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Transforming Russia's Auto Industry

From Recovery to Competitiveness



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Transforming Russia's Auto Industry

From Recovery to Competitiveness

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AT A GLANCE

By 2020, Russia is projected to grow into the largest European car market—and the fifth-largest globally—with annual sales of 4.4 million vehicles.

Will the industry be able to build on its recovery from the crisis to achieve international competitiveness?

In this report, we sift the evidence and plot a potential pathway toward a more stable, modernized future for this sector. We assess the imperatives for competitiveness that are influenced primarily by policymakers and by macroeconomic developments—that is, achieving a large and stable domestic demand, competitive factor costs and infrastructure, and a predictable and supportive regulatory environment.

We also assess the imperatives for competitiveness that are influenced primarily by the industry itself—that is, building a critical mass of local and localized producers, an efficient supply base that includes basic materials, lean and compliant processes throughout the value chain, and customer-oriented products and sales operations.

RUSSIA'S AUTO INDUSTRY IS back from the brink. It recovered to precrisis sales levels in 2012 and—more importantly—is currently benefiting from an unprecedented amount of investment into new and modernized production facilities. With more than US \$10 billion committed to upgrading facilities and expanding capacity through 2020, the auto industry is the one industrial sector in Russia that is attracting serious levels of direct foreign investment.

This revival was undoubtedly driven by the Russian government's policy of supporting foreign investment in the auto sector. Such investment followed a "localization through partnership" blueprint that encouraged global OEMs to invest in local production, source components locally, and form partnerships that support the modernization of domestic OEMs.

Yet it remains to be seen whether this wave of investment and modernization will be sufficient to transform the Russian auto industry. The question is whether the upgrades and expansion will elevate the sector's products, customer service, productivity, and cost efficiency to be globally competitive in the face of a more uncertain macroeconomic outlook, slower growth in demand, and continued pressure from imports.

In this report, we look back at the "tectonic shift" that has transformed the auto sector since the crisis, explore all the factors contributing to a positive scenario for the sector's development to 2020, and examine the seven key requirements that will make this projected scenario a reality. The auto industry presents a highly visible case for testing Russia's effort to sustain and modernize its industrial base. The industry's importance vastly outweighs the 2 percent share of national GDP that it currently represents.

A Glance in the Rearview Mirror at Life-Saving Measures

In 2009, Russia's auto sales were in a free fall. They declined 50 percent from their peak in 2008—the steepest drop-off witnessed in any major economy. Demand had collapsed as real disposable incomes fell and consumer credit disappeared. Domestic producers and their supply chains were either on the brink of bankruptcy or on life support provided by the state budget or state-owned banks. Tariffs had been raised to 30 percent for new cars and to 25 percent for new trucks, and prohibitive tariffs had been placed on used vehicles.

Unemployment was rising in the industrial cities of the Volga Belt, where

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automobile producers and their suppliers are the main—and sometimes the only—employers. The bid by the Sberbank-Magna International consortium to buy Opel from General Motors—seen by some as a silver bullet for an industry in need of new technology and know-how—was rejected at the last minute in November 2009.

Already, the industry's precarious past of just four years ago feels very remote. But can a patient so recently raised from its deathbed soon be fit to compete in the global automotive Olympics?

At that point, it had become clear that financial support for producers and higher customs duties alone were not going to transform a continuously declining industry. This left the country with three options:

- Abandoning the industry to its fate and becoming a pure importer
- Merging domestic automakers and suppliers into a centrally managed state enterprise, as had happened in the aerospace industry
- Motivating global industry leaders to localize in Russia by forming partnerships with domestic firms.

The government, aware of the success of localization policies in countries such as China and Brazil, chose the third option—and implemented it with unparalleled speed and zeal. Regulatory Decrees 166 and 566, which govern industrial investments by automakers, were revised. Customs duty benefits were awarded to producers (and their suppliers) that established annual production capacity of more than 300,000 units within 48 months of the supplementary agreement and boosted the local value added to 60 percent within six years. These incentives were a major bone of contention during the negotiations surrounding Russia's joining the World Trade Organization, but the final accession protocol permits them until 2019, along with a sliding scale of import duties.

Introduced to save the industry, the regulations and their gradual cutback will continue to shape competition. Already, the industry's precarious past of just four years ago feels very remote—but can the Russian auto sector build on its success?

Spotlight on 2020: A Positive Future with Some Question Marks

Our current projection is that the Russian auto market will grow by an annual average rate of 6 percent through 2020, when it will reach an annual sales volume of 4.4 million vehicles. As Exhibit 1 shows, this growth would propel it past Germany, positioning it as the top market in Europe and the fifth-largest market globally—behind only China, the U.S., India, and Brazil. This forecast takes into account the current weakening of both the Russian and worldwide auto markets.

To make this projection a reality, Russian producers and suppliers will need to compete in a challenging global environment. The sector is being transformed not only through rapid technological change but also through the shift in demand from developed to developing markets. Emerging markets are projected to account for 65 percent of global automobile sales in 2020, more than double the 28 percent they accounted for in 2000.

EXHIBIT 1 | Russia Is Projected to Rank as the Fifth-Largest Auto Market in 2020



Sources: Global Insight; BCG analysis.
¹Passenger cars and light commercial vehicles weighing less than 3.5 tons.

