end markets thanks to their rising GDP and wages. Russia is one of these markets. However, its business environment differs from Western markets in many ways and poses specific challenges. This complicates a supply chain, because it not only needs to be globally managed but also adapted to local conditions. Therefore, the objective of our research has been to understand the supply chain challenges companies face when entering the Russian market, and to offer some advice for overcoming those challenges.

**Obstacles to efficient supply chain management**

Through interviews with logistics providers and manufacturers, and through reports on logistics in Russia, we learned that issues arise in all areas of the supply chain – planning, sourcing, production, distribution, reverse flows, ... – and they all require special attention.

Many factors complicate supply chain planning. Customers are dispersed over a large territory (so that long distances must be bridged), and they are becoming more demanding regarding quality, response time and service levels. Forecasting is challenging because of high growth rates, lack of point-of-sales data, bad communication throughout the supply chain, and low supply reliability due to unreliable deliveries and delays at customs. On top of this, the legal environment is unstable and inconsistent, with local authorities applying and enforcing laws arbitrarily.

**Sourcing** for the Russian market poses other challenges. We distinguish three available sourcing options: sourcing from local suppliers, importing from abroad, or convincing foreign suppliers to move to Russia. Each option has its own challenges:

- The local suppliers offer an adequate technical level at competitive prices and are able to settle disputes with Russian officials, but they face issues with poor delivery reliability, capacity constraints and quality levels. Improvement is expected in the future thanks to spill-over effects from Western partners and global suppliers.
- When opting for import, disadvantages include high import duties, complicated regulations and licensing requirements, competition from grey import, inefficiency and corruption at customs, and protectionist measures for certain goods.
- Convincing the established Western supplier base to move to Russia can be a viable alternative, but this requires a certain minimum production volume, which is often difficult to achieve in a start-up phase.

Companies also experience challenges when they produce in Russia. Staff turnover is high, driven by short-term employment contracts, and there is a lack of well-trained logisticians and qualified managers. When setting up local production plants, companies may encounter problems acquiring land, constructing facilities, importing equipment, and gaining access to utility networks.

**Delivery** is challenged by the fact that Russia is by far the largest country in the world. Inferior transport infrastructure, lack of warehouses, and a fragmented market of logistics service providers all reinforce the problem. Although Russia has the largest railway system in the world, the tracks, locomotives and railcars are in bad condition and are owned by the government. Moreover, the Russian railway gauge is different from the European one, so goods have to be transferred at the border. Ports are in urgent need of modernisation and increased capacity. Inland waterways are often frozen, required depths are not always maintained, and the main waterways flow from south to north whereas goods need to be transported in the east-west direction. Air transport is expensive and, although it is fast, delays at customs undo this advantage. Finally, multi-modal transportation is developing, but the infrastructure to link the different modes is often not available and communication between the different players does not run smoothly.
Imbalance in supply and demand for warehouses leads to high real estate prices in Moscow and St. Petersburg. Alternative regions are becoming more important, but their warehouse quality is often poor. The logistics service providers (LSPs) market is highly fragmented, but consolidation is expected, especially with the current economic crisis. LSPs charge high prices because they face the same logistic obstacles. Moreover, because the flow of goods is predominantly ‘one-way’ – that is, the volume delivered into Russia is much larger than the volume transported back into Europe - LSPs are faced with inefficient deliveries. Future development will be based on services offered, reliability, safety and quality. Currently, no LSP is able to offer the entire logistics portfolio throughout Russia. Furthermore, the supply chain for returning goods is still underdeveloped. Companies trying to implement reverse logistics processes face a lot of difficulties, especially when goods have to cross the border again.

A couple of additional issues call for attention. First of all, corruption is still present, especially in public bodies (e.g. customs officials), due to low government salaries, bureaucracy, weak law enforcement, and lack of transparency. Secondly, a weak banking system with high interest rates and lack of long-term loans incites companies to finance investment with retained earnings. Nevertheless, the good news is that, with the prospect of joining the World Trade Organization, the Russian government is currently reforming its laws and regulations, resulting in a more transparent and predictable business environment.

Appropriate supply chain strategies for the Russian market

Challenges can be managed. So, what are our recommendations?

First of all, every market needs an appropriate supply chain strategy. The instability and the uncertainty of the developing Russian market calls for a supply chain strategy oriented towards effectiveness, flexibility and responsiveness, rather than efficiency.

Moreover, when forecasting demand for supply, it is of utmost importance to understand Russian consumer behaviour. For instance, Russian consumers do want a broad range of choice, but they are willing to switch if products are unavailable. Additionally, demand forecasts and out-of-stock levels can be improved through better information sharing. This can be achieved by implementing integrated IT systems, and it will also be facilitated by the rapid evolution of the telecommunications network. However, information sharing requires good relations with customers and suppliers, and so mutual trust and commitment are crucial. This will take time to develop. In the meantime, it is advisable to keep extra safety stocks. To deal with the administrative barrier, sufficient time, attention and people should be assigned to fulfil the paperwork. Seeking guidance from local advisors or intermediary firms can help cut through the excessive governmental regulations. We also recommend carefully selecting a local business partner who knows his way around the administrative labyrinth, and who can also be helpful in forming and maintaining good relationships.

To facilitate sourcing, the local supplier base can be improved by supplier development initiatives (e.g. transfer of know-how and technology). Bringing in global suppliers that have world-class procedures and technologies can also strengthen the supplier base. If companies choose to import, good preparation is imperative. Customs authorities should be consulted in advance, directly or through a customs broker. Regardless of the sourcing mode, it is wise to keep extra stock, either in anticipation of inferior quality and/or delays in deliveries from local suppliers, or to counterbalance bottlenecks at customs.
To deal with the production challenges, appropriate HRM policies are needed to keep employees loyal and competent. Career opportunities, transparent and fair income policies, results-oriented bonuses, training, familial atmosphere, international exposure and involvement are all recommended. When setting up manufacturing facilities, good relationships with local government are essential.

As delivery is troubled by one of the most insurmountable challenges in Russia – namely, poor infrastructure – the right choice of transportation mode is vital. In addition to transportation costs, inventory costs and required responsiveness levels must also be taken into account. In general, road transport is the most common transportation mode in Western Russia; trains are used to reach regions beyond the Ural Mountains. Warehouse location decisions should take the growing attractiveness of some regions into account. Locating distribution centres near those markets can be an opportunity to decrease transportation costs and increase responsiveness. LSPs should be selected based on their service offering, geographical coverage and reliability.

Finally, when confronted with corruption, companies should not give in. Paying bribes may prevent delays in the supply chain (e.g. faster customs clearance), but this sends a signal to other entities that you are 'bribable'. Not giving in to bribery requires buffers within the supply chain to compensate for possible delays.

For more information

This paper synthesises the results of An Van Esser and Evelien Vanderhasselt, under the supervision of Professor Robert Boute.

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