

Russian E-Commerce Market

Behind the Numbers

March 2011

This research report focuses on the contrasts between the Russian e-commerce market compared to US and other major international markets, from the perspective of a foreign company contemplating entering the Russian e-commerce marketplace. It focuses on consumer-oriented e-commerce, also known as "B2C".

This is an Executive Summary. The full report is available only to clients and partners of Interstice Consulting.

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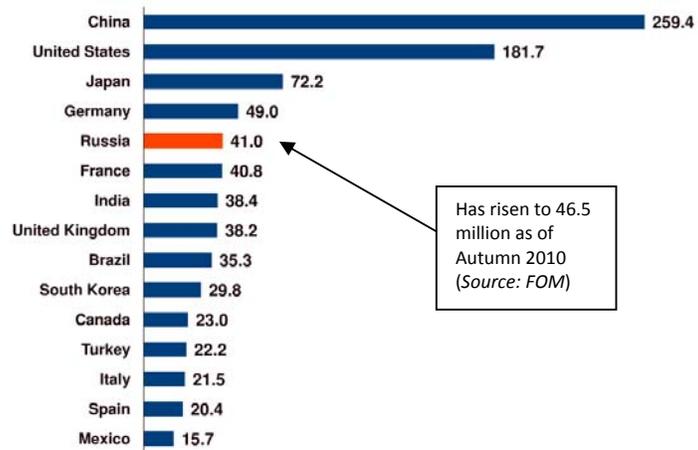
Executive Summary

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Internet Users, Age 15+, April 2010

(Source: comScore)



- Russia presents a lucrative market to global e-commerce players, especially those who have been successful in their home markets and have achieved a scale of operations where they are looking to international expansion to deliver the next phase of growth.
- At the same time, Russia presents a unique challenge to an international company. In addition to adapting to a different language and culture, there are profound differences in business and payment processes, as well as online advertising and marketing. Half-hearted attempts to serve the Russian market are pointless: according to the most recent national census by Rosstat in 2002, less than 7 million Russians speak English (that's less than 5% of the population). Even fewer would be interested in transacting with a foreign company having no local representation.

Homegrown companies have adapted successful foreign business models and try to position themselves as takeover candidates

- These challenges have caused many of the global e-commerce players to defer entry into Russia, enabling the entrenchment of local companies which employ copycat business models. An example of this is social networking giant VKontakte, whose functionality and even interface bear a striking resemblance to Facebook's.

The e-commerce market in Russia is dominated by domestic players, and is very difficult for foreign competitors to enter

- The Russian e-commerce market is dominated by domestic Russian companies. In terms of overall volume, the greatest share of e-commerce sales are in the travel and telecom sectors, where all of the players have offline presences which provide assurance to consumers that they will have recourse to a "real" company in the event of a problem.

In terms of volume, most e-commerce transactions in Russia are made with companies having both an online and offline presence

- Moreover, major retailers such as Sedmoi Kontinent and Utkonos (groceries), M Video, Eldorado, Techno Sila and Ion (computers and electronics) maintain captive web-based shops and account for the majority of “online” sales in these segments. Pure-play Internet retailers are at a disadvantage due to the country’s poor logistics and payment infrastructure, as well as consumer mistrust. The majority of orders which originate on the Internet then enter an offline process and are finally made on a cash-on-delivery basis. In this sense, e-commerce in Russia consists largely of “online ordering” as opposed to completing the entire transaction online (including verifying physical inventory, payment and shipment).

Two broad strategies to enter the Russian market are by acquisition or through establishing a local operation from the ground up

