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## RUSSIA'S FORESTRY INDUSTRY OVERVIEW

September 2007

The Russian Federation has experienced significant changes since the volatile years of the 1990's. Nine straight years of consistent GDP growth along with political stability, high commodity prices, and a great influx of foreign direct investment have transformed Russia into a modern and vibrant 9<sup>th</sup> biggest economy in the world.<sup>1</sup> The country's newfound wealth is driving the modernization of all major industries in the country and especially the forestry sector.

With the passing of the 2007 forest code and continuing modernization in equipment and techniques, the Russian forestry industry has the potential to increase wood products output by 4 times its current rate.<sup>2</sup> Considering that Russia contains one quarter of the world's forests, industry experts proclaim that "the potential of the national timber industry is no less than that of the oil, iron, and steel industries."<sup>3</sup> According to some experts, **the economic potential of Russia's forestry industry can be estimated at more than 100 billion US dollars!**<sup>4</sup>

### Russia's Forest market

*John Deere-85% of the machines and equipment used in the Russian timber industry is obsolete.*<sup>5</sup>

With the Russian economy continuing to flourish and demand for timber rising domestically as well as abroad, industry experts believe that Russia can increase its harvesting capacity significantly in the coming years. The total area of forests in the Russian Federation is 1173.4 million hectares and the reserves of standing wood exceed 82 billion m<sup>3</sup> (cubic meters).<sup>6</sup> U.S. Commercial Service reports that in order to increase the share of Russia's forestry industry in world trade and to change the situation in favor of the production and export of value-added products, the industry requires modern equipment<sup>7</sup>.

In 2005, forest harvesting in the Russian Federation totaled around 186 million m<sup>3</sup>, making Russia the world's third biggest harvester, after the U.S. and Canada.<sup>8</sup> The current harvesting yield is around a third of the Government's estimated total technical annual allowable cut which has been set at 576 million m<sup>3</sup> per year.<sup>9</sup> Removals have increased sharply in recent

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<sup>1</sup> "Is Ivanov now the presidential front runner," Russia profile.org. June 20 2007. Available on-line at: <http://www.russiaprofile.org/page.php?pageid=Business+New+Europe&articleid=a1182349717>

<sup>2</sup> "Timber Industry Development in Russia: Problems and Forecasts." Available on-line at: [http://www.runa.info/files/5494/Timber%20Industry%20Development%20in%20Russia%20\(Problems%20and%20Forecasts\).pdf](http://www.runa.info/files/5494/Timber%20Industry%20Development%20in%20Russia%20(Problems%20and%20Forecasts).pdf)

<sup>3</sup> Russian Forestry Review 2006. Available on-line at: <http://www.russianforestryreview.com/news/release218.html>

<sup>4</sup> Ibid.

<sup>5</sup> "Construction and Forestry Division," John Deere. Available on-line at: [http://www.deere.com/en\\_US/investinfo/media/pdf/analysevent/brock.pdf](http://www.deere.com/en_US/investinfo/media/pdf/analysevent/brock.pdf)

<sup>6</sup> Ibid.

<sup>7</sup> Mikhail Minkevich. "Russia: Market for Forestry/Woodworking Equipment" US Commercial Services. May 2006. Available on-line at:

[http://commercecan.ic.gc.ca/scdt/bizmap/interface2.nsf/vDownload/ISA\\_5238/\\$file/X\\_8558010.PDF](http://commercecan.ic.gc.ca/scdt/bizmap/interface2.nsf/vDownload/ISA_5238/$file/X_8558010.PDF)

<sup>8</sup> Ibid.

<sup>9</sup> "Russian timber industry - detailed statistics for year 2006". 27, February 2007. Available on-line at: <http://www.runa.info/eng/press-center/events/view.html?id=6385>

years as demand for industrial round wood and raw logs has increased in domestic and export markets. European associations believe that with the recent Russian legislation (2007 forest code), modernization, and new equipment, the country has the potential to increase the harvest to 250 million m<sup>3</sup> within five years.<sup>10</sup>

### Forest based products

According to official statistics, up to 150 million m<sup>3</sup> of wood products is produced in Russia annually.<sup>11</sup> With the proper modernization of equipment and the adaptation of Western business practices, industry experts estimate that the country could improve this index by almost 4 times.<sup>12</sup> The country's forest-based products industry generated a total output of around \$12 billion in 2005.<sup>13</sup>

