Russia Building Materials Market Update
U.S. Foreign Commercial Service in Russia
February 1, 2002

SUMMARY

The Russian market for building materials and products, roughly estimated at $2 billion in 2001, has been growing steadily at a rate of 10-15% for the last two years, matching the growing demand in the construction industry and of the emerging middle class. Industry experts foresee further growth of this sector at a rate of 10% annually for the near future.. This increase in demand for quality building products is generated predominantly by the recovery of the Russian economy following the 1998 ruble devaluation, especially in import substitution industries, and stable prices for oil. The two have contributed to a strengthening and expanding of a middle class that, in turn, is driving the building materials industry. The local distribution system is quickly developing and the number of retail outlets dealing with home hardware and building products continues to rise steadily. Exhibition firms report of record sales of space at building product trade shows.

The import market for building products is currently dominated by European suppliers and the domestic industry shows signs of recovery after dramatic decline of late 1990s. Import barriers are moderate, but although the market is favorable entry requires considerable promotional effort. so U.S. firms targeting the Russian market should consider various approaches. Currently, U.S. products are represented by several well-known brands, as well as by agents and distributors of the products of a variety of smaller, lesser-known firms. The potential for greater expansion of U.S. building products in the Russian market is considerable. Opportunities exist for direct export as well as for investments in local manufacturing of modern building products.

This report focuses on building products and materials used in the finishing process because, at the moment, demand is concentrated in this subsector (including wall and floor coverings, ceiling products, doors and windows, plumbing and electrical equipment). The subsector for basic building materials, such as bricks, concrete, reinforcements, sand and gravel is dominated by local producers and is specifically not covered in the report. The report discusses the current state and outlook for these products in Russia as a whole and highlights some examples Moscow and St. Petersburg.

In order to assist new-to-market U.S. exporters to enter the Russian market, the U.S. Commercial Service often organizes "U.S. Product Literature Centers" (catalog shows) at major local trade shows devoted to building products industry. In April this year, for example, we are organizing PLCs at Mosbuild/Batimat in Moscow and at Interstroyexpo in St. Petersburg. Please see Section D for more information.

A. MARKET HIGHLIGHTS & BEST PROSPECTS

- General Characteristics of the Market

The continuing growth of the Russian economy in 2001 and political stability has resulted in the growth of incomes and a boom of the construction market. Economic forecasts for the year 2002 are favorable, and overall economic growth can be seen in the finishing products market. Recovering from the financial crisis and ruble devaluation of August 1998, the market for finishing products has been growing at a 10-15% rate annually in the years 1999-2001. This is explained by the growing incomes of the middle class, which is purchasing more and more apartments and needs finishing materials for the modernization of existing housing or outfitting of new dwellings, rather then by increase in the market of new residential space. According to statistics published by the State Committee of Statistics of Russian Federation, the construction of new residential space has held fairly constant in recent years: 30.7 million sqm (1998), 32.0 (1999), 30.3 (2000) and 31.1 (2001). Statistics also shows that the major trend in the Russian residential construction industry can be described as a sharp decline in government financing of the industry and gradual growth of private financing. This may explain growing demand for modern imported building materials, because private customers are more interested in quality of new dwellings than state entities.

- Market Size

There are no official published statistics available on the size of the market for imports of building and construction materials in Russia. However, the estimates of total sales of finishing products for year 2001 are $2 billion on national level. The market grew by 15% in 2001; the prediction of "Expert" business magazine for the market growth in year 2002 is at 10% for the finishing products market in general. Although growth rates differ depending on the segments of the market (the fastest growth is in wallpaper segment), there are no segments that saw decline in the last two years. All experts agree that the market is far from saturation in all cities and regions of Russia.

- Best Sales Prospects

Prospects for sales of building products to Russia will strengthen in the next years. This is due to the general political and economic stabilization, an expected growth of investment in the construction industry and growth of incomes of the population. Forecasts for growth in demand by different analysts range from 5 to 15% annually.

The most significant product categories in the market are wallpaper, different types of glues, paints and varnishes and dry cementing mixtures. The wallpaper segment is growing at the fastest pace, which reflects the growing interest of the middle class in repair of the apartments. All the other segments are stable or have insignificant growth and volume.

