

# The Emerging Component Market in Russia:

The Russian Automotive Industry and the PricewaterhouseCoopers Automotive Component Suppliers Database



# About PricewaterhouseCoopers

PricewaterhouseCoopers refers to a global network of firms that closely follows the development of the automotive industry both at international and Russian level. Our professionals have significant experience working with companies in the sector, which allows them to generate solutions to company-specific issues. Fifteen major car manufacturers and 20 key suppliers in the industry worldwide employ the services of PricewaterhouseCoopers.

PricewaterhouseCoopers first appeared in Russia in 1913 and re-established its presence here in 1989. Since then, PricewaterhouseCoopers has grown to become the largest professional services provider in Russia.

According to the annual rating prepared by the independent rating agency Expert RA, published in Expert magazine, PricewaterhouseCoopers is the largest auditor and tax and legal adviser in Russia (see *Expert*, 2000–2008).

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# Introduction

This publication provides current and prospective participants in the Russian automotive component industry with a brief overview of the market and issues affecting investment in the sector.

A short projection of the Russian auto component market's potential development is followed by a detailed description of the sector's structure. We also introduce the PricewaterhouseCoopers Automotive Component Suppliers Database and outline how this research tool may be of use to both new and established market participants.

A discussion highlighting tax and other issues that new entrants to market may face is followed by a description of the various automotive industry services and solutions PricewaterhouseCoopers offers.

We conclude with a summary of solutions which PricewaterhouseCoopers can provide in assisting new businesses establishing operations in the Russian automotive industry.



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# Auto component industry overview

## Russian automotive industry

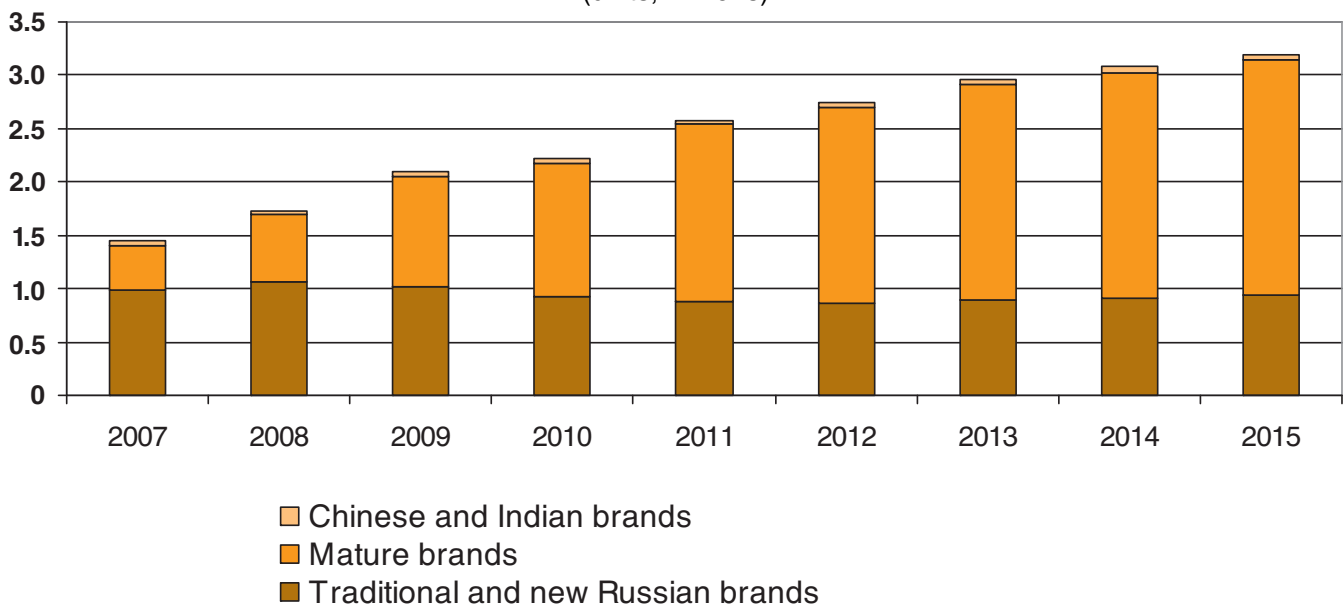
In 2007, Russian automotive sales grew 35% to 2.8 million cars compared with the previous year making Russia the second-highest sales volume market in Europe after Germany. Over the past five years, the demand for cars has increased five-fold in value, from US \$10 billion in 2002 to more than US \$53 billion in 2007. The main reasons for such rapid growth include steady increases in personal disposable income; better access to car financing, and expansion of sales outlets and dealership chains across the country. We anticipate further market growth, and if the growth continues unabated, the Russian car market will become the largest in Europe.

