



The past, the present, and the foreseeable future of Russian manufacturing subsidiaries of Western multinational corporations

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Abstract

This article retraces the development of Russian manufacturing subsidiaries of Western multinational corporations from the late 1980s until 2019. Using secondary sources and a unique handcrafted database on significant extensions of manufacturing facilities of Western multinational corporations in Russia during 2012–2018, we present the position of Russian manufacturing subsidiaries of Western multinational corporations before and after the beginning of sanctions. We also indicate the major strategic challenges that they currently face, including the necessity to maintain dual loyalty (to home country and host country authorities), manage the deteriorating quality of business regulations in Russia, and overcome the increasing shortage of qualified personnel at all levels. The data on the opening of new facilities in 2017–2018 reveal that such issues impede but cannot stop the quantitative development of foreign-owned Russian manufacturing facilities. At the same time, saving on managerial expenses and low “investments in non-current assets” of the established manufacturing subsidiaries may break down “the innovation engine” assembled in many Russian manufacturing subsidiaries of Western multinational corporations and bring them into the periphery of their corporate parents, where the attention and resources from the corporate center are lacking.

Keywords

Foreign direct investments, manufacturing, post-Soviet history, Russia, subsidiaries

Introduction

In the sixth year of political hostilities between Russia and the West, accompanied by a tit-for-tat exchange of economic sanctions and supplemented by a plunge in the ruble exchange rate (in December 2014) that caused the sudden drastic decline in many local markets and the subsequent continued decrease in the purchasing power of both consumer and industrial sectors of the national economy, the time has come to assess the current position of Russian manufacturing subsidiaries of Western multinational corporations (MNCs) and their foreseeable future. Manufacturing subsidiaries are the focus because they are largely formed from highly specific assets; divesting industrial subsidiaries is difficult and typically incurs substantial sunk costs. Thus, decisions on the future of such assets and their further development, which can be executed by injecting equity from the corporate parent,

reinvesting retained earnings into the subsidiary itself, using long-term credits or divesting them, also can take different forms (preventing capital investments in a subsidiary, scaling down the production site, halting production, divestitures, or liquidations) and usually present strategic choices of corporation-wide importance (see Graham et al., 2013; McDermott, 2010).

This article presents the conditions under which Russian manufacturing subsidiaries of Western MNCs are currently

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operating in different industrial segments and the range of strategic options available for corporate parents regarding their Russian manufacturing assets. To properly present the aforementioned elements, we briefly present the entire history of the appearance and development of manufacturing subsidiaries of Western MNCs in Russia, the developmental milestones of the industries that Western MNCs were permitted to penetrate through joint ventures or wholly owned subsidiaries, the institutional environment, the set of value-adding and value-extraction methods allowed by the host country authorities, the strategies to manage the local embeddedness of foreign-owned manufacturing subsidiaries, subsidiary mandates, the configuration of decision-making autonomy in various functional areas, and some peculiarities of internal organizational practices.

This article is organized as follows. In the first section, we present a short review of the literature and the information sources on manufacturing subsidiaries of MNCs in Russia. In the next section, we present our research framework to explore (and understand) the strategic actions of Russian manufacturing subsidiaries, their corporate parents, and other stakeholders that influence subsidiaries' actions. The third section outlines the major periods of development of industrial subsidiaries of Western MNCs in Russia. In the fourth section—the key section of the article—we present a picture of the current strategic actions of industrial subsidiaries of Western MNCs in Russia and outline their major current and future challenges. The last section provides conclusions and suggestions for further studies.

A review of the literature on Russian industrial subsidiaries of Western MNCs

In the topics studied, the literature devoted to Russian subsidiaries of Western MNCs is copious but a bit narrow. McCarthy and Puffer (2013) presented 223 academic studies dated from 1986 to 2012 on business and management in Russia; 43 of these works address the issues of entering the Russian market and managing businesses there. After 2012, at least 35 more academic studies appeared on that topic. However, most of the academic literature is devoted to the “soft” side of managing foreign business in Russia—finding the common ground in business ethics (Puffer & McCarthy, 1995), searching for the optimal forms of personnel training and other methods of knowledge transfer to Russian employees (Bedward et al., 2003; Holden & Cooper, 1994; Jonsson, 2008; May et al., 2005; Michailova & Jormanainen, 2011), successful organizational practices in Russian foreign-owned subsidiaries (Koveshnikov et al., 2012), and the experience of Russian employees working in subsidiaries of foreign MNCs (Morris & Hinz, 2018). Only occasional publications exist on other important aspects of the functioning of manufacturing subsidiaries in Russia—market segmentation (Wilson & Mukhina, 2012),

organizational learning (Engelhard & Nägele, 2003), implementing and maintaining quality control (Khoo & Tan, 2002), and the financial performance of subsidiaries (Gurkov et al., 2018b). We also seek to identify a number of academic cases (Golikova et al., 2011; Gurkov, 2016d; Gurkov & Kossov, 2014) that present the development of Russian subsidiaries over an extended period.

In this respect, we should identify not single interesting academic studies but the most informative series of works—sometimes by different authors—that refer to previous works in the respective areas and confirm (or reject) prior findings and prepositions. The first among such “chains of works” are those devoted to *structuring and performing the human resource management function* in Russian subsidiaries of Western MNCs. We can point to a number of such prior studies (Fey & Björkman, 2001; Fey et al., 1999; Shekshnia, 1994, 1998) for which the findings were subsequently checked on and generally confirmed (Gurkov, 2016b; Gurkov et al., 2017; Zavyalova et al., 2011).

