

PRESENT



E-COMMERCE WAREHOUSING & FULFILMENT IN RUSSIA

What businesses need to know to set up and optimize
their operations in one of the emerging world's largest
e-commerce markets

VERSION 1 – FEBRUARY 2017

WITH THE SUPPORT OF

About this whitepaper

This research study was conducted by East-West Digital News in partnership with EY and NAMO, with the support of Arvato and Radius Group. It is based on exchanges with over 30 industry players and experts.

About the publisher

East-West Digital News is the first international information company dedicated to Russian digital industries. Its website EWDN.COM provides news, market data, business analysis and updates pertaining to the Internet, e-commerce, mobile and telecom industries, digital TV and satellite systems, software and hardware innovation, as well as to the related investment activity and legal developments.

A consulting branch, East-West Digital Consulting, provides international players with assistance for business development in Russia and advises Russian companies on their international strategies.

For more information, please contact us at contact@ewdn.com the investment community.

Copyright policy

The content of this report is protected by copyright. Individuals and organizations can, without prior authorization and free of charge, copy and use short extracts in the form of quotes. East-West Digital News must be clearly indicated as the source and a link to the EWDN.COM website must be offered.

To copy and republish large extracts, or the full report, or for other editorial cooperation opportunities, please contact us at editor@ewdn.com.

Advertising, sponsorship and distribution opportunities

To inquire about advertising and sponsorship opportunities, or if you would like to get involved in the distribution of this study, please contact us at ads@ewdn.com.

Research partners



Participating companies



Key findings

- ◆ In 2016, **the Russian e-commerce market reached some \$26 billion in 2016, including \$16 billion for physical goods** (including cross-border sales).
- ◆ **The cross-border segment is the fastest growing** (+80% in number of parcels and small packages in 2016), exceeding \$4 billion in 2016. Since 2014, this growth has been driven essentially by Chinese players, but big western companies are also eyeing the Russian market.
- ◆ Since 2014, due to the crisis, **the real-estate infrastructure has become dramatically cheaper and more accessible.** Leveraging these opportunities, several international and local key players in the retail industry are engaged in huge projects to build, expand or upgrade their warehousing and fulfilment facilities.
- ◆ **Half of e-commerce companies have their own in-house fulfilment infrastructure.** Up to 20% of these companies consider outsourcing certain fulfillment operations to address seasonal demand flows.
- ◆ **On the fulfilment service market, growing demand from e-commerce players still exceeds offer.** The number of fulfillment providers is growing, but large e-commerce companies tend to outsource their operations to just a dozen of key providers.
- ◆ **The distinction between fulfilment, transportation and delivery services is becoming more blurry** with the development of full-cycle offers. However, in spite of improvements over the past years, the service performance of many providers leaves to be desired.

Table of contents

FOREWORD	7
INTRODUCTION: THE RUSSIAN E-COMMERCE MARKET	9
Internet in Russia	10
The e-commerce market	11
PART 1: WAREHOUSING	15
1.1. Market figures and trends	16
1.2. Opportunities in crisis times	17
Expert advice:	
• Maximizing return in any investment climate: Quality and compliance are key	22
• Should an e-commerce company build/own their own warehouse, or rent it?	23
• Choosing the right location	24
Interview:	
• Eric Poulet, Director of Supply Chain at Leroy Merlin Vostok	25
Insights:	
• Auchan builds high tech logistics center in Moscow region	28
• South Gate Industrial Park	29
• Radius InSite: Integrated data modeling from the design phase to the construction phase	32
PART 2: FULFILMENT SERVICES	35
2.1. Key market figures	36
2.2. Current market trends	37
2.2.1. On the supply side	37
2.2.2. On the demand side	39
2.2.3. Pricing	42
Interview:	
• Michael Poetschke, CEO of Arvato Russia	43

Table of contents

PART 3. INSOURCING OR OUTSOURCING 45

3.1. Reasons for insourcing	46
3.2. Reasons for outsourcing	46
3.3. Choosing a fulfillment service provider	47
3.4. Contract terms	49

Expert advice:

• Key legal risks related to fulfillment outsourcing contracts	50
• A few tips to organize and optimize logistics	52

Insights:

• Outsourced fulfillment operations from the point of view of a last-mile operator: PickPoint	53
---	----

Case studies:

• Ozon's in-house strategy	54
• La Redoute's outsourcing strategy	56

Interview:

• Dmitry Kholomtsev, Head of KupuVIP E-Commerce Services	57
--	----

PART 4. CROSS-BORDER OPPORTUNITIES & CHALLENGES 58

4.1. Fast growing volumes	59
4.2. Latest trends in cross-border logistics	60

Interview:

• Olga Evteeva, Site Manager at Next Russia	61
---	----

E-COMMERCE WAREHOUSING
& FULFILMENT IN RUSSIA

FOREWORD

FOREWORD



Michael Poetschke

CEO of Arvato Rus

Online retail is no longer “terra incognita” in Russia: over the past few years this sector has become a noticeable part of economy, providing domestic and international players with an array of growth opportunities.

In implied in these opportunities are also complex challenges. These include, at the operational level, warehousing and fulfilment processes, as well as the related supply chain and IT issues, which are so vital to succeed in this dynamic market.

It is complex, but necessary to review, analyze and discuss such topics. This is the aim of this research.

This report, which reflects the practical knowledge of leading industry experts and players, will be interesting to anyone conducting e-commerce projects in Russia, or considering to do so.

In addition to solid market data and trend analysis, this report is bringing elements of answer to a key question: is e-commerce giving over its laurel to omnichannel, or is staying on its own?

We are proud to have teamed up with the EWDN, EY and Radius teams, in particular, to deliver this research which will undoubtedly be useful to all in their work.

E-COMMERCE WAREHOUSING
& FULFILMENT IN RUSSIA

INTRODUCTION

THE RUSSIAN
E-COMMERCE
MARKET

INTERNET IN RUSSIA

Russia, which lagged far behind most other European countries in terms of Internet penetration in the recent past (with a 37% penetration rate in 2010), has been catching up rapidly over the past few years.

In late 2015, according to a GfK poll, Internet penetration exceeded 70%, with 84 million Russians aged 16 or more — up 4 million in one year — declaring that they use the Internet.

Much of the growth can be attributed to mobile connectivity. According to GfK, mobile Internet access in Russia more than doubled during the year. By the end of 2015, 37.5% of users 16 and older went online by way of their phone and 19.5% from tablets (up from 17.6% and 8.4%, respectively, in 2014). Thus approximately 50 million Russian users (42% of the adult population) accessed the Internet from mobile devices as of late 2015.¹

Russians in bigger cities and primarily Moscow are more practiced Internet users. The Internet penetration in Moscow exceeds the country average and has a significantly higher mobile and tablet uses than other areas.

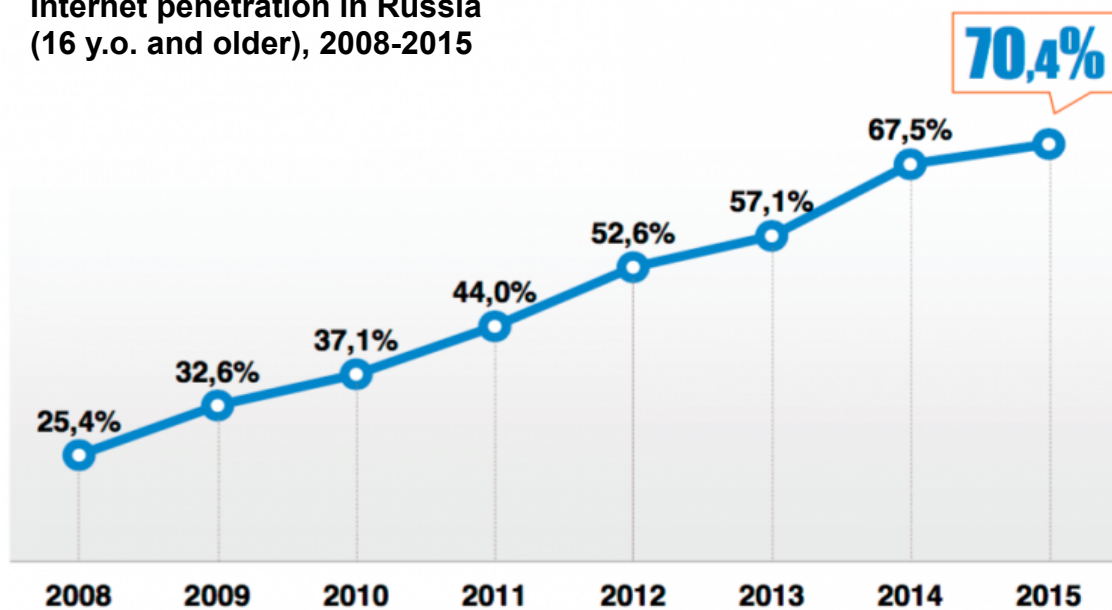
Russians from places with smaller populations are less practiced Internet users but the regions are slowly catching up with larger cities thanks in large part to mobile accessibility. Often the lower costs of mobile connectivity encourage Internet use.

Among the key factors explaining these regional contrasts are differences in the standard of living, purchasing power and development of broadband and wireless Internet access, as well as computer and Internet literacy.

In 2015 almost three quarters of all Russian Internet users lived in the European part of Russia.

1. <http://russiansearchmarketing.com/everything-mobile-devices-platforms-and-cost-of-connectivity-in-russia-2015/>

**Internet penetration in Russia
(16 y.o. and older), 2008-2015**



Source: GfK Omnibus survey 2015, all Russia, 16+

THE E-COMMERCE MARKET

With 195 million small packages and parcels sent to online consumers in 2016, up 20% from the previous year, Russia's domestic online retail market grew in real terms. It also grew in value reaching some 800 billion rubles (+23%), with an average order value exceeding 4,000 rubles, according to Data Insight.

Given the ruble's depreciation (from 31.5 rub. per dollar in 2013, to 62 rub. in 2015, to 67 rub. in 2016), the picture looks more modest in dollars: in 2016, market size was just \$12 billion for physical goods, up 14% from 2015. These numbers do not include cross-border orders, deliveries of ready meals as well as corporate, C2C, MLM and group purchases.

The fastest-growing categories were sporting goods and leisure items, pet goods, children's goods, clothing and footwear, as well as groceries. Meanwhile, electronic devices, home appliances, cosmetics and perfumes were less in demand than in 2014-2015.

Aggravating their chronic financial issues, the economic crisis led a range of players to suspend their activities. Among them were online auction and marketplace Molotok.ru, one of the country's most established e-commerce sites, and Mamagazin.ru, a kids goods online store launched in 2014 under a \$30 million investment plan.² Of the three entities of the IQ One holding – Utinet.ru, Sotmarket.ru and e96.ru – only the latter survived, following a failed merger attempt. The two former fell victim to internal weaknesses and the impact of the economic crisis. Wikimart, a marketplace launched in 2008 with massive support from western funds, was set to go bankrupt in early 2017.

In 2015 KupiVip, Russia's leading fashion flash sales site, analyzed the new online consumer behavior that emerged as the economic crisis unfolded. The vast majority (83%) of clothing and footwear buyers were looking primarily for discounted products, while Russian online consumers tended to be more restrictive than previously when spending on gifts.³

However, several major players continued to grow in 2015-2016. Ozon.ru, one of the most established Russian online retailers, saw its sales grow by 20% year-on-year in the first seven months of 2016. Its CEO expects a 30% growth in 2017.⁴

Lamoda.ru, a leading retailer of footwear and clothing launched by Rocket Internet in 2011, saw its net revenues grow to €125.6 million in the first half of 2016 — up 41.1% on a constant currency basis (or 15.4% in euros) from the same period in 2015.⁵ KupiVip, on its side, reported a 50% growth rate in 2015.⁶

Several offline retailers continued to develop online sales channels, as exemplified by H&M,⁷ Vans,⁸ L'Oréal⁹ and Furla,¹⁰ which launched online sales in 2015 and 2016, as well as Perekrestok (X5 Group), Magnit and Lenta, which were preparing their own e-commerce projects.

Meanwhile, demonstrating their faith in the future, several e-commerce and omnichannel players continued to invest in giant fulfillment centers.

2. <http://www.ewdn.com/2015/08/03/russian-e-commerce-in-crisis-molotok-ru-shuts-down-mamagazin-suspends-activities/>

3. <http://www.ewdn.com/2015/04/02/kupivip-survey-new-online-consumer-behavior-emerging-in-crisis-times/>

4. <http://www.ewdn.com/2016/09/01/ozon-not-profitable-yet-but-expects-fast-growth-and-still-considers-western-ipo/>

5. <http://www.ewdn.com/2016/09/20/lamoda-ru-increases-revenues-reduces-losses-in-h1-2016/>

6. <http://www.ewdn.com/2016/02/18/in-2015-kupivip-saw-its-sales-increase-by-50-and-became-a-fully-profitable-business/>

7. <http://www.ewdn.com/2015/09/28/hm-to-open-online-store-in-russia/>

8. <http://www.ewdn.com/2015/09/25/us-brand-vans-launches-online-retail-store-in-russia/>

9. <http://www.ewdn.com/2016/08/11/loreal-group-launches-mono-brand-e-commerce-sites-in-russia/>

10. <http://www.ewdn.com/2016/10/17/italian-luxury-brand-furla-launches-online-sales-in-russia/>

The domestic Russian e-commerce market in 2016

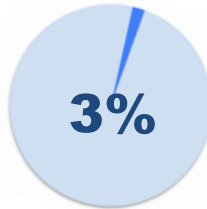
Total market size for physical goods:

800 bn rubles
(approx. \$12bn)

Domestic sales of physical goods, not including cross-border sales; food deliveries, C2C, MLM, tickets, coupons, etc.