Based on our latest estimates, and assuming no long-term global recession or unforeseen political developments, we could see sales rising above 5 million units per annum over the next 10 years. Recent government forecasts indicate the sales could reach even higher levels. Thus, the Russian car parc, currently around 28 million vehicles, will grow to between 55 and 75 million vehicles by 2020.

This growth is accompanied by a transformation of the market's structure. Russian car manufacturers are losing their market share to foreign brands, which either import or have assembly plants in the country. These new foreign brands accounted for 78% of the market by transaction value in 2007. This is not surprising considering the government has offered tax breaks to companies that start major assembly lines in Russia. Ford, Renault, GM, KIA, Great Wall, Hyundai, Fiat, SsangYong, Toyota, Volkswagen and Isuzu vehicles are already being assembled in Russia. Suzuki, Nissan, Peugeot/Citroen, Mitsubishi and others are building factories or have announced plans to build assembly plants. Consequently, an influx of foreign automotive component manufacturers is expected over the next several years.

These factors have a significant impact on car production in Russia. Again, assuming no major unexpected political or global economic developments within the next five years, domestic production of light vehicles could double, the majority of which would be Western brands.

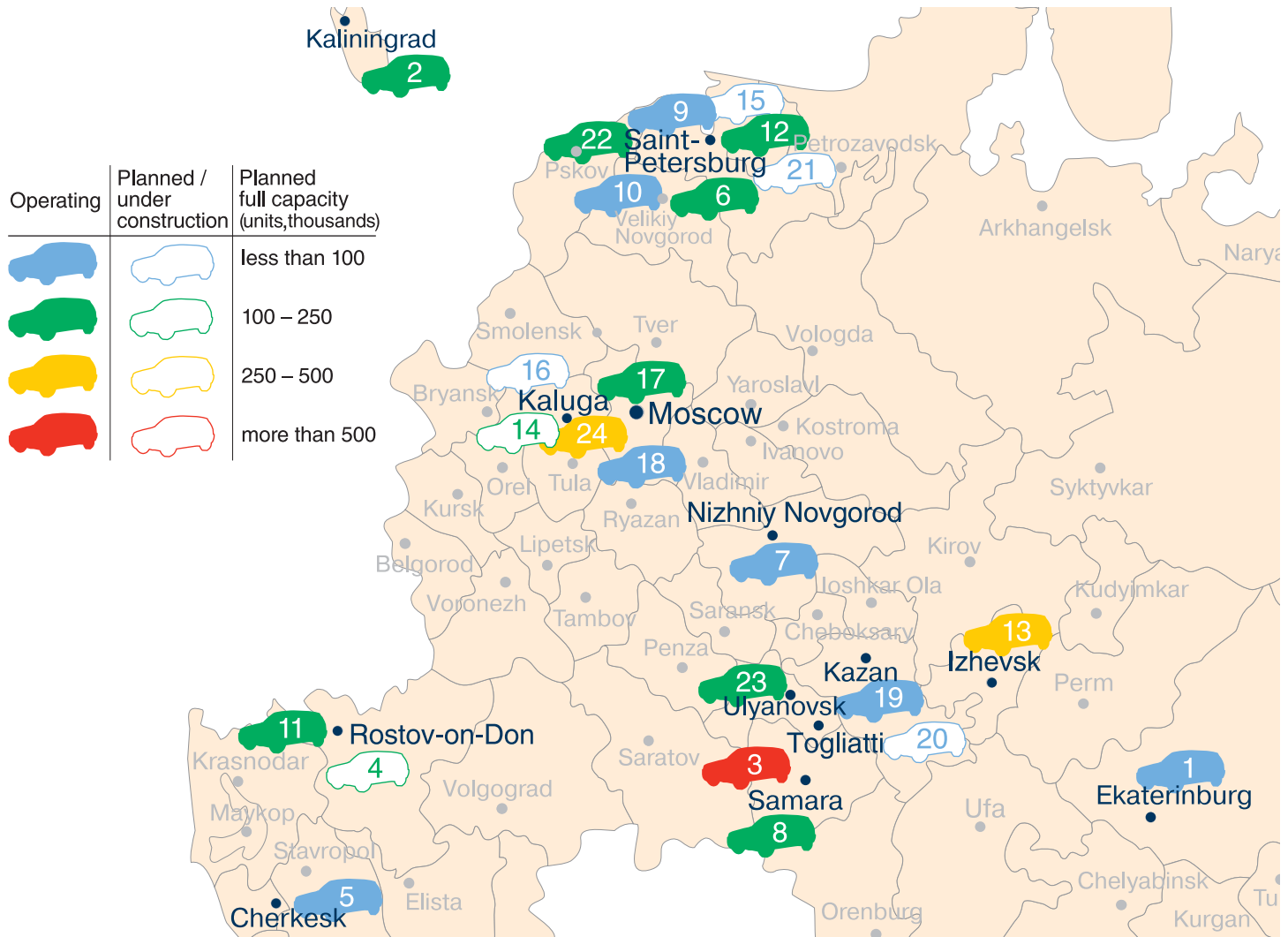
**Production of light vehicles in Russia**  
(units, millions)



Source: PricewaterhouseCoopers Automotive Institute

The following map shows the locations of the key existing and developing automotive clusters in Russia.

**Map of car production in Russia**



	1	2	3	4	5	6	7	8
Car manufacturer	Amur	Avtotor	Avtovaz/ Renault	Chery (TAGAZ)	Derways	Ford	GAZ	GM-Avtovaz
	9	10	11	12	13	14	15	16
Car manufacturer	GM Arsenal	GM Shushari	Hyundai (TAGAZ)	Hyundai St. Petersburg	KIA (IZH-Avto)	Mitsubishi (JV with PSA)	Nissan	Peugeot-Citroen (JV with Mitsubishi)
	17	18	19	20	21	22	23	24
Car manufacturer	Renault	SEAZ	Fiat (Sollers)	Ssang Yong (Sollers)	Suzuki	Toyota	UAZ	Volkswagen

Source: companies announcements in press

## Russian automotive component industry

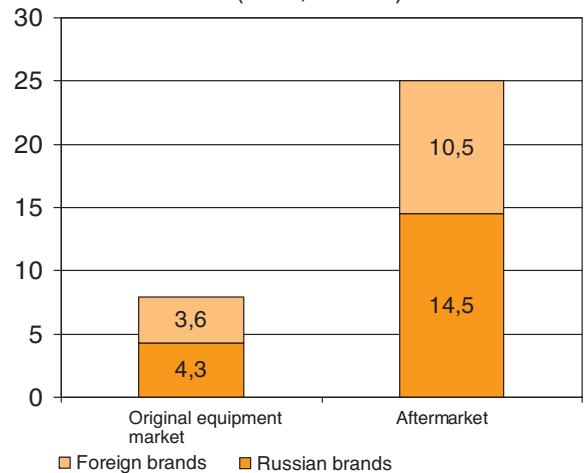
The rapid development and change in the Russian automotive industry creates significant expansion opportunities for the automotive suppliers. Several foreign component producers that are taking advantage of these opportunities, including Nokian, Bosch and Johnson Controls.