How competitive Russia’s domestic and localized auto sector can be will determine how much of these sales the Russian automotive industry will capture, and how much of each of these vehicles will be produced locally. The challenges that the industry faces include the exchange rate of the ruble, the far faster rise in wages over the rise in productivity, and bottlenecks in infrastructure.

But we can foresee a scenario in which Russia can build a large, well-regulated, and internationally cost-competitive auto industry that is based on a critical mass of lean local and localized producers and underpinned by efficient suppliers and after-sales businesses taking a customer-first approach. We believe that Russia can follow Brazil and China in ascending from an “export target” to become a “competence center for manufacturing and sales” that holds a dominating share of locally produced vehicles. We also believe that the Russian auto sector is capable of transforming its local supply base into a globally competitive one.

But can the sector also hope to become an “innovator and exporter” like South Korea and, to some extent, India? We do not expect to see automotive innovation becoming a major factor in Russia in the near future. Some niches exist, such as all-wheel-drive technologies for commercial vehicles, in which Russian engineering is state of the art. But Russia is traditionally an importer of Western auto technology, paying owners of technology through product transfer prices or royalties. Innovation at the OEM level in many countries is driven by the specifics in local demand. But in the absence of specific local standards and preferences in Russia—such as the rare examples of larger windscreen-wiper water tanks, rough-terrain suspensions, or winter packages—even adaptation engineering has been very limited.

We expect that Russia will still be a net importer of vehicles in 2020, but we also expect that exports will increase markedly as global producers manage their plant

networks through the cycle. In 2012, Russia imported 15 passenger cars and 8 trucks for every vehicle it exported, and almost 90 percent of the exports went to neighboring CIS countries. Exports of auto parts were negligible.

But here too we see opportunities for change over time. The close proximity of European markets and the highly cyclical nature of demand make it unlikely that global producers and suppliers will build capacity in Russia to cover 100 percent of local demand. Instead, they will continue to rely on imports during upswings. But during downswings, we expect that companies will tap more exports from Russia to send to other markets. By 2020, global players will be the primary exporters of Russian vehicles—possibly focusing on selling to other CIS countries.

One big advantage that the Russian sector enjoys is that the automotive tastes of Russian consumers are more aligned with those of their Western counterparts than with the tastes of Chinese, Brazilian, and especially Indian consumers, for example. As a result, product designs are relatively more compatible between the Russian and Western markets, and vehicles built in Russia for export to the West would need less adaptation.

Yet global competitiveness remains a core criterion for exports. Russia still falls a bit shy of its global competitors in terms of cost and quality. Therefore, we believe, policymakers and auto companies must meet seven critical prerequisites that will bring the Russian auto sector up to global standards.

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Seven Imperatives for Competitiveness

The following seven imperatives will spur the competitiveness of the Russian auto industry.

Primarily dependent on policymakers and macroeconomic developments are the imperatives to create:

- A large and stable domestic demand
- Competitive factor costs and an effective infrastructure
- A predictable and supportive regulatory environment.

Primarily dependent on the auto industry itself are the imperatives to deliver:

- A critical mass of local and localized producers
- An efficient supply base that includes basic materials
- Lean and compliant processes along the value chain
- Customer-oriented products and sales operations.

A Large and Stable Domestic Demand

The revival in demand was faster and stronger than generally anticipated, assisted in 2010–11 by the “scrappage scheme,” which led to 600,000 purchases. The return of commercial credit to finance purchases and the recovery of disposable incomes were equally important.

Further growth may come at a slower rate, but we will continue to witness some gains. Russia’s automotive penetration of 290 vehicles per 1,000 inhabitants still falls short of the norms for Eastern Europe, Western Europe, and the U.S., which total 400, 560, and 740, respectively. And many of the cars that are owned in Russia are old. Both of these realities should attract global producers looking beyond their stagnating home turfs. As long as positive economic conditions continue, we project sufficient demand to support a large local industry.

The downside, however, is endemic volatility. Demand correlates with macroeconomic variables such as real income growth, the price of oil, and net new credit issued. Swings in the oil price can translate into sharp quarterly jumps or drops in automotive demand. This makes Russia the most volatile of the large auto markets, with a historic standard deviation in monthly sales twice as high as that of Brazil, the U.S., or Germany—and higher even than that of booming China.

During the last four years, sales were more than four times higher in peak months than they were in the slowest month. This volatility threatens the development of Russia’s automotive industry. It leads to high risk discounts in corporate planning

OPPORTUNITIES FOR ACTION

Policymakers should:

- *Take measures to contain volatility.* Policymakers need to be aware of the root causes that drive volatility, such as oil prices and the availability of credit. They need to establish long-term and creative incentives and mechanisms to counter the tendencies of the market to alternate between overheating and slumping. They should ensure the smooth introduction of changes in tariff schemes and other incentives as well as in environmental and safety regulations.
- *Encourage exports.* As long as Russian motor companies rely heavily on sales in their own nation, they remain vulnerable to local volatility. Beyond serving as a hedge against volatility, exporting also brings many other benefits.
- *Have contingencies ready for crises—and for excessive upswings.* When containment measures fail, governments must have emergency schemes ready for rapid implementation. For economic crises, this could include a scrappage program that encourages consumers to replace older vehicles; for upswings, contingency plans could limit credit.

and to cautious investments, both of which jeopardize the modernization and expansion of products, plants, processes, and sales networks. One client told us: “In Russia, we expand cautiously and manufacture by contract, since we don’t know when the next 50 percent drop in demand will happen.”