HS 6910 Ceramic sinks, washbasins. Washbasin pedestals. Baths. Bidets. Water closet bowls. Flush tanks. Urinals and similar sanitary fixtures.
HS 3922 Baths, shower baths, washbasins, bidets, lavatory pans, seats and covers, flushing cisterns and similar sanitary ware of plastics.
HS 3925 Builders' ware of plastics, (including reservoirs, tanks and vats, doors, windows and their frames, door thresholds, shutters, blinds and similar articles).

HS 4814 Wallpaper and similar wall coverings; window transparencies of paper.
HS 8301 Builders' hardware: locks and padlocks.
HS 8302 Builders' hardware: base metal mountings, fittings & similar articles for doors, trim, etc.
HS 3918 Floor coverings of plastics; wall or ceiling coverings of plastics;
HS 5703 Carpets and other textile floor coverings, tufted
HS 6809 Plaster panels.

- Opportunities for Investments

Many analysts and local government officials believe that strong position in the Russian market can be secured only by foreign firms capable of investment in local production of modern building products. In fact, local production increases opportunities, not only for winning government tenders, but also for increasing profits due to reduction of costs. Currently, both federal and regional government authorities encourage foreign investors and are trying to improve the investment climate. The most investment-friendly locales in Russia are considered to be Leningrad, Novgorod and Samara Regions. However, potential investors should keep in mind the following factors apart from general concerns regarding political instability and relatively poor infrastructure:

1) domestically manufactured products may be associated with low quality by customers, despite the foreign manufacturer's trade mark, that is why the origin of the product should not be over emphasized and additional promotion efforts may be required to convince the customer

2) products manufactured by joint ventures are considered by consumers worse than those made by foreign firms, since there is a prejudice against domestically made goods and Russian quality control;

3) quality standards for the Russian market should be as high as for the Western markets, since Russian middle class customers are very sensitive about the quality, and would prefer to buy more expensive but quality imported product rather than a locally-made cheap and doubtful substitute

4) The U.S. Commercial Service in Russia can assist you in entering the market and with partner selection for your investment projects in Russia. At the end of the report you will find information on our services designed to facilitate entering the market for US exporters and investors.

B. COMPETITIVE ANALYSIS

- Local Production

Building materials and products used for finishing and decorative purposes were not traditionally of vital importance in Russia in Soviet days. The majority of housing was state-owned and almost 80% of the population were tenants. State-owned construction companies did not pay much attention to the quality of finishing, which was supposed to be performed by the tenants at their own expense. But even if tenants did care, the poor quality and lack of variety in finishing materials prevented them from obtaining modern products. They usually preferred to purchase quality furniture and hardware rather than have quality finishing.

With the fall of the Soviet Union and liberalization of the economy, those local manufacturers who understood the necessity to modernize their facilities in order to compete in the market established joint ventures with foreign companies or purchased imported equipment and technologies in order to produce up-to-date products. Local trade sources say that a Gasprom-owned PVC-tiles producer in Samara which uses imported equipment and technology is one of few Russian producers capable of producing marketable building products.

There are also several examples of foreign investments in the local building products industry. The German company Knauf invested $100 million in several Russian manufacturers of building products, including the St. Petersburg-located Pobeda Brick factory that is now 90% owned by Knauf. The firm manufacturers gypsum products and bricks. The Finnish oil company Neste has recently invested $3 million and put into operation production facilities in St. Petersburg to manufacture foam-polystirol, insulation material severely required by the Russian construction industry. There are also several German-owned companies producing building products in Russia, including plywood, floor coverings and insulation materials.

After the ruble devaluation in 1998, when the Russian national currency dropped 300% against the main Western currencies, imports of construction materials to Russia decreased dramatically. Local companies seized the opportunity and, working hard to substitute imports, occupied a significant share of the market. Local production of building materials has been growing at a rate of approximately 10% annually since 1998. This tendency is especially noticeable in paints and varnishes segment, where several local firms have established strong presence. These are TEKS, a St. Petersburg based company which enjoys a 25% market share in the region and 4% nationwide, Yarolslavl Paints Factory and several other smaller producers.

