Market traveler

In my 20 years of visiting Russia, its development has been patchy. One area that stands out: information technology (IT).

Russia has turned Soviet-era legacies into free-market strengths bolstering fields such as internet, social media, and fintech.

As an emerging market investor, I see the pieces coming together for another Russian IT success story: thriving e-commerce.

20 years in Russia

Thanks to a devalued ruble—courtesy of U.S. and European sanctions—I was able to afford a hotel room on the edge of Moscow’s Red Square on my recent trip to Russia. From the lobby bar, I could enjoy an expertly crafted drink with a clear view of the Kremlin and St. Basil’s Cathedral. My cell phone worked perfectly and the food was terrific. On my mind: a meeting I’d just had with the social media team at one of Russia’s largest internet companies, Mail.Ru.

This snapshot in time barely resembled my first trip to Russia exactly 20 years ago.

To be fair, in 1998, I also had a view of Red Square. However, my vantage point was a ramshackle room at the Rossiya, a Soviet-era hotel with questionable plumbing and chaperones stationed on each floor to keep guests out of trouble. The bar was frankly dangerous and the food so bad I took my last three meals at the newly opened McDonalds down the road. The same week I was there, The Economist ran an article on the Rossiya, painting a picture of roving rats, exploding TVs, and menacing characters in the lobby.

Back then, Russia was still reeling from post-Soviet period tumult and there was a true Wild West feeling to the country. Western goods and luxuries were not yet readily available and the region’s infrastructure still had a distinctly Cold War-era feel. We got around by simply walking to the curb and raising our hands. Soon enough, a Muscovite heading home from work or the store would pull over and negotiate a price to take us where we wanted to go. It was Uber 1.0!

Fast forward to late 2018. My first observation in visiting Mail.Ru’s headquarters:

How things have changed!
The vibe was Silicon Valley–esque, but this was no Facebook copycat. Fashionably dressed employees sipped lattes in the lobby Starbucks, while others donned sweats scored goals in the indoor court for five-a-side, a form of indoor soccer. The social media team was young, tech savvy, and excited about their work—and for good reason. Mail.Ru is tackling something that’s eluded social media players around the world. The Russian tech giant has been building an app in app intended to provide seamless integration between its social networking, mobile messaging, content, and digital payment capabilities—all combined into a single user-friendly service powered by artificial intelligence.

As we viewed a series of virtual demos highlighting Mail.Ru’s innovations, two things stood out in my mind. One, I wish I’d had its app during my 1998 trip to Russia (cut to me rebooking at a new hotel, posting missives about Rossiya’s rats, and messaging folks at home to say I’m safe). And two, it was clear that this company—along with an ecosystem of impressive Russian tech firms—is helping build the foundation of a significant e-commerce economy in a region that for years has lagged in online retail.

**Turning Soviet-era challenges into IT opportunities**

Russia has changed almost beyond recognition in the past 20 years, but it has been an uneven transition. Much of the country remains bogged down in inefficiency and corruption, despite its undeniable natural advantages. Consider the Russian agriculture sector. After government-enforced collective farming hollowed out Russian farms’ productivity and yields, it took years for private enterprise to spread through the region’s vast heartland, allowing Russian agriculture to reach its potential. Today, Russia is the world’s #1 wheat exporter, but only after outgrowing its historical disadvantages. Other areas, like manufacturing, infrastructure, and parts of the natural resources sector, are still lagging global peers.

Russia’s IT sector, however, is another story. While Soviet-era dynamics may have posed a disadvantage for Russian farming, they had almost an opposite effect on Russian IT.

First, Russia’s reemergence into the global economy coincided with the dawn of the digital age. Historically, countries tend to face an uphill slog when trying to overcome the burdens of outdated technology infrastructure. However, after the Soviet Union dissolved, Russia had no real legacy infrastructure holding it back (stories about waiting years for a phone were true!). From scratch, the region built a strong mobile and broadband network that is superior to those of many Western countries.