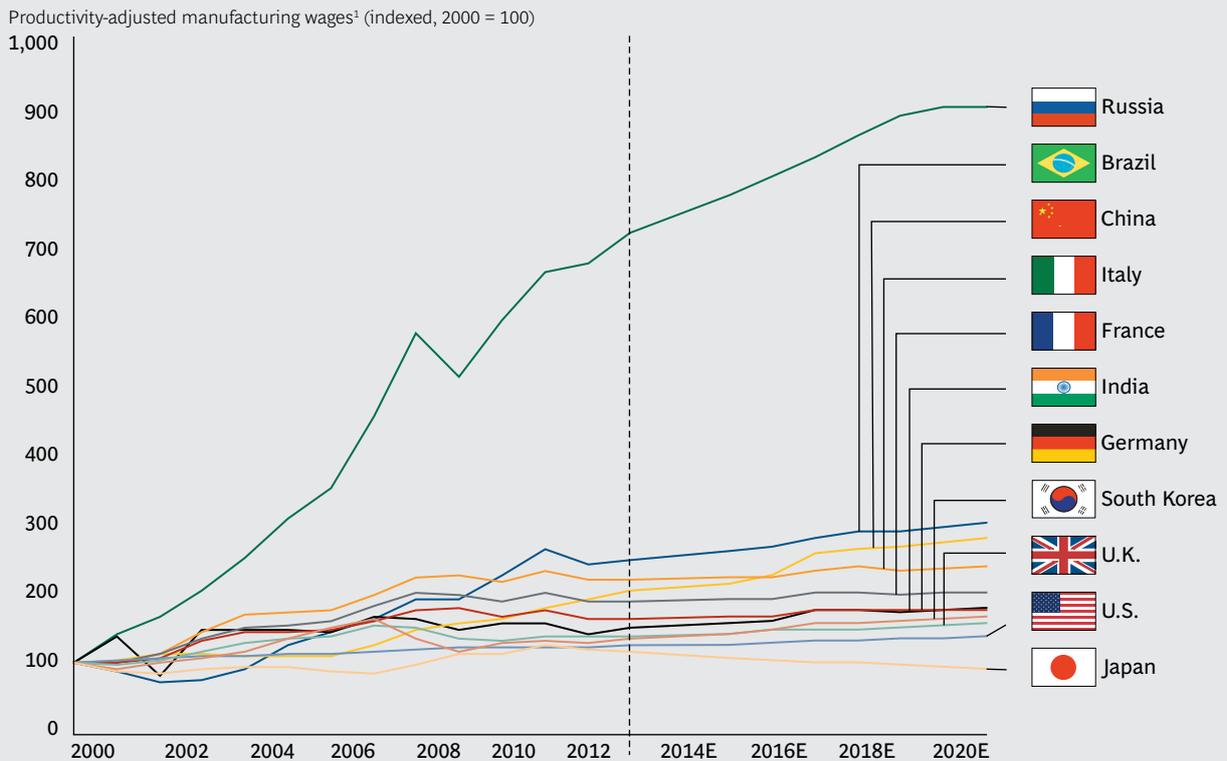
Competitive Factor Costs and an Effective Infrastructure

Rocketing costs probably pose the biggest threat to the revival of the Russian auto industry. The appreciating ruble, the tightening labor market, and higher productivity elsewhere are fueling labor-cost disadvantages in the country. In 2013, Russia’s productivity-adjusted wages are seven times higher than they were in 2000; in Brazil and China, these wages have risen only twice as high in the same period. Other countries have seen these wages grow at lower levels. (See Exhibit 2.)

This presents a double handicap for Russia. Not only do the country’s products lose competitiveness at home and abroad, but investment in manufacturing in Russia also becomes less attractive.

Energy costs are also rising fast in Russia; electricity prices rose by an annual average of 13 percent over the last five years. Also, logistics remain pricey. It costs

EXHIBIT 2 | Labor Costs in Russia Are Growing Much Faster Than in Peer Countries



Sources: EIU; BCG analysis.

¹Labor cost is calculated as a ratio of average hourly wages in manufacturing to overall productivity of labor (measured as GDP at purchasing power parity, per worker).

OPPORTUNITIES FOR ACTION

Policymakers need to:

- *Foster the creation of a more effective infrastructure.* Serious investment is needed to counter one of Russia's most serious handicaps. Reliable, high-speed routes between the automotive manufacturing hubs and the locations with the highest consumer demand

would reduce both costs and bottlenecks. A mix of road and rail routes is likely to be needed.

- *Encourage liberalization in both transport and energy.* Introducing competition into these often-protected industries is necessary to eliminate structural inefficiencies and to limit costs.

as much to move a container from Nizhniy Novgorod to Saint Petersburg as it does to move it to Busan in Korea, although the latter city is 20 times farther away. One client told us that it costs more to saturate the Ukrainian demand with vehicles produced at facilities in Russia than with vehicles produced in Japan.