Another notable “chain of research” was devoted to local embeddedness by Russian subsidiaries of Western MNCs or, in other words, to developing formal and informal relationships between foreign investors and various local actors. We indicate that the line starts from the early works by Lawrence and Vlachoutsicos (1993), through Lawrence et al. (2005), Ledeneva (2008), and Holtbrügge and Puck (2009), to Salmi and Heikkilä (2015), Yakovlev et al. (2018), and Gurkov et al. (2018b).

We should also point out a “chain of works” that presents from different angles the mechanisms of the innovative development of Russian subsidiaries of MNCs (Gurkov, 2014, 2015; Gurkov & Filippov, 2013; Gurkov & Saidov, 2017a). Finally, there are a few papers that retrace the development of Russian industries, which dominate foreign-owned companies (see Berman, 2011; Montenero, 2018).

In addition to purely academic works devoted to the management of Russian subsidiaries of foreign MNCs, we should indicate the high value of works of “different shades of grey” (see Adams et al., 2017). By this we mean, for example, an article written by the former head of the Russian subsidiary of a large German corporation (Knauf Gips KG), which presents frank memoirs on the actions in establishing and developing Russian manufacturing subsidiaries (Lenga, 2015).

The “post-sanctions” period was the subject of a number of academic publications (Bozadzhieva, 2016; Gurkov, 2016a, 2016c; Gurkov et al., 2017; Gurkov & Saidov, 2017b) that attempted to explain why—despite shrinking gross domestic product (GDP) growth, sanctions, and a volatile ruble—no large-scale exodus of MNCs from Russia had occurred.

In addition to academic publications, invaluable sources of information on the current activities, problems, and aspirations of Russian subsidiaries of MNCs are non-academic

works. First and foremost are large documents (more than 60,000 words) prepared for annual plenary sessions of the Foreign Investment Advisory Council (FIAC) in Russia. This body has existed since 1994 and serves as a liaison office between the largest foreign investors and the Russian government. Currently, the FIAC has 53 members and four “observers”—56 large multinational companies from 21 developed countries and one financial institution (the World Bank). Particular parts of documents prepared for the annual FIAC sessions are developed by seven specialized working groups headed by one of the FIAC’s members, and finally combined and edited by Ernst & Young (EY). Equally informative are publications of the Association of European Business (AEB), especially annually published bilingual “position papers” (see AEB, 2019)—large documents devoted to regulatory issues that foreign businesses working in different Russian industries must face (the AEB has 19 committees that specialize in particular industries, 14 cross-industrial committees on specific business problems, and six working groups for sub-industries, such as the Tires Producers Working Group) and the accumulated experience on how to address such issues. Apart from these condensed documents, several business magazines (such as *AEB Quarterly*) are available in Russian for foreign investors, and occasional publications and guides are produced by international consulting and law firms (see, for example, Beiten Burkhardt, 2016; EY, 2015). In general, the current academic and “grey” literature on Russian manufacturing subsidiaries of Western MNCs can be considered sufficient to form the background for further academic studies on the topic.

Research framework

To assess the past, present, and the foreseeable future of Russian manufacturing subsidiaries, we developed a dual research framework—the assessment of the qualitative position of a subsidiary within a particular host country and the assessment of the qualitative position of a subsidiary within the corporate parent. The assessment of the qualitative position of a subsidiary within a particular host country is quite traditional and is based on the assessment of the share of foreign-owned subsidiaries in local markets. The assessment of the qualitative position of a subsidiary within the corporate parent is based on a recently presented model of value exchange between the corporation and a subsidiary (see Gurkov, 2019; Gurkov et al., 2018). In this model, the position of a subsidiary is assessed by the intensity of value transfer in different forms (goods and services, financial resources, knowledge, talent) between the corporate center and a subsidiary, or between a subsidiary and its foreign sister-subsidiaries. Intensive and unobstructed transfer of value in any direction (from the corporate center to a subsidiary, for a subsidiary to the corporate center, between sister-subsidiaries) makes a subsidiary a part of the corporate core, despite the possible institutional and physical

distances of a subsidiary from the corporate center. Different types of obstacles (legal obstacles to transfer specific types of resources, lack of particular resources to transfer to or from a subsidiary) bring a subsidiary into “the corporate periphery,” which pull together corporate units that lack attention from the corporate center and therefore are deprived from crucial resources for their further development.

In this article, we used both parts of the research framework—we tried to assess the quantitative position of Russian manufacturing subsidiaries within the Russian economy and their qualitative position within their parent companies.

Data and method

This study is based on two types of information. First, we assembled a unique handcrafted database on all publicly revealed significant industrial investment projects completed in Russia by Western MNCs from January 2012 to December 2018. The database includes information on the corporate parent(s), the location of the objects, the Standard Industry Classification (SIC) codes of production, and others. Among 411 objects of the database, 261 were new factories and 150 were extensions of existing factories. The data on new factories are complete because, in Russia, hiding a new plant opening from the public is impossible (a public opening ceremony is mandatory for new factories in Russia, and such ceremonies are presented in the local press and TV; see Gurkov, 2016a; Gurkov & Kokorina, 2017). The data on the extension of existing factories are incomplete because many facility developments were done in secrecy. Nevertheless, the assembled database turned out to be a very reliable source of information regarding extensions of subsidiary mandates (which occurred when corporate parents built their first Russian manufacturing facility) and the development of firms that had already established manufacturing facilities. The database also allows for a comparison of the dynamics of new facilities’ installations during both pre-sanction and post-sanction periods.

The second sources of materials used as data were the texts of the mentioned documents prepared for FIAC plenary sessions during 2014–2018 and the AEB documents. We used such documents as evidence of the major strategic issues faced (and imposed) by MNCs operating in Russia.

Among the methods used, we should mention a frequency analysis of the distribution of new facility development among industries. In an analysis of narratives (published documents), we followed the standard methods of the use of such information in management research (see Flory & Iglesias, 2010): accounting not only for the content but also for the context and, especially, the tone of the message. Thus, we paid special attention to distinguishing between the cognitive (presenting facts) and affective (presenting emotions) elements of the documents.