The government has affirmed its support for the automotive component industry's development by introducing a number of Special Economic Zones which offer tax concessions and other incentives for investment. For example, the industrial Special Economic Zone Alabuga specifically targets foreign automotive component producers.

Additionally, there are industrial assembly agreements available which offer potential tax concessions in the initial years of investment.

In 2007, the total value of the automotive component market was US \$33 billion. The current breakdown between the original equipment and aftermarket in Russia is estimated to be 24% and 76%, respectively. Today, Russian brands account for greater than half the market volume for each market sector.

**Automotive component market volume**  
(USD, billions)



Source: AutoStat

### Original equipment market

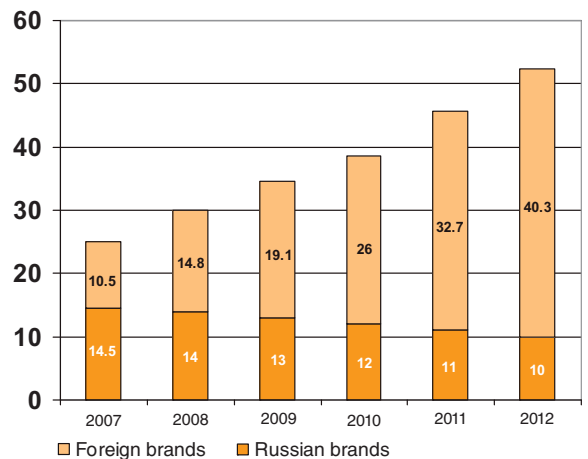
The original equipment market for Russian-made foreign components has significant growth potential:

- In 2007, 440,000 Russian-made foreign-brand cars were produced;
- The market value of Russian-made components for foreign-brand cars made in Russia was only US \$360 million because the majority of components were imported or of low value;
- Many foreign auto manufacturers have signed investment agreements with the Russian government and have agreed to reduce the monetary value of their imported components by one third within seven years.
- Therefore, the original market for foreign-quality components will approach US \$10 billion over seven years. This growth is possible if we assume:
  - 1) That the production volume of Russian-made foreign brands exceeds 2 million units by 2012;
  - 2) The average price of a car will be approximately US \$25,000;
  - 3) 60% of the vehicle cost is for components;
  - 4) And that at least 30% of the components are produced locally.

### Aftermarket

As a result of the dramatic increase of foreign brands into the Russian car fleet, we expect strong growth in the aftermarket for foreign-brand components.

**Auto component aftermarket volume**  
(USD, billions)



Source: AutoStat, PwC estimates

# Structure of the Russian auto component industry

The Russian auto component industry can be divided into four broad groups: Russian auto manufacturers; Russian financial-industrial groups; foreign manufacturers operating in Russia; and smaller, independent Russian manufacturers. In the future, large Russian chemicals and metals companies, which to date have taken little interest in the automotive sector, may also play a role.

## Russian auto manufacturers

Under the Soviet Union, the automobile industry was fully vertically integrated and based in three locations: Nizhny Novgorod (GAZ), Togliatti (AvtoVAZ), and Naberezhny Chelni (Kamaz). Operations were large scale – Togliatti had a capacity of 750,000 cars, GAZ and Kamaz 300,000 trucks. These plants did everything from smelt metal and produce machine tools to manufacture components and modules to vehicle assembly. Through 1991, the vast majority of the automotive component sector fell under this rigid integrated structure.

After 1991, the three large manufacturers had to succeed on their own under harsh economic conditions, which included the lack of government investment, hyperinflation, the growth of a barter economy, and a fledgling taxation regime that was not supporting industrial growth.

## Russian financial-industrial groups

Consequently, these large entities began to spin off non-core component manufacturing subsidiaries. At the same time, a new generation of Russian entrepreneurs – including former managers of the three aforementioned manufacturers – saw an opportunity to acquire these habitually inefficient and unprofitable entities and build component producing groups.