- One strategy for entering the Russian market is via acquisition. Groupon, the fast-growing US group-buying e-commerce giant (which has also taken on Russian investors), has gone this route by buying out Russia’s Darberry (one of at least half-a-dozen Groupon copycats) in August 2010. Darberry was launched a mere five months prior to its buyout by Groupon.
- There are a couple of major risks to this strategy. Firstly, the success of e-commerce companies is generally not dependent on any patentable invention and is thus largely due to the individual dynamism of the founders and senior executives, many of whom are at “flight risk” of departing the company once acquired. Secondly, Russian law and business practices differ widely from international practices and an international company required to comply with laws and norms of general corporate governance in its home country will find many issues which, while commonplace for Russian companies, would be unacceptable and require immediate action in integrating the acquired company. It can be argued that such restrictions form a competitive disadvantage to internationally-owned companies in Russia, not only in the Internet space but in the economy at large.
- A more enduring strategy would be to build out the Russian operations from the ground up, selecting staff and putting in place business practices and processes which are sustainable and consistent with the parent company’s practices. Given the rapid changes in the Internet and e-commerce marketplace, this strategy is also not without its risks. However, the principal risk is that the local operation does not reach sufficient scale to be economically significant to the parent, rather than a potentially large financial hit from an acquisition gone awry. This is the approach adopted by eBay, which established its Russian-language operation in February 2010.

Traditional foreign retailers have had a tough time competing in Russia

- The lure of Russia’s large population (140 million) has attracted foreign companies for hundreds of years, yet the challenge in traditional retail has been the low population density (outside of Moscow) and a populace dispersed amongst nine time zones amid harsh weather conditions, combined with a weak transportation and storage infrastructure. A recent study ranked Russia number 125 out of 139 countries on the quality of its road infrastructure

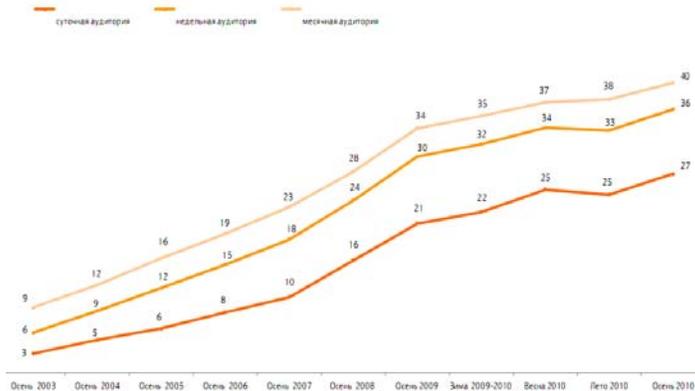
(Source: *The Global Competitiveness Report, 2010-11*).

Moreover, the breadth of the gap is quite shocking: Russia has approximately 44 km of paved roads per 1000 square km, compared to 1,805 km in Germany, 836 km in Poland, 478 km in India, and 80 km in China (Source: *Rosstat*). In this sense, e-commerce opens up the promise of reaching Russian consumers without the need to build out costly physical retail infrastructure.

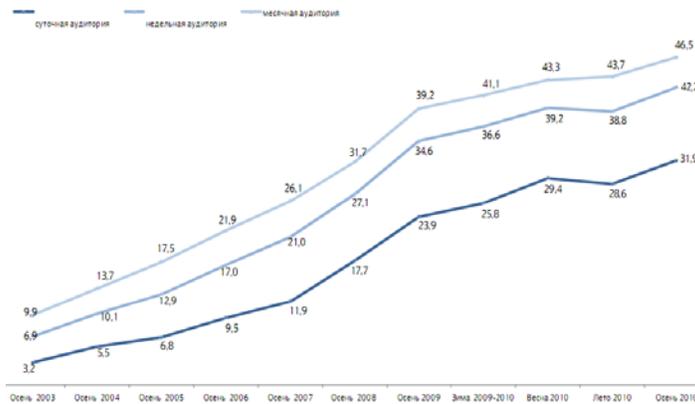
- Foreign companies have had a tough time breaking into Russian retail in any significant scale. The most successful examples have been Sweden's IKEA, Germany's METRO and OBI, and France's Auchan. Since June 2009 IKEA has frozen its further expansion in Russia while it waits for permits for a couple of its newly-built outlets. While not stating it publicly, the company is taking this stance as a protest against the requests for bribes by local inspectors.
- France's Carrefour, the world's largest hypermarket chain which is successful in many other countries including throughout Eastern Europe, abandoned the Russian market in October, 2009 after only four months of operations. It had been operating three outlets in different Russian cities.
- Global retail juggernaut Walmart of the US made an attempt to enter Russia by opening an office in Moscow and trying to buy out an existing retailer. However, after a 2-year fruitless search, it closed down in late 2010.
- While these companies have cited the difficulty of making acquisitions in order to achieve sufficient scale, no doubt other reasons were at play, including the country's notorious lack of transparency.
- At the same time, the lure of Russia's numbers is still encouraging foreign investment. PepsiCo agreed in December 2010 to buy a controlling stake in Wimm-Bill-Dann, one of Russia's leading producers of juice and dairy products, for \$3.8 billion. Indications are that PepsiCo will retain the local branding of Wimm-Bill-Dann's products.
- Speaking strictly about e-commerce, the transportability of international Internet brands to Russia is even more questionable. Google, Facebook and eBay are all struggling against their entrenched local competitors.
- Internet penetration and usage has been growing steadily. FOM statistics (Source: *Internet in Russia, Autumn 2010*) place penetration – in terms of monthly Internet users – at 40% of the adult population, whereas Internet subscribers number 46.5 million.