Findings

Major periods of development of manufacturing subsidiaries of foreign MNCs in Russia and their major achievements before 2014

We can easily distinguish four major periods of development of manufacturing subsidiaries of foreign MNCs in Russia: 1987–1991, 1992–1999, 2000–2014, and 2015 to the present. The possibility of creating joint ventures was permitted in the former USSR in 1987. In 1991, almost 2,000 joint ventures existed, mostly wholesale, and 80% of the created joint ventures have not started their operations. The remaining joint ventures were overtaxed (taxes on import, taxes on high profitability) and had neither intentions nor possibilities to build new manufacturing facilities or seriously enhance existing ones.

The real history of Russian manufacturing facilities of Western MNCs began in 1992. Hundreds of Western firms entered Russia in search of business opportunities in a “frontier market.” The special lack was to purchase a factory known to a foreign corporation through previous Soviet-times deals (especially through turnkey contracts that called for a foreign firm to be responsible for the entire project, including a facility’s design, the selection of equipment suppliers, importing equipment, construction and installation, training the local personnel, and even achieving the planned output level during the specified period). When no suitable objects were available for purchase, foreign corporations dared to establish joint ventures, usually with much lower success (the problem of managing joint venture conflicts in Russia became the subject of several publications; Fey & Beamish, 1999, 2000). Despite the relatively high failure rate of acquisitions and joint ventures, foreign corporations’ performance during 1992–2000 was outstanding in building specific skills in four areas: (a) identifying a suitable location for a newly established subsidiary, (b) developing an human resource management (HRM) system that fostered the absorptive capacity of Russian manufacturing subsidiaries, (c) building a multilevel system of win–win relationships with different stakeholders, and (d) allocating authority over different functional areas of subsidiary development among corporate headquarters, regional headquarters, and Russian subsidiaries.

First, by trial and error, foreign investors have learned the principles of location choice for their Russian investments, namely, how to identify regions (*oblast*) and even districts with less corruption. The second area that stipulated the success of foreign direct investments in manufacturing in Russia was the building of a distinctive HRM system. Fey et al. (2000) presented four major elements of that system: (a) the remuneration system is based on good basic salaries that are slightly higher than the basic salaries of neighboring enterprises; (b) bonuses range between 20% and 40% of the basic salary; (c) rich additional non-monetary benefits are

provided, including free or heavily subsidized hot meals during shifts and additional medical insurance; and (d) attention is paid to training and development.

To these four elements, we must add three equally important elements of HRM in foreign-owned companies: (a) timely wage payment (wage arrears were pandemic in Russian industries in the 1990s; see Earle & Sabirianova, 2002); (b) predominance of permanent job contracts for employees of all ranks; and (c) very generous severance payments when factories are closed or during massive layoffs.

Almost 20 years later, Gurkov et al. (2017) surveyed the heads of foreign-owned manufacturing plants in Russia and confirmed that all of the mentioned seventh elements of HRM systems in Russian manufacturing subsidiaries of MNCs are still in place, including the predominance of permanent job contacts and the existence of a free or subsidized three-course meal for employees in the middle of a shift. Regarding severance payments, a few closures of foreign-owned plants during 2014–2018 were executed in a very civil manner with respect to employee dismissals, and severance payments were two to three times the amount stipulated by local labor legislation. For example, General Motors (GM) paid employees of its closed Russian factory a severance package of 6 months’ salary. For the closure of its Chelyabinsk brewery, Carlsberg spent 300 million rubles to compensate 458 laid-off employees (severance payment equal to 7 months’ average salary, advance payment to women on maternity leave for the entire remaining leave period, coverage of expenses related to job agencies for finding new jobs, and others).

The described elements of an HRM system enabled an increase in the absorptive capacities of newly established manufacturing subsidiaries regarding both technological processes and ways of doing business. Moreover, in smaller subsidiaries in processing industries, the applied elements of an HRM system helped create a specific organizational climate that can be characterized by high mutual trust and empathy among employees of different levels, high innovativeness of managers and engineers, low resistance to change, and minimal “scapegoating.”

The third element that was mastered by foreign companies during 1992–2000 is the ability to build large networks of local stakeholders. Holtbrügge and Puck (2009, pp. 376–381) described the system of the relationship of a Russian subsidiary of a German firm (Knauf Gips KG), which includes the federal government, the State Duma, the assembly responsible for improvements in legislation regarding counterfeit products, professional associations, such as the Council of Russian Builders and the Association of Manufacturers of Building Materials, which coordinate various policies and activities, including technical and sales policies, standardization, and voluntary certification, and help prevent trade wars, foreign investor associations, such as the German Trade Chamber and the AEB in Russia,

which serve as partners in coordinating official positions and lobbying public authorities in Commonwealth of Independent States (CIS) countries; the Ministry of Internal Affairs in Russia and the CIS countries, which helps identify and prevent the production and sale of counterfeit products under the Knauf brand name; local authorities and companies that share the costs of infrastructure development in public/private partnerships; the business media, which highlight the company's achievements and projects that have industry-wide significance; preference is given to noted industry journals and federal information agencies; and trade unions that anticipate and predict possible social tensions and prevent strikes.

Similar multilevel systems were developed by all large companies establishing numerous manufacturing subsidiaries in Russia and used for "active mobile defense"—if one actor behaved in an unfriendly manner toward a Russian subsidiary of an MNC, its actions could be neutralized by the actions of other equally or more influential actors.