## Foreign manufacturers operating in Russia

By the mid-1990s, several of the larger foreign auto component manufacturers, including Bosch and Delphi, began to enter the market with the intention of supplying the three large Russian manufacturers. The next decade saw a number of global Tier 1 suppliers following cautiously in their footsteps, but the risks, uncertainties, cultural differences and bureaucratic complexity of doing business in Russia limited this influx to only the boldest and strongest companies.

## Smaller, independent Russian manufacturers

Amid the fallout from the break-up of the Soviet structure and the collapse of Russian manufacturing in general (aerospace and defence, railways, consumer goods, chemicals, etc.), many entities went bankrupt. Those that managed to survive often did so only to the heroics of local management and the loyalty of their workforce. Some of these smaller independent companies that survived the economic chaos are now succeeding in the more favourable conditions in Russia today. These companies tend to be smaller than those bought by the larger financial-industrial groups and are easier to negotiate with because of a simpler ownership structure.

## Large Russian chemicals and metals companies

One group that barely exists within the sector today, but which could play a significant role in the future, are large chemicals and metals companies which have traditionally spurned the automotive sector. With easier opportunities for profit elsewhere, Russia's booming metals giants have to date largely ignored the industry's need for quality galvanised sheet metal.

Similarly, the chemicals sector has largely ignored the demand for high quality plastics for car interiors. As these large Russian entities begin to appreciate the automotive component sector's potential, there could arise new, automotive component-focused businesses within the sector.

Based on 2007 sales figures, the aftermarket is dominated by large Russian auto manufacturers and financial-industrial groups. Foreign manufacturers, smaller independent Russian producers and the large chemicals and metals producers have yet to make a significant impact on the aftermarket.

## An Industry in Transformation

### Main players at the Russian automotive component market

Group	Share
<b>Russian car manufacturers</b> (AvtoVAZ, UAZ, GM-AvtoVAZ among others)	50%
<b>Holdings</b> (SOK, Autokom among others)	34%
<b>Foreign imports</b>	8%
<b>Indirect components</b> (plastic, rubber etc.)	6%
<b>Small specialist producers</b>	2%
	<b>100%</b>

Source: AutoStat, PwC estimates

We expect the automotive component market structure to transform significantly over the next ten years with a large shift in favour of smaller independent producers, foreign producers and large chemicals and metals companies. We also expect the larger Russian entities to continue rationalization of automotive assembly businesses and to spin off more non-core component businesses.

Russian industry is emerging from decades of zero investment, technological backwardness, an absence of customer-focussed product design, and the associated lack of quality control. Thus, there is a lack of management know-how in product development, production organisation and marketing. Amongst Russian auto component producers much manufacturing equipment is out-dated, processes are inefficient, and entities are giant and unfocussed when they need to become smaller and nimble. Yet the opportunities for growth facing the industry are enormous and cannot be overlooked.

Meanwhile, the international auto sector has evolved into one of the most efficient manufacturing sectors in the world, having adapted with decades of fierce competition, rapid technological change, cost pressure and intense focus on quality. The price/quality coefficient for a modern passenger car has never been more favourable for the customer. Foreign manufacturers' equipment is state of the art and their processes are extremely efficient. There is a flourishing critical mass of small-scale, world-class producers. And yet the opportunities for growth in developed markets are limited.

While these very different levels of industrial development have existed for a while, recent strong growth in the Russian automotive sector has encouraged cooperation between the two sides.

The growing market promises strong revenues from investment in the sector.

Moreover Russian players are beginning to have the cash and willingness to share with their foreign counterparts some of the financial risks of investing. There are opportunities for foreign manufacturers across each of the five component groups named, but each group presents a different set of risks and rewards for the potential investor and requires a different negotiation approach.

Thus, the synergies currently existing between the foreign and Russian auto component industries have also reached an unprecedented level.