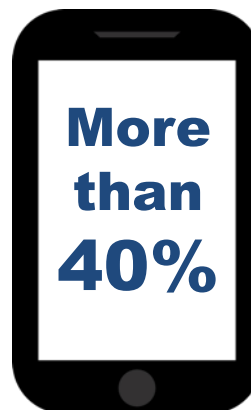
Up +23%
from 2015
(or +14% in USD)

or approximately



of the total Russian retail market (or 4% if including cross-border online sales)

More than 30 million online shoppers
generated an estimated **195 million orders**
(+20% from 2015)

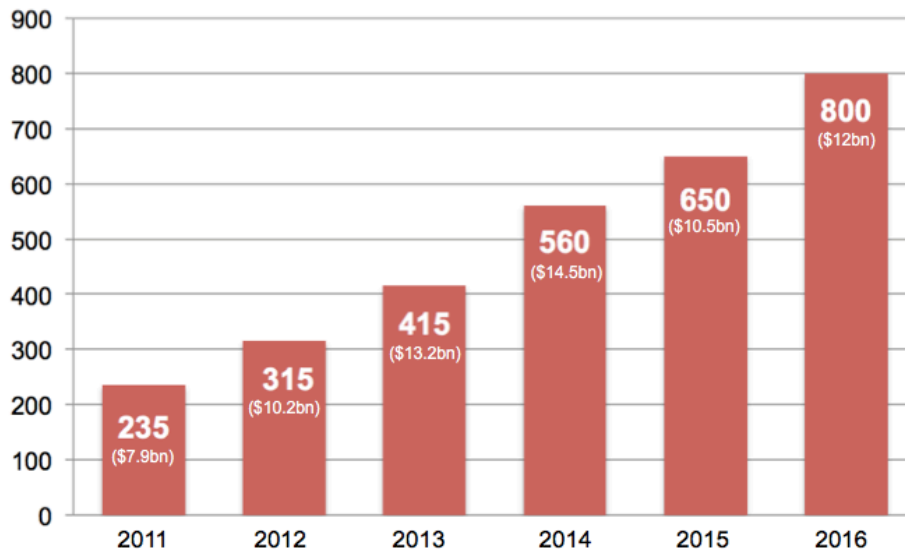


More than 40%
of orders were made via mobile devices

Average order value in 2015: Approx. 4,050 rub. (\$65)

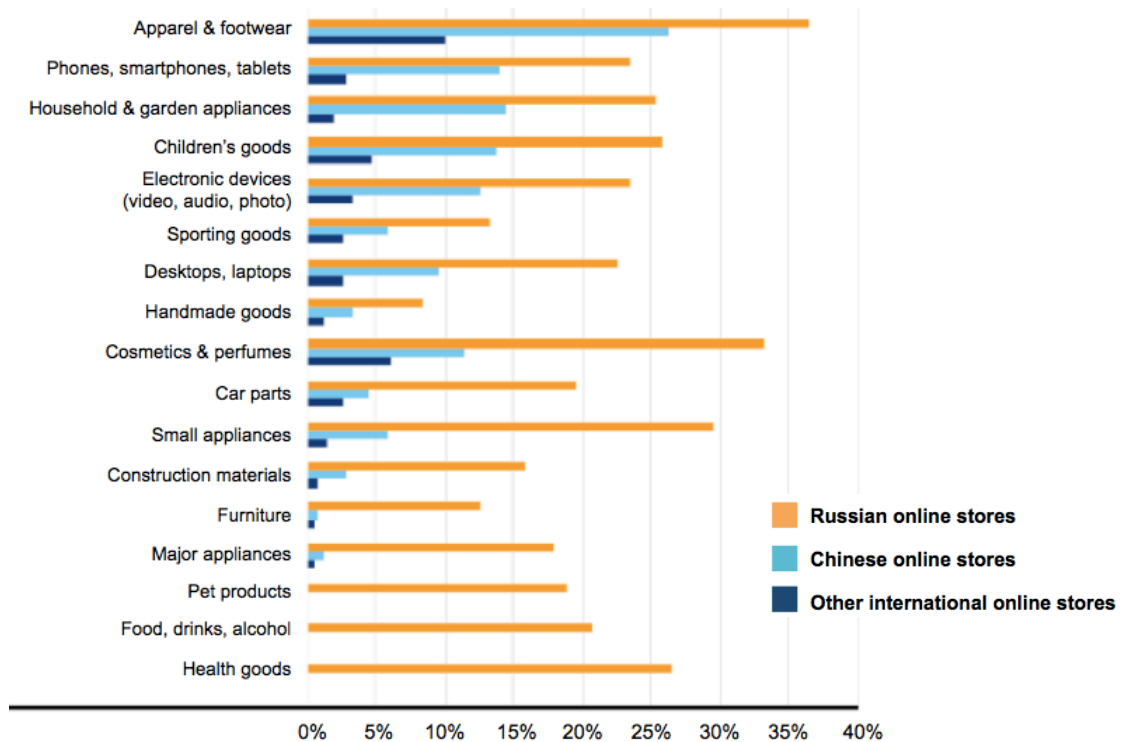
Source: Data Insight

Russia's domestic online retail market
Physical goods 2011-2016, in billion rubles



These numbers concern only physical goods. They do not include cross-border orders, deliveries of ready meals as well as corporate, C2C, MLM and group purchases – Source: Data Insight

Goods purchased from Russian and foreign online stores
Share in all online buyers in percentage in Sept. 2016



Survey by GfK – Yandex Market

On-demand research
Market entry consulting
Growth and optimizations



East-West **Digital News**

***An international expert team
for your success in Russia***

East-West Digital News is the first international market research and consulting company dedicated to Russian e-commerce and digital industries.

Get in touch with us at contact@ewdn.com

E-COMMERCE WAREHOUSING
& FULFILMENT IN RUSSIA

PART 1

WAREHOUSING

1.1. MARKET FIGURES AND TRENDS

In 2014 and 2015 the Russian economy faced a perfect storm of low oil prices and geopolitical turmoil. The result was a steep recession, with GDP falling by almost 5% and a severely devalued ruble pushing down consumption of imported goods and services by almost 30%.¹

The depth and severity of the crisis have hit companies hard, causing many international players to reevaluate their Russia strategy. Some have elected to slim down their retail networks and scale down their expansion plans or, like GM, to drastically reduce their presence in the country.

Other multinationals, however, see today's tough conditions as a strategic opportunity. After all, with the world's fifth largest economy by purchasing power parity,² and ranked ninth by population,³ Russia is still a hugely significant market in European and even global terms. Retail sales of \$640 billion in 2015 and 148 million potential consumers mean Russia is, in the words of consultancy AT Kearney, "too big and important for retailers to ignore."⁴

Thus since 2014, the real-estate infrastructure that companies need in order to serve Russian markets has become dramatically cheaper and more accessible. As speculative real-estate construction projects which were started before the crisis come on-line, they have struggled to find occupiers.

For the warehouse and logistics real-estate sector, vacancy rates in the Moscow region raised to 14% in Q3 2016 – above the level recorded in 2009. True vacancy rates could be even higher, if 'hidden vacancies' – unused properties still under lease – are included.

This is a dramatic shift in a region with a structural shortage of industrial space. In 2012 and 2013, vacancy rates in the area hovered below 2%, and developers could not build fast enough to meet demand. In early 2016 the vacancy level in the Moscow region was over 800,000 sq. m., the highest in the market history for the region.

As a result, overall USD-denominated rents have fallen by nearly 60% in Q3 2016 compared with the average level in 2011-2013, well below levels recorded during the 2008 financial crisis. In addition, the market has migrated from USD-denominated rents to ruble-denominated rents.

In extreme cases, "some B2B fulfilment service operators, hit by the crisis, offer their warehousing facilities for almost zero today on the market," notes Evgeny Schepelin, CEO at eSolutions, a subsidiary of the Otto Group.

Thus companies looking for manufacturing or distribution space can currently rent premises at rates lower than those necessary to stimulate the development sector to construct new facilities.

1. Source: OECD

2. Source: World Bank

3. Source: World Bank

4. Source: Global retail expansion, an unstoppable force. AT Kearney 2015

1.2. OPPORTUNITIES IN CRISIS TIMES

The current condition of real-estate markets creates significant opportunities for companies operating in Russia. That is especially true for companies looking to develop the sophisticated supply chain infrastructure that modern markets and efficient operations require. The nature of those opportunities depends on the organization's chosen response to the economic crisis.

▪ **Opportunity #1: Maintain functionality while reducing fixed costs**

Tough market conditions mean companies with existing facilities in Russia have been able to renegotiate leases on favorable terms, or to take advantage of additional capacity in the market – and commercial flexibility – to re-configure their operational footprints to better suit their current and anticipated future needs.

Since 2009, for example, US agricultural equipment maker John Deere has operated one of its four global strategic spare parts depots alongside a machinery manufacturing operation in a 76,500 sq. m. facility outside Moscow. In 2015, John Deere reconfigured its existing operations into a reduced footprint of ~ 50,000 sq. m., while simultaneously relocating its Russia HQ from central Moscow to the same facility. The change has allowed John Deere to maintain full functionality while enjoying increased operational efficiency at a dramatically reduced Russian real-estate cost.

As part of its Russia restructuring efforts, Adidas has purchased outright the distribution center in the South of Moscow that it had previously leased. Adidas was able to acquire the 120,000 sq. m. building at a relatively low price from a landlord in need of capital, a less costly option for the sportswear company than its previous US dollar denominated long-term lease contract.

▪ **Opportunity #2: Upgrade existing real-estate infrastructure at historically low rental values**

Companies are looking for operational efficiency improvements as well as cost reductions in order to maintain the profitability of their Russian operations. High quality, well designed and energy efficient warehouses and manufacturing facilities have an important role to play here, and some companies are taking advantage of lower real-estate costs to shift their activities to better premises.

Low rents, flexible lease arrangements and the availability of long-term leases denominated in rubles rather than dollars mean that such upgrades can often be made on more favorable terms than those in place for older, less appropriate facilities.

▪ **Opportunity #3: Expand functionality and improve operational efficiency at historically low investment costs**

Some companies, particularly ambitious retail players, are accelerating their investment and expansion plans, using the crisis to secure new property at costs that would have been unthinkable before the crisis.

In October 2016, illustrating these opportunities, Leroy Merlin opened a 100,000 sq. m. national distribution center South of Moscow near the Domodedovo Airport. It is the largest single user retail distribution center in the history of the Russian Federation at the time of investment (see below the interview with Eric Poulet, Director of Supply Chain at Leroy Merlin Vostok / Groupe ADEO).

PART 1: WAREHOUSING

French retailer Auchan invested €138 million in Russia during 2015, and the company has announced plans to invest a further €195 million (18 billion rubles) in 2016 to build 10 new hypermarkets and 40 new supermarkets in Russia, together with associated supply chain infrastructure. The company also has plans to develop a new 100,000 sq. m. distribution center, scheduled for opening in 2018 (see case study).

In November 2016, St. Petersburg-based Ulmart – Russia’s leading online retailer in 2015 – opened a fulfilment center on Piskarevsky prospekt. This 25,000 sq. m. facility could be brought to 60,000 sq. m. in the future; it will be used for the needs of Ulmart and other suppliers participating in its marketplace. This opening is part of a plan to launch 10 such centers until 2020. Each of these facilities requires an investment of 2.5-2.7 billion rubles (approximately \$40 million).

Another leading online retailer, Wildberries, has acquired a 25 ha territory in Podolsk in the Moscow region, planning to build there a 135,000 sq.m. fulfilment center. The company has not disclosed any information about the costs, but total project cost could amount to some 3.5 billion rubles (approximately \$55 million) – which is still cheaper than acquiring a ready-made fulfilment center, according to an industry expert cited business daily Kommersant in October 2016.⁵

Meanwhile, according to unconfirmed reports, IKEA is looking to set-up a dedicated e-commerce facility of some 30,000 sq. m. with possibility to expand to 70,000 sq. m. in the coming years.

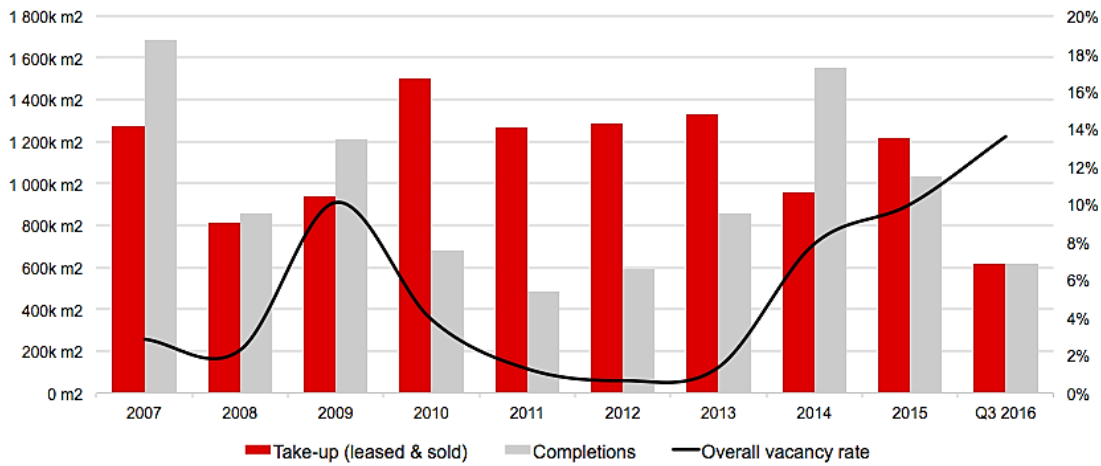
Such moves have been made easier by the low real-estate prices, even in and around Moscow, where price levels have become closer to those in farther areas.

“This is a sharp contrast with the previous situation. The real-estate rents were significantly higher 5-7 years ago, vacant warehouses with good transport availability were hard to find” says Dmitry Ovsyannikov, Director of Fulfilment Operations at SPSR Express.