Sales by Russian and Belorussian companies have been growing in the last three years in such categories as tiling, wallpaper, synthetic floor coverings, paints and varnishes. The reason for the growth is that these companies are consistently improving the quality of products in these categories and their prices have been consistently lower than the prices for imported products. In other categories Russian and Belorussian companies do not yet match the imported products in quality, and their sales growths are not that significant. Those foreign companies that established their own production in Russia did not suffer that dramatically from the financial crisis of 1998. Mentioned among them should be Tikkurila, a Finnish company that managed to establish both local production and a strong brand awareness and reputation.

- Imports

The Russian import market for building products is dominated by western European suppliers. The most active are Finnish, German, Swedish, Italian and Spanish companies. In some cases, these companies have established their own production in Russia in order to meet the growing demand and reduce their costs. In Northwest Russia, Finnish and German firms dominate the market for wall and floor coverings, paints, plumbing products, windows and doors. They exhibit at the major local trade shows and arrange seminars and presentations for traders and construction industry officials. Italian and Spanish suppliers are the strongest in the segment of ceramic tiling. Polish and Czech suppliers, producing less expensive, but quality products are also trying to increase their market shares, lost after the disintegration of the Council for Mutual Economic Assistance (CMEA). Belorussian companies have strong presences in the segment for low-tear brands, as their prices level is even lower than that of the Eastern European producers. However, Russians are more inclined to buy Western products, since they have been traditionally considered of better quality going back to Soviet days.

Imported products are mostly present in large specialized chains, such as Maxidom in St. Petersburg and Starik Khottabych in Moscow. The share of imported products on the shelves of these chains is around 85-90%, as the management of the stores is mostly concerned about quality of the products and there is a general prejudice against the quality of the locally produced goods.

An important feature of the Russian import market is that there is a lot of "black" or "gray" import, which makes official customs statistics biased and inefficient source of information. The most common techniques of illegal import are: non-declaration of imported finishing products, declaration of finishing goods as other products and lowering the customs price of imported goods.

- U.S. Market Position and Share

U.S. imports of finishing building products to Russia have good prospects for steady growth in the future. The current position of U.S companies in imports to Russia is insignificant. Russian trader and construction sources do not have any prejudice against U.S. building products. The main reasons why American products are not currently preferred by Russian importers over other Western imports are:

1. local wholesalers and end-users have little information about American products and are generally satisfied with the quality of products offered by third-country firms
2. third country competitors are more active in the Russian market
3. due to a lack of product information, local customers consider American building products less adaptable for use in Russian conditions
4. according to some industry analysts, U. S. as a producer is not associated with building products in the minds of the Russian consumers, while Germany has a strong reputation of a quality paint producer and Finland is a country famous for roof tiles

However, the U.S. position can be improved if American companies implement a more active marketing campaign in this industry sector. The recent research conducted by Komkon-2 market research company demonstrated that there is little brand loyalty in the finishing products market, and the purchasing decision is under strong influence of recommendations the customer receives from friends and acquaintances that had previously bought the product. The purchasing decision is also under strong influence of salesperson's advice and the product's country of origin.

- Important Factors

Flexibility is a requirement. Some companies have encountered difficulty in finding an importer that can order a full container for the first shipment. Normally, importing companies prefer to purchase several palettes initially to test the marketability of the product. In this situation, exporters that have a stock already in a local warehouse or those that can offer mixed containers will have an advantage entering the market. Another method of market entry might be to exhibit prospective products at a local show room where customers may place orders for products on the spot. In order to use this method, the exporter must send samples of the product, along with catalogs and price lists to a local firm operating a building product show room. The product will be displayed to potential customers, show room assistants provide information on the product, price and terms of shipment and inform the exporter of all parties interested in the product. Contact information for such firms is provided below.

Another important factor is educating local workers and sales force about characteristics of the products and the proper ways of working with them. Many retailers acknowledge that training technically competent work force is a problem, and it is only few major retail chains, such as Maxidom in St. Petersburg, can afford having their own in-house training center. Another concern is training the personnel of small construction companies to work properly with the finishing products. Complaints about poor quality of service of such companies are widespread all over Russia; this low level of service quality is explained mostly by lack of skills of work with new building products from the West, which require special knowledge and treatment.

- Information Sources

Buyers and potential distributors obtain information on building and construction materials from visits to trade shows, outdoor and media advertisements, sales visits by suppliers, and through referrals from their trade contacts. A popular means of disseminating information in Russia is to conduct one-day seminars or presentations in the major cities. Government officials and potential buyers and distributors are invited to attend these sessions. Government agencies and or multipliers such as chambers of commerce and industry associations can assist with seminar arrangements.

