FDI MOTIVATION AND ENTRY STRATEGIES OF RUSSIAN COMPANIES IN THE CHINESE MARKET*

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Abstract

Russia maintains a strategic partnership with China, which became its largest trading partner. Bilateral relations have become even stronger because of Russia's "Pivot to the East" policy. China continues to provide ample opportunities for foreign investors in its market, gradually liberalizing the investment regime. Since foreign direct investment (FDI) follows trade flows, it is reasonable to assume the expansion of Russian FDI in China. In fact, we observe a reverse trend, as Russian FDI is very small and declining since the global crisis. The article reveals the motivation of Russian companies investing in China and their market entry modes. Particular attention is paid to main obstacles and key success factors of Russian companies in China.

Keywords: Russia, foreign direct investment, China, multinational enterprises, internationalization

JEL code: F210; F230

Introduction

For many years, China remains to be among the largest recipients and the most attractive sites for foreign direct investment throughout the world. Even despite the recent slowdown of the Chinese economy, an inward FDI continue to grow, albeit at a slower pace than prior the crisis. In 2015, China launched a new phase of liberalization of the investment regime to simplify the procedures for registration of foreign enterprises, improve the quality of inward FDI, and eliminate restrictions on FDI in a number of sectors.

Russia attaches great importance to the development of economic relations with East Asia through the establishment of strategic partnerships with China, Vietnam and R. Korea, as well as the conclusion of bilateral free trade agreements with these countries. China has recently become the largest trade country for Russia. The introduction of anti-Russian sanctions has led to further strengthening of economic ties between the two states. Since then, the countries have concluded a number of major commercial deals, including the construction of The Power of Siberia, a trans-border gas pipeline expanding their cooperation into financial and other new areas. In October 2017, Eurasian Economic Union finalized negotiations on Agreement on Trade and Economic Cooperation with China (an agreement not leading to a Free trade area). However, the rapid growth of trade and construction of large-scale projects does not lead to an increase in Russia's direct investment in China. On the contrary, they are declining after the global crisis.

Due to small volumes, the developments of Russian FDI in China are not sufficiently addressed in the literature. Despite a small amount of investment, Russian companies from a wide range of industries operate in the Chinese market. The paper reveals motivation of Russian

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companies investing in China, identifies main obstacles in their activities in the Chinese market and key success factors.

Theoretical framework

Russia consistently ranks among the top ten largest exporters of capital around the world, behind the United States, Japan, China, Hong Kong and a number of EU countries. Since 2014, due to sanctions, Russia's place in world ratings has decreased, although the reduction in the export of FDI was not as significant as the inflow of FDI into the country.

The regional distribution of the Russian FDI is characterized by the dominance of Europe and the Commonwealth of Independent States, which account for about 80% of the total outflow, due to better knowledge of local environment, less language and cultural barriers, and the active use of a number of European offshore jurisdictions. The predominance of Europe in the Russian FDI is also due to the region's leading position in Russia's foreign trade. However, Kuznetsov (2013) drew attention to an emerged trend of regional diversification of Russian direct foreign investments since late 2000s, which indicated the growing competence of the Russian business about more distant foreign markets. Until 2014, the Russian FDI grew rapidly in the Middle East, Africa, India, and even in Latin America, although the expansion of FDI in East Asia remained sluggish.

Numerous studies have examined various aspects of Russian outward foreign investment, the stages of internationalization of the Russian business, typology of the Russian multinational enterprises and their motivation for foreign expansion. Kalotay (2008) applies different investment paradigms to explain the Russia's outward FDI. Panibratov (2010, 2013) stresses the divergence in the internationalization strategies between various industries in terms of entry modes, and the role of the Russian state in internationalization.

There is a great number of country-specific and industry-specific studies related to the Russian outbound FDI. Most studies relate to certain countries or a group of countries in Eastern and Western Europe, or the Commonwealth of Independent States where the bulk of the Russian FDI is accumulated. Yet research on the Russian FDI in China never conducted. Among industry-specific studies, the largest number of publications is dedicated to oil and gas, and metallurgy sectors or to the outbound expansion of Russian telecom companies and banks (Lisitsyn et al., 2005; Panibratov, 2012; Latukha, Panibratov, 2013).