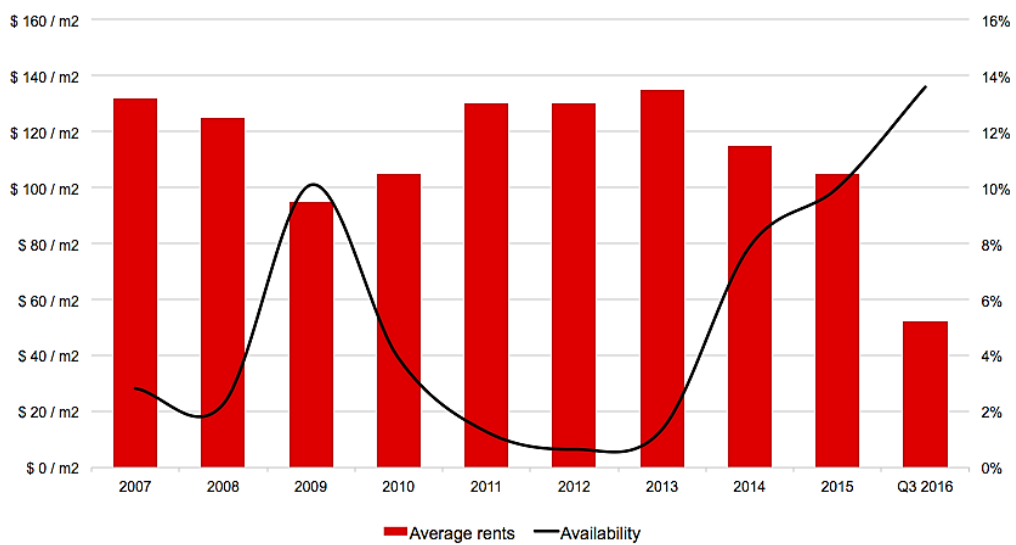
5. <http://kommersant.ru/doc/3127374>

Moscow real-estate market

Key market indicators for Class A warehouses



Rents and vacancy rates for Class A warehouses



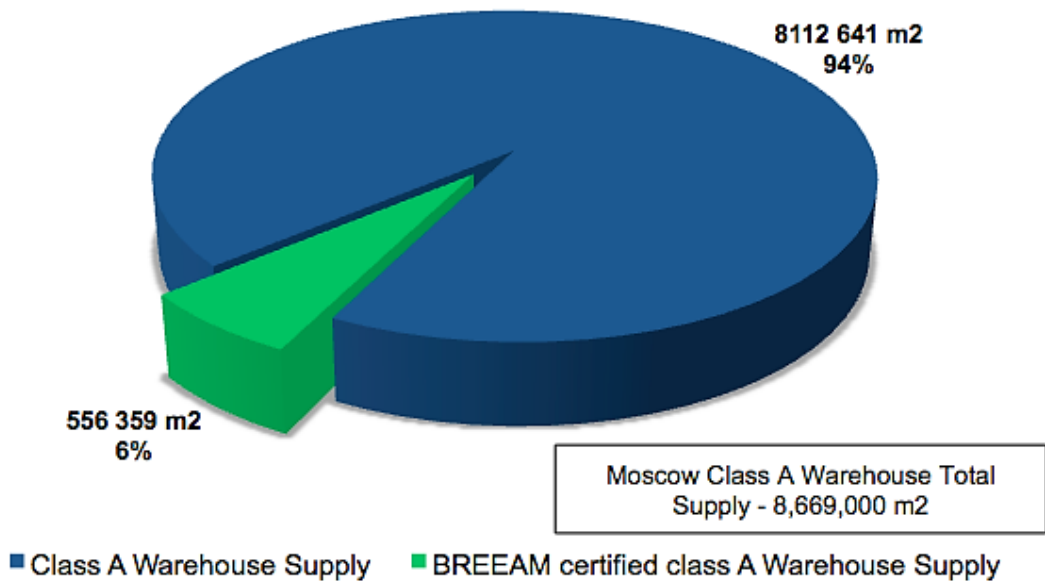
Comparative construction costs
Moscow, Russia vs. Seattle, USA in June 2016

PROPERTIES	MOSCOW, RUSSIA		SEATTLE, USA
	Rubles	USD @ 64 rub.	USD
Industrial			
Warehouse/factory units – basic	38 000p. / m ²	\$590 / m ²	\$953 / m ²
Large warehouse distribution centre	45 000p. / m ²	\$700 / m ²	\$1 289 / m ²
High-tech factory/laboratory	70 000p. / m ²	\$1 090 / m ²	\$4 500 / m ²

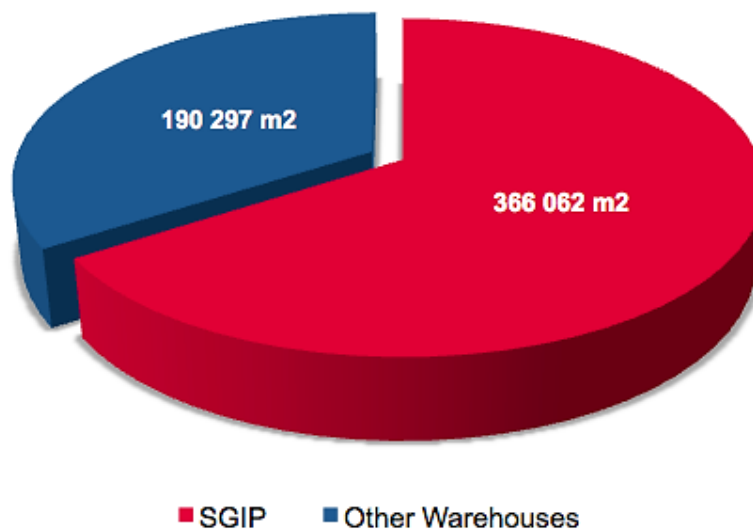
Source: JLL Research, based on data from Turner & Townsend with exchange rate corrected by EWDN

Warehouse supply in the Moscow region

Moscow region Class A warehouse stock in Q3 2016:
BREEAM-certified warehouse supply



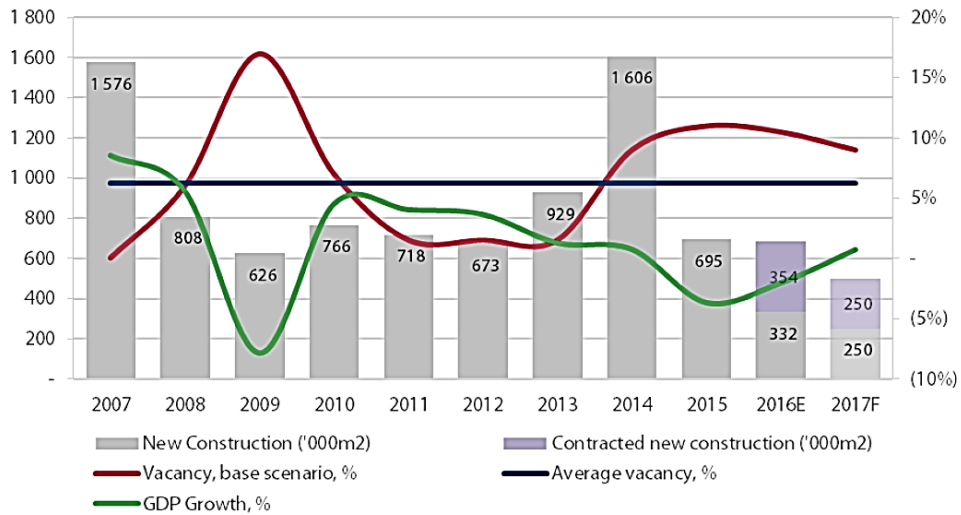
Moscow region Class A warehouse stock in Q3 2016:
South Gate Industrial Park supply



Source: Cushman & Wakefield, Green Book Live

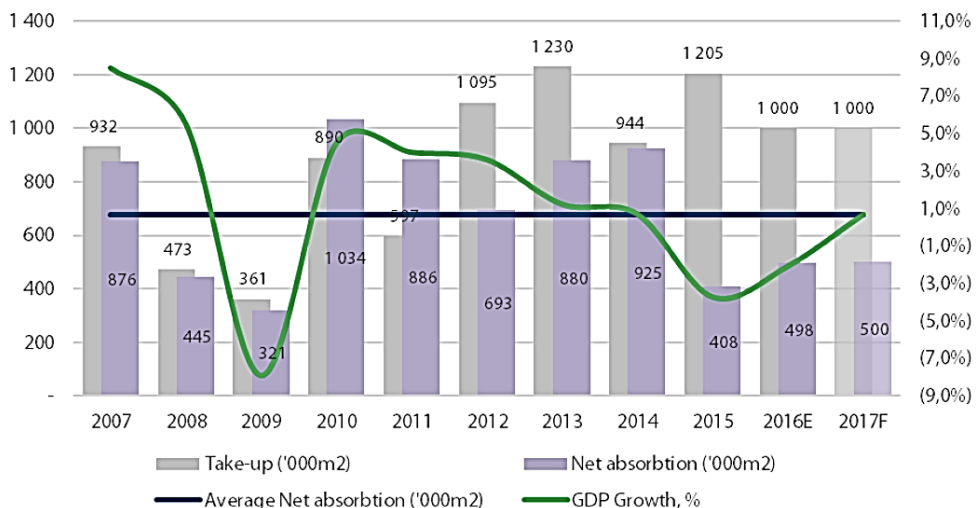
Moscow region industrial market balance

New construction (in thousand sq. m.) and vacancy rate (%)



New construction is drying up. Only 332,000 sq.m. available premises are expected to be delivered in 2016, which is historical low since 2005. Meanwhile, since 2014, vacancy rate has been several times higher than historical average.

Take-up and net absorption (in thousand sq. m.)



The seven-year average absorption allows to absorb the existing vacancy within 1.5 years. Annual take-up is expected at 1 million sq. m. Approximately half of it (500,000 sq. m.) will represent pure growth of the market; the rest will be driven by optimization of currently occupied space.

Source: CBRE Research, Oxford Economics

PART 1: WAREHOUSING



Maximizing return in any investment climate: Quality and compliance are key

By Radius Group

Whatever the business case for changes to their Russia supply chain footprint, some key considerations will help companies to achieve the best long-term value from the decisions they make today

▪ Existing buildings

Even around Moscow, Russia's industrial property markets remain relatively immature. Moreover, the high cost of capital puts pressure on the margins of property developers, leading many to emphasize low construction costs over the longevity, operating performance, or even legal and regulatory compliance of buildings.

As a result, international companies – especially those looking for class A accommodation built to international standards and owned by reliable landlords – can still find it difficult to access the property they need. Detailed due diligence is essential, therefore, and this should include not only the construction and condition of buildings, but also the quality and availability of utilities and the business practices of developers and landlords

▪ New construction

If an organization cannot meet its needs from existing stock yet has access to suitable capital, the crisis has also created extremely favorable conditions for new construction. The Ruble has lost more than half its value against the US dollar since 2013. At the same time, construction investment has slowed dramatically, creating capacity in the market. Moscow was identified as the world's sole "cold spot" for construction in 2015, according to analyst Turner and Townsend.

As the result of these two trends, land and construction costs have fallen significantly for international firms. At \$550 per sq. m. as of early 2016, average construction costs (excluding land, infrastructure and pre-development costs) for large distribution facilities in the Moscow area were around 40% cheaper than similar facilities in the USA, for example.

Over and above the 'normal' demands of delivering a large construction project within time, quality and budget constraints, developing property in Russia comes with its challenges, which should not be underestimated. Key considerations include securing utility capacities, development permissions and construction permits for connecting all necessary utilities to the land site; managing the cost and timing of establishing such utility connections, and ensuring reliable, cost-effective long-term utility supply.

In addition, it can be hard to ensure – and document – compliance with appropriate fire safety, security and environmental performance standards, especially when working with contractors unfamiliar with internationally accepted construction practices.

PART 1: WAREHOUSING



Should an e-commerce company build or buy its own warehouse, or rent it?

By Radius Group

▪ The economics of warehousing

To a large extent, the question depends on cost of capital. A warehouse and logistics building is a long-life, low-return asset. If an e-commerce company has a low cost of capital, then they should own it. If it has a high cost of capital, then it may make sense to lease the building.

Comparatively, Russia is a high cost of capital environment. The central bank's key lending rate is 10% for rubles, while the European central bank offers 0% for euros, and the US federal funds rate is between 0.25% and 0.5% for US dollars.

Thus large multi-nationals operating in Russia typically have a low cost of capital available to them within their global operations when compared to companies operating only in Russia such as real-estate developers. As a consequence, for a multinational that is dedicated long-term to Russia, it may make sense to own "core" real-estate. It is for this reason that Leroy Merlin and Auchan have adopted ownership approaches for their "core" logistics platforms located south of Moscow city at South Gate.

Also, once an e-commerce operation is up and running, it is difficult and expensive to move, in addition to carrying risks of disrupting the business of getting orders to customers.

If an e-commerce company chooses to lease its building, then the company needs to make sure it has a great landlord.

Scalability is also necessary to take into consideration. In the case of NEXT at South Gate (see case study), they took a bigger building than they needed for the first few years to grow. The winning strategy is to build the building where the e-commerce company wants to be over long term. Being cheap in the beginning becomes much more costly as the business scales in terms of customer service or operating cost.

▪ Pick the right partner

For companies looking for build-to-suit accommodation, a growing understanding of the requirements of international customers has produced a new breed of property developer able to deliver high-quality properties. Demand for such properties has also been driven by investors, who understand that a longer lasting, higher value asset is a safer investment warranting a lower return on capital. For tenants, that means lower rents, lower cost of operations, lower energy consumption and lower maintenance costs while enjoying greater operating efficiencies that high quality facilities allow.

Technology has helped too. Advances in computer-aided design and project management tools have transformed the transparency and efficiency of the construction processes, allowing designs to be optimized, problems to be identified early and progress against plan to be monitored in real time, greatly reducing construction risk.



Choosing the right location

By Radius Group

What e-commerce requires of real-estate are essentially two things: a location close to centers of consumptions; and high-quality buildings allowing for quality operations over the long term.

Once an e-commerce fulfilment center is established, it is expensive, risky and difficult to move. Fulfilment centers are large-volume facilities combining substantial information technology, internal infrastructure (conveyors, picking mezzanines), and other functions such as call centers. What's more, moving an e-commerce facility may lead to a serious disruption in customer service.

Thus NEXT understood the importance of “getting it right the first time,” choosing South Gate due to its location on the outskirts of Moscow as well as its high-quality design and construction.

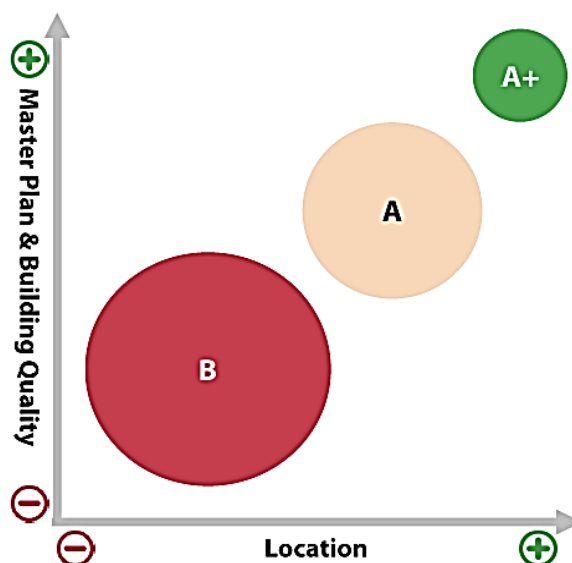
By locating its facility in another location, a major footwear online retailer made an arguably less optimal choice. While also close to the city of Moscow, this location's infrastructure leaves much to be desired – the poor internal road design generates poor traffic flows, and the building quality is not Class A. Meanwhile, moving to a new location would entail excessive costs and be potentially disruptive to the business.