C. END-USER ANALYSIS

The end-users for building products in Russia are small and mid-sized construction and building renovation contractors, large contractors, government agencies, and individuals. The most important end-user groups are small and mid-sized building renovation contractors and individuals. Around 80% of the construction services market and more than 90% of building renovation services market are dominated by small and mid-size private companies (see Table 1). Their major customers are the middle class individuals, real estate developers, banks, trading companies, large Russian oil and gas companies, offices of foreign firms in Russia and Russian government agencies. All these customers use quality western building products for renovation of offices, construction of office centers, and modernization of apartments. Despite the use of western building materials, there is a concern about quality of services provided, as in many cases the companies lack professionally trained personnel and do not have general knowledge about the characteristics of the materials that they use.

Recently, in order to ensure quality of the renovation services provided, several real estate companies in Moscow and St. Petersburg have set up small building renovation companies, which serve the needs of the clients of real estate firms. Also, many retailers offer application services to buyers of their products, for example, laying of floor coverings or sticking of the wall-paper.

Table 1. Number of Construction Contractors

	Total number of contractors	
1996	134,620	
1997	136,908	
1998	137,112	
Late 1999 - Early 2000	136,659	

Source: State Committee of Statistics of Russian Federation

As seen from the table, the number of the construction companies has been growing quite slowly, reflecting the fact that the market for their services - maintenance and repair - has not grown dramatically on the scale of the whole country and the market is more or less saturated. However, the share of small and mid-size companies is growing as the large construction contractors either go out of business or split. Small and mid-size construction contractors buy building products from distributors or in retail outlets. They do not normally import themselves.

The distribution network in Russia is quite developed; the number of retail outlets continues to grow to match the increase in the demand. St. Petersburg hypermarket chain *Maxidom* plans to open two more hypermarkets (with projected monthly incomes of the new hypermarkets being as high as $3 million) in the city, as *Maxidom* sales of finishing products grew by 15% in year 2001. With the opening of two new stores the total number of *Maxidom* stores in St. Petersburg will be 4, each having total sales area of over 10,000 sq. meters. Sort of a Russian Home Depot, *Maxidom* targets middle class buyers rather than small contractors. There are other distributors, or warehouse retailers who focus on contractors.

Moscow's market is growing at even faster pace, given the higher income levels of the middle class in Moscow. *Starik Khottabych* chain that sells finishing materials in Moscow opened five new shops in Moscow in 2001 alone. Plans of the company include construction of 30 new stores all over the country in the cities with population over 500,000. *Tvoi Dom* hypermarket in Moscow doubled sales of finishing products in 2001 compared with 2000.

The most important group of individuals that should be considered in this context is the growing middle class (families with income from $150/month per capita - although in St. Petersburg and, especially Moscow, this figure will be higher), which now generates most of the demand for finishing products. The percentage of the middle class in Moscow is 20% or about 1.5 million people, in cities with population over 1 million it is around 10%, and in smaller cities it is nearly 6%. As for the total number of middle class in Russia, in 2000 there were around 4 million families with such levels of income.

The sub-group of the middle class with lower incomes is present in the smaller cities; these customers tend to buy such finishing products, as wallpaper, PVC tiles and paints - these products are cheaper and allow making some noticeable improvement in condition of a house or apartment without service company's assistance. These consumers mostly do repairs by themselves, as the level of income does not allow them to afford ordering services of a construction company. The upper middle sub-class is more selective in purchases of finishing products and focuses on higher quality brands and products for more fundamental repairs: ceramic tilling, wooden floor coverings and other more expensive products that require assistance of professionals in installation.

The general reference for the repair quality of the middle class is "European standard." This standard of repair implies the 100% flattened and evened walls and ceiling, replacing doors and windows, complete overhaul, installation of imported sinks, tubs, taps and other equipment and use of imported finishing products for the repairs.

In Moscow, 90% of middle class representatives order services of small construction companies for repairs. These companies are mostly staffed by guest workers from Moldova, Ukraine and elsewhere in Russia and CIS, and are notorious for their low quality of service, due to lack of professional training of the workers. A few of the richest customers may decide to deploy a Western design firms and remodeling agency. In St. Petersburg, 11% of the population hire services of small construction companies, while 70% repair the flats by themselves, and the tendency of hiring small construction companies is growing.