<table>
<thead>
<tr>
<th>Country</th>
<th>Internet Penetration</th>
</tr>
</thead>
<tbody>
<tr>
<td>Russia</td>
<td>78%</td>
</tr>
<tr>
<td>China</td>
<td>71%</td>
</tr>
<tr>
<td>Mexico</td>
<td>67%</td>
</tr>
<tr>
<td>Brazil</td>
<td>70%</td>
</tr>
<tr>
<td>South Africa</td>
<td>59%</td>
</tr>
<tr>
<td>India</td>
<td>25%</td>
</tr>
</tbody>
</table>

Source: Pew Research Center, June 2008

Russia’s vast size also comes into play. It’s the largest country in the world, at 17 million square kilometers, but it’s also sparsely populated, at 8.8 people per square kilometer. Between geographical distance and the fact that Russia was starved for outside information for so many years, Russians have largely embraced the internet and the connectivity it provides. They’ve also embraced smartphones, as their costs decreased in recent years.

There is one more historical catalyst to add into the mix. Russia boasts a large base of well-educated engineers, mathematicians, and computer programmers, whose knowledge—originally intended for fields such as aerospace and defense—has helped build an ecosystem of world-class IT expertise. This ecosystem has helped drive consumer-focused technologies.
Winning on home turf by engaging Russian consumers

Speaking of Soviet legacies, what of the Kremlin’s influence? Internet companies in Russia have actually grown up largely free of government interference—and in fact enjoy a regulatory regime that supports innovation and competition. In contrast, internet giants in another key emerging market region, China, have grown under Beijing’s protective regulatory umbrella (the Great Firewall of China) that excludes Western tech giants. Russia, however, has gone head to head with the West and has largely won on its home turf.

- With an ability to process the nuances of Russia’s unique alphabet, a well-informed read on Russia’s distinct culture, and aggressive business instincts, companies like Yandex N.V., Russia’s dominant search engine, have beaten back the likes of Google.
- Meanwhile, Mail.Ru’s VKontakte app has been outperforming its Western competitor Facebook in terms of the app’s number of monthly Russian users, particularly among Millennials. In our meeting, Mail.Ru’s management noted the average Russian social media user spends 33 minutes per day on VKontakte, compared with the 22 minutes they spend on Instagram.

Beyond search and social, these two Russian IT players have made inroads in growing their user bases, across various consumer touch-points. Harking my experience flagging down drivers 20 years ago, mobile app-driven ride sharing has taken off in Russia, with Yandex leading the Russian market. Yandex’s myriad businesses also include a leading search engine among Russian users, online advertising services, email hosting, GPS navigation, and a proprietary method of machine learning that powers the company’s technologies. Mail.Ru offers a similar range of services, on top of its integrated social media; online messaging; and, very importantly, its digital payment technologies.

Popularity of digital payment technologies in Russia

Russians purchasing with contactless payments from smartphones
- 2017: 10.1%
- 2018: 39.2%

Russians purchasing with e-wallets from smartphones
- 2017: 34.8%
- 2018: 53.7%

Source: “Online Payments in Russia” study by Mediascope research agency, 2018 (polled Russian internet users ages 18 to 55)
Russian companies have increasingly used fintech to access new customers, better assess creditworthiness, and fill market gaps traditional banks have ignored. For example, Tinkoff Bank develops online retail banking services in Russia. It has no branches; all banking is done via computer or smartphone. Tinkoff began in 2009 with about 300,000 customers and now has about 4.7 million, according to company data. Local player Qiwi has developed a range of payment platforms, including online wallets. Qiwi says it serves 47 million users per month, giving the firm a formidable database of consumer buying habits to study. Digital payments, from homegrown solutions to Apple Pay and Android Pay, have seen exceptional acceptance in Russia. Together, firms like Mail.Ru, Yandex, and various fintech players have been making gradual, chess-like moves to capitalize on Russian consumers’ widespread adoption of digital technologies. Their next move—and the most startling insight from my recent trip—is to build a full-fledged e-commerce industry.