Warehouse Class:

- Class A+ (Premium)
- Class A
- Class B

Attributes:

- **Location**
 - Front Line Major Highway
 - Distance to Moscow
 - Proximity to Airport
- **Master Plan & Building Quality**
 - Density (Roads & Maneuvering)
 - Onsite Infrastructure
 - Technical Specification



PART 1: WAREHOUSING

INTERVIEW



Eric Poulet, Director of Supply Chain at Leroy Merlin Vostok: "Our new 100,000 sq. m. warehouse is still insufficient"

– Let's begin with bit of history – when did you start operations in Russia?

Offline sales began in 2004, first in Moscow and then in Rostov, Krasnodar, St. Petersburg, Samara and Novosibirsk. We plan to open even more outlets in 2017: in Irkutsk [Siberia], Khabarovsk [in the Russian Far East], and Kaliningrad [on the Baltic sea]. We also plan to launch operations in Kazakhstan and Belarus in the future.

We began online sales in Russia only in 2014. Initially, these e-commerce operations were based on a rather basic dark store¹, which now has more advanced functions. Initially, we only made a very limited assortment available online – hard construction materials, essentially. Now we have an online assortment of 15,000 SKUs, which is still less than in our offline outlets. Deliveries are available only around Moscow, Rostov, and St. Petersburg. These deliveries involve our logistic center in the Moscow region, while in St. Petersburg and in Rostov our retail outlets are used as pick-up centers.

– How important a market is Russia for your group?

In 2016, our local operations generated 230 billion rubles [approximately €3.1 billion at the average exchange rate], up from 177 billion rubles in 2015 [€2.6 billion]. This makes Russia our group's second largest market after France – out of 32 business units.² On average, each outlet in Russia generates twice as much sales revenues as one in France. The volumes are huge – more than 1 billion pieces sold in 2016 – with a relatively low average value per article.

The crisis hasn't changed much: our Russian business is still growing, though at a slower pace, while some of our competitors have seen their sales decrease in absolute terms. Unlike our competitors, we are still investing strongly in Russia – more than 30 billion rubles each year [€440 million], to build 20 new stores every year and develop logistic and support capacities.

We expect Russian sales to continue generating double-digit sales growth in the next five to ten years. And I would not be surprised if, at a certain point, Russia became the group's largest market – surpassing even France.

– Did the economic crisis have any impact on your operations in the country?

The crisis did have an impact on the retail industry, with some positive changes and some new challenges. Due to the crisis, the cost of money has increased considerably in Russia, making it more difficult to purchase a flat, a car, or a new kitchen. Many consumers are looking for cheaper products to protect their purchasing power. They tend to postpone big spending decisions.

On the other hand, our customers understand that Leroy Merlin provides the best offerings at the best prices on the market today. This crisis has also led us to develop even stronger partnerships with our local suppliers, contributing to the development of the country.

1. Distribution center that caters exclusively for online shopping

2. With its 15 retail chains, including Leroy Merlin, the ADEO group generated €17.9 billion in turnover, including tax, in 2015.

E-COMMERCE WAREHOUSING & FULFILMENT IN RUSSIA

PART 1: WAREHOUSING

– What have been the challenges of switching from an essentially offline business to an omnichannel strategy?

One of the biggest challenges has been the information system. We don't have a cross-channel system yet. The information flows related to each channel do not cross each other, while we need to have the same value, what ever channel is involved, system-wide.

Our IT systems are evolving. We aim to have the same stock in physical terms and in online catalogs.

The second challenge is to continue developing the omnichannel “store of tomorrow.” This implies the creation or improvement of new processes at a larger scale and lower cost in the fields of packaging, reverse logistics, stock management, etc. In an offline-only retail business, accurate stock management systems are necessary, but not an absolute requirement (you just face lower turnover if your don't have such a system). When you add the online dimension, however, these systems are indispensable. You just can't run the business without them.

The third challenge is to improve our delivery capacities at the lowest cost, taking into account speed requirements and environmental factors. (This applies both to orders made in shops and online orders, with the latter – for now – accounting for just a tiny but growing fraction.) This is a huge challenge due to the very big distances in this country as well as the traffic congestion in big cities like Moscow and St. Petersburg.

Thus we are in the process of reducing the carbon impact of our delivery operations. We have managed to fill our trucks by 30% more than a few years ago – which means huge savings and a significant reduction of carbon emissions. We are also developing deliveries by train. Our target this year is to reach a level of 50% of deliveries via train in relevant areas.



Leroy Merlin's new facility in South Gate on the outskirts of Moscow (photo credit: Leroy Merlin)

PART 1: WAREHOUSING

– To address these challenges, can you capitalize on the experience of your group across different countries?

Each country is run by autonomous units. But now we understand that we have a lot of good practices to share and develop together, and that our IT systems should be more integrated across the group.

– Please tell us about your warehousing facilities in Russia.

Currently we have four warehouses: two in the Moscow region, including a 45,000 sq.m. facility in Dmitrov and the brand-new 100,000 sq.m complex in South Gate; one in Samara (20,000 sq. m.); and one in Novosibirsk (20,000 sq. m.). We're planning to open additional facilities in Rostov, Vladivostok and St Petersburg.

South Gate, which we launched in October 2016,³ is unique, not just because of its exceptional size. In the area of security, it is the most modern warehouse in the group. Its norms far exceed Russian regulatory requirements. Our insurer demands that the norms be at the highest level of the French and Russian regulations, combined.

South Gate is also the only one of our Russian warehousing facilities that manages online orders. In the regions, our e-commerce fulfilment operations are supported at the outlet level.

– Why such gigantic facilities?

On average, each of our outlets in Russia has 20 million quantities on sale. This means more than 1 billion quantities in 50 outlets. In 2021, there will be 140 outlets with 3 billion quantities to manage.

Today, 60% of these quantities go through our warehouses (the remaining 40% are direct supplies to the outlets). Do the math: our warehouses have to manage 600 million quantities – which is 50% more than our business in France. In 2021, the percentage handled by our warehouses will reach 75%.

Given these circumstances, our warehousing facilities, which were designed to supply 75 stores, are far from oversized. In fact, they are too small when considering our future needs, which is why we are still investing in additional warehouses.

– How much did the South Gate facility cost your group?

About 5 billion rubles [approximately €73 million in 2015], including all equipment, IT systems, and security.

– Do you own all your warehouses in Russia?

In Moscow, yes. Like our stores, we are investing for the long term with a clear focus on the business. We have already started our second project: similar to our South Gate warehouse, this new facility will be located in the north of Moscow. It will replace our Dmitrov warehouse – which we currently rent – in 2019.

All our IT logistics systems (WMS-YMS-SWP-TMS) are deployed in SaaS mode using Generix solutions. The warehouse teams are outsourced everywhere excepted in Samara, where we are conducting an in-housing experiment. Trucks and deliveries are outsourced.

3. http://www.radiusrussia.com/sites/default/files/press_release_leroy_merlin_eng_final_v4_2.pdf

PART 1: WAREHOUSING

CASE STUDY



Auchan builds high-tech logistics center in Moscow region

In October 2016, Auchan Retail Russia announced an agreement to build a major new warehousing and logistics centre in the Domodedovo district of Moscow region. The facility will have a total area of more than 138,000 sq m, making it the biggest single-user building in Europe.

The developer for the project is Radius Group, a major developer of class-A warehouse and industrial real estate in Russia. Auchan will invest about 6 billion rubles (approximately \$95 million) in the project, which will create more than 750 new jobs.

The new center will be constructed in a highly energy-efficient and environment-friendly building, using advanced technologies. It will have a planned capacity to handle loading and unloading of more than 230 trailers simultaneously, and will service more than 50 Auchan stores in the Russian capital and around. The center will be located on a dedicated land plot at South Gate, an industrial park of 144-ha developed by Radius Group, which offers developed infrastructure and excellent transport accessibility. The area is already a home to distribution centres of major retailers including Leroy Merlin and Decathlon.

“During the first stage we plan to build infrastructure for a warehousing center that will allow us to expand it in the future,” said Oleg Alkhamov, CEO for hypermarkets at Auchan Retail Russia. “This is a major investment project that we intend to implement in Moscow region. Russia has always had, and continues to have, enormous potential for our future growth, and logistics is a key element in successful retailing.”

“This agreement once again illustrates that major retailers are continuing to invest in logistics as a key competitive advantage despite challenging economic circumstances and the market situation in Russia,” noted David Simons, Managing Director at Radius Group.

The project will be developed and constructed with the use of Radius InSite’s suite of 3D and other digital management tools, providing “unparalleled control and transparency over the design process and control on budget and schedule.”

PART 1: WAREHOUSING



South Gate Industrial Park

Built on the outskirts of Moscow, South Gate Industrial Park is a multiphase warehouse and logistic complex. The complex includes the leading Class A+ warehouse serving Moscow and its suburban areas, which account for 85% of the economically vital regions throughout Russia.

The facility was developed by Radius Group with the aim to create state-of-the-art commercial real estate to meet the needs of international clients.

K E Y F I G U R E S	
<ul style="list-style-type: none"> Over 147 ha land area Over 650,000 sq. m. capacity Over 475,000 sq. m. (73%) constructed* 	<ul style="list-style-type: none"> About 175,000 m² (27%) available capacity* Over \$500 million investment <p>* As of late 2016</p>

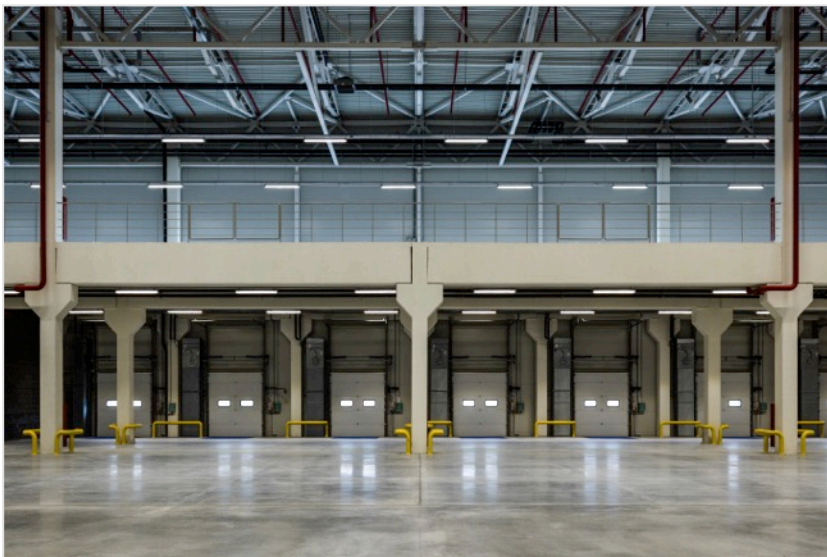


E-COMMERCE WAREHOUSING & FULFILMENT IN RUSSIA

PART 1: WAREHOUSING



Build-to-suit loading Docs configurable for large trucks and small delivery vans to meet any logistics requirement and lower operational costs. (Photo credit: Radius Group)



Mezzanines are configurable to meet e-commerce office requirements, and advanced, energy-efficient LED lighting systems enhance productivity and lower operating costs. (Photo credit: Radius Group)



High performance Permaban flooring provides superior stability for tall inventory racking, enabling custom inventory layouts and improving inventory turnover. (Photo credit: Radius Group)

E-COMMERCE WAREHOUSING & FULFILMENT IN RUSSIA

PART 1: WAREHOUSING

Fire safety and suppression meet or exceed Russian and international standards – and South Gate has 3x redundant water pumping system. (Photo credit: Radius Group)

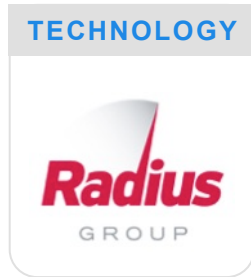


State of the art energy-efficient heating and cooling systems, and use of natural lighting, lower operating costs and enhance productivity. (Photo credit: Radius Group)



Location at the crossroads of two federal highways dramatically lowers transport time to the Moscow market – lowering transport costs and enabling same-day delivery services. (Photo credit: Radius Group)





Radius InSite: Integrated data modeling from the design phase to the construction phase

According to the company, Radius InSite is the only 5D Digital Management Platform for real estate development in Russia generating usable insights at each step of the design and construction process, addressing inherent real estate development problems due to lack of data. Through integrated data modeling from the design phase to the construction phase, Radius InSite delivers real-time project knowledge that helps customers maximize the design opportunity and minimize construction risks, improving the building outcome.

The design phase is about 10% of project cost but offers 90% of project optionality, yet traditional design methods provide insufficient tools for collaborating and overseeing the various design trades. Radius InSite models customers' future building using a proprietary 4D Design Model (spatial dimension + cost) in bi-weekly collaboration with the architect and other design trades such as civil and mechanical engineers.

Over the course of a year, for example, Radius InSite can iterate a building design up to 26 times versus just four times in a traditional design process, according to the company. "Moreover, input from the construction team are sought early and often so that design decisions can be made with realistic cost data and input from our construction experts," Radius Group says.

Radius InSite also empowers customers to significantly improve tolerance of the design documentation and solve, at the beginning of the design phase, many of the issues which are typically only discovered later in construction because of the trouble and impact they have already caused. At last, the final design documentation for the building is generated from the same 4D Design Model.

Prior to the construction phase, Radius InSite integrates the construction schedule with the 4D Design Model and final documentation into its proprietary 5D Construction Model (spatial dimensions + cost + time), also known as 5D BIM. Radius InSite then coordinates and supervises construction with the general contractor and subcontractors using the 5D Construction Model.