Russian forest products output accounts for just over 3% of global output in value terms, but much more in volume terms.<sup>14</sup> This is due to the fact that unprocessed timber accounts for over 40% of export values.<sup>15</sup> The government is trying to change this trend by implementing a policy that seeks to export less raw timber and more value added wood products. With the passing of a new Forest Code in 2007 and a unified national forestry policy, more responsibility for the forest sector has been given to the country's regional governments. This in turn is expected to supply a legislative base for the industry and provide the stability needed to attract more foreign investments. At the same time, various tariff modifications and other government measures are being implemented to promote the export of higher-value processed products rather than logs.<sup>16</sup>

### 2007 Forest Code

Industry observers believe the new Forest Code opens a new era in the history of forest utilization in Russia. One of the significant changes is in lease terms - the leasing period of the forestry concessions have been extended to 99 years from its previous 50 years.<sup>17</sup> Additionally, the government announced a transition from a tender system of awarding leases to an auction-based system. The new Code also contains provisions designed to make Russian forestry projects more attractive to investors. For example, an investor willing to undertake a project valued at above \$193.7 million can enter into lease agreements without going through an auction.<sup>18</sup> To an extent, this measure ensures security of raw material supply to such an investor. The law contains several other provisions designed to reduce investor risk and encourage investment.<sup>19</sup> This includes a provision that allows companies to export some logs at a reduced tax rate if a certain amount of the harvest is processed in Russia.<sup>20</sup> Another

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<sup>10</sup> "Russian log exports and lumber production soaring," Wood Markets Monthly. March 2003.

<sup>11</sup> "Timber Industry Development in Russia: Problems and Forecasts." Available on-line at: [http://www.runa.info/files/5494/Timber%20Industry%20Development%20in%20Russia%20\(Problems%20and%20Forecasts\).pdf](http://www.runa.info/files/5494/Timber%20Industry%20Development%20in%20Russia%20(Problems%20and%20Forecasts).pdf)

<sup>12</sup> Ibid

<sup>13</sup> "Risks & Rewards. Forest, Paper & Packaging in Russia," Pricewaterhousecoopers.

<sup>14</sup> Ibid.

<sup>15</sup> Ibid.

<sup>16</sup> Ibid.

<sup>17</sup> "Russian log export tax," CIBC World Markets. Available on-line at:

<http://www.cpbis.gatech.edu/resources/industryreports/CIBC/070313%20CIBC%20-%20Russia%20Log%20Export%20Tax%20Update.pdf>

<sup>18</sup> Zakhar Smushkin. "Growing Illum Pulp," Paper Age. Available on-line at:

[http://www.paperage.com/issues/may\\_june2007/05\\_2007ilim.pdf](http://www.paperage.com/issues/may_june2007/05_2007ilim.pdf)

<sup>19</sup> Ibid.

<sup>20</sup> "Russian log export tax," CIBC World Markets. Available on-line at:

<http://www.cpbis.gatech.edu/resources/industryreports/CIBC/070313%20CIBC%20-%20Russia%20Log%20Export%20Tax%20Update.pdf>

important component of the new code is the establishment of a forestry Investment Fund. The government has announced the creation of special financial instruments and a legislative framework for providing assistance for infrastructure development in the framework of any investment project valued above \$193 million.<sup>21</sup>

*Given that Russia is currently harvesting well below what experts consider to be a sustainable rate, there is great potential for the development of modern, sizeable forest-based industries.<sup>22</sup>*

### **Outsourcing to Russia**

The passing of the 2007 forestry code has already brought significant investment to the industry. Because of the various incentives in the new code, more foreign companies have begun outsourcing their manufacturing operations to Russia. The combination of abundant resources, a well-trained workforce, and low labor costs makes moving operations to Russia very attractive. Investing in Russia allows foreign players to provide a cost effective stream of timber supply to their downstream operations. Foreign companies that have harvesting as well as wood processing and manufacturing facilities in the region benefit even more.

Companies from all over Europe have begun to enter the market. Europe's second largest pulp producer, Botnia, built a mill in the country in 2006, and has planned to invest another 1.7 billion euro in the country to help rearrange its timber supplies.<sup>23</sup> The newly constructed mill is reported to be the most advanced woodworking mill in Europe.<sup>24</sup> Companies from other neighboring countries such as Finland, Sweden, and Germany are also entering the market. German Kronospan recently established a production facility in the Moscow region and has allocated 500 million euros for further expansion of the facility.<sup>25</sup>