As per motivation of the Russian OFDI, many researchers have noted "safeguarding of private assets" as a specific motive typical for the Russian FDI in the European region. Among the "normal" internationalization drivers, the researchers indicate market- and resource-seeking motives as prevailing for Russian companies, while cost- and technology-seeking are less common as compared to multinationals from other countries (Kuznetsov, 2013; Panibratov, 2013). Meanwhile, Filippov (2011a, 2011b) revealed that Russian firms in the emerging IT and software sectors internationalize via innovation and using their competitive advantage.

Among the Chinese scholars, Zou (2004) dealt with the issue of cooperation between Russia and China in the field of information technologies. Gao (2011, 2012) and Gao and Lu (2012) observed a positive correlation between the Russian-Chinese trade and the Russian investment in the PRC, although due to small volumes of Russian FDI, an impact of increased investments on bilateral trade is insignificant. Zhang (2015) has estimated the correlation between the Russian-Chinese trade and Russian FDI in China.

Data and sample

The difficulty in conducting this study is the lack of statistical information on regional and sectoral distribution of the Russian FDI in China because of their small volumes. The only available

source of information that provides data on the Russian FDI in China is the "Foreign Direct Investment Report" published by the Ministry of Commerce of the PRC. The report examines key trends in China's inward FDI during 2002−2012. To analyze the motivation and entry strategies of Russian companies in the Chinese market, the authors use data from company websites, interviews with the CEO and other open publications in the media that cover various aspects of activities of Russian companies in China. The compilation covers 27 Russian companies representing various industries and services (see Annex, Table 1). The companies' selection is not exhaustive, and not cover the entire Russian business in China.

Empirical results

China has recently become the largest trade country for Russia. Merchandise trade between the two countries almost tripled over the past ten years reaching its peak in 2014 (95 bln USD). The introduction of anti-Russian sanctions has led to further strengthening of economic ties between the two states, although the volume of trade suffered sharply from the economic slowdown in Russia after 2014. Bilateral trade fell by 27.8% to $ 64.2 billion in 2015, but the next year it began to recover again. The Russia-China trade complementarity index has increased by around 14% over the past decade, though it has not changed since the introduction of sanctions. In Russia's trade with China, particularly, in exports, trade complementarity is higher than with EU or many other partners. Since FDI has traditionally followed trade flows, it is reasonable to assume that Russian investors are actively expanding their business in the Chinese market. In fact, the Russian FDI in China is very small and tends to decline. They are even lower than Russian investments in India, Thailand or Vietnam, with which Russia has a very modest trade turnover.

According to the "Report on Foreign Investment in China", it was observed a decline of Russia in total FDI received by the country during 2002−2012, as well as in the number of projects. Thus, in 2002, the volume of Russian investments amounted to 38.65 million of USD (0.07% of total FDI) − ten years later, the Russian companies invested only 30 million of USD (0.03%). Again, in 2015, China received just 13.12 million of USD as direct investments from Russia. The total number of Russian FDI projects in China reached 2500. The decline in the Russian FDI in China began since the global crisis. Until 2014, the share of the Russian FDI varied between 0.02−0.04% of the total inflow of foreign investments into China.