General features of the buying behavior of the middle class as a whole is the stress on quality since 92% of the middle class are ready to pay more for the quality products. Selection criteria for same quality products are price, retail outlet reputation, and brand reputation. 40% of the middle class are planning to improve their housing conditions, which will generate new demand for finishing products in the future. 33% of the middle class, or 3.5 million families all over Russia, are planning to purchase a new house or an apartment in the next four years.

For the most of the middle class there is little brand loyalty. The choice of a product is most often made based on the outlook of the product and trust to the country of origin. Recommendation of a salesperson at the point of sale can have a significant role in the buying decision. Word of mouth also plays an important role.

The market for the finishing products has a clear seasonal pattern, with spring and early to mid summer being the peak months, while the rest of the year is a more quiet season. This seasonal pattern of demand is explained by the fact that Russians are used to repair or renovate their homes in summer - the vacation season, when it is possible to spend more time on renovation, as well as send families away from the apartment under renovation.

The more exclusive the repair, the higher the share of imported finishing materials that are used in repairs of homes of the Russian middle class. In the high-end of the repair market the proportion of imported vs. Russian products is 90% to 10%.

D. MARKET ACCESS

- Import Barriers

The import climate for building products is not considered protectionist. Following are import tariffs for selected items:

HS Code	Description	Tariff (%)
HS 3209	Paints and varnishes based on synthetic polymers	15
HS 6910	Ceramic sinks, washbasins. Washbasin pedestals. Baths. Bidets. Water closet bowls. Flush tanks. Urinals and similar sanitary fixtures.	25
HS 3922	Baths, shower baths, washbasins, bidets, lavatory pans, seats and covers, flushing cisterns and similar sanitary ware of plastics.	25
HS 8481	Plumbing fittings, faucets.	15
HS 3925	Plastic wares, (including reservoirs, tanks and vats, doors, windows and their frames, door thresholds, shutters, blinds and similar articles).	
HS 690510	Glazed ceramic tiles for walls.	25
HS 4814	Wallpaper and similar wall coverings; window transparencies of paper.	15
HS 8301	Builders' hardware: locks and padlocks.	25
HS 8302	Builders' hardware: base metal mountings,	25

fittings and similar articles for doors, trim, etc.

HS 3214 Glaziers' putty. Grafting putty, resin 5
cements. Caulking compounds and other mastics; painters' fillings' non-refractory surfacing preparations for facades, indoor walls, floors, ceilings or the like.

HS 3918 Plastic floor coverings; wall or 25-30
ceiling coverings.

HS 57 Carpets and other textile floor coverings. 30

HS 6809 Plaster panels. 15

In addition all goods imported to Russia are subject to 20% Value Added Tax.

- Distribution System

There are still no country-wide hardware retail chains in Russia. Several companies handle up to 15 shops under one name in 1-3 major cities, but the majority of retail sales go through small companies running one or two shops. The distribution system for building products has been maturing and currently is still in the process of development. As in the United States, it is a three-level system with importers, wholesalers and retailers. However, there are importers and wholesalers who run their own retail outlets, and some department stores import directly.

New-to-market overseas suppliers interested in the Russian market are advised to find capable agents or distributors who are fully knowledgeable about both importing and the Russian distribution system. In general, direct sales by U.S. suppliers to retailers are not recommended as retailers do not have staff that are knowledgeable about import procedures and are not able to maintain large inventories. Nonetheless, some direct sales to major retailers are possible. Department stores can also be potential retail outlets for high-grade U.S. products. However, department stores in Russia are considerably different from their American counterparts. In Russia, they generally carry their goods on a consignment basis and do not purchase goods on their own account. Also, they often act as a leasing company which opens an account with a supplier and provides space to the account holder (the sales space is usually staffed by the personnel of the account holder). This method is used for many imported brand-name and innovative products.

There are few warehouse retailers in Russia; mostly these companies are concentrated in the suburban areas of large cities and concentrate on low-tear brands and finishing products. A U.S. firm that considers investment in the establishment of a warehouse retail facility in a major Russian city could benefit from being the first in the region. However, there are certain political and economic risks to be considered.