There have been a number of studies aimed at mapping the Russian auto component sector, including a study by the European Bank for Reconstruction and Development, a paper produced with the support of the IFC and others. However, we believe a more detailed mapping of the Russian auto component market is long overdue and much needed. The results of such a mapping should be made generally available and incorporate the opinions of key players in the industry. However, this would be expensive and time consuming.

Consequently, PricewaterhouseCoopers has developed an Automotive Component Suppliers Database. It is designed to be a research tool for prospective, new and established players in the Russian auto component industry, as well as an overall aid promoting the industry's general development.

# Entering and operating in Russia: main issues\*

## General issues

### Gaining entry into the Russian market

There are several ways of gaining entry into the Russian automotive market: purchasing existing companies, Greenfield projects, or setting up joint ventures with Russian partners. Choosing a location, corporate form and structure require significant analysis of the relative advantages and disadvantages of each option.

## Issues arising at the feasibility stage

### Tax registration and permanent establishment issues

The presence of foreign employees in Russia for over 30 calendar days cumulatively in a year gives rise to tax registration requirements. Consideration should also be given to permanent establishment rules that apply to branch or representative offices.

### Tax treatment of set up costs

Set-up costs incurred prior to registration/start up cannot be pushed down to subsequently registered Russian entities and are usually treated as non-deductible for Russian profits tax purposes. Therefore, these costs should be carefully structured in order to avoid adverse tax treatment in Russia.

## Structuring ownership of buildings/land/assets

### Ownership of assets and operations

Assets and operations may be owned separately (i.e., by separate legal entities) or together (i.e., by the same legal entity). The advantages and disadvantages of each option should be considered.

### Acquiring buildings/trade equipment

There are various options for acquiring buildings/trade equipment (i.e., construction, lease, purchase or charter capital contribution). The advantages and disadvantages of each option should be considered. For example, trade

equipment imported into Russia as an in-kind contribution to an entities' charter capital may be exempt from customs duties and VAT, and certain types of equipment imported into Russia may be subject to 0% rate of import duty.

### Acquiring land

Land may be purchased or leased. A comparative analysis of the tax advantages and disadvantages of each option should be performed.

## Staffing in Russia

### Shortages of qualified, experienced staff and high turnover

One consequence of the recent economic boom in Russia is the expansion of jobs much faster than the number of people with the skills to fill them.

### Developing local employment policies and procedures

Employment policies and procedures may need to be adapted for Russian entities in order to avoid adverse tax treatment.

### Employing expatriate personnel

Employing foreign workers can be complex and bureaucratic. Foreign workers have the right to work in Russia only if they hold individual work permits. In addition, an employer is entitled to employ foreign workers only if it holds an employment permit. Income received by expatriate employees staying in Russia less than 183 days in a calendar year is subject to higher tax rates. Further, many types of compensation that multinationals usually provide to employees at the group level are non-deductible for Russian tax purposes.

\*For more details please see PricewaterhouseCoopers publication "Doing business and investing in the Russian Federation"

## Other issues arising at operational stage

### Funding Russian operations

Several financing options are available for Russian operations (e.g., loan financing, charter capital contribution, contribution to the property of a limited liability company, etc). The advantages and disadvantages of each option should be considered in light of exemptions from customs duties and VAT, thin capitalisation rules and other restrictions. Careful consideration should also be given to determining an appropriate debt-equity ratio.

### IP rights

There are many bureaucratic procedures for the protection of IP rights in Russia. Ownership and use of such rights should be carefully structured by the group.

### Russian statutory and tax accounting requirements

Companies operating in Russia should maintain both Russian statutory accounting ledgers and tax accounting registers. Statutory and tax accounting legislation set extensive documentation requirements. Existing accounting models generally need to be significantly adapted or developed for Russia.

### Customs issues

Customs rules require the subsequent buyer to ensure that goods were properly cleared through customs by the importer and that all customs taxes were paid. Violating customs rules and understating customs payments result in significant fines and delays in Russia. Imports from related parties require special attention and documentation.