A Predictable and Supportive Regulatory Environment

Although legislation is sometimes slow and cumbersome, it still outpaces the motor industry's product development and product life cycles. It can take four to five years to develop a new vehicle, and many vital and irreversible decisions are made early in the process; once developed, the life cycle of the vehicle is approximately seven years. Investment decisions take even longer, since automotive plants have no expiry date.

Consequently, short-term changes in regulations create problems for manufacturers. If a company has to wait for the next product cycle to incorporate a new regulation, the time lag may span a decade. This, again, limits the effectiveness of regulations.

OPPORTUNITIES FOR ACTION

Policymakers should:

- *Think about long-term results.* Incentive schemes that foster investment in products and capabilities or in process improvements and efficiency enhancements are needed. Sometimes the policymakers must move fast; by doing so during the past crisis, they have saved the auto industry during the downturn. But in the

long run, preventive measures are both more sustainable and less expensive.

- *Provide the industry with sufficient notice of any regulatory changes.* Early clarity on the timing and scope of regulatory changes, such as the introduction of emissions norms, will greatly improve the industry's ability to respond and to benefit from the changes.

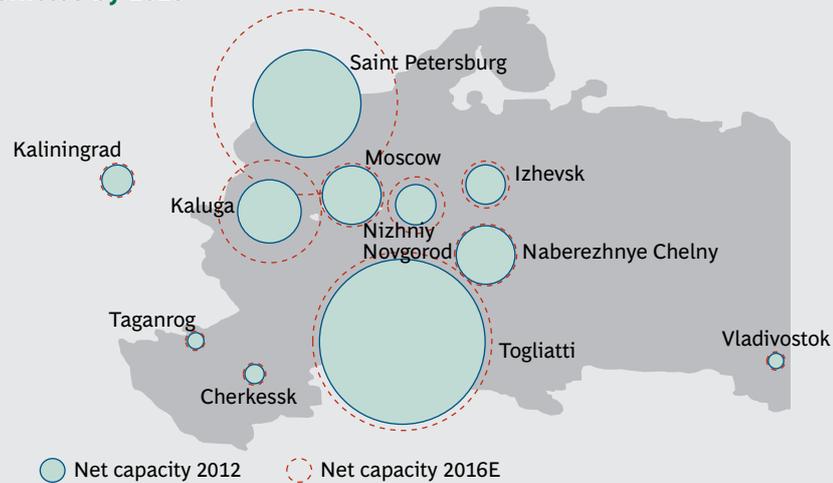
A Critical Mass of Local and Localized Producers

In 2010, our cost analysis found that car companies manufacturing in Russia bore a cost disadvantage of 15 to 20 percent, caused in part by unfavorable factor costs and higher quality costs—but created largely by small production scales. Since then, localized operations have increased in scale.

During 2011 and 2012, localized international carmakers—such as BMW, Ford, General Motors, Hyundai/Kia Motors, Mazda, PSA Peugeot Citroën/Mitsubishi Motors, Renault-Nissan, Toyota, and Volkswagen/Audi—announced new or expanded capacity. Together with the expansion plans of domestic carmakers, this will raise total capacity to about 3.3 million units per year by 2016. Of this, 50 percent will be greenfield—or from newly built plants. (See Exhibit 3.) Brownfield expansion comes from such activities as adding capacity to an existing plant.

An important milestone was reached in 2012: for the first time, cars made by localized international producers captured more of the Russian market than either imports or domestic brands; the categories commanded 41 percent, 36 percent, and 24 percent, respectively. As recently as 2005, the share held by localized international producers was just 7 percent. Several localized models and shared platforms of international players—such as the Hyundai Solaris/Kia Rio, the Ford Focus, the Renault Logan/Dacia Sandero, the Opel Astra/Chevrolet Cruze, and the VW Polo—achieved high customer-approval ratings. All of these localized models exceeded 50,000 units in the peak year of production, an important threshold for deep localization since volumes this high allow more and more tools to be amortized profit-

EXHIBIT 3 | Russia's Total Capacity Is Expected to Reach 3.3 Million Vehicles by 2016



	Capacity (thousands of vehicles)			Growth, 2007–12	Growth, 2012–16
	2007	2012	2016		
Greenfield capacity	395	970	1,720	146%	77%
Brownfield capacity	1,230	1,360	1,620	11%	19%
Total	1,625	2,330	3,340	43%	43%

Sources: Global Insight; press search; expert interviews; BCG expertise.

Note: Data reflect passenger cars and light commercial vehicles weighing less than 3.5 tons.