Value added wooden goods production has also begun to be outsourced to the country. A company by the name of Swedwood has recently commissioned a furniture manufacturing factory in Tihvin, Russia. The new factory will output pine furniture to be delivered to shops in Russia and abroad. With its timber harvesting operations already in the country, Swedwood is able to take part in the production chain from timber harvesting to furniture production all in Russia. Transportation within the nation is well developed and it is relatively easy to import and export goods out of the country. Russia's wide network of transportation has close to 550,000 miles of roads and a railway system considered one of the most extensive in the world, covering some 95,000 miles of broad rail.<sup>26</sup>

### **Product Demand**

Domestic demand is also expected to increase as a large number of Russian citizens are beginning to have access to bank financing. The increased demand for apartments will

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21 Zakhar Smushkin. "Growing Illum Pulp," Paper Age. Available on-line at:

[http://www.papera.com/issues/may\\_june2007/05\\_2007ilim.pdf](http://www.papera.com/issues/may_june2007/05_2007ilim.pdf)

22 "Risks & Rewards. Forest, Paper & Packaging in Russia," Pricewaterhousecoopers.

23 Russian Forestry Review 2006. Available on-line at:

<http://www.russianforestryreview.com/news/release218.html>

24 Mikhail Minkevich. "Russia: Market for Forestry/Woodworking Equipment" US Commercial Services. 31, May 2006.

Available on-line at:

[http://commercecan.ic.gc.ca/scdt/bizmap/interface2.nsf/vDownload/ISA\\_5238/\\$file/X\\_8558010.PDF](http://commercecan.ic.gc.ca/scdt/bizmap/interface2.nsf/vDownload/ISA_5238/$file/X_8558010.PDF)

25 Ibid.

26 "Countries Information." Available on-line at:

<http://www.paagproducts.org/countries.html>

stimulate growth in the construction of inexpensive houses and further drive domestic demand for wood products.<sup>27</sup>

In addition to the domestic market, there is a significant opportunity to export eastwards to the fast growing markets of Asia. Export markets such as China and Japan, where demand for wood fiber far outstrips supply, and the close proximity of the region provides easy access to transportation routes.<sup>28</sup> In recent years, Russia has become the number one exporter of timber products to China supplying over 48% of China's total timber product imports in 2006.<sup>29</sup> Mature markets westward also present good opportunities, where efficiently produced and delivered value-added forest products would be highly competitive.

Western markets such as the United States and Canada also present good opportunities for exports and Joint Ventures. As a result of environmental and regulatory policies that have greatly reduced timber harvests from public lands, the U.S. does not have the domestic capacity to meet its demand for lumber. Additionally, restrictions that have taken effect this year have decreased the amount of timber coming from Canada.

According to vice president Howard of NAHB (National Association of Home Builders), "Today, the U.S. is overly reliant on Canadian imports to meet its lumber needs, we are reaching out to you to correct this problem and we are looking to Russia to add equilibrium to our market for this essential commodity for the home building industry". The U.S. is reaching out to Russia to supply the demand for wood. A recent study done by Harvard University estimated the U.S. will build an additional 18 million new homes in the next 10 years.<sup>30</sup>

Aginsky Consulting Group (ACG) believes that North American companies should expand their operations into Russia not only to secure a future source of timber, but to produce direct and complimentary products that go into housing. "The ability to produce higher quality products combined with the superior qualities of Russian fine-grained pine, larch, and spruce logs, virtually guarantees Russian log and lumber exporters excellent selling opportunities to buyers throughout western Europe and Asian markets (especially China and Japan)", state most industry experts.<sup>31</sup> By harvesting Russian timber and manufacturing value added products such as doors, window frames, and furniture on site, a company can use the geographic location to reduce manufacturing and export costs. Russia's close proximity to the thriving nations of China, Japan, and South Korea, as well as Western Europe make it a great location to set up a distribution base and target new markets with their products.

### Opportunities in Forestry Equipment

*Demand for forestry equipment is expected to be high over the coming years as Russia modernizes its aging fleet of forest harvesters and adapts new western equipment and techniques.*

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27 Mikhail Minkevich. "Russia: Market for Forestry/Woodworking Equipment" US Commercial Services. 31, May 2006. Available on-line at:

[http://commercecan.ic.gc.ca/scdt/bizmap/interface2.nsf/vDownload/ISA\\_5238/\\$file/X\\_8558010.PDF](http://commercecan.ic.gc.ca/scdt/bizmap/interface2.nsf/vDownload/ISA_5238/$file/X_8558010.PDF)

28 "Risks & Rewards. Forest, Paper & Packaging in Russia," Pricewaterhousecoopers.