### Structuring profits and cash repatriation

Commonly used profits and cash repatriation techniques are dividends, royalties, fees for provision of various types of services, and headquarters support. Since intra-group transactions are usually scrutinised by Russian tax authorities, proper documentation supporting the nature of intra-group charges would be critical for deducting underlying expenses. Standard

cost-sharing arrangements that are usually applied by multinationals are generally not viable in Russia from a tax perspective and require modification.

## Key tax issues

### Profits tax

General business expenses are tax deductible in Russia. There are, however, some restrictions for certain types of expenses. The Tax Code establishes the criteria for deductible expenses; in particular, the expenses should be (a) economically justified, (b) supported by proper documentation, (c) incurred in the course of income-generating activity and (d) not specifically mentioned by the Tax Code as non-deductible for tax purposes.

### VAT

VAT is applicable to goods (works, services) sold in Russia and goods imported into the country. The Tax Code establishes the place of supply rules for works and services. Input VAT incurred on purchases is generally recoverable against output VAT, provided that the VAT recovery requirements established by the Tax Code are met. However, there are certain difficulties with the recovery/refund of input VAT in Russia, for instance: (a) delay in the recovery of input VAT incurred on construction, (b) VAT charged to foreign companies is not recoverable, and (c) obtaining cash refunds from the state is extremely difficult.

### Other major types of taxes payable

Property tax, payroll taxes, transport tax, excise tax and land tax are all payable in Russia. Appropriate tax planning should be performed in advance of any investment into the country.

# PricewaterhouseCoopers Automotive Component Suppliers Database



As outlined in the industry overview, we believe a detailed mapping the Russian auto component market is long overdue and much needed for automotive industry players. As part of our contribution to address this need, we have created a PricewaterhouseCoopers Automotive Component Suppliers Database.

The database is designed to be a research tool for prospective, new, and established Russian automotive market players.

## Benefits for prospective market participants

- Information on approximately 500 Russian automotive companies throughout the country.
- Identification of potential suppliers, customers and JV partners in any region.
- Information sortable by region, sector, financials, quality standards, main customers, export potentials, ownership, etc.
- Full contact details are provided.

## Benefits for existing market participants

- Increased visibility of local producers for potential foreign investors, partners and customers.
- Opportunities for database users to analyse the industry and aid in the development of business strategy.
- Easy identification of potential partners throughout Russia.
- Global visibility through the PricewaterhouseCoopers network.

# Using the PricewaterhouseCoopers Automotive Component Suppliers Database

## Partners for a joint venture

### Identification and short-listing

We help find appropriate business partners for joint ventures. In doing so, we follow a number of steps:

- PwC advisors help you define the main selection criteria and information needed to identify a long list of candidates. Then a mutually agreed list of requirements/selection criteria is created. Further steps are based on this list.
- Our specialists compile a list of potential candidates based on the criteria set in the previous stage. This list includes general information on the potential partner, including their location, type of production, contact details, etc.
- After analysing the list in detail, PwC assists in refining the screening criteria. Once more specific criteria have been agreed upon with you, we recommend a short list of candidates using more detailed information.

### Closing the deal

As your lead financial advisor, we will act as project managers structuring the process to facilitate a successful outcome:

- PwC approaches the short-listed parties on your behalf and assists with the first meetings. We conduct a preliminary value analysis and assist you in drafting non-binding offers.
- PwC coordinates your advisors' work during the due diligence phase. Based on the results of the due diligence, we refine the value considerations and assist in preparing the binding offer.
- PwC provides support during negotiations and the signing/closing of the deal.

Throughout the process, we coordinate the work of tax, legal, and due diligence providers.