The fourth element mastered during 1992–2000 by MNCs regarding their Russian subsidiaries was the system of allocating the optimal level of authority over various functional issues. In general, Russian manufacturing subsidiaries received significant discretion over HRM processes (recruitment, remuneration, promotion) and some marketing rights (finding the optimal level and forms of advertising, developing the product mix, adjusting pricing across regions). At the same time, financial controls remained very tight, especially controls over capital expenditures. In most cases, the amount and the detailed structure of capital expenditures (CAPEX) were determined annually by corporate headquarters.

The four mentioned skills mastered by MNCs in the 1990s (selecting an appropriate location for acquisitions or greenfield investments in manufacturing facilities, designing efficient HRM systems, developing extended local networks of relationships with different stakeholders, building the appropriate scheme of distribution of authority over particular business issues between corporate headquarters and Russian subsidiaries) enabled foreign MNCs to capture a significant share of the explosive growth in Russian consumer demand in the 2000s. From 2000 to 2012, the share of imports in Russian consumer markets remained relatively stable (40%–43%), whereas the consumer market (in retail prices) grew from US\$80 billion in 2000 to US\$700 billion in 2012. These numbers indicate that local production of consumer goods grew from US\$35 to US\$300 billion (based on wholesale prices). A significant portion of this market increase was captured by Russian manufacturing subsidiaries of foreign MNCs. Because of restrictions on participating in the most lucrative industries (oil, gas, and ferrous and non-ferrous metals), the manufacturing activities of foreign MNCs in Russia were mostly concentrated in consumer markets: foodstuffs and food packaging, personal and home care products, construction

materials, home appliances, consumer electronics, and car assembly. For example, foreign tobacco companies that produced tobacco products in Russian factories held almost 90% of the 2011 local market (and now control 100% of the local production of cigarettes), a few global beer companies controlled 85% of the local beer market, and major foreign motor vehicle producers controlled almost 90% of local Russian car production (2 million cars per year). In 2012, at least 16 global manufacturing corporations had sales higher than US\$1 billion in Russia. Dozens more MNCs had local production volumes exceeding US\$100 million.

During 2009–2013, foreign MNCs actively expanded beyond consumer goods. We mention the multibillion dollar 50/50 joint venture between Solvay and a Russian chemical corporation SIBUR to build a new plant with an annual capacity of 350,000 tons of polyvinylchloride (PVC) and 235,000 tons of caustic soda (opened in 2014), Siemens' joint venture for manufacturing gas turbines, and the purchase by Alstom of a 25% stake in a Russian holding company that controls most of the facilities for rolling stock manufacturing (in 2015, Alstom increased its stake in that Russian company to 33%).

In reality, most leading global European and US corporations in many industries (fast moving consumer goods, car and truck manufacturing, chemicals and pharmaceuticals, machine building, construction materials) in 2012 either had already established their Russian manufacturing facilities through acquisitions and greenfield investments or had begun construction on such facilities. More importantly, during 2010–2013, initial subsidiary mandates of Russian manufacturing subsidiaries rapidly expanded toward innovation activities, especially process innovations (see Gurkov, 2014; Gurkov & Filippov, 2013; Gurkov & Kossov, 2014). Some process innovations gained the status of "best corporate practices" and were implemented in the foreign manufacturing subsidiaries of the parent, whereas other process innovations were local-specific (like new methods to deal with snow which covers large territories of plants during the harsh Russian winter or unique methods of equipment repair). This system of accelerating process innovation and implementing continuous improvements in manufacturing processes became possible with strong support from corporate parents and sister-subsidiaries (see Gurkov, 2015). An important part of that system was the network of personal relations between Russian plant heads and superintendents and their foreign colleagues in sister-subsidiaries. Such networks were maintained through regular corporate-wide formal meetings and conferences of plant heads and superintendents from different countries and, in particular, by promoting meetings in informal settings, which turned out to be the most efficient way to transfer ideas on possible process innovations (see Gurkov & Saidov, 2017a).

Looking at the position of manufacturing subsidiaries of foreign multinationals in Russia 2012–2013 within

the proposed research framework, we can indicate steady quantitative and especially qualitative development of Russian manufacturing subsidiaries of MNCs: (a) there was a rapid expansion of manufacturing subsidiaries of MNCs (through acquisitions and greenfield investments) in terms of their absolute number and the shares in the local markets, (b) there were no obstacles on transfer of goods (although foreign companies usually complained about complicated customs regulations and expenses procedures of customs clearance) and services between Russian subsidiaries and their foreign sister-subsidaries, and (c) there were no obstacles in transfer of capital (equity injections, credits to be converted into equity) from corporate parents to Russian subsidiaries and no obstacles to repatriation of profits and revenues through dividends, royalties, and other types of payments of subsidiaries to corporate centers. More importantly, there was a growing flow of reverse knowledge transfer from Russian subsidiaries to corporate centers and to foreign sister-subsidaries that secured the position of Russian subsidiaries inside or near the “core” of their parents.

Sanctions, countersanctions, and the Black Tuesday of December 2014

Although the first wave of Western sanctions caused foreign subsidiaries and genuine Russian companies to worry, the real effect of these sanctions was very limited. The disruption in the economic relations between Russia and Ukraine was much worse—for many Western MNCs, especially in the Fast moving consumer goods (FMCG) sector, Russia and Ukraine were considered a single market with an intensive bidirectional flow of raw materials and finished products. The self-imposed Russian embargo on imported foodstuffs had a positive effect on many Russian manufacturing subsidiaries of Western MNCs because it weakened several direct competitors in the food markets that relied on imports (such as the Finnish dairy manufacturer Valio).

The decisive moment came in the second half of December 2014 with the sharp devaluation of the ruble. This devaluation occurred at the worst time—the end of the year—which was the end of the financial year for most Western corporations. Thus, the devaluation of the ruble caused large negative foreign exchange effects (the effects of differences in the dynamics of the exchange rate of the currencies of the countries in which an MNC operates and the currency in which the consolidated financial reporting of the MNC is performed).