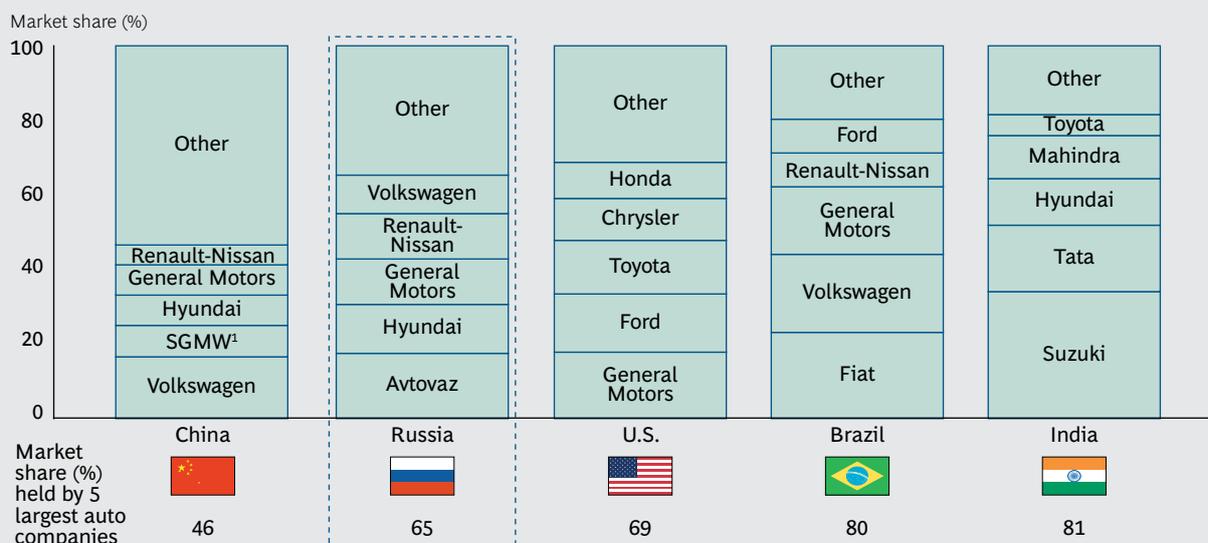
ably. Interviews with OEMs reveal that productivity in newly built assembly plants in Saint Petersburg and Kaluga continue to improve with scale. Quality, an issue in their early days, is now comparable to global standards—and recognized as such by consumers.

Domestic producers are driving both professionalization and expansion. They have embraced the challenge of modernizing product lines and plant productivity. AvtoVAZ launched the new Lada Granta sedan and the Lada Largus MPV in order to regain market share in the budget segment and plan a blitz of further product launches on joint platforms with Renault-Nissan. GAZ is concentrating on its commercial vehicles, while limiting itself to contract manufacturing in the passenger car and van segments.

Kamaz has formed an alliance with Daimler and is betting on a new generation of heavy trucks developed in collaboration with international suppliers. And Sollers, which discontinued business with Fiat and engine supply to GAZ, has since 2010 expanded an already large portfolio of vehicle plants and joint ventures through further cooperation with Ford, Toyota, and Mazda. Most are using international partners to streamline production processes and introduce world-class efficiency.

As both localized international and domestic players increase their output and drive down their costs, profitability remains a key issue for OEMs battling with the twin problems of market share fragmentation and a potential overexpansion of production capacities. Nearly all OEMs lost money in 2009, and most barely broke even in 2010, so most did not return to sustainable profitability until 2011.

EXHIBIT 4 | The Russian Auto Market Is More Fragmented Than the Markets in India, Brazil, and the U.S.



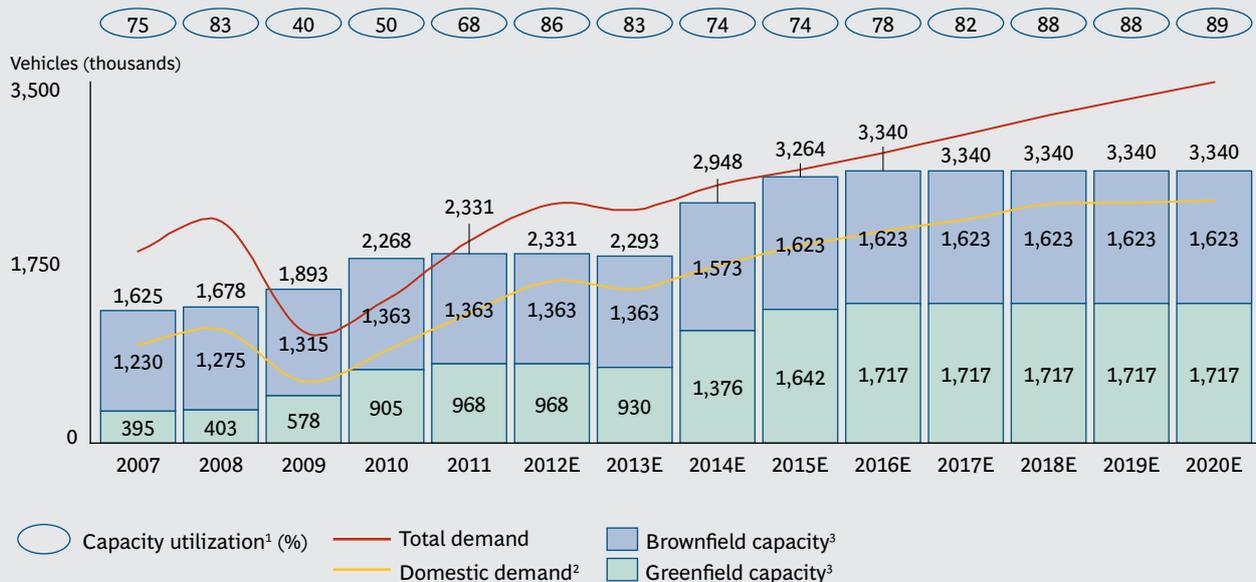
Sources: Global Insight; IHS Automotive; BCG analysis.
 Note: Data reflect passenger cars and light commercial vehicles weighing less than 3.5 tons.
¹SGMW is a joint venture of SAIC Motor; Liuzhou Wuling Motors; and GM China.