## Potential suppliers

- PwC advisors work with you on what type of components the potential supplier can produce and on any specific criteria that the supplier should meet. After this phase, the main parameters for future research and analysis are developed.
- PwC recommends a list of potential suppliers meeting the criteria set forth.
- After supplier analysis, PwC assists in refining the search criteria. Once more specific criteria have refined, and we recommend a short list of suppliers with more detailed information.
- Working together, one or two final candidates are selected and we prepare a due diligence report. In this report, the financial, operational and forensic aspects of the supplier's business are analyzed.



# Specialised solutions provided by PricewaterhouseCoopers for the automotive industry

Challenges	How PricewaterhouseCoopers can help
<b>Market entry</b>	<ul style="list-style-type: none"> <li>Analysing market potential and key characteristics;</li> <li>Defining market entry strategy, i.e. entry mode, target client/customer group, product range and specific product characteristics, market positioning and pricing strategy, distribution channels, assistance in partner selection, etc.;</li> <li>Defining organisational and operational strategy for the new market;</li> <li>Defining sourcing strategy;</li> <li>Advice on corporate structure, labour and migration issues;</li> <li>Advice on Russian legislation, including anti-monopoly law, and support with obtaining certain types of licenses;</li> <li>Drafting corporate documents and support with establishing the business unit in Russia.</li> </ul>
<b>Tax and customs issues</b>	<ul style="list-style-type: none"> <li>Accounting treatment of transactions typical for car dealers and manufacturers;</li> <li>Regional tax concessions;</li> <li>Financing and profit repatriation techniques; thin capitalisation rules;</li> <li>Deductibility issues, including start-up costs;</li> <li>International taxation; double tax treaty benefits;</li> <li>Transfer pricing issues;</li> <li>General VAT advice: VAT recovery, exemptions, imports and exports;</li> <li>Advice on setting up the customs clearance process; assistance in dealing with the customs authorities.</li> </ul>
<b>Systems and process solutions</b>	<ul style="list-style-type: none"> <li>Managing systems risks due to introduction of new accounting or ERP systems: <ul style="list-style-type: none"> <li>System compliance with Russian accounting regulations;</li> <li>Access, security and authorisation controls;</li> <li>Data migration reviews.</li> </ul> </li> <li>Managing process and controls risks from a business or compliance perspective: <ul style="list-style-type: none"> <li>Reviews of compliance with specific reporting requirements;</li> <li>Internal controls reviews and optimisation;</li> <li>SOX, J-SOX and other compliance reviews and preparation.</li> </ul> </li> </ul>
<b>Supply chain management</b>	<ul style="list-style-type: none"> <li>Assessing existing supply chain and procurement processes, recommendations for their optimisation based on global best practices;</li> <li>Developing the process for selecting and establishing relations with potential vendors and partners, due diligence of local vendors;</li> <li>Assistance with finding appropriate production facility locations and logistics hubs;</li> <li>Advice on stock level optimisation;</li> <li>Assistance with implementing tailored supply chain information solutions.</li> </ul>
<b>Fraud prevention and fraud detection</b>	<ul style="list-style-type: none"> <li>Fraud risk management programme;</li> <li>Anti-corruption/bribery programme;</li> <li>Internal corporate investigations.</li> </ul>
<b>Due diligence</b>	<ul style="list-style-type: none"> <li>Analysing and assessing the financial assumptions underpinning a deal, detailed review of a target company's tax position;</li> <li>Checking past trading experience with focus on purchase price issues and purchase agreement considerations;</li> <li>Commercial due diligence.</li> </ul>
<b>Human resources</b>	<ul style="list-style-type: none"> <li>Assistance with recruitment and retainment strategies, negotiating with trade unions; expatriates management;</li> <li>Support in developing KPIs to meet enterprise business objectives;</li> <li>Help in designing a compensation system with competitive benefits; incentive plan design and compensation benchmarking.</li> </ul>
<b>Professional development</b>	<ul style="list-style-type: none"> <li>IFRS/US GAAP: from basic theory seminars to training using actual company data;</li> <li>Strategy, finance and management tools: various trainings to address client needs.</li> </ul>

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