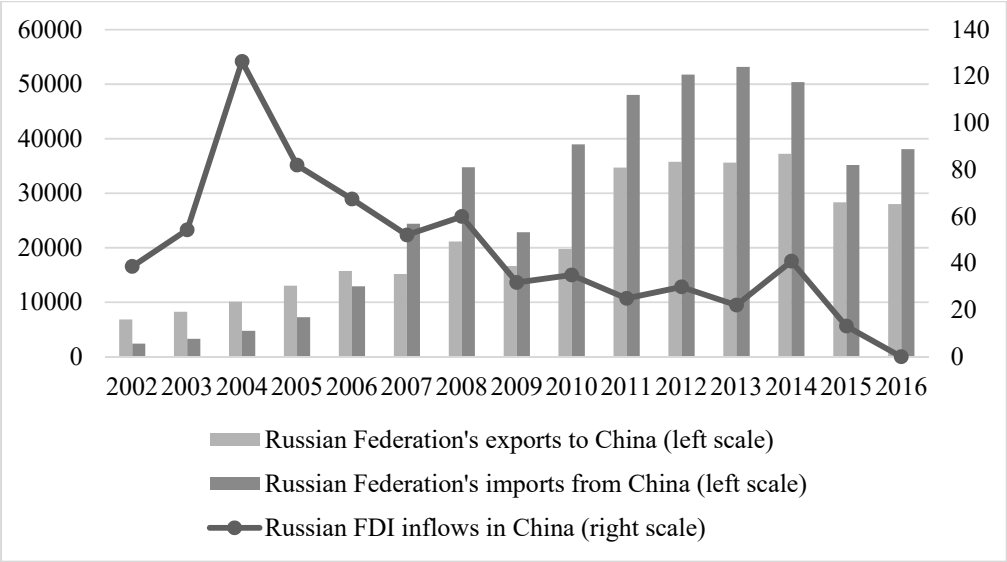

Figure 1. Bilateral trade with China and annual inflow of Russia's FDI into China, mln USD. Source: "Foreign Direct Investment Report" (2013).

Noteworthy, that the decline in Russian investments into China coincides with the improvement of legal regulatory framework for mutual investments and ongoing liberalization of the Chinese market after joining the WTO. Over last decade, Russia and China significantly improved legal and institutional conditions to expand mutual FDI. In 2006, the countries signed a bilateral agreement on encouragement and mutual protection of investments, which came into force in 2009. Later that year the countries adopted the "Plan of the Russian-Chinese investment cooperation" intended to regulate investment cooperation between the two states. Since 2012, the Russian−Chinese investment fund of 4 billion of USD initiated by China Investment Corporation and the Russian Direct Investment Fund began to operate. In 2014, a Russian-Chinese intergovernmental commission on investment cooperation was established with the aim to strengthen the coordination of bilateral cooperation and address systemic barriers to investment flows.

It seems, all these initiations should have led to an increase of Russian investments in China. Yet, we observe the opposite trend. This reverse development is partially justified by imbalances in the documents that pay disproportionately higher attention to promotion of the Chinese investment in Russia, but not vice versa. Meanwhile, despite the continued liberalization of the market, China still has the most stringent FDI regime among other important trading countries. According to the OECD (FDI Restriction Index) estimates, for a decade FDI Restriction Index has only slightly decreased from its high level.

We may assume that actual volumes of Russian FDI invested in the Chinese economy exceed the figures recorded by the national statistical services, since some investments from Russia to China come indirectly through subsidiaries registered in Hong Kong or other offshore jurisdictions. In addition, some investments in China come from overseas funds owned by Russian businessmen. It is rather difficult to calculate the volume of such FDI due to the low transparency of operations.

According to the "Foreign Direct Investment Report", the sectoral distribution of Russian investments has shifted from manufacturing to services since 2011, which corresponds to the general trend in attracting FDI to China ("Foreign Direct Investment Report" (2013)). In addition,

we can note the regional diversification of Russian foreign direct investment in China – if until 2012 the bulk of the Russian investments was concentrated in the Northeast, in recent years the Russian companies are more actively investing in Shanghai area, Jiangsu and Guangdong provinces. The state support of Russian companies entering the Chinese market is crucial in such sectors as oil and gas, nuclear power, and some other industries, which is also typical for expansion of the Russian business in other foreign markets. Most Russian enterprises entering the Chinese market do not enjoy any support from the Russian authorities.