Internet penetration has been growing steadily and underpins the growth in Russia's e-commerce potential

Internet Penetration in Russia (2003-2010) % of population



Internet Users in Russia (2003-2010) millions



- This growth in usage and access supports the future growth in e-commerce in Russia. Even through the recent Global Financial Crisis, Russia has maintained its position as the fastest-growing Internet user base in Europe. Total users grew by about 15 million from Autumn 2008-2010.
- International interest in the Russian Internet market is also growing, no doubt piqued by the headlines made by Russian-based Digital Sky Technologies (now Mail.ru). Founded in 2005, the company is backed by Aliser Ushmanov, a prominent Russian oligarch, and specializes in late-stage investments in Internet-based companies. It has invested large sums in global Internet leaders Zynga, Facebook and Groupon. Within Russia, it controls leading Russian e-mail provider Mail.ru and its sister properties VKontakte and Odnoklassniki. Mail.ru raised US\$912 million via a listing on the London Stock Exchange in October, 2010.

The overall backdrop for a lucrative Russian e-commerce market exists, although the current market is fairly small

- The leading Russian search engine, Yandex, is also slated to go public in 2011. Goldman Sachs, Deutsche Bank and Morgan Stanley have been appointed as lead underwriters for the offering, which could raise up to US\$1 billion.
- Broadband penetration is closely linked to the popularity of e-commerce. Broadband penetration nationwide stood at 26% in 2009 with plans to grow to 60-80% by 2015, although there are vast regional differences. Broadband penetration in Moscow is currently over 80% vs. about 20% in the regions (*Source: EBRD*). Therefore, most of the growth will come from buildouts of the high speed network to Russia's regions. Broadband growth in the regions will certainly open up more of the online shopping market, as online shopping "leapfrogs" bricks-and-mortar retail.
- Russians are highly educated and computer literate. Out of the online population of 46.5 million, almost all use the Internet to search for products and services (*Source: Citibank/Google study, November 2010*). The same study pegged online spending for 2010 at \$20 billion (via bank cards alone), with another \$1.7 billion spent via e-wallets. However, stripping out the travel and telecom segments (for which the Internet is but one means of distribution) total online bank card spending in Russia comes out to around \$7.2 billion. While this is a pittance for international standards (Amazon.com alone had revenues of \$34.2 billion in 2010) the growth is, nonetheless, impressive. The authors of the study expect a 33% increase in bank card spending by 2012, driven by greater card issuance and an increasing comfort for consumers to buy online.
- Most Russians own their own flats and do not have consumer debt. Combined with a low 13% rate of personal income tax, and the common practice of receiving part of their salaries in (undeclared) cash, Russians have very high level of disposable income in relation to their declared gross income. Market estimates place disposable income at 70% of earned income, versus 40% for Western consumers (*Source: Thomas White International*).
- The social media trend is also prevalent in Russia. Russians exhibit the highest per-capita hourly usage of social media sites at 9.8 hours per visitor, roughly twice the world average (*Source: comScore, August 2010*). However, accounting for a large part of Russia's lead in this statistic is no doubt the country's lax intellectual property enforcement. The largest social media network, VKontakte, has a feature which enables peer-to-peer streaming of music and other media files.
- Particularly in the soft goods segments, urban Russia manifests a very designer-label conscious, conspicuous spending culture (admittedly, this is an unscientific assessment). Part of the propensity to save rather than spend is the lack of trust in financial institutions. People would rather buy hard goods than take their risks with banks and

investments. Russia has an extremely low participation rates in public financial market investments (in relation to income). Recent estimates are that individual investors in Russian stock markets amount to only 6 million (*Source: Public Opinion Foundation, 2007*).