Their underlying problem is that the Russian auto market remains very fragmented. (See Exhibit 4.) The top five OEMs control only 65 percent of Russia’s market share—a lower percentage than in any other major market except China. While this enables Russian consumers to benefit from great choice and competitive pricing, it causes producers to find their pricing power very limited.

In addition, production capacity is expected to continue to outpace demand. Once imports are factored in, capacity utilization in 2012 is estimated to be 86 percent, around the industry’s break-even point. Planned capacity expansion could lead to lower utilization rates in 2014 through 2016, but recovery to a healthy level is expected again thereafter. (See Exhibit 5.) These averages conceal the likelihood that the most competitive players will be operating close to full utilization, with some less competitive brownfield operators pushed back into the loss zone.

In summary, we predict that a critical mass of about 20 OEM plants will develop, concentrated in the clusters of the Volga Belt as well as in Saint Petersburg and in Kaluga. They will create internal and external economies of scale and increase platform sharing across brands, making investments in tools more profitable and attracting suppliers. But generating a profitable return will remain a challenge, particularly in the high-volume segment, since high output from both new (greenfield) and refurbished (brownfield) capacity will put pressure on margins and costs.

EXHIBIT 5 | If All Announced Expansions Are Realized, Capacity Utilization Rates at OEMs Will Remain at Precrisis Levels



Sources: IHS Global Insight; company websites; BCG analysis.
Note: Passengers cars only. Due to rounding, for some years, the brownfield and greenfield capacities do not add up to the total capacity.
¹Capacity utilization rate = (total sales – imports)/capacity.
²Domestic demand = total demand – net imports.
³Reflects net capacity, adjusted for projected idle time.

OPPORTUNITIES FOR ACTION

Automotive OEMs and suppliers

should continue looking for further cost reductions, both internally and from domestic and localized international suppliers. They also should limit fragmentation and increase scale. These steps will require that they:

- *Build critical scale using common product designs.* It may be necessary to develop strategies—such as the use of common product designs—that are capable of building platforms of up to 50,000 vehicles or more annually. If scale cannot be utilized within a company’s Russian operations, it must be generated across nations and in collaboration with other producers.
- *Share production facilities.* Cross-

company alliances help make the business case for the investment required to increase localization and effectiveness.

- *Increase exports.* Short-term export programs established during quickly emerging crises usually remain unsuccessful since it takes time to build logistics and sales infrastructures, market competencies, and relationships. The large number of unsuccessful car-export programs in Brazil over the last 30 years underlines this point. Export programs must be set up strategically and not tactically, be initiated in good times so that they can take advantage of the next downturn, and consider scale-based increases in international competitiveness.

An Efficient Supply Base That Includes Basic Materials

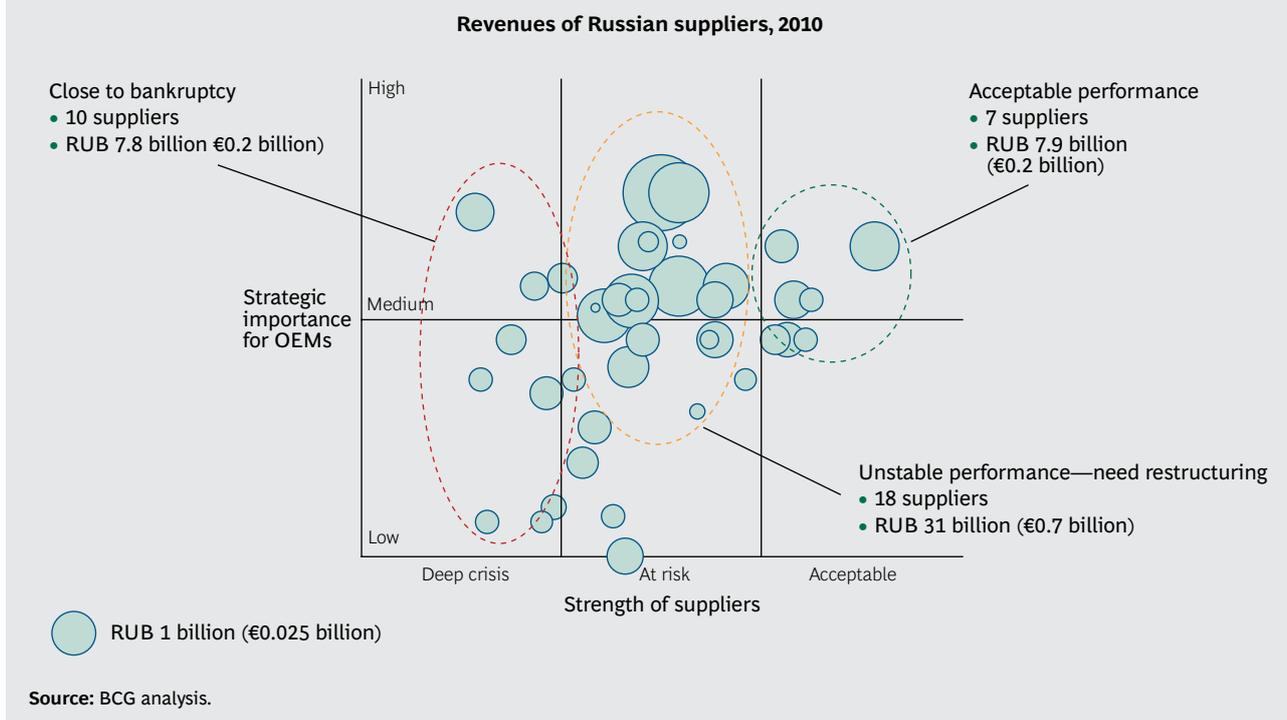
Parts supply has historically been the Achilles’ heel of the Russian automotive industry. Domestic producers were usually backward-integrated, and they produced most of their own parts—on a small scale and at quality levels inadequate for later generations of vehicles. Product designs were unchanged over decades, while rigid long-term production plans and a lack of competition meant suppliers did not need to conduct their own R&D, regularly modify processes, apply change management and continuous improvement, or flexibilize production.