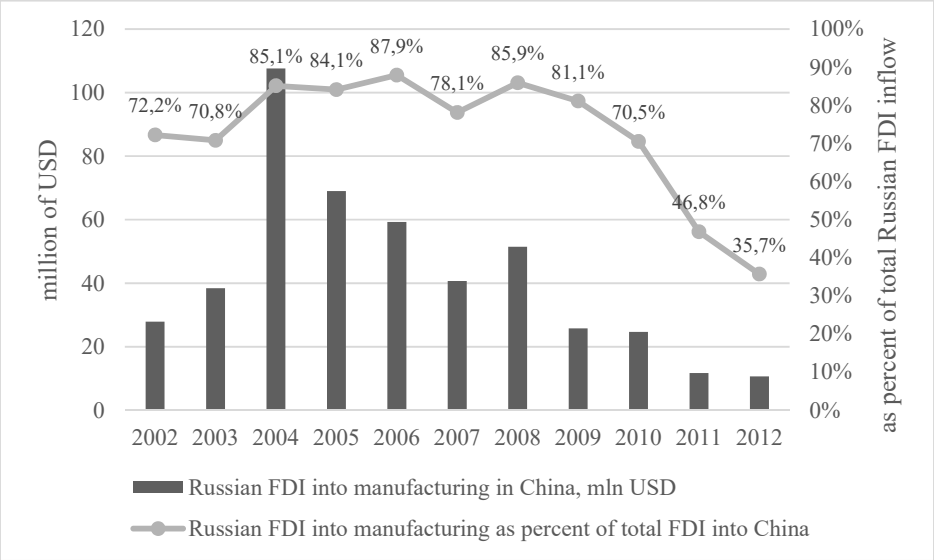

Figure 2. Russian FDI into manufacturing in China (mln USD, as % of total FDI).
Sourse: Foreign Direct Investment Report 2013.

Despite a small amount of investment, Russian enterprises of different size from a wide range of industries operate in the Chinese market. The most successful among them are companies from the chemical industry including petrochemicals (Acron, Petropavlovsk PLC, KuybushevAzot, Sibur), IT sector (Kaspersky Lab, i-Free), e-commerce (Teclot.com), software and entertainment (Riki Group). Noteworthy, that among Russian firms in China there are no telecommunication companies, which are leading Russian investors in Eurasian countries outside the CIS. This suggests that, despite continued liberalization in China, there are still high entry barriers for FDI in this sector.

Many Russian enterprises entering the Chinese market have strong technological advantage, expertise or intellectual product, which is typical for companies originating in developed countries. For most Russian companies, regardless of their industry and business scale, market seeking is the dominant motive for making foreign direct investment in China. The Chinese market attracts them with its huge size and high growth rate. Companies often decide to open production facilities in China upon obtaining experience in exports. Quite rare Russian companies investing in China pursue efficiency- and resource-seeking motives. Analyzing the motivation of Russian foreign direct investment in China, we could not find the technology-seeking motive. A “safeguarding of private assets” motive popular with Russian companies investing in the EU, is not found among Russian investors in China. For some companies and individual entrepreneurs, the entrance to the Chinese market was caused by business failure in Russia (Teclot.com, Maya's West Bakery) or

deterioration of economic situation since 2014 (Sportmaster, Almaz-holding, Dodo pizza, Doft&Hoft) (Agarkova, Demenina, 2014).

The entry mode and strategy of expansion of Russian business in China largely depend on the industry in which the companies operate and the size of the business. The analysis showed, that the bulk of Russian FDI in China is greenfield investments, while the number of mergers and acquisitions involving Russian companies is small (see Annex, table 1). This contrasts with investment strategies used by the Russian multinationals in Europe or elsewhere. The Russian oil and gas firms are getting an access to upstream markets in China or building trans-border pipelines in exchange for China's state corporations taking minority participations in those firms' domestic extraction projects, as well as equity acquisition (Rosneft, Sibur). Both companies relied on greenfield investments when entering the Chinese market. Metallurgical companies that enter the Chinese market promote a combined strategy by both acquiring the Chinese companies and establishing joint ventures (Vi-holding, Rusal). Russian companies from the chemical, automotive (KAMAZ), oil refining and other industries, including services regardless of their ownership type – public or private, prefer the joint venture as the main entry mode. Small businesses, as a rule, are entirely owned by the Russian investors (Ministry of Commerce of the PRC, 2013).

Most of the Russian firms operating in China notice the importance of support by a local partner as a key factor of their success. This form provides the newcomer more stability in the Chinese market. For instance, KuibyshevAzot, which entered the market through a joint venture, noted the support from a local partner was particularly important at initial stage of business, when the company was obtaining permits and numerous approvals, and later in establishing business contacts (A Chinese element of KuibyshevAzot, 2013). Among other key factors contributing to success in the Chinese market, the companies point out the need to hire local marketers, engineers, as well as necessity of product customization. Thus for Riki Group China, which promotes Smeshariki brand, an important factor of success was an adaptation of the original cartoon series to local customs and habits. Many companies also emphasize the importance of personal relations between people (guanxi) in business. For example, for Riki Group China personal relations were crucial factor in winning the Chinese market. These findings confirm the results obtained by Ul'yanova (2015).

An important factor facilitating Russian companies to start their business in China is the recent emergence of Russian banks and insurance companies in the market. Thus, the Chinese branch of VTB bank provides trade finance and loans for both Russian companies in China, as well as local customers. In particular, VTB bank arranged financial support to KuibyshevAzot and Sportmaster at initial stage of their expansion in the Chinese market. SOGAZ, which opened its office in Beijing in 2015, has become the only Russian insurer authorized to conduct cross-border reinsurance transactions with Chinese companies.