Local traders have expressed interest and a willingness to act as agents and/or distributors for American exporters of quality American building products. They noted that a potential U.S. supplier must be able to provide a broad range of products and to compile mixed container shipments.

- Financing

Due to current economic conditions, and an underdeveloped Russian banking and credit system, trade sources recommend that Russian firms be required to make prepayments, especially for the first transaction. However, selling new products in this emerging market requires that exporters be flexible enough to compete with domestic producers as well as with manufacturers from third countries, many of which offer delayed payment terms. Local trading companies surveyed noted that a prepayment requirement for American products puts U.S. building materials at a competitive disadvantage due to the long delivery times. Most Russian end-users and intermediaries surveyed requested some type of delayed payment arrangement. Sources say that compromise is at times possible between prepayment and credit extension in starting a business with prepayment requirements accompanied by a schedule for extending credits as the relationship develops. In addition, most Russian distributors expect assistance and a contribution from the foreign seller toward the cost of promotion and marketing. Since the market is not well organized at the moment, the future belongs to companies that are innovative and creative and are willing to play an active role in steering the market through this transitional period.

- Recommendations

The most important factors that must be taken into consideration by American companies seeking to penetrate the Russian market are:

1) pricing strategy;
2) financing considerations, e.g., extension of credit;
3) ability to handle mixed container shipments or to keep a stock of goods in a local warehouse; and
4) willingness to invest in education of potential dealers and customers.

Recommended marketing techniques are:

1) direct contacts with Russian trading firms specializing in building products and construction equipment;
2) participation in exhibitions at national and local levels;
3) advertising through specialized magazines (see listing below) and at the points of sale
4) presentations and seminars (availability of technical information in Russian language is very important);
5) direct contacts with retail firms specializing in building products.
6) establish procedures for training adequate work force, create awareness about the products both among sales force and workers of small repair companies.

- Key Contacts

The U.S. Commercial Service in St. Petersburg maintains a list of producers of building products. Representatives of U.S. firms may contact the author for details.

<u>Construction and Renovation Companies and Associations</u>

The U.S. Commercial Service in St. Petersburg maintains a list of construction and renovation companies and associations. Representatives of U.S. firms may contact the author for details.

<u>Building Product Show Rooms</u>
St. Petersburg Construction Center
5 Torzhkovskaya Str
St. Petersburg 197342 Russia
Tel: 7-(812)246-2461; Fax: 7-(812)246-2929
Business: permanent exposition operator, organizer of seminars and presentations.

<u>Distributors</u>
The U.S. Commercial Service in St. Petersburg maintains a list of distributors and dealers of building materials and products. Representatives of U.S. firms may contact the author for details.

- Trade Shows

Mosbuild Batimat 2002
April 9-12, 2002 in Moscow (Annual event)
Organizer: ITE
16 Chekhov Str
Moscow 103006 Russia
Tel: 7-(095) 935-7350, 299-4012 ; Fax: 7-(095) 935-7351
or
Byronhouse 112a
Shirland Road London W9 2EQ, UK
Tel: 44-171 286 9720; Fax: 44-171 286 0177
E-mail: building@ite-exhibitions.com
Internet: www.buildingshows.com
***The U.S. Commercial Service in St. Petersburg is organizing a "U.S. Product Literature Center" (catalog show) at Mosbuild Batimat 2002 for American companies. U.S. companies interested in this cost effective program are encouraged to contact the author of this report.*

Interstroyexpo 2002
(The largest trade show devoted to building products in North-West Russia)
St. Petersburg (annual event)
April 23-27, 2002
Organizer: LenExpo Center
P.O. Box 19, St. Petersburg, 191040 Russia
Tel: 7-(812) 355-5810; Fax: 7-(812) 355-5132
***The U.S. Commercial Service in St. Petersburg is organizing a "U.S. Product Literature Center" (catalog show) at Interstroyexpo 2002 for American companies. U.S. companies interested in this cost effective program are encouraged to contact the author of this report.*

St. Petersburg Batimat 2002
September 2002 (Annual event)
Organizer: ITE/Primexpo
23 Malaya Morskaya
St. Petersburg 190000 Russia
Tel: 7-(812) 380-6001; Fax: 7-(812) 380-6001
E-mail: strax@primexpo.spb.ru; Internet: www.primexpo.spb.ru

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