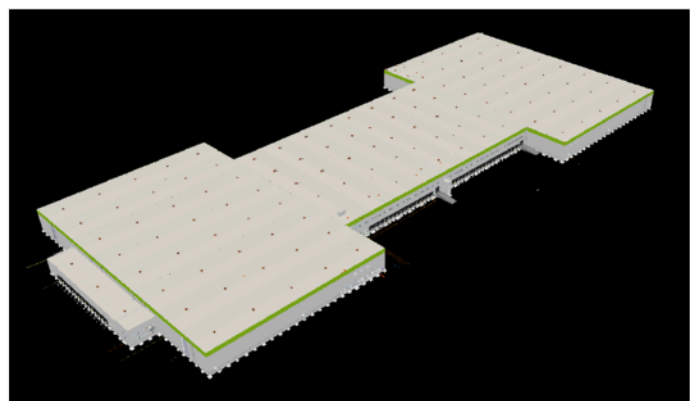
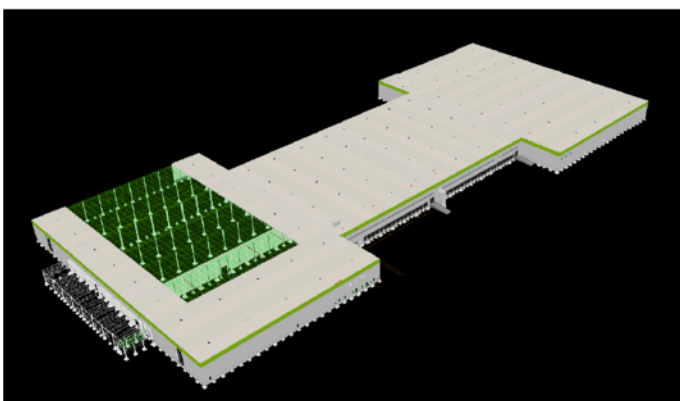
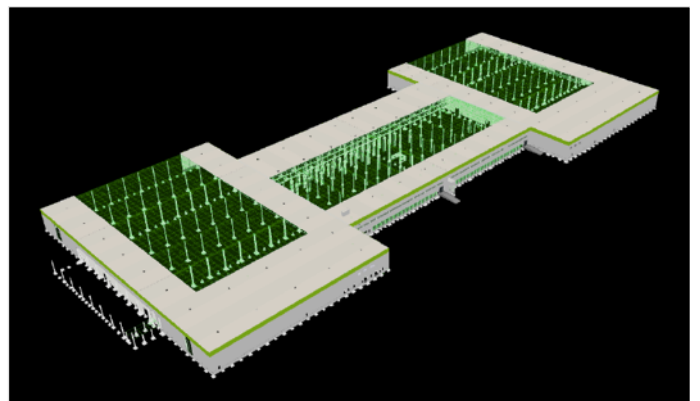
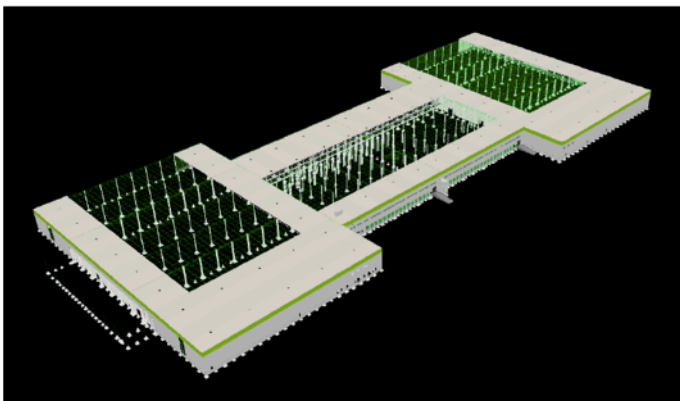
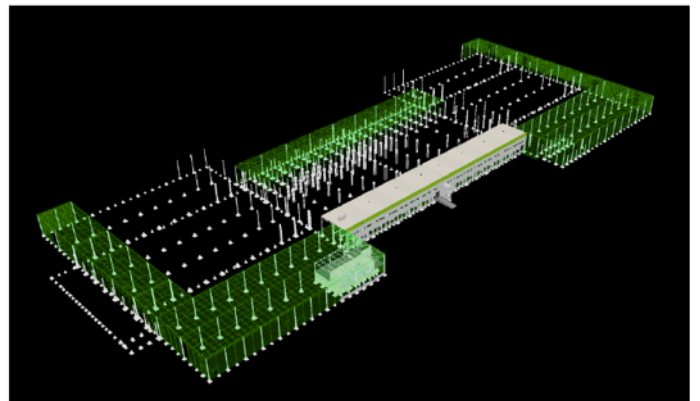
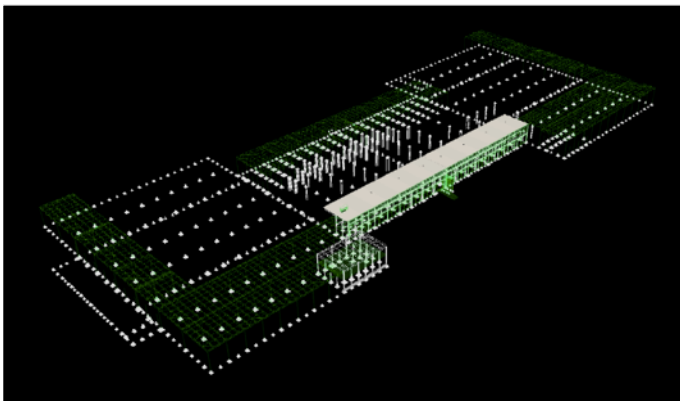
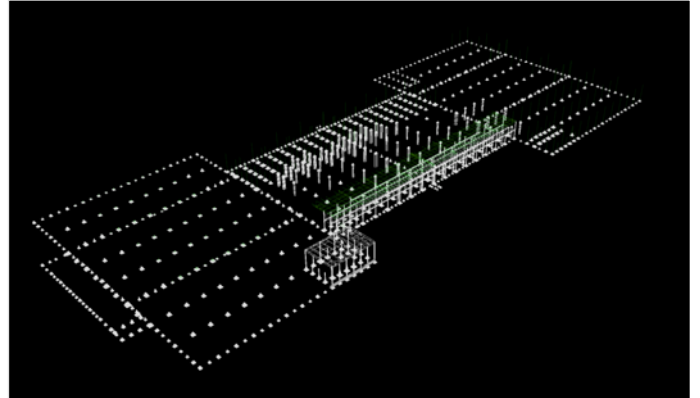
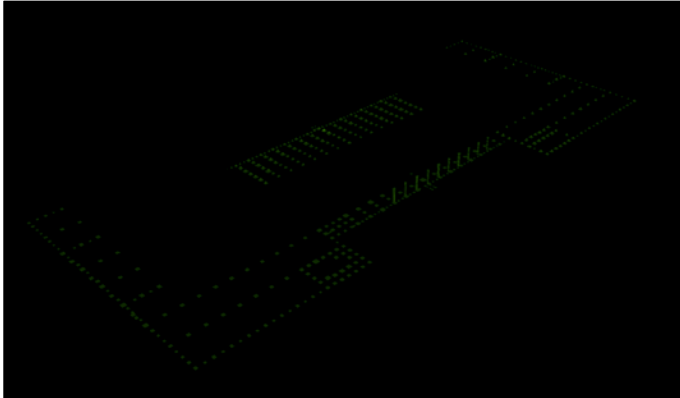
Finally, during the construction phase, Radius InSite continuously updates the 5D Construction Model with actual work on the construction site, enabling the customer to track actual project progress in terms of quantities, cost and schedule in 3D visualizations to a high degree of detail.

Radius InSite empowers the customer and their project team to gain unprecedented insight into project activities and make better decisions. For example, the Radius InSite team can project future project performance months in advance given present activity levels, thereby allowing corrective measures to be taken proactively before any negative impact on project outcomes.

Radius claims that its solution offers "an unprecedented level of control over project outcomes compared to the traditional methods," allowing to avoiding expensive mistakes.

"Instead of the project management team reacting to project issues long after the impact was made, thus throwing the project into costly changes and delays, Radius InSite will empower Auchan and the project team to be proactive, gain insights and take action to avoid negative project outcomes."

Radius InSite 5D Digital Management Platform



PART 1: WAREHOUSING

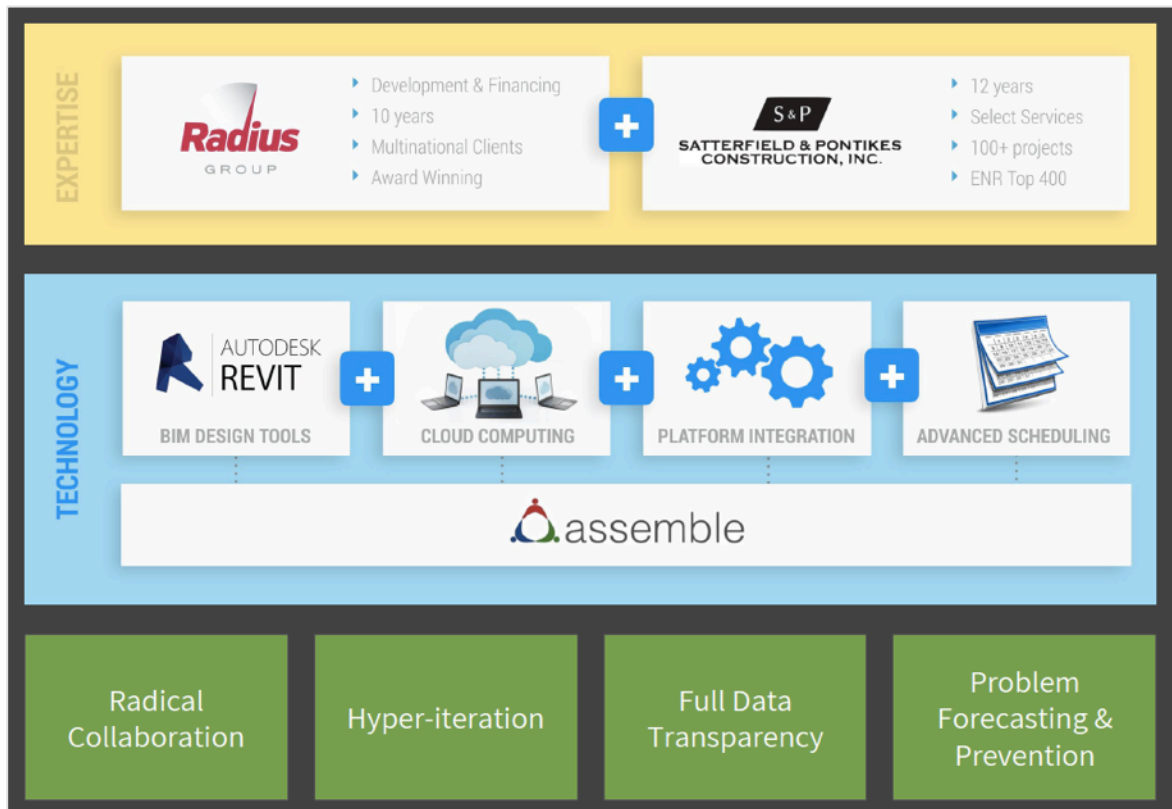
K E Y T E C H F E A T U R E S

Design phase:

- Automated coordination of design disciplines in a proprietary 4D Design Model (spatial dimension + cost)
- Precise numerical tracking of design development progress
- Real-time tracking of compliance of the design with estimated construction budget, and visual design difference analysis integrated with the budget difference comparison
- Data rich and visual analysis of budget sensitivity

Construction phase:

- Advanced project schedule optimization & tracking in a proprietary 5D Construction Model (spatial dimension + cost + timing)
- Visual simulation of the construction schedule
- Detailed schedule updating and auditing based on actual construction progress
- Tracking and projecting construction progress, with visual 3D representation of progress data, to identify schedule problems & delays before they occur.



E-COMMERCE WAREHOUSING
& FULFILMENT IN RUSSIA

PART 2

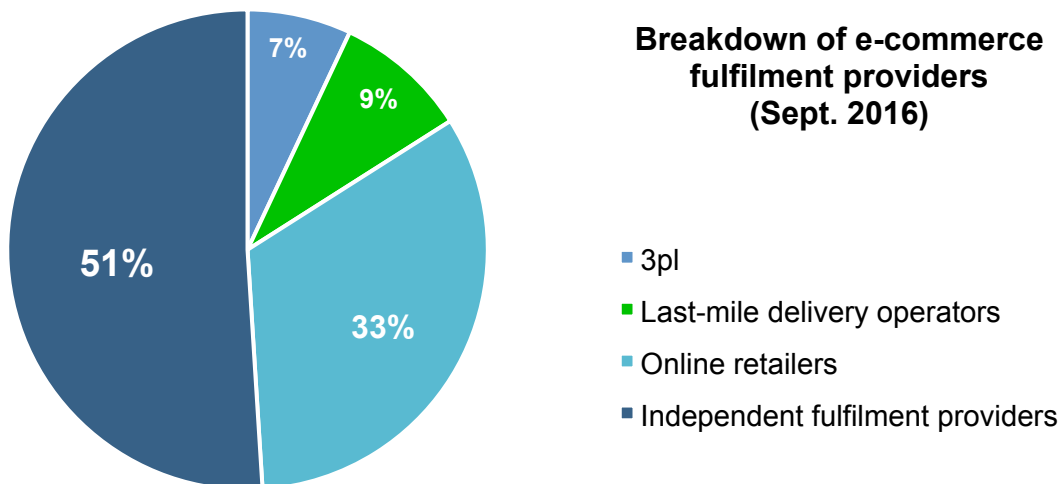
**FULFILMENT
SERVICES**

2.1. KEY MARKET FIGURES

Between 40 and 100 companies currently provide outsourcing fulfilment services as third-party operators in Russia, according to different market studies.¹ Arvato's survey in late 2015 and late 2016 (see Part 3) found that around half of these operators are independent companies whose core business is fulfilment, while others have grown from classic logistics service providers (3PL – 7%), last-mile delivery (9%) and distance selling companies (33%). These players consider fulfilment services as an attractive new business development direction to balance seasonal flows and benefit from the opportunities of Russia's fast-growing e-commerce market.

The fulfilment services market is far from maturity, with demand from e-commerce players still exceeding the capacity of fulfilment services providers to supply. This is illustrated by the fact that the number of e-commerce companies considering outsourcing these operations is growing (see Part 4), even though providers' capacities are limited.

The number of fulfilment providers is growing, but large e-commerce companies tend to outsource their operations to just a dozen of them, according to Arvato's survey. The reason lies in the considerable differences between providers, be it in their service offerings, IT support, warehouse infrastructure, pricing models, or corporate culture. Leading service providers tend to focus on regional logistics hubs and IT solutions development. On their side, the smaller fulfilment service providers may face challenges in efficiently organizing the supply chain, including internal warehousing operations.



Source: Arvato Russia survey, Sept.-Nov. 2015 and Sept.-Nov. 2016

Market volume estimates

Russian fulfilment service providers process, presumably, 30-50 million parcels and packages each year. No precise market size data is available, due to the fact that most players do not disclose their numbers.

1. Sources: researches by Arvato (<https://www.arvato.com/ru-ru/industries/outsourcing-fulfillment-russia.html>) and Data Insight (<http://logistics.datainsight.ru/fulfillment2016>)

2.2. CURRENT MARKET TRENDS

2.2.1. ON THE SUPPLY SIDE

▪ **A more competitive but still concentrated market**

Just a few years ago, the Russian market for fulfilment services for e-commerce was very small. Independent companies were few and quite small, and many big e-commerce players did not need to outsource their processes.

But around 2013, some of these players – including KupiVip, Ozon and the Otto Group – began sharing their fulfilment systems and other service capacities which they had initially built for themselves.¹

Today, medium-sized and large logistics service providers are expanding as a growing number of online stores and distance selling companies are moving to outsourcing – not only for delivery operations, but also for fulfillment. Simultaneously, many small service providers are leaving the market.