Tackling a logistics nightmare to build a true e-commerce sector

So what might the future look like? E-commerce has grown slowly in Russia, but things are speeding up. Experience in other markets shows that internet and smartphone penetration generally leads to e-commerce growth, and Russia appears to be well positioned there. The region has 63 million online shoppers, compared with 105 million internet users, according to Morgan Stanley estimates. And the frequency of online shopping is accelerating, particularly since 2015 when Russia’s recession pushed many consumers online to look for bargains. If history is any guide, the demand for online shopping will only grow.

But, it won’t be easy.

Recall what I said about Russia’s large size and sparse population being a driver of internet adoption. The opposite applies when it comes to e-commerce logistics. Russia covers one-eighth of the world’s landmass. Vast distance and poor infrastructure have meant that the cost of fulfilling orders and shipping goods has been extremely high. In fact, moving goods around the country has been the single biggest roadblock to the development of e-commerce. It probably does not stretch the imagination to suggest Siberia is a tough place to deliver to under the best of circumstances.
While it’s true that China faced a similar problem, it took decades of massive government-directed investment to put a Chinese infrastructure network in place. Along with infrastructure came logistics companies. China now boasts a number of world-class logistics players. Not so in Russia. Soviet roots run deep in the region’s logistics industry. More than 50% of parcels are delivered by Russian Post, which has a notoriously bad track record. It is often prohibitively expensive to ship goods quickly and reliably, as more affluent—and profitable—customers expect. This is less problematic in affluent-dense major cities, but until the logistics challenge is resolved, e-commerce will struggle.

Further adding to costs and obstacles, Russia—unlike, say, China—manufactures very few high-quality consumer goods within its own borders, so most stock has to be imported. Altogether, these structural issues have meant that investment in the e-commerce space has dramatically lagged that of other countries, and e-commerce remains less than 5% of total retail sales.

E-commerce as a percentage of total retail sales by country (%)

<table>
<thead>
<tr>
<th>Country</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mexico</td>
<td>3%</td>
</tr>
<tr>
<td>India</td>
<td>5%</td>
</tr>
<tr>
<td>Russia</td>
<td>5%</td>
</tr>
<tr>
<td>Argentina</td>
<td>5%</td>
</tr>
<tr>
<td>Brazil</td>
<td>6%</td>
</tr>
<tr>
<td>Taiwan</td>
<td>10%</td>
</tr>
<tr>
<td>U.S.</td>
<td>12%</td>
</tr>
<tr>
<td>U.K.</td>
<td>17%</td>
</tr>
<tr>
<td>China</td>
<td>21%</td>
</tr>
</tbody>
</table>

Source: HSBC and Euromonitor (as of 2017—most recent data)

Building a do-it-yourself logistics platform to scale up

While a handful of Russian logistics companies exist as alternatives to Russian Post, they operate on a much smaller scale than the logistics industry in China. However, in true entrepreneurial fashion, sometimes you have to create your own opportunities to succeed. Local player Ozon is also making a run at developing the market by building out its own distribution network and offering it to third-party sellers.

This approach may offer a near-term advantage. Ozon claims that 40% of the Russian population is covered by next-day delivery, and it has rolled out same-day delivery in five cities. This suggests the model can work in Russia, although it is at a cost. Logistics costs in Russia remain among the world’s highest, accounting for as much as 16.1% of gross domestic product, according to 3PLogistics. However, logistics is a classic scale business. Volume drives prices down very quickly.

Russian tech companies vying for e-commerce leadership may also gain an advantage based on the current market share leader’s lack of scale among key demographics.

The supply side of Russia’s e-commerce equation remains underdeveloped. The market leader in Russia is actually China’s Alibaba, which relies on Russian Post to deliver goods it imports from China. Alibaba focuses on selling low-priced, basic goods to price-sensitive consumers who may be more than happy to wait two to three weeks for delivery of a package of T-shirts or a cell phone case. This allows it to take advantage of its scale in China as well as China’s massive manufacturing base.

How is Alibaba’s model faring in Russia? Its focus on cheap goods has hampered its ability to grow in larger cities and among more affluent, demanding consumers. This could open the door for local companies like Ozon; Yandex; local niche player Wildberries; and Avito, the online classifieds company owned by South African internet giant Naspers.