As a result, independent Russian suppliers generally lack either technological and financial muscle, or the ability to ensure seamless and consistent delivery—or both. A recent BCG study found that only about 20 percent of domestic suppliers were likely to survive until 2016. (See Exhibit 6.)

International suppliers were slow to localize in Russia, preferring to focus on Eastern Europe, China, India, and Brazil. This explains why the share of locally produced parts in locally assembled vehicles rarely exceeds 25 percent—well below the target of 60 percent set by the government’s Decree 166.

But major growth in local production capacity is on the way; 26 of the 40 top international suppliers have begun production in Russia. Pioneers such as Bosch, Delphi, and Magna see huge opportunities for growth and are expanding quickly through a mix of greenfield plants, acquisitions, and local partnerships. And inte-

EXHIBIT 6 | Only 20 Percent of Russia's Domestic Suppliers Are Likely to Survive until 2016



grated supplier groups at AvtoVAZ and GAZ are becoming more active and positioning themselves as independent suppliers. Many OEMs assist the domestic suppliers in establishing joint ventures with international players, or vice versa.

Ultimately, the development of the supplier industry will depend on whether parts can be produced in a cost-competitive manner. Our study in 2010 found that parts made in Russia were, on average, 20 percent more expensive than those made by the same suppliers in their home countries. The higher cost was due to smaller scale, higher scrap rates, and higher logistics costs in Russia. Larger scale and leaner production processes have reduced this disadvantage to some degree, shrinking it to 13 percent. International suppliers' best Russian plants are reaching global productivity levels. But much more investment and improvement will be needed to ensure that the overall supplier industry in Russia—and not just a few marquee players—will be globally competitive.

A similar picture emerges around tier 2 and tier 3 suppliers as well as in basic materials. The importance of transport costs means that the proximity of base industries such as steel, plastics, glass, and rubber shall not be neglected. Most localized vehicles built in Russia use materials imported from Western Europe, Korea, or Japan. Given the size and importance of Russia's metallurgical and petrochemical industries, this trend creates a vast opportunity to substitute localized forged, cast, and extruded materials for imported ones, since local producers should have a comparative advantage. They are now beginning to meet the stiffness, mass, and other high-quality standards of international automotive suppliers

OPPORTUNITIES FOR ACTION

Domestic OEMs should:

- *Progressively reduce the protection offered to affiliated suppliers.*
- *Open commodities to internal suppliers.*
- *Enforce supplier development.*

Localized international OEMs should:

- *Define their long-term supply strategies.*
- *Temporarily modify processes to create an “open door” for local suppliers.*

- *Enforce supplier development.*

Local suppliers should:

- *Launch full-scale transformation programs.*
- *Expand their customer portfolios.*
- *Strengthen their innovation capabilities.*

International suppliers should:

- *Adapt their operations to local factor costs.*
- *Expand their customer portfolios.*
- *Consider exporting from Russia.*

and producers. One example is the investment made in press shops for stamping metal parts for vehicle bodies from Russian steel.

Last but not least, constantly rising electricity prices pose the risk of further undermining the cost competitiveness of Russian suppliers. How competitive these suppliers are will depend on decisions by Russia’s power regulators.

Lean and Compliant Processes along the Value Chain

Bureaucracy cripples companies just as it does state agencies. While some bureaucracy is the unavoidable consequence of legal requirements, much of it is derived from overhead, particularly in companies that inherited Soviet structures. At one of our clients, we found that its overhead was 35 percent higher than international benchmarks—and 25 percent higher than its own internal “best of the best” benchmark measuring labor profitability variances across functions.

Russian companies, which have not yet rationalized their organizational structures, have excessive spans of control or unnecessarily high numbers of reporting levels—or both. Inefficiencies are often invisible to company leadership. One client said: “We found employees on our company balance sheet who never turned up for work and who nobody knew.”