These effects included the following: (a) reduction in invested capital on consolidated balance sheets (e.g., the total volume of invested capital of the Carlsberg Group decreased in 2015 by 14% because of weak Russian and other CIS currencies; see Carlsberg Group, 2016), (b) brand impairment (because future sales forecasts of particular brands that were expressed in a foreign currency also deteriorated), and (c) impairment of other tangible and intangible assets.

The overall foreign direct investment flow to Russia declined in 2015 by 92% (United Nations Conference on Trade and Development (UNCTAD), 2016), partly because of the end of “capital round tripping” (see Ledyeva et al., 2015). The regional and country headquarters of major MNCs had to spend the last decade of December 2014 developing completely new operating plans for 2015 that anticipated a decline in most markets. Such plans should have been checked and approved in January 2015 by global headquarters. As noted by the tone of the earning calls for the first quarter of 2015 for major global corporations with significant Russian assets, country managers and regional headquarters did quite well in designing new patterns of operations in Russia. Although parents’ financial reports stoically calculated negative foreign exchange effects and an overall decrease in global sales because of weak performance in the Russian market, global CEOs expressed on quarterly earnings call transcripts their satisfaction with Russian teams’ handling of the situation. Some heads of Russian subsidiaries who managed these teams in 2014–2015 were later promoted up the corporate hierarchy, also a sign of a well-done job coping with suddenly worsening market conditions.

Some of the developed new operating plans called for accelerating the opening of new Russian manufacturing plants (see Figure 1).

In 2015, the number of plants opened by foreign multinationals in Russia (54 plants) set a record. The situation was truly paradoxical: new factories were opened in all industries, including in those experiencing significant declines in demand, such as the market for heavy machines for road building, which decreased by 60% in 2015 and a further 10% in 2016 (AEB, 2019, p. 175). The car market also decreased in 2015 by 27% and a further 7% in 2016, making the Russian car industry work at 40% of its capacity (Avtostat.ru, 2016). However, during 2015–2016 in Russia, foreign companies opened new factories for car components, and Daimler-Benz was building a new assembly plant near Moscow opened in April 2019. The food market mostly stagnated during 2015–2016; however, in 2015–2016, foreign companies again opened four new factories and installed 24 new production lines in existing factories in different food production segments.

We should also stress that during 2012–2015 and 2017–2018, the majority of newly opened plants represented the first Russian manufacturing facility of the corporate parent. In 2016, the share of the “first plants in Russia” was almost equal to the plants established as additions to already existing Russian manufacturing facilities of Western MNCs.

Gurkov et al. (2017) attempted to explain why facility expansions were carried out during the market downfall and found several reasons: (a) opening of car part factories was related to existing contracts on “industrial assembly” that stipulated the preferred tax regime for a car manufacturer under conditions to reach the predetermined level of locally

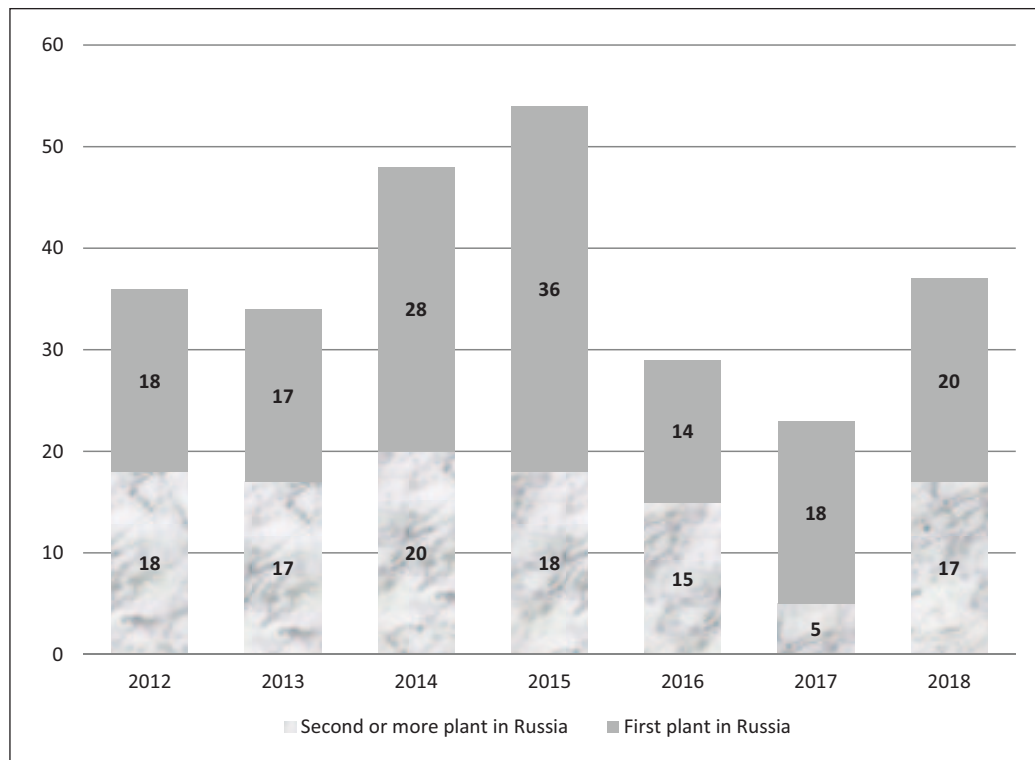


Figure 1. Number of new plants opened in Russia by foreign multinational companies in 2012–2018 (combining the first Russian plants of foreign corporation and the new plants opened by foreign corporations which already owned manufacturing facilities in Russia).

sourced car components within a given period; (b) for some other industries (construction materials, paints, beauty and cosmetics, among others), the option to open a new facility that works at even a fraction of its planned capacity was preferred to the option of accumulating net losses without any revenues (we should recall that, usually, the core personnel for a new factory in processing industries is assembled at least a year before its official opening; see Gurkov, 2016d); (c) some newly opened facilities targeted the segments that have not experienced a decline, such as baby and pet food, or specialized industrial goods (technical gases, industrial explosives used in open mining, specialized equipment for oil extraction); and finally, (d) the efforts of the Russian government toward “import substitution” provided a strong impetus for the development of local manufacturing facilities for pharmaceuticals and medical equipment and in agricultural machinery and some other industries.