29 "Russian Logs in China." The softwood commodity chain and Available on-line at:

<http://www.forest-trends.org/documents/publications/Russian%20Logs%20in%20China%20-%20FINAL.pdf>

30 "U.S. home builders seeking new lumber source in Russia," NAHB. Available on-line at:

[http://www.nahb.org/news\\_details.aspx?newsID=3422](http://www.nahb.org/news_details.aspx?newsID=3422)

31 "Russian Log Exports & Lumber Production Soaring." Press Release 2003. Available on-line at:

<http://www.woodmarkets.com/Press%20Releases/03-03-27%20-%20Russia%20Wood%20Industry.pdf>

According to John Deere, 85% of the machines and equipment used in the Russian timber industry is obsolete.<sup>32</sup> John Deere estimates the **annual Russian forestry equipment replacement market to be around \$350 million (1,200 units).**<sup>33</sup> Rapid modernization is already taking place at most pulp and paper plants, wood harvesting and processing companies, and is expanding outward to smaller companies across the country.<sup>34</sup> Among these is Ilim Pulp Enterprise, which is currently implementing a \$600 million investment program for the development of its production facilities and the purchase of new equipment.<sup>35</sup>

For many years, the Russian forestry and woodworking industry has been export-oriented. Today, however, exports of raw timber are generating smaller profits and many enterprises are re-tooling their operations to produce value-added items for the domestic and foreign markets. Products include those used in domestic construction and in furniture production, such as construction board, beams, doors, and window frames. Because of strong local demand, the domestic wooden housing industry is growing and requires modern equipment for production of various types of board and other wooden construction materials.<sup>36</sup>

### Russians Prefers North American Equipment

Despite the lower cost and wide availability of domestically produced equipment, local purchasers prefer to buy imported equipment. This is because imports usually provide higher manufacturing quality and better compliance with particular manufacturing methods. Imports of woodworking equipment include direct supplies to end-users and supplies to wholesale trading firms and distributors.<sup>37</sup> Another important factor that makes North American forestry equipment in Russia so attractive is the increasing devaluation of the American Dollar against the Euro. The recent decline in the dollar has given U.S. companies a notable advantage in international trade as Russian consumers seek to purchase quality products from trusted North American companies.

An additional positive note is that the Russian government stresses that import duties on integrated timber processing equipment will continue to decrease. "All this shows that the government is pursuing a consistent policy aimed to create conditions for effective development of the Russian processing industry."<sup>38</sup> Because of the sheer size of the forest resource in the Russian Federation and its potential to increase exports significantly, developments in the country will strongly influence the global supply and demand balance for forest products. With more money available from a surging economy and foreign direct investment, Russian businesses will continue to modernize their forestry equipment as they aspire to get back to the harvesting capacity of the old Soviet days.

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32 "Construction and Forestry Division," John Deere. Available on-line at:  
[http://www.deere.com/en\\_US/investinfo/media/pdf/analysevent/brock.pdf](http://www.deere.com/en_US/investinfo/media/pdf/analysevent/brock.pdf)

33 Ibid.

34 "Timber Industry Development in Russia: Problems and Forecasts." Available on-line at:  
[http://www.runa.info/files/5494/Timber%20Industry%20Development%20in%20Russia%20\(Problems%20and%20Forecasts\).pdf](http://www.runa.info/files/5494/Timber%20Industry%20Development%20in%20Russia%20(Problems%20and%20Forecasts).pdf)

35 Mikhail Minkevich. "Russia: Market for Forestry/Woodworking Equipment" US Commercial Services. 31, May 2006.  
Available on-line at:

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36 Ibid.

37 Ibid.

38 Russian Forestry Review 2006. Available on-line at:  
<http://www.russianforestryreview.com/news/release218.html>

## Opportunities

Aginsky Consulting Group (ACG) believes that the recent development in Russia's forestry sector has created the ideal environment for North American companies to outsource their operations to the region. What better way to diversify and strategically secure a source of timber for the future, while manufacturing high end products at low costs, than by taking advantage of the labor arbitrage opportunities that exist in the market. Companies from Western Europe have identified these opportunities and are moving at great speed to take advantage of them. It is time for North American companies to realize the potential of the market and make Russia part of their immediate and long term strategies.

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If you have any questions about this report or would like to obtain additional information regarding this opportunity, please feel free to contact Mr. Andrey Arbuzov, the forestry program manager, at [a.arbuzov@aginskyconsulting.com](mailto:a.arbuzov@aginskyconsulting.com).