Compliance is also a serious problem, particularly for domestic automotive companies. To start with, compliance has a unique meaning in Russia. In developed

OPPORTUNITIES FOR ACTION

Domestic companies should continue streamlining their processes. Specifically, they should:

- *Expose affiliated companies, such as suppliers and service providers, to competition.*
- *Build effective compliance structures that meet international standards and reduce theft.*
- *Build partnerships with international carmakers seeking contract opportunities.*
- *Apply lessons from these partnerships to their core processes.*
- *Outsource noncore activities.*
- *Accept that international benchmarks can—and must—be met or exceeded in Russia.*

Localized international companies should establish lean and compliant structures, especially in partnerships with domestic players. Specifically, they should:

- *Adapt the standards and requirements of processes to local conditions.* They should avoid high-cost practices used elsewhere.
- *Hedge the business against volatility.* They should “flexibilize” their supply, capacities, and processes. They also should ensure that they have effective volume-planning and sensitive early-warning systems.
- *Maintain the startup mentality.* Companies should avoid slavishly following high-volume processes prescribed by corporate headquarters.

countries, compliance means meeting legal norms and company guidelines of the company itself and its business partners. For Russian companies, compliance refers to preventing theft and fraud, especially in production and logistics. These companies have made significant progress in recent years.

Customer-Oriented Products and Sales Operations

Neither domestic nor localized international OEMs operate to full effect in Russia. Domestic OEMs have often lost out to international competition in larger cities and Western Russia, while localized international OEMs are failing to exploit the vast sales potential of the midsize cities—tiers 3, 4, and 5—and of Ural/Western Siberia and the East.

Several factors drive both of these failures. Domestic OEMs struggle to find investors, such as large dealer groups, in larger cities. Localized international OEMs have problems finding local partners that are capable of selling their products and matching their ambitious quality standards. They complain of excessive bureaucracy. One client from a Western European premium car manufacturer told us: “I have worked in China and Latin America, but I have to sign more papers in Russia than anywhere else.”

Processes also fall below Western standards, with most dealers unable to assume the Western model of a seamless customer journey. Domestic carmakers struggle with tedious ordering processes, and long logistics processes and lead times are a general problem. These difficulties are due in part to the size of the country but also largely to the lack of high-quality last-mile logistics providers in Russia.

Furthermore, our studies show that neither domestic nor localized international automotive companies fully exploit the profit potential of after-sales and financial services. Domestic companies have traditionally seen after-sales parts as a necessary evil rather than as a potential source of profits for themselves and dealers, focusing merely on legally required warranty parts.

OPPORTUNITIES FOR ACTION

All companies should:

- *Professionalize their sales operations.* Such an approach would expand revenues and, in particular, increase income from after-sales parts. Employees should treat their dealings with customers, in particular with key accounts, as relationships rather than simply transactions. This transformation requires a serious commitment to training and development, so it will take time and money, but it will more than pay for itself.
- *Develop effective after-sales and spare-part services.* Companies should incorporate effective parts-logistics networks, potentially in collaboration across several OEMs. They also should develop programs to combat unauthorized parts, and intensify support for and professionalization with dealers. Furthermore, companies should ensure that incentive and warranty systems match the needs of local wholesalers and retailers while also defining and enforcing standards.

Domestic companies should:

- *Let the customer be the king.* Make listening to and serving customers the priority rather than fulfilling production plans and “serving” business partners.
- *Abolish heritage structures in sales operations.* Be bold in ending agreements with ineffective dealers, whether or not the dealers are affiliated with the manufacturer.
- *Reduce the number of sales levels.* “Own” the customer yourself and cut any dependence on tiered wholesalers, intermediaries, and body-builders.

International companies should:

- *Adapt products and services to Russian requirements.* A client told us: “Our headquarters is convinced that Russia is just another European market with very similar requirements. People who know Russia realize that Russian car buyers actually want to be treated, at second glance, very differently during the sales process than those in the West.”

Production bottlenecks have made spare parts scarce, encouraging suppliers to build up their own distribution networks. Alternative Russian and—increasingly—East Asian suppliers have further heated up the competition. This means that the market share attributable to OEM-manufactured spare parts is low—for some models, it is as low as 8 percent, compared with similar shares of 30 to 50 percent typical in Western Europe. The do-it-yourself market is extensive, accounting for approximately 20 percent of the Russian market, compared with 2 to 5 percent of markets in Western Europe. Consequently, the profitability in Russia of after-sales parts and services from both OEMs and suppliers is significantly below Western levels. In Western Europe, dealers traditionally earn 50 to 70 percent of their profits from spare parts sales and service. In Russia, the same share is often only 10 to 30 percent.

RUSSIA'S AUTOMOTIVE MARKET has experienced an almost phoenix-like recovery since 2009, when sales dropped by 50 percent and survival was secured only by swift hands-on regulatory actions. If current growth paths can be continued, the Russian market has the chance over the longer term to both overtake Germany as the largest European automotive market and to be globally competitive by 2020. Achieving these goals demands that Russia's government and automotive companies—localized as well as domestic suppliers and automakers—each do their share.

Through their individual efforts, the players can collectively achieve several critical common goals that are required to attain worldwide competitiveness: fostering a large, sustainable, local demand; ensuring that operations achieve (and surpass) international standards so that efficiency and effectiveness offset the existing cost disadvantage; and increasing the customer orientation of all products and operations.

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