Whereas most foreign multinational companies preferred the option to complete previously launched Russian industrial projects over the option to abandon or postpone these projects to build new Russian manufacturing facilities, the financial performance of newly opened plants was severely worsened by the shrinking local markets and the devaluation of the local currency. Gurkov et al. (2018b) analyzed the financial performance of the plants opened in 2012–2015 and found that in 2014–2015, the majority of

the recently installed Russian manufacturing plants of MNCs were loss-making. Only in 2016 did the share of profitable enterprises among the recently installed Russian manufacturing plants of multinational companies surpass 60%. In addition to direct and indirect losses caused by the devaluation of the local currency, the 2014–2016 period was characterized by greater scrutiny by Russian tax authorities of cash flows to and from Russian subsidiaries of MNCs. First, in one case in 2014, Russian tax authorities considered that royalties paid by a Russian subsidiary for the use of a parent’s trademarks were an inappropriate method of revenue extraction, and the company was heavily fined. This fine moved all similar royalties into a “grey zone” of profit and revenue expatriation from Russia. Second, the Russian tax authorities and the Ministry of Finance decided that transfer pricing rules should apply to loan contracts. Therefore, a Russian subsidiary can lend money to the parent company (or to any other corporate structure), but such loans to “interdependent” legal entities must be provided using “normal market interest rates.” Furthermore, the Russian company must inform the tax authorities about such loans and provide documentation confirming that the interest rate was indeed close to the average market level (Lazareva, 2015). This requirement further narrowed the set of methods for value appropriation from Russian subsidiaries, making dividend payments the

only “legally flawless” method of profit expatriation from Russian subsidiaries. Declining markets caused a decrease in revenues and gross margins; subsequently, net profits quickly evaporated. Thus, Russian industrial assets moved toward the “backwaters” of corporate business portfolios (see Gurkov et al., 2018, p. 28)—when channeling funds from the parent of sister-subsidiaries was not particularly sensible because nothing can be extracted back.

The recession in many markets ended in 2016. For example, car manufacturing grew 21% in 2017 and 18% in the first half of 2018. Slow recovery from the low base was experienced by other industrial markets, but most consumer markets stagnated during 2017–2018 (retail turnover increased by 1.2% in 2017, reaching 29,804 billion rubles [US\$510 billion] and further increased by 3% in 2018). The number of new plant openings also returned in 2018 to the pre-crisis level (34–37 per year). However, the variety of industries in which new plants were opened largely decreased. In 2018, new plants in just three industries (food and kindred products, chemicals and allied products, industrial and commercial machinery) occupied more than half the new plants opened in that year by foreign multinationals in Russia.

In this way, comparing the destiny of the 16 companies with more than US\$1 billion in Russian sales in 2012 is interesting. On average, the US dollar-denominated Russian sales of those 16 companies were 28% lower in 2017 than in 2012. Only one company among those 16 managed to increase its US dollar-denominated Russian sales. As a result, four companies left “the club of US\$ billionaires” regarding their 2017 Russian sales. At the same time, three companies with 2012 Russian sales lower than US\$1 billion increased their Russian sales and joined “the club of US\$ billionaires.”

These facts are just partial indicators of a significant dispersion in the sales dynamics of Russian manufacturing subsidiaries—not only among industries but also within the same industry. For example, in car assembly, Hyundai/Kia Russian plants worked in 2018 at full capacity, whereas Ford plants worked at just 40% of their installed Russian capacity and planned to close its plants in Russia. GM closed its Russian plant in 2015 but maintained a joint venture with AvtoVAZ (controlled by Renault) to produce smaller all-road cars (Chevrolet NIVA).

Position of Russian manufacturing subsidiaries of MNCs in 2019—major strategic issues

At the end of 2018, the ruble was devaluated again against the US dollar. On January 1, 2018, the exchange rate was 57.60 rubles per US dollar. On December 31, 2018, the exchange rate was 69.47 per US dollar, and the weighted average rate for 2018 was 62.71. Whereas revenues, gross profit, net profit, and cash flows are recalculated for subsidiaries’ internal reporting to their corporate parents using

the average weighted rate, the “hard” parameters (fixed and total assets and total liabilities) are presented in International Financial Reporting Standards (IFRS) annual reports using the exchange rate on the last day of the reporting period. Therefore, the weakening of the ruble at the end of 2018 was beneficial for the internal corporate reporting of Russian subsidiaries of gross and net returns on assets (gross and net returns were recalculated at the average weighted rates for 2018 of 62.71, whereas total assets were recalculated using the exchange rate on December 31, 2018, but the weakening of the ruble further downgraded the relative importance of Russian subsidiaries in corporate portfolios regarding the amount of revenues and, especially, the amount of assets).

In addition to such operational matters, during 2016–2018, a number of strategic problems were aggravated and became acute in 2019.