Meanwhile, as their traditional activity was affected by the economic crisis, some B2B fulfilment service providers have begun to offer B2C e-commerce fulfilment services, hoping to find more clients and better margins in this segment.²

In the short term, these players rarely reach sufficient B2C volumes to achieve a good synergetic effect, believes Evgeny Schepelin of eSolutions. "However, these B2B players may benefit from master contracts with specific brands. From these brands' point of view, dealing with a unique (B2C+B2B) provider may be more convenient. From a long-term perspective, these providers could gain significant part of the B2C fulfilment market," Schepelin concedes.

For their part, B2C fulfilment services providers are also trying to expand their service range to B2B operations – as witnessed by recent or expected moves from Arvato, SPSR Express, KupiVip, and eSolutions.

"These fulfilment services providers will have their chances in this competition, too, because it is arguably easier for B2C players to expand to B2B than the other way around," says Schepelin.

▪ **Towards full-cycle offers**

The distinction between fulfilment, transportation, and delivery services is becoming more blurry with the development of full-cycle offers.

"The current economic situation and industry trends will drive fulfilment providers to develop an end-to-end offer, starting from freight assembling to last-mile delivery, with an IT platform covering the supply chain and regional warehouse developments," confirms Dmitry Ovsyannikov of SPSR Express.

1. <http://www.ewdn.com/?p=17680>

2. This migration is not always easy. "E-commerce fulfilment operations require complex and tailor-made solutions for very different business models and product and consumer groups – including integration of CRM, reverse logistics, tracking systems, last mile management and much more. High flexibility and specific competencies, and – last but not least – a very sophisticated information system are needed here," says Arvato Russia General Manager Michael Poetschke.

PART 2: FULFILMENT SERVICES

▪ Quantitative and qualitative issues still remain

In spite of a growing number of providers and undeniable progress in service quality, the market for warehousing and fulfilment is far from mature, from quantitative and qualitative standpoints.

Fulfilment capacities are still not sufficiently available. "In our country there are just a few fulfilment providers with a sufficient capacity to address the warehousing needs of companies with a wide product range," notes Alexander Ivanov, President of the National Association of Distance Selling (NAMO).

Moreover, some basic fulfilment functions – such as returns processing – are not even available everywhere.

Service quality leaves to much be desired with a number of providers. This is especially true across Russia's regions, where the service quality offered by new providers rarely meets the required standards, as noted by Data Insight.

"In a sector that chronically lacks qualified human resources, some new service providers have come to the market without sufficient capacities or competencies. Some of them come from the offline retail world, or are entrepreneurs with few qualifications trying to improvise an e-commerce offer – which doesn't work. There are cases of failures of e-commerce projects due to such low-quality service providers," notes Alexey Zhukov, founder of Pulse Express.

At the upper end of the supply chain, insufficient standardization does not help. "Usually there is no general standard for the supply of goods; various suppliers approach it differently, often without even using barcodes to speed processing. The quality of carton packaging, individual packaging and so on also leaves something to be desired. Therefore many processes in the logistics chain and fulfilment require a lot of manual work," explains Michael Poetschke of Arvato Russia.



Many processes in the logistic chain and fulfilment require a lot of manual work – Fulfilment operations at Arvato (photo credit: Arvato Russia)

2.2.2. ON THE DEMAND SIDE

- **Ever-growing demand**

In spite of the difficulties faced by some e-commerce players in these crisis times, the demand for fulfilment services in Russia continues growing.

As venture capital investments are scarce and loans are getting expensive, the current economic situation requires e-commerce companies to outsource warehousing and fulfilment operations.

"Most players lack the means to build new facilities of their own, and those who do have some financial means are questioning the profitability of their in-house strategy," notes Zhukov.

Consequently, more and more companies are tending to focus on their core business, showing a readiness to outsource, in particular, their warehousing, fulfilment and delivery services.⁴

A considerable potential, however, still lies ahead.

"A myriad of small and mid-sized e-commerce companies – in Russia as in other countries – don't even know or understand what outsourcing fulfilment services is all about," says Zhukov.

According to Arvato's survey in 2015 and 2016 (see Part 3), one third of e-commerce companies with an in-house strategy are considering outsourcing fulfilment operations. And the proportion of companies actually outsourcing their operations increased by 3-5 percentage points in one year.

A growing number of e-commerce companies outsource their fulfilment operations to several distinct service providers in a bid to diversify their risks and optimize their costs.

- **Focus on small and mid-sized e-commerce companies**

While the demand for e-commerce fulfilment services from large domestic retailers is limited, some international FMCG retailers eyeing the Russian e-commerce market have postponed their market entry plans due to the economic environment. In such circumstances, service providers are showing more interest in small and medium-sized e-commerce projects, which implies some operational adjustments and the development of dedicated solutions for this segment.

"The e-commerce market directly depends on the general macroeconomic context and the population's purchasing power. When the latter decreases, the number of orders and the average order value also decrease. In these circumstances, fulfilment providers tend to focus on the small to medium-sized e-commerce segment. They may adapt their operations and IT processes, implementing SaaS / PaaS solutions to make implementation of new projects easier and more accessible," confirms Nataliya Przystaw, Commercial Director at Arvato Russia.

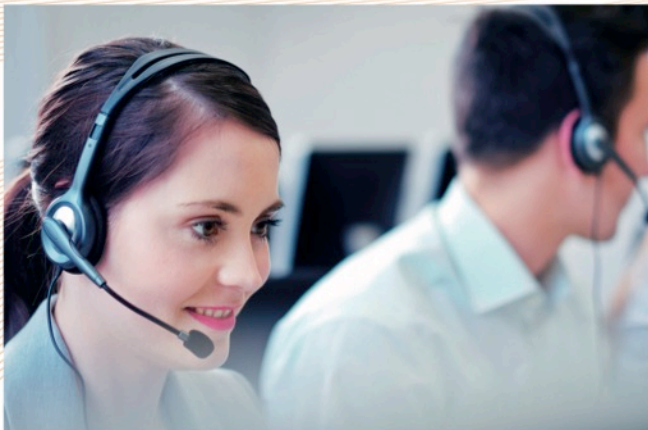
While dealing with small and mid-sized players, fulfilment providers often use the cross-docking model, and pick-and-pack orders without a dedicated storage area.

However, working with small e-commerce companies also means significantly higher costs and lower profits for fulfilment service providers.

4. In this context, pricing with transparent costs are in particular demand. Such pricing allows customers to get exact understanding of costs per order, which is very important for budgeting and setting selling prices," notes Dmitry Ovsyannikov of SPSR Express.

WE MEASURE OUR SUCCESS THROUGH
SUCCESS OF OUR CLIENTS

arvato
BERTELSMANN

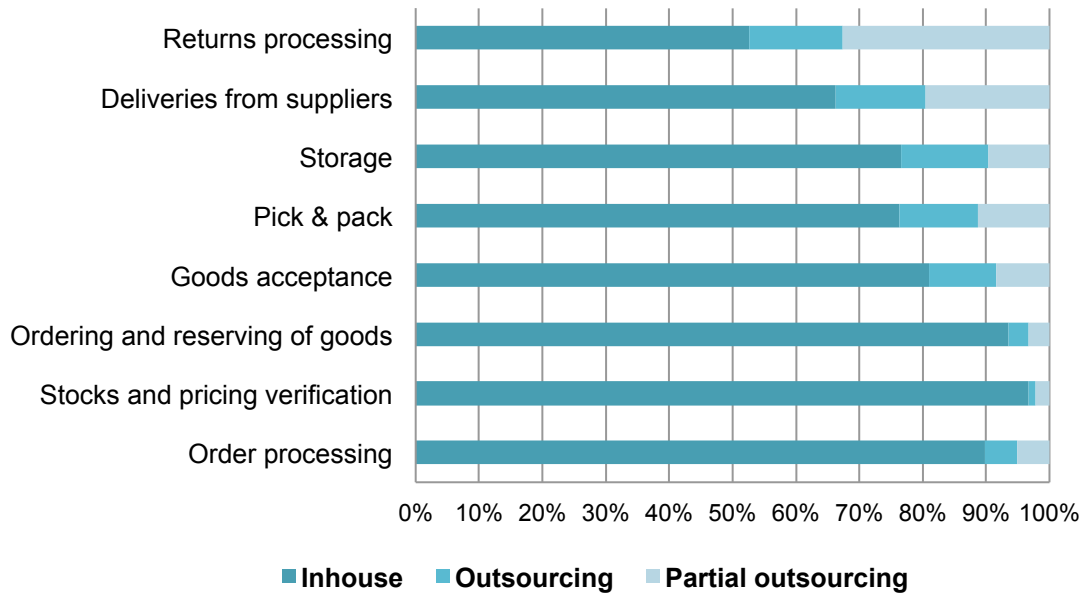


INTEGRATED SOLUTIONS FOR E-COMMERCE COMPANIES:

- Supply chain management and logistics
- E-commerce solutions
- CRM and customer services
- Financial Services
- Loyalty Programms

www.arvato.com/ru-ru

Which types of logistics processes are outsourced



Source: Data Insight survey, 2016

▪ New capacities in the regions

Over the past few years, the number of orders from outside the two capitals, Moscow and St. Petersburg, has grown steadily. According to SPSR Express, the regions accounted for some 60% of all orders in the country in 2016, compared with less than 50% just two years before.

"This trend is important, since developing local operations may require a review the fulfilment and delivery cycle. Customers want to receive their parcels quickly, which is not always possible when shipping from a Moscow warehouse to the Far East. Excessive delivery times may lead to an increase in the refusal rate," notes Dmitry Ovsyannikov of SPSR Express.

To address this trend, some nationwide delivery and fulfilment operators have developed or strengthened full-cycle service capacities in regional facilities.

"As online consumers in the regions become more and more active, logistics capacity is developing both within and across the regions," confirms Leonid Zondberg of DPD Russia.

"As a major improvement in the near future, delivery times will be reduced to one day or even less, at least in major cities. This will require retailers to adapt their capacities accordingly, e.g. via the development of a network of intermediary warehouses, as exemplified [in other countries] by the Amazon Now system," Zondberg adds.

2.2.3. PRICING

Before the crisis which began in 2014, the cost of e-commerce fulfilment services was traditionally high in Russia. Low productivity and big deficits in infrastructure and human resources were the primary factors affecting costs.

"For Western companies coming to Russia it was a shock at first to find out that everything is more expensive here compared to Europe or the USA. They usually expected it to be the other way around," recalls Michael Poetschke of Arvato Russia.

Since then, prices have remained flat in ruble prices for these service – but due to the ruble's sharp depreciation,⁵ their value in US dollars or euros has fallen. As a result, prices for fulfilment services are now no higher in Russia than in Western Europe.

Prices for last-mile delivery services have also decreased in US dollar or euro value – and even in rubles – due to new offers from some existing and new players, notes Alex Zhukov of Pulse Express.

5. The ruble's value fell by half between 2013 (around 30 rub. per USD) and 2016 (around 65 rub. per USD)

INTERVIEW



Michael Poetschke, CEO of Arvato Russia: “The general level of logistics services in Russia is still too low”

– Which are the latest trends in the Russian e-commerce market as you perceive them?

E-commerce is still growing in spite of one of the worst economic crises in Russia's modern history. In 2015, according to market research agency Data Insight, the sector grew by 16% in rubles, and market experts agree that stronger market will resume after the crisis.

Among the main trends of online retail in Russia is the growth of average order value (AOV) due to inflation. This is the main driver of e-commerce growth in 2015.

Another important trend is the increase in the number of buyers. Many people start buying online to access new goods, or because of lower costs. Some are attracted by the convenience of online purchases, while Internet penetration is still growing. Thus according to the last researches, in 2015 the number of active online buyers grew by about five million people. The increase of the number of purchases per customer is also noticeable. But the most significant change is arguably the constantly increasing demands set by consumers and their expectations towards e-commerce.

– What are the most promising segments from your viewpoint for e-commerce?

Fashion, cosmetics, appliances and electronics are widely present online. But we expect the strongest growth in sports, food, DIY, luxury and home decor. These categories appeared online much later than others, that's why their growth potential is so considerable.

From a logistics business point of view, furniture and other bulky goods have the most interesting potential, as well as what we call two-men handling products. Many companies offering such goods can't find acceptable solutions at the moment. What makes satisfied customers is to add services like the installation of a heavy TV or setting up a whole furniture set in the living room. The demand for such services from the end consumers is growing, and we are thinking about new ways of addressing it. To make them happy makes our customers successful. This means to extend the value chain of services we offer.

– Which difficulties do online retailers typically face when dealing with logistics?

E-commerce startups face many issues. These start at the supply stage. Usually there is no standard for the supply of goods; various suppliers do it differently, often even without barcodes to process with. The quality of carton packaging, individual packaging and so on leaves to be desired. Therefore many processes in the logistic chain and fulfillment require a lot of manual work. This is a reflection of the level of logistics in Russia, which is too low in general.

HR is another acute issue. It is very difficult to find good specialists for almost all areas of e-commerce: purchasing, marketing, IT, logistics, accounting and so on. And of course, the economical crisis is still negatively influencing the purchasing power of consumers.

PART 2: FULFILMENT SERVICES

– What are the main advantages and disadvantages of outsourcing for e-commerce companies?

Outsourcing is a good cost-saving instrument. It is much easier to use an outsourcing company than to hire additional people yourselves, rent extra locations, to develop all the processes from “zero” and to try to cover peaks and order fluctuations. When relying on a fulfillment provider you can get not only the full range of services professionally organized based on long-term experience, but you will save costs as well.

Even more important is the fact that outsourcing allows e-commerce companies to concentrate on their assortment, marketing, building customer satisfaction. If you have the right fulfillment provider, a flexible and reliable one, all your logistics “headaches” are properly taken care of.

– Next year Arvato will celebrate its 20 years on the Russian market. Which have been the company’s main achievements over these years?

The most important is that Arvato has become a leading independent service provider for e-commerce not only in Europe, but in Russia as well, especially for fashion, cosmetics and household goods.

In addition, we have built complex supply chains for software and hi-tech companies. Arvato Russia has developed unique solutions for loyalty programs and supply chain management for aftersales maintenance.

As we are acting always on the “backstage” of the business of our customers, we are little visible. For example, when people download or buy software applications, they are dealing with us. Some of the top 100 Russian online stores started their business with us as so called start-ups, relying on our experience and competencies. Now they have grown to top positions in the E-Commerce ratings.