Among the main obstacles for the Russian FDI in China are unfamiliar business environment, cultural and language barriers, rising wages, an employee turnover, improper intellectual property rights protection and the lack of information about the opportunities for entrepreneurship in the market. It is not easy for Russian companies to achieve recognition in China, even despite the high demand in the market and high quality of their products or services. A major difficulty is the promotion of Russian brands, which are mostly unfamiliar to the Chinese consumer. Finally, the growth of investments from Russia is prevented by a high level of competition and rather strict regulation in a number of sectors and activities.

Concluding remarks

The study showed that despite the growing volume of trade, along with high potential of the Russian multinationals for outbound FDIs and huge capacity of the Chinese market, actual amount of the Russian FDI in China is insignificant and tends to decline. Strategic partnership relations do not facilitate easier penetration of Russian investors into the Chinese market by providing more favorable conditions for FDI or opening an access to protected sectors of the economy. On the contrary, like other foreign investors, Russian companies face tough competition and high protectionism in a number of economic activities in China. Even Russian companies enjoying state support in their foreign expansion are underrepresented in the Chinese market. We suggest a more active institutional support for business from the Russian side, covering not only companies from strategic sectors, but also extending to other areas, including industry and services, can play an important role in expanding Russia's direct investment in China. This support may include the provision of information and consulting services to Russian investors, as well as the promotion of Russian companies and brands in China. A more balanced nature of the intergovernmental investment agreements, which had better reflect the interests of Russian companies, can also increase the Russian FDI in China.

Analyzing the strategies and motives for Russian companies to enter the Chinese market, we found some differences in their behavior as compared to other foreign markets. First, a "safeguarding of private assets" motive typical for Russian companies investing in the EU is not found among Russian investors in China. Secondly, the bulk of the Russian FDI in China are green investments, whereas M&As involving Russian businesses are few, which contrasts to the investment strategies used by Russian multinationals in Europe or elsewhere. Thirdly, Russian companies from chemical, electronic, automotive, oil refining and other industries, including services, prefer a joint venture as the main entry mode. Finally, there are certain features in the drivers of internationalization of Russian companies investing in China. While Russian multinationals investing abroad in general pursue more complex motivation, the dominant driver for FDI in China for most Russian firms is market seeking.

The analysis revealed strong competitive advantage of Russian companies in the sphere of services, as most successful among them in China are companies from IT sector, e-commerce, software, and entertainment. With liberalization of investment regime in China and a shift of the economic activity from labor-intensive industries towards high-tech and services, we may expect more Russian FDI inflows into IT sector, health and high-tech industries.

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Appendix

Table 1. FDI by Russian companies in China, industry breakdown and market entry mode

Industry	**Company**	**Market entry mode**	
		Greenfield investments	**Brownfield investments**
Chemical	*Acron*	yes	no
	Petropavlovsk PLC	yes	no data
	KuybushevAzot	yes	no
	Sibur	yes	no
	Monocrystal	yes	no
Metallurgy	*Rusal*	yes	yes
	Vi Holding	yes	yes
	Evraz	no	yes
Oil & gas	*Rosneft*	yes	no
Nuclear	*Rosatom*	yes	no

Industry	Company	Market entry mode	
		Greenfield investments	**Brownfield investments**
Cable industry	*Institute of Nuclear Physics, Novosibirsk Branch of the Russian Academy of Sciences*	yes	no
Auto industry	*Kamaz*	yes	no
Air conditioning, heating systems	*Rusclimat*	no data	no data
IT	*Kaspersky Lab*	yes	no
	i-Free	yes	no
Entertainment	*Riki Group*	yes	no
Banking, insurance	*VTB*	yes	no
	Sberbank	yes	no
	Gazprombank	yes	no
	Promsviazbank	yes	no
	Sogaz	yes	no
Retail	*Sportmaster*	yes	no
	Almaz-Holding	yes	no
Electronic commerce	*Teclot.com*	yes	no
Logistics	*Fesco Lines China Company*	no data	no data
Catering	*Dodo Pizza*	yes	no
Food production	*Doft&Hoft*	no data	no data