The first problem was the growing difficulty in maintaining the double loyalty of foreign businesses operating in Russia to both the country of origin and the Russian authorities. On the surface, the Russian government exhibits no enmity against Russian subsidiaries of Western MNCs—regular meetings of the executive committee of the FIAC are held with the Minister for Economic Development, and the Prime Minister presides, as usual, at plenary sessions of the FIAC. Such sessions are preceded by a number of technical meetings at the Ministry for Economic Development between the Ministry’s officials and members of the FIAC executive committee (see Ministry for Economic Development, 2018). Moreover, large MNCs with sizable Russian assets are considered natural allies of the Russian government regarding sanctions’ issues. For example, on November 1, 2018, the President of Russia met with members of the “Eastern Committee of the German Economy” and presented figures on the activities of German companies in Russia—5,000 active companies with total annual revenues of US\$50 billion—and promised “to remove excessive administrative barriers and invest significant resources in infrastructure—in short, to do everything necessary so that foreign investors, including German investors, feel comfortable in our country” (Kremlin.ru, 2018). Local governors attending plant opening ceremonies of new Russian plants of foreign corporations made even more affective statements about creating a favorable business environment in their regions (see Gurkov et al., 2018a).

The FIAC also obediently presents at its plenary sessions detailed suggestions and recommendations on topics that are of special interest to the Russian government (see Table 1).

The second issue that concerns foreign companies operating in Russia is the rapidly deteriorating quality of the government’s regulatory efforts. Since the 1990s, the problem of business regulations has been at the top of the agenda of FIAC meetings and, through mutual effort, Russian business law

Table 1. Major issues presented by working groups at plenary sessions of the FIAC of Russia in 2014–2018.

Years				
2014	2015	2016	2017	2018
Technical regulations and elimination of administrative barriers	Administrative barriers and technical regulation	Improvement of customs law	Localization of production in Russia	<i>Digital economy and innovative technologies*</i>
Improvement of customs law	Improvement of customs law	Technical regulations and elimination of administrative barriers	Improvement of tax administration	Localization and regional development
Financial institutions and capital markets	Financial institutions and capital markets	Financial institutions and capital markets	Improvement of customs procedures	Improvement of tax and customs law and administration
Trade and the consumer sector	Trade and the consumer sector	Improvement of tax law	Administrative barriers and technical regulation	The development of consumer market and technical regulation
Innovation development	Energy efficiency	Health care and pharmaceuticals	Trade and the consumer sector	Health care and pharmaceutical industry development
Energy efficiency	Health care and pharmaceuticals	Trade and consumer sector	Energy efficiency	Financial institutions and capital markets
<i>Health care and pharmaceuticals*</i>	<i>Localization of production in Russia*</i>	Localization	Health care and pharmaceuticals	Natural resources and the environment
Improvement of tax law		Energy efficiency	Efficient use of natural resources	
		Efficient use of natural resources in Russia	The banking sector and financial markets	
		Innovation development	Innovative development	
		<i>Development of the Far East and Siberia*</i>		

Sources: FIAC (2014, 2015, 2016, 2017, 2018).

The order of issues in the table follows the order of issues in the original documents. Eight issues were determined at the establishing of FIAC in 1994: (a) energy efficiency, (b) administrative barriers and technical regulation, (c) customs law, (d) tax law, (e) banking sector and financial markets, (f) trade and consumer sector, (g) implementation of the Russia's investment climate, and (h) efficiency of the use of natural resources (see Gurkov et al., 2014, p. 43). Asterisk (*) and italic indicate the first appearance of the issue. FIAC: Foreign Investment Advisory Council.

became more comfortable for foreign businesses in many areas, including taxation, customs legislation, and practices, among others. However, the technical regulation of particular activities became “clumsier” and does not account for nuances and scenarios related to the application of regulations. In reality, AEB position paper 2019 contains at least a few dozen issues related to recently passed laws. Each of those laws had good intentions (e.g., road safety, quality of goods and services), but each law had “side effects” harmful for foreign companies’ operations.

In addition to laws, government resolutions exist (approximately 1,600 per year, many affecting foreign investors’ interests). In general, foreign companies working in Russia and, in particular, manufacturing subsidiaries must adapt to increasingly clumsy legislation, government decisions, and regulatory practices.

The third issue that affects most foreign companies working in Russia in manufacturing industries is the absolute and relative lack of qualified personnel. This absolute lack can be measured by the ratio of candidates for announced vacancies in existing plants or in a plant to be opened. Gurkov et al.

(2017) described the problem between the supply and the demand of skills for a newly built plant *near Moscow*:

The situation related to personnel selection . . . can be depicted as a cocktail glass (wide footing, thin leg, V-shaped upper part) because the pool of candidates for the lowest positions of “hand work at machines and mechanisms” (packers, sorters, others) are typically quite satisfactory, as is the pool of candidates for management positions. However, recruitment of “mid position workers”—setup technicians, assistant engineers, and foremen—is a significant problem. (p. 597)

This problem is not new (see Gimpelson et al., 2010) but, during the 2010s, affected an increasing number of industries and a greater variety of positions. The relative and not the absolute shortage of skills, that is, the insufficient skills of applicants to low-level as well as high-level positions, was reported in both FIAC and AEB documents. For example, FIAC (2018) stressed,

Today, we face a shortage of qualified engineers, especially those with world-class cutting-edge expertise and foreign

language knowledge . . . Only a limited number of leading Russian universities, located in the cities of Moscow and St. Petersburg and the Tomsk and Moscow regions, supply highly skilled specialists for the technology sector. At the same time, the science and technology capabilities of regional economies remain poor, as local universities are slow to progress and improve education quality for students studying competencies that are in high demand on the labor market . . . In the indicated situation, Russian subsidiaries of foreign multinationals must simultaneously resort to two expensive measures: so-called over-skilling (recruitment of persons with excessive education to positions that do not require such an education) and long-term on-site training, including training missions abroad to other plants of the corporate parent or to foreign suppliers of a plant's equipment. (pp. 6–7)