But other factors impede the current attractiveness of e-commerce

- Given a choice, Russian consumers prefer to deal in cash. Payment cards were used for only 3.8% of retail purchases in 2009 (*Source: Central Bank of Russia*). This hesitation to use bank cards extends to online purchases as well, and is especially true when dealing with new or locally-unknown companies and brands which lack a bricks-and-mortar presence.
- The financial services sector remains under developed. Surveys show that only one-third of Russians with money to save trust their money to banks, and about one-half keep cash at home. Ninety percent of Russians do not invest in the stock market, and do not intend to (*Source: Russia Profile, 2008*).
- Moreover, many consumers don't even possess credit or debit cards. Payments are made using cash kiosks, ATMs and, increasingly, online through the websites of their banks. Many person-to-person payments are made through SMS-based billing systems maintained by telecom service providers. The financial turmoils of 1991 and 1998 led to vast consumer disillusionment with financial institutions and, indeed, a mistrust of money itself.
- However, things are changing. The relative strength of the Ruble and stability of the financial markets under the Putin regime has fostered increasing confidence in banks, and the current generation of younger Russians (who are more likely to have traveled abroad and also inclined to be early adopters of e-commerce) have not experienced any financial shocks.
- The public postal system (Russian Post) is widely regarded as slow, inefficient, unreliable and corrupt. Few consumers would be confident enough in their services to agree to having their online purchases sent via the regular post. Russian Post offers premium categories of services which offer delivery confirmation, and is the local affiliate of the global EMS courier service. Private courier companies have also stepped in to bridge the gap in the marketplace, but at higher rates.
- Import regulations are specific to Russia and introduce higher costs and delays for imported goods. While not specific to e-commerce, the system is unpredictable and can involve long delays as products sit at the border waiting for proper documentation, and as negotiations on the market value of the shipment are carried out with customs officials (to which taxes and duties are to be applied).

The Russian e-commerce market is developing to overcome barriers with an array of home-grown solutions

- An array of home-grown payment methods serve the needs of Russian e-commerce, including online credit card payment processors, payment kiosks, e-wallets, branch-based person-to-person payment networks, and cash couriers. Direct bank transfer is also an option offered by many Russian e-commerce companies.

Popular Payment Methods for Russian E-commerce

E-wallets



Payment kiosks



Person-to-person network



Online bank card processors



Forecasts of online spending are uniformly rosy

- A study of Russian e-commerce co-authored by Citibank and Google was released in November 2010. While its scope only covers spending on bank cards, it does provide some useful insights into Russian e-commerce.
- In relative terms, online spending in Russia accounts for less than 1% of the total retail market. Another indication of the huge room for growth in online spending, is that such spending accounts for less than 0.5% of Russia's GDP compared with 7% in the UK (although this is only comparing bank card spending).
- More specific indicators of interest in online buying are also very positive. Google tracks related search terms and reports that since 2009, the query "buy" has grown twice, while the query "buy online" has grown three times.

The top web properties in Russia differ markedly from the top global web properties

Top 10 Most-Visited Websites – Globally and in Russia

	Global	Russia
1	Google (google.com)	Яндекс (yandex.ru)
2	Facebook (facebook.com)	Почта@Mail.ru (mail.ru)
3	YouTube (youtube.com)	Google (google.ru)
4	Yahoo! (yahoo.com)	V Kontakte (vkontakte.ru)
5	Windows Live (live.com)	Google (google.com)
6	Blogger.com (blogger.com)	YouTube (youtube.com)
7	Baidu.com (baidu.com)	Wikipedia (wikipedia.org)
8	Wikipedia (wikipedia.org)	LiveJournal (livejournal.com)
9	Twitter (twitter.com)	Одноклассники.ru (odnoklassniki.ru)
10	QQ.com (qq.com)	Facebook (facebook.com)

(Source: Alexa, February 2011)