In total, more than 1,500 people are working at Arvato Russia – and we bear an important social responsibility for them. We have incorporated in our Russian business the highest principles of the Bertelsmann values, code of conduct, management responsibility, compliance and quality management.

– What is your strategy for further development in Russia?

Our priorities for the next 5-10 years are to extend our current production capacities and e-commerce service portfolio, addressing the expected market growth. We will also serve new industries, develop B2B services for global companies, after-sales services, financial and loyalty operations for Western brands operating in Russia.

Presently, we have not only built a new modern warehouse for fashion clients, but are setting up an absolutely new temperature-controlled warehouse to start services for healthcare companies. Healthcare B2C services have become already quite important in Europe, now we see an increasing demand in Russia as well.

E-COMMERCE WAREHOUSING
& FULFILMENT IN RUSSIA

PART 3

**INSOURCING OR
OUTSOURCING?**

3.1. REASONS FOR INSOURCING

According to two surveys conducted by Arvato Russia in 2015 and 2016,¹ 51% of e-commerce companies have their own in-house fulfilment infrastructure. However, up to 20% of these companies consider outsourcing certain fulfilment operations to address seasonal demand flows.

Some 19% of the surveyed companies rule out outsourcing fulfilment operations due to what they judge to be an unacceptable price/quality ratio. Meanwhile, 12% are afraid to lose control over processes and fear becoming dependent on a logistics provider.

Another 6% do not consider outsourcing operations due to a lack of statistics and market reports.

Another issue is that third-party providers may be perceived as an unnecessary element in the supply chain from online stores to end customers.

Notably, one-third of the companies which currently insource their fulfilment operations had outsourcing experiences in the past. In more than half these cases, the main reason for returning to in-house operations was that the providers had failed to meet KPIs (key performance indicators) and/or the requirements of the service level agreements (SLA). Additional reasons included technical issues such as IT systems integration and functioning, as well as communication problems in project management.

3.2. REASONS FOR OUTSOURCING

The basic reason for outsourcing fulfillment operations lies in unit economics. The cost per parcel/order is one of the main indicators which e-commerce companies need to minimize, according to almost half of the respondents.

Nearly one-third of e-commerce companies (29%) cite the lack of investment means for warehousing infrastructure, equipment, IT, HR or other fixed assets as the cause for not having created in-house logistics infrastructure.

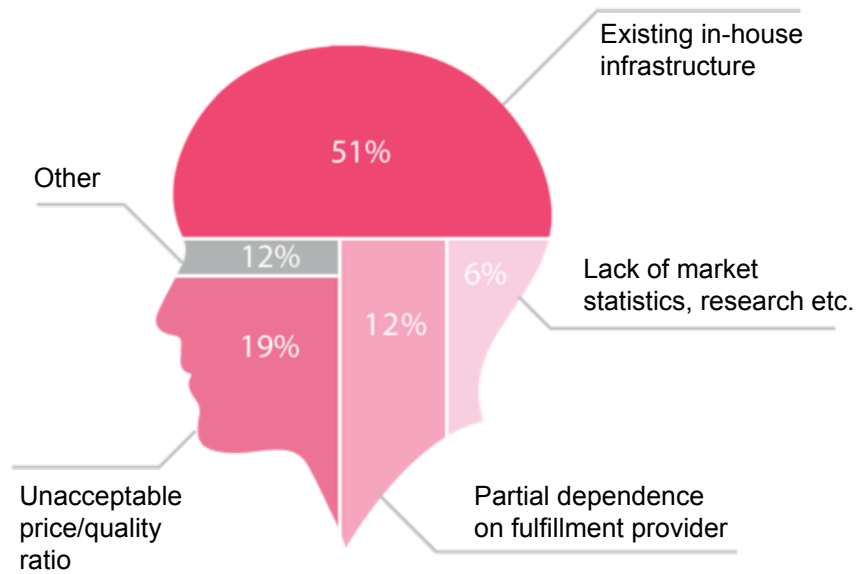
A quarter of the surveyed e-commerce companies do have an outsourcing strategy for fulfillment operations. In many cases, this involves international companies entering the market, which are not willing to create all their logistics infrastructure from scratch.

To a large extent, insourcing or outsourcing strategies are determined by the type of goods. Thus beauty products and fashion goods are outsourced more often, since these products require special expertise – for example, in terms of processing returns – which some logistics solution providers are used to managing. By contrast, retailers of sporting goods tend to internalize fulfillment operations because few fulfillment service providers have the capacity to process oversized or heavy dispatches with several items inside.

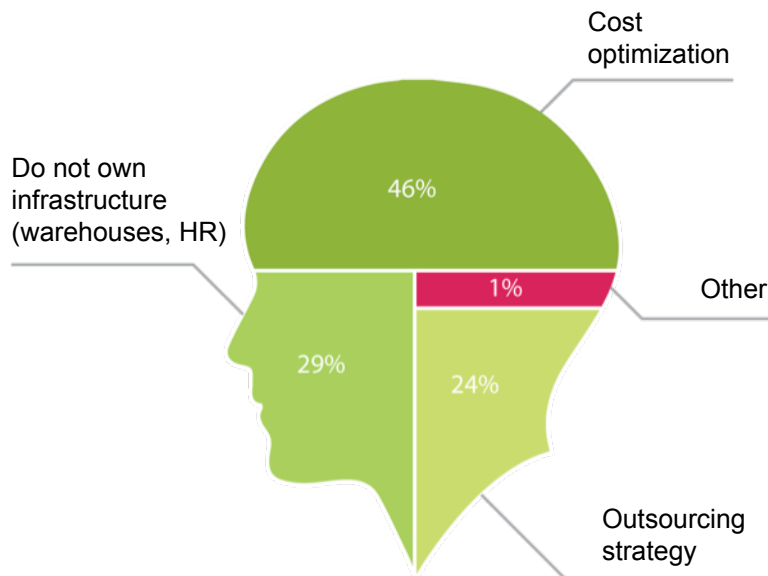
1. This online survey was conducted in Sep-Nov 2015 and Oct-Nov 2016, with participation from 558 e-commerce companies in total.

Insourcing or outsourcing: Russian e-commerce players respond

Why Russian e-commerce companies in-source fulfilment operations



Why Russian e-commerce companies outsource fulfilment operations



Source: Arvato Russia survey, Sept.-Nov. 2015 and Sept.-Nov. 2016

3.3. CHOOSING A FULFILMENT SERVICE PROVIDER

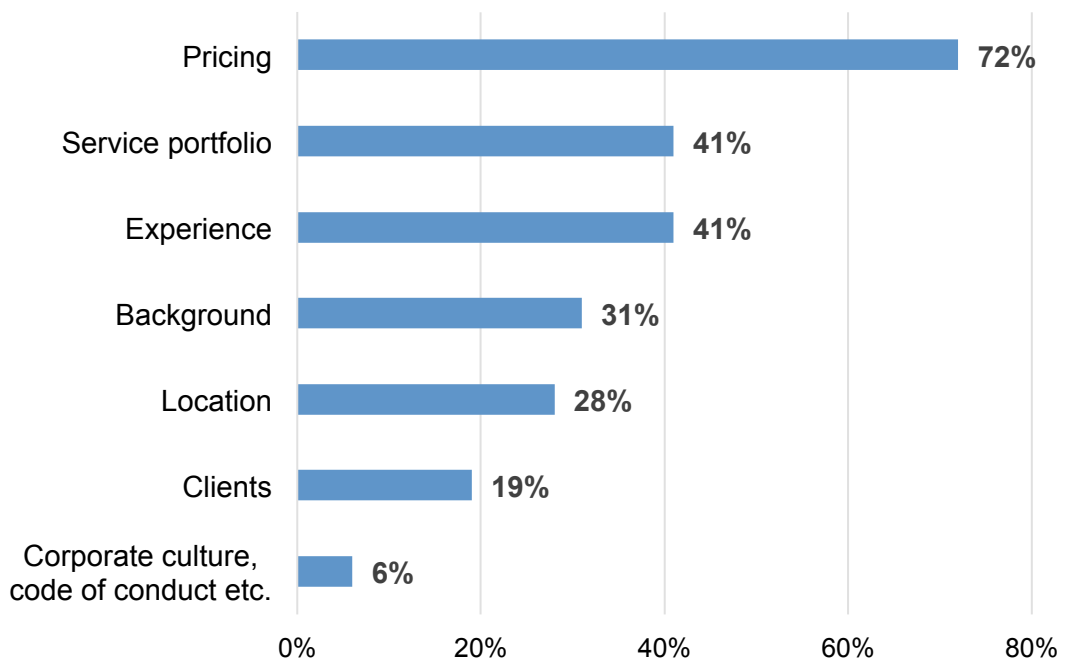
When choosing a fulfilment service provider, pricing is a key factor. Most e-commerce companies (58%) prefer transparent pricing per operations, while 22% and 17% choose revenue share models and fixed costs per month.

According to the survey, which was conducted over two years, the provider's experience, service range and client portfolio seem to play an increasing role in companies' decision-making, which reflect significant awareness of outsourcing risks.

The availability of additional services are another factor which e-commerce companies pay attention to. Only 15% of them say that they are not interested in such services. Arguably, a provider may support its customers' growth more efficiently by providing services such as customs clearance, web development, online marketing, management of last-mile delivery, and call-center services.

Corporate culture, compliance standards, and industry certifications are also important factors. In this regard, international service providers may have a competitive advantage over many Russian players, which may not yet have these fully developed or officially documented.

Key factors in choosing a fulfilment provider



Source: Arvato Russia survey, Sept.-Nov. 2015 and Sept.-Nov. 2016

3.4. CONTRACT TERMS

The young Russian e-commerce market offers only a few examples of long-term partnerships between e-commerce or distance selling companies and fulfillment service providers.

Companies frequently opt for short-term outsourcing contracts in order to minimize risks. In fact, the Arvato survey has revealed that half of all contracts are structured for a period of up to three years – which reflects, in many cases, a lack of trust between customers and providers.

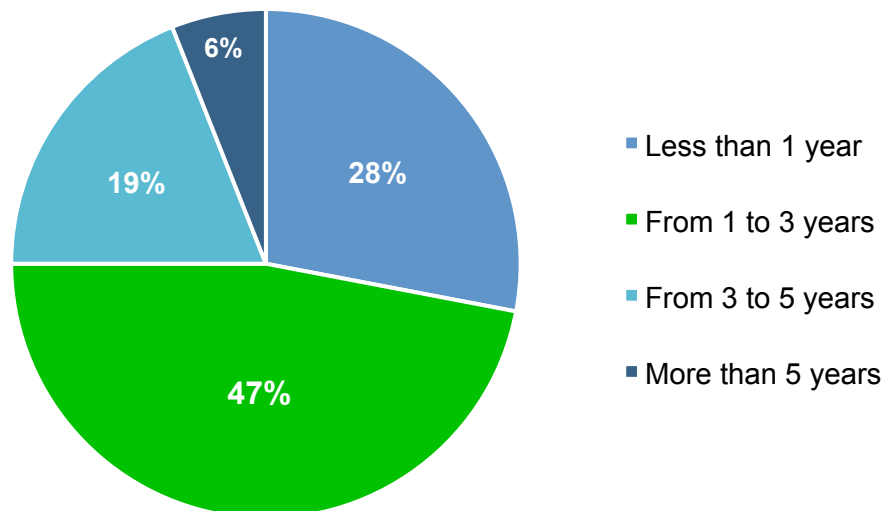
In other cases, contracts were cancelled, or not renewed/extended, because providers failed to meet their quantitative or qualitative obligations, as seen above.

This does not include cases where outsourcing contracts were canceled due to customer bankruptcy (for example, startups as Sapato, Heverest, and Sotmarket which failed over the last few years).

“This situation is a barrier to the development of outsourcing capacities in Russia, since outsourcing projects require a co-investment process, which can be truly profitable only when there is a long-term partnership,” notes an Arvato executive.

Investments in logistics process automation are also made difficult due to customers’ specific requirements in terms of fulfillment services and warehousing processes.

Average duration of outsourcing contracts



Source: Arvato Russia survey, Sept.-Nov. 2015 and Sept.-Nov. 2016



Key legal risks related to fulfilment outsourcing contracts

By Igor Nevzorov, Director, and Anastasia Kuznetsova, Senior lawyer, EY Intellectual Property Center of Excellence (CIS)

Russian civil law does not set any special requirements for fulfilment agreements and does not directly classify them as a special type of contract. A fulfilment agreement may be considered a mixed contract, i.e. a contract that includes elements of different types of contractual obligations to regulate the provision of multiple types of services (complex services). Some of these services are subject to special civil regulation (e.g. warehousing, transportation, agent services, etc.) with specific rules and reallocation of risks between the service provider and the client.

The key risks related to fulfilment services can be reallocated between the parties during contract negotiation to minimize their negative impact on one or both parties. This is usually done by including clauses on liability, indemnities and warranties and providing a detailed description of the services to be rendered as well as means and grounds for the effective termination of contractual relations, etc. If a foreign party is involved, it is also important to choose more flexible provisions in applicable law, because Russian law is still not fully adapted to the new legal instruments.

▪ **Defining and checking the provider's KPI**

A full and detailed description of service parameters is crucial for the evaluation of service performance. Such description may also be a key factor in payment structuring, while providing the client with grounds for applying the "exception for non-execution" clause. It can also greatly simplify the collection of evidence related to contractual terms and create more possibilities for terminating contractual relations with unsatisfactory service providers. In the absence of detailed and measurable requirements for service quality, the regime of "acceptable average quality level" may be applied as defined by Russian law. In this case, fulfilment providers may use contract ambiguities to avoid or minimize liability.

▪ **Confusion between goods from different clients**

The provision of fulfilment services to multiple clients may lead to the delivery of goods belonging to another e-merchant. This may happen in cases of inadequate management of warehouse facilities or improper organization of storage and packaging processes. A contract should thus require that the provider properly individualize client goods and eliminate any liability in the case of delivery of goods from a third party.

▪ **Financial liability for delays in delivery**

According to Russia's Consumer Protection Law, a retailer is liable for delays in delivery, even if a delay is caused at the level of the fulfilment provider. If the delivery deadline for prepaid goods is violated, consumers may return the goods and claim damages (a statutory penalty of 0.1% of the prepaid amount for each day late). To increase the chances that the fulfilment provider will organize the delivery process in the most efficient way, a contract may require the provider to pay this penalty (performance of the obligation by a third party).

PART 3: INSOURCING OR OUTSOURCING?