While none of these Russian businesses are at scale yet, this may be about to change. Key IT players are ramping up investment in e-commerce while finding creative options to reduce the costs of order fulfillment.

Partnering up to own the e-commerce game

If Ozon’s success will likely come from creating its own opportunities, other Russian IT players are drawing strength from exciting partnerships.

The ever-present Yandex already runs a leading e-commerce site among Russian users, Yandex Market. However, this is largely a price-comparison search engine, not a true e-commerce business. So in early 2018, Yandex created a joint venture with Russia’s largest bank, Sberbank, to create an e-commerce platform called Beru.com. Beru.com will focus on cross-border sales (like Alibaba) but will sell higher-quality,
Together, firms like Mail.Ru, Yandex, and various fintech players have been making gradual, chess-like moves to capitalize on Russian consumers’ widespread adoption of digital technologies.

branded goods to increase the average order size. Beru.com likely will benefit from Yandex’s ubiquitous reach and cross marketing. For instance, the recently announced Yandex smartphone will come preinstalled with the Beru.com app. The venture will draw upon the benefit of Sberbank’s advanced payment systems—not to mention its 61 million digital customers.

Not to be outdone, Mail.Ru is getting cozy with market leader Alibaba. Mail.Ru already has an e-commerce offering called Pandao, but partnering with Alibaba should accelerate Mail.Ru’s entrance into the space. In September 2018, Mail.Ru and Alibaba formed a joint venture called AliExpress Russia to increase the scale and technological edge of both companies. The deal also gives Alibaba a 10% stake in Mail.Ru.

Mail.Ru also has access to a vast amount of customer data though its social media app, potentially allowing the company to provide targeted advertising and social e-commerce opportunities. The company’s data-driven findings could offer a trove of insights into the Russian consumer’s mindset. Its VKontakte app reaches over 90% of the Russian internet population and, as mentioned, is particularly popular with younger Russians. Based on what I saw in my recent meeting with Mail.Ru’s team, I’m optimistic about the possibilities.

Worth noting: South Africa’s Naspers owns stakes in both Mail.Ru and classified ad giant Avito. I believe a tie-up between these two companies could benefit Mail.Ru and its partners, as they eye the top of Russia’s e-commerce food chain.

Russian e-commerce players also may have opportunities to partner with brick-and-mortar retailers.

Leading Russian retailers have aggressively been adding space over the past decade as they race to gain market share from small, unorganized players. These moves have, in turn, resulted in significant logistics capacity. The top two convenience store chains, Magnit and X5, together have over 30,000 stores between them, which requires a massive logistics backbone.

In fact, Magnit’s founder, Sergei Galitsky, began his career focusing on building distribution networks in Russia, something that later helped drive Magnit’s growth strategy. I could see e-commerce players partnering with brick-and-mortar businesses to both piggyback on their existing logistics networks and use their retail store networks as collection points, bridging last-mile challenges. The latter is already occurring to a limited degree, as many physical stores have pickup boxes from online retailers located in their front lobbies.

Final thoughts: Studying Russia’s next moves with hopeful eyes

The pieces appear to be in place for Russian e-commerce to grow rapidly. Over the next several years, I think they will come together and create an exciting opportunity. The market is at a very early stage and competition is intense, so careful monitoring and risk management will be critical for those who are interested in investing in the sector. Investors observing Russia’s e-commerce developments not only will have to watch out for new competitors and new technologies but also will have to keep an eye on consumer preferences, technology trends, and geopolitical developments. The potential reward will be access to one of the more interesting growth opportunities in the IT sector over the next decade.

Ten years may seem like an eternity, but a lot can happen in that time. After all, my terrible hotel from 1998 was razed to make way for building Moscow’s first major public park in 50 years, which The Economist recently described as “ambitious, thoughtful, and transformative for the area.” Can Russia’s IT sector do the same with e-commerce? From my perch over Red Square, things looked promising for the industry and its quest to bring Russian retail online.
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