The fourth issue that affects foreign companies in Russia is the strengthening of migration legislation and migration control practices. Established foreign-owned manufacturing companies do not suffer much from imposing stronger migration legislation—the total number of expatriates in such companies is low (a plant manager, a financial controller, and a technical director; many foreign-owned companies employ only local personnel). However, for facility development (building new factories or installing new shops and production lines in existing factories), the strengthened migration legislation presents challenges. Typically, stages such as installation and putting in motion new facilities are performed by multinational teams assembled by employees from headquarters and foreign sister-subsidaries. Such employees can enter Russia through a simplified procedure for “highly qualified specialists” (HQS). Two major criteria for such employees—to possess unique knowledge and skills and to earn 500,000 rubles per quarter before taxes (US\$2,500 per month)—are not a problem. However, the new Russian migration legislation stipulates that to obtain a work permit under the standard procedure, HQS are required to provide a certificate attesting to having passed an examination in the Russian language, history, and the basics of Russian law. In practice, work permits for qualified specialists under standard procedures are processed for foreign employees who arrive in Russia on the basis of a visa for short-term project work. In most cases, the aforementioned persons are in Russia for the first time, do not fluently speak Russian, and use a foreign language during their work. Such demands, which significantly complicate the process of sending a foreign employee to Russia, affect the speed at which the necessary launch team is assembled.

We mentioned just a few issues that *directly affect the operations of manufacturing subsidiaries of foreign MNCs in Russia*:

- maintaining dual loyalty under increased pressure from both sides (home country and host country authorities);
- deteriorating quality of business regulations;

- shortage of qualified personnel at all levels and difficulties in assembling multinational launch teams for new facility installations and putting them in motion.

Such issues, coupled with the increased difficulties in repatriating revenues (instead of net profits) from manufacturing operations and the low demand in both consumer and professional markets, determined the position of Russian manufacturing subsidiaries of Western MNCs in 2019.

The foreseeable future of Russian manufacturing subsidiaries of Western MNCs—quantitative and qualitative aspects

Based on the revealed dynamics of sales of the largest Russian subsidiaries of MNCs, the dynamics of newly opened plants of both manufacturing “veterans” and “novices” in Russia, and the revealed strategic issues affecting the operations of manufacturing subsidiaries of foreign MNCs in Russia—especially the shortage of qualified personnel at all levels and the increased difficulties in assembling multinational launch teams for new facility installations—we may make some predictions about the immediate future of manufacturing subsidiaries of Western MNCs in Russia.

First, we do not expect the massive “exodus” of Western MNCs of Russia in terms of either divestitures or closing down existing plants. Sporadic divestments may occur, especially in the car assembly industry; however, at the same time, the overall number of foreign-owned plants in Russia will increase, particularly through the opening of new plants by “novice” investors (foreign corporations opening their first manufacturing facility in Russia). Large subsidiaries in all industries, especially those acquired or built during 1990–2000s, will continue to install new shops and production lines—either to capture the specific niches in the local consumer and professional markets or simply to replace the morally and physically depreciated existing production lines and certain production and auxiliary facilities.

Much more uncertainty surrounds the second factor that determines the immediate future of manufacturing subsidiaries of Western MNCs in Russia—their ability to maintain the once-achieved intensity of product and, especially, process innovations. In reality, the outlined “lack of qualified personnel at all levels” does not affect the level of innovations in both established and newly built subsidiaries; as is the case in most manufacturing subsidiaries, only a very small pool of “idea generators and idea implementers” is required to start and operate “the innovation engine.” The following three elements are more important for maintaining innovation activities: (a) proper motivation of “idea generators and idea implementers,” including both monetary rewards and moral recognition at the subsidiary and corporate levels; (b)

maintaining a network of personal contacts with colleagues in other countries; and (c) allocating sufficient resources to continuously improve production processes.

The last point depends on the proportion of the net profits channeled as dividends to corporate parents and retained for “investments in the non-current assets” of a subsidiary. The first two points depend on overcoming the temptation to save on managerial costs when US dollar-denominated sales are falling or stagnating and on the overall level of attention of top corporate executives toward the corporation’s Russian manufacturing assets (including the time spent on “field visits”). Meanwhile, the intensity of innovation activities at the subsidiary level determines the perspectives of Russian manufacturing subsidiaries of MNCs, not just the immediate future but also the long term. Without intensive innovations, Russian subsidiaries have no opportunity to remain “strategic centres” for their corporate parents (see Gurkov, 2016d, p. 55), which are characterized by a quasi-equal exchange of value between the subsidiary and the corporate center. Instead, they are quickly downgrading into “cash cows” or—in the absence of significant net profits to be repatriated as dividends—move toward the corporation’s “deep periphery” that receives little attention and minimal resources from the corporate parent and survives only because of high exit costs.

Conclusion

We presented the relatively short history of Russian manufacturing subsidiaries of Western MNCs, the challenges created by sanctions, the unexpected devaluation of the local currency at the end of 2014, the immediate reaction to those challenges, and the strategic issues currently faced by these subsidiaries. The surprisingly high number of plants opened in 2018 by Western MNCs in Russia indicates that the outlined strategic issues, including increased difficulties in bringing to Russia multinational “launch teams” to put into motion newly installed production facilities, impede but do not stop the quantitative development of these subsidiaries.

At the same time, low “investments in non-current assets” of established manufacturing subsidiaries and reducing managerial expenses may break down “the innovation engine” assembled in many Russian manufacturing subsidiaries of Western MNCs. Without such an “innovation engine,” Russian manufacturing subsidiaries of Western MNCs are doomed to move to the periphery of their corporate parents, where attention and resources from the corporate center are lacking. In this respect, the future of Russian manufacturing subsidiaries of Western MNCs is not secure.

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