▪ **Making quality control effective**

To build a successful relationship and fully adapt the fulfilment process to the client's business needs, service performance evaluation should be efficient, and service provision methods should be modifiable. A detailed description of the evaluation process through all stages of fulfilment should include a predefined inspection procedure with regular periods of control and the possibility of amending contractual terms based on evaluations. The contract should also include clauses on free access to fulfilment facilities by the client, on contract amendments and on the designation of an independent third party to settle any disputes.

▪ **Damages**

Difficulties in proving the actual amount of damages caused by a breach of contract are a common issue for different types of contracts under Russian law. Penalty clauses with fixed amounts may not be sufficient or relevant. Actual penalty amounts may be even lower in court practice (without any reference or demand by any party in some cases). The parties may be protected against these risks if contractual clauses include adequate penalty amounts and specify that a penalty is *in addition* to damages. To better compensate financial losses, a mechanism of "losses resulting from circumstances" may be defined in the contract. The parties may set a fixed amount or determine how to calculate the amount of compensation for losses in each circumstance (e.g. accidental loss of stored goods or actions of third parties).

▪ **Information exchange**

The provision and exchange of information (e.g. changes in procedure, consumer claims) are of particular importance in view of the specifics of fulfilment services, the high level of dependence between the client and the provider and the risks of liability to consumers. The traditional (formal) approach to stipulating the provider's obligations is usually insufficient. Inclusion in the contract of a detailed scope of information to be provided, means of providing information and penalties for violating this obligation should be considered.

▪ **Protection of sensitive information**

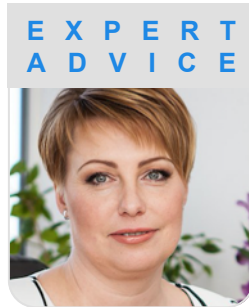
Due to the interdependence between the fulfilment cycle and the client's business model, a fulfilment service provider is likely to receive access to highly sensitive information related to the client's business. NDA agreements should include a detailed specification of data transferred to the service provider. Necessary and reasonable obligations for a provider to protect information against accidental disclosure to other clients as well as technical measures to protect information from illegal transfer should also be specified in order to minimize risks.

▪ **Amendments and termination of fulfilment contracts**

Russian law provides for the unilateral termination of a service contract. Any party may terminate a contract at any time by simply notifying the other party and compensating the incurred damages or expenses. While making it easier to end a failed collaboration, this principle may leave a party unprepared for sudden contract termination. A sufficient period term between notification and termination as well as a fixed payment in the case of withdrawal from a contract (generally accepted by Russian courts) should be negotiated in advance in the interests of both parties.

▪ **Legal risks related to counterfeit goods**

The storage of goods produced or packaged for further distribution in Russia in violation of patent or trademark rights is regarded as storage of counterfeit goods. This may result in legal action including prohibitory measures and penalties. To mitigate this risk, a contract should include warranties from the client (retailer) with regards to intellectual property risks and require the service provider to inform the client of any IP-related claims.



A few tips to organize and optimize logistics

By Nataliya Przystaw, Commercial Director at Arvato Russia

What aspects should be primarily regulated by your logistics provider? What are the most important things to pay attention to when building an effective supply chain? Here are a few tips:

- **Decide what you will do in-house and what should be outsourced**

Depending on what you regard as your core competencies, determine the scope of your in-house functions. While some e-retailers keep control of most operations, others favor an end-to-end solution -- outsourcing everything except purchasing, including the web store, CMS, SEO, SEM, customer service, payment processing and fulfillment/delivery. All processes should be exactly defined and covered in a general flow chart, clearly showing who does what and which interfaces for exchange of which data are necessary. You should look for proven, standard solutions and processes to be provided by your fulfillment partner with standard interfaces. This avoids unnecessary complexity, gives higher reliability, and reduces cost.

- **Determine the processes to be organized and agreed to**

This has to be done only once, but preferably before you start your business. If the business changes, the processes will be updated accordingly. The basis is your business concept, plan, and budget (you certainly have one). All a fulfillment partner needs is some basic data from your business like: number of SKUs, master file of products, average quantities per SKU in stock, average orders/day, average items/order, packaging (material), dispatch by mail/courier, payment options offered, expected returns rate, data exchange interfaces, online-shop system, ERP. All the planning data (stock, deliveries and orders) should be given by month for the first year and growth rate over the next 2-3 years.

- **Agree upon a cost structure**

On the basis of the agreed-upon processes your partner will provide, the most appropriate costing method can easily be identified and agreed upon. You may choose transaction cost, CPO, or percentage of sales (net sales).

- **Designate an in-house logistics specialist**

Just one. You need to have one logistics/fulfillment specialist in-house to be the sole contact with your provider. He should understand and speak the language of fulfillment. Everything else can be outsourced to your provider. You don't need to have a big team to duplicate functions you actually want to outsource and which the provider can do more effectively.

- **Prepare a contract**

Choosing a fulfillment partner is an exercise you don't want to do every year. Usually a fulfillment contract is concluded for 3-7 years. Therefore, measure ten times, cut once. In the end, you want to forget about logistics and fulfillment and concentrate on growing your business successfully.

PROVIDER'S POINT OF VIEW



Outsourced fulfillment operations from the point of view of a last-mile operator: PickPoint

By Nadezhda Romanova

PickPoint cooperates with online stores both directly and via fulfillment service providers in case of outsourcing. Such service providers are convenient for us to connect with small sellers who need a limited range of services and do not require any individualized approach. This model also applies to online stores which have opted for outsourcing for economic reasons.

When a big online store wishes to use our self-pickpoint network via a fulfillment service provider, a kind of trilateral communication is being established between us, the fulfillment provider and the online store. Some operational aspects, e.g. a special promo to attract customers, may need to be discussed or coordinated by the three parties.

Working without intermediaries is usually faster and more efficient, allowing to provide more services, performance reporting, quantitative operational and other information about new features, services, or service preferences.

Nadezhda Romanova is General Director of PickPoint, a leading provider of self pick-point services (postomats) in Russia



CASE STUDY



Ozon's in-house strategy

Based on exchanges with the company's press service

■ Current capacities

As of late 2016, Ozon has three warehousing and fulfilment capacities:

- The company's main facility is located in the Tver region, some 150 kilometers away from Moscow. In this 42,000 sq m. facility – which serves all Russia excepted the Urals and Volga regions – the company stores about 1 million SKUs and 5 million items. In peak December days, Ozon can fulfil more than 30,000 order a day. In 2015 Ozon proceeded and delivered more than 5,5 millions orders, with an average of 4 or 5 items per order.
- Ozon rents additional facilities in Ekaterinburg (5,700 sq. m.) and Kazan (3,500 sq. m.), covering the Urals and Volga regions, respectively. Around 200,000 SKUs and 350,000 items are stored in each of them. 2,500 orders are handled everyday. The output can be increased according to business needs. The Ekaterinburg and Kazan facilities have allowed Ozon to increase its sales revenues by 50% and number of orders by 40% in their respective areas since their launch in the spring of 2016.
- A warehouse in Moscow is rented and used as a delivery hub.



In Ozon's warehouse in Tver (photo credit: Ozon)

PART 3: INSOURCING OR OUTSOURCING?

Billions of rubles were invested in building and equipping the Tver facility. Each of the new warehouses in Ekaterinburg and Kazan required about 100 million rubles (around \$1.5 million at the average exchange rate in 2015-16). The company plans to launch an additional facility in Krasnodar, southern Russia, in spring 2017. This 4,000 sq.m. facility is designed to store some 500,000 items.

▪ Insourcing or outsourcing?

Ozon used to rent its main warehouse from company start in 1998 to 2005. Since then, Ozon has had its main warehouse own while also renting a few secondary warehouses. During all this time, fulfilment operations were made internally.

The company names the following reasons to internalize warehousing and fulfilment:

- Operational flexibility, including the possibility to create or adapt quickly the order processing processes according to business needs;
- Business predictability: further capacity extension can be planned in terms of both costs and time;
- No dependence on a service provider.



*An Ozon courier
in Moscow
(photo credit: Ozon)*

The same in-sourcing strategy would be valid today, Ozon believes, even the market of warehousing and fulfilment services has developed considerably since the mid 2000s.

"We believe that warehousing, fulfilment and delivery are core functions for a large, multi-category e-commerce business in Russia. You should do it internally as much as you can if you deal with millions of different goods and tens of thousands of orders in a predictable and quality manner."

Ozon has fully internalized fulfilment operations. For delivery operations, Ozon relies on its own delivery service, Ozon Dostavka (formerly known as O'Courier), which covers 350+ cities and 2,000+ self pickup points. This service also serves third-parties, claiming more than 100 clients. Nevertheless, Ozon still has part of its own deliveries fulfilled by service providers.

CASE STUDY

La Redoute

La Redoute's outsourcing strategy

*Based on an interview with Polina Kolupaeva,
Director of Logistics at La Redoute Russia*

La Redoute is a French fashion brand, specializing in distance selling of clothes and interior goods. The company is represented in 26 countries, including Russia, and has over 10 million customers all over the world.

▪ Current capacities

Having come to the Russian market in 2006, the company opted for an outsourcing strategy for warehousing, fulfilment and delivery, which it believed was more business-wise than costly development of in-house capacities. Thus the company started working with several delivery and warehousing service providers. Very soon, however, it became obvious that these providers' capacities were not sufficient. La Redoute had to find a new partner to provide end-to-end e-commerce supply chain management solutions. ready and integrated solutions for all the stages of the fulfilment processes.

▪ La Redoute's requirements

- Acceptance of shipments directly from a warehouse in France
- Pick-and-pack, order tariffing and shipping
- Effective management with irregular loading of production in peak periods
- Optimization of service level, client satisfaction and cost savings
- Regular mini-inventory accounting, stock checking and warehouse optimization
- Work in La Redoute's IT system "VC"

▪ Solutions offered by Arvato

- A dedicated storage and production area in a new Class A warehouse.
- Fast and high quality processing of orders and returns according to agreed KPIs
- Processes adapted to irregular loading, seasonal variations and marketing campaigns
- Further increase of service level, client satisfaction and cost savings
- Parallel stock management in the warehouse management systems of Arvato and La Redoute
- Integration between the IT systems of Arvato and La Redoute
- Integration with Russian Post and other delivery service providers to optimize delivery service and tariffs for La Redoute

▪ Polina Kolupaeva, Director of Logistics at La Redoute Russia

"We were looking for an experienced partner in the field of warehouse operations, fulfillment and parcel delivery business in Russia. For us it was important that the goods be placed in the warehouse in an optimal way so that parcels could be assembled correctly and quickly, then packed and sent to their recipients at the best possible postal tariff."

"La Redoute works with several express delivery providers and pick-up point companies. They are all integrated through Arvato's IT system. Another important point of Arvato processes is high security commercial storage as well as careful attitude to the customer's equipment."

PART 3: INSOURCING OR OUTSOURCING?

INTERVIEW



Dmitry Kholomtsev, Head of KupiVIP E-Commerce Services: "We built our own infrastructure because we aimed at market leadership"

— Why did you initially decide to build your own warehousing and fulfilment capacities?

Russian consumers are pretty demanding in comparison with European ones: they like their goods to be delivered quickly and pay in cash on delivery. So establishing an online store in Russia means not only to deal with assortment, IT and marketing. You have to build your own infrastructure: a warehouse, delivery services, call-center, pick-up points, etc.

From the very start in 2008, KupiVIP invested a lot in infrastructure, developing its own services, aiming to become market leaders.

— Would you adopt the same strategy if you started your business today, now that the market of warehousing and fulfilment services has developed more significantly?

We were pioneers in this market, so we had no choice but to build our owned infrastructure. We carefully studied international best practices to make sure we bring the best experience to Russia.

— Can you describe these capacities to date?

The KupiVIP distribution center is located in Klimovsk, about 1 hour from Moscow. The daily capacity of the warehouse reaches 40,000 SKUs inbound, 15,000 orders outbound. The facility operates 24/7/365.

We also have 2 distribution centers — one in Russia and one in Berlin; — two delivery hubs in Saint-Petersburg and Rostov-on-Don; our own fleet of cars in key Russian cities; several pick-up points in Russia; and a partnership with a pick-up point company in Kazakhstan.

Not only are we, thanks to this infrastructure, market leaders in Russia, but we also provide e-commerce and fulfilment services to other Internet stores, sharing with them our capacities.

— Can you tell us more about these services?

This is particularly interesting for companies willing to start selling to Russian consumers without building their own infrastructure and services. Now we're serving more than 20 clients. In 2016 three famous brands – Levi's, Converse and Chicco — came to us. These companies were present in offline retail for a long time, and understood that they needed to go multichannel. They avoided investing a lot by outsourcing these services to us.

— How much did you invest in building your in-house infrastructure?

We cannot disclose exact numbers, but these have been long-term investments which continue today. This is due to business growth and to the necessity of keeping up-to-date with technology, which evolves very fast. In 2016 we made our first steps in offline retail — and these developments require several changes in fulfilment.

E-COMMERCE WAREHOUSING
& FULFILMENT IN RUSSIA

PART 4

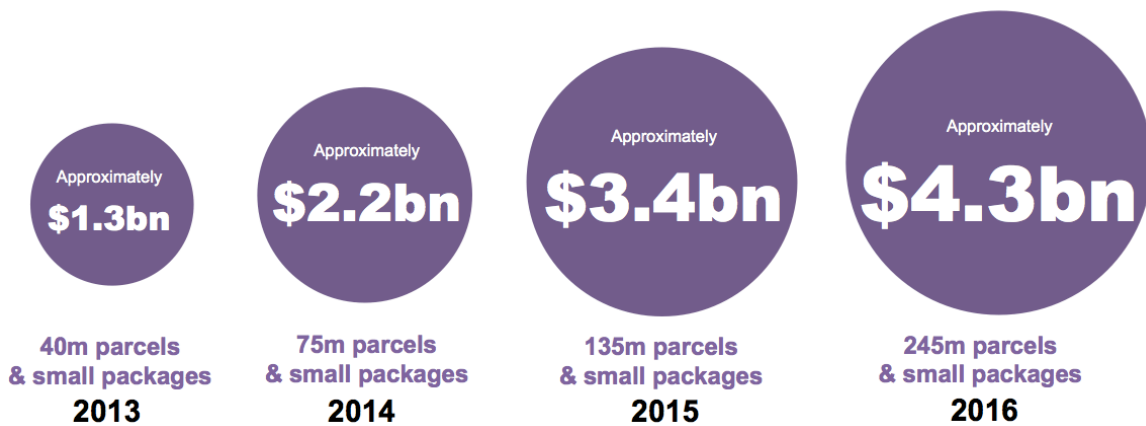
CROSS-BORDER
OPPORTUNITIES
& CHALLENGES

4.1. FAST-GROWING VOLUMES