Observations:

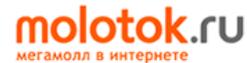
- Russian search engine Yandex is far more popular than Google, and its lead is holding steady over time. For the month of February 2011, Yandex had a search market share of approximately 65.0% vs. Google's 21.4%. In February 2010, Yandex had a 61.9% share vs. Google's 21.8% (Source: *Liveinternet.ru*)
- Similarly, local operator VKontakte remains the king in the realm of social media. Russian-language social media properties LiveJournal and Odnoklassniki also outrank Facebook in terms of popularity. Although Facebook is playing rapid catch-up, nearly doubling its reach between February 2010 and February 2011, it still attracts only about 10% of VKontakte's audience (Source: *Liveinternet.ru, TNS*). However, a strict comparison of the two sites is somewhat misleading as one of VKontakte's most sticky features is live streaming of MP3s, which is a murky area in terms of intellectual property. Facebook has just cracked the Top 10 most popular websites in Russia, according to Alexa.
- Twitter is not yet as popular in Russia as in the rest of the world, but is also growing rapidly and is a commonly-used mode of communication by President Dmitry Medvedev.

**Russian Internet “Hall of Fame”
... or “Hall of Shame”?**

Companies big and small can find their counterparts in the Russian Internet space:

You say...

Наш ответ...



*acquired by Groupon

Takeaways

Would you like to be next?

Globally-focused companies looking for the next phase of their growth realize that this won't come from the developed US or European markets but rather the emerging markets of Asia, Latin America and Eastern Europe. Russia, with its large population and high disposable income per capita, is a lucrative retail market and will soon be the largest consumer market in Europe.

Legions of enterprising Russians are scouring the market for successful foreign business models and attempting to adapt them to Russia before the foreign companies wake up. Their tactics range from simple domain-name squatting, on the low end, to wholesale “adaptation” of functionality and even interface. Rest assured that if you have even a moderately successful e-commerce business, someone in Russia is already working to bring your idea to Russian consumers.

The Russian e-commerce market is as hot as it’s ever been.

Now is the time to act.

This is an Executive Summary of “Russian E-Commerce Market – Behind the Numbers, March 2011”

The full report is available only to clients and partners of Interstice Consulting.

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About Interstice Consulting Russia

In Russia, Interstice Consulting offers existing, foreign, e-businesses a full solution to adapt their businesses to the Russian e-commerce market. Our services include:

- Consulting on e-business strategy in Russia
- Business setup and administration
 - Business registration and ongoing administration
 - Sourcing of local directors and representatives
 - Domain name registration and ongoing administration
 - Tax registration and compliance
 - Intellectual property protection
 - Accounting and recordkeeping
 - Bank account setup and administration
- Web development and online marketing
 - Converting existing website to Russian language and to appeal to the behavioural characteristics of Russian Internet users
 - Usability testing
 - Designing and implementing Russia-specific online marketing and advertising campaigns
 - Search engine optimization for Russian language key words and phrases, in view of algorithms used by popular local search engines
 - Website maintenance, updates and hosting
- Customer contact, service and relationship management in Russian language
- Logistics
 - Import of physical goods and customs clearance
 - Warehousing
 - Distribution/delivery
- Payment collection, processing and crediting

The **key benefits** to our e-business localization services include:

- **A "one-window" approach:** we provide a complete, end-to-end solution. Our client deals only with Interstice Consulting and we manage all coordination with our network of Russian specialists.
- **Speed to market:** we are experienced in bringing foreign e-businesses to Russia and have a standardized methodology and project management
- **Risk reduction:** our senior staff are experienced in the standards of international business and clients have complete access to their financial and operating records, with ability to verify/audit as appropriate
- **Flexible cooperation models:**
 - Consultation only: we can work purely as your consultant on a time and materials basis; or
 - Partnership: we can act as your representative in Russia and share in the risks and rewards of the business. This enables the client to achieve a lower initial investment as well as the benefits of outsourcing of operations, rather than investing in an office, warehouse, and employees from the outset. Under this approach our ultimate compensation for localization services is tied to the revenues generated from the client's Russian operations.

To discuss your entry into the Russian e-business market, please contact us via e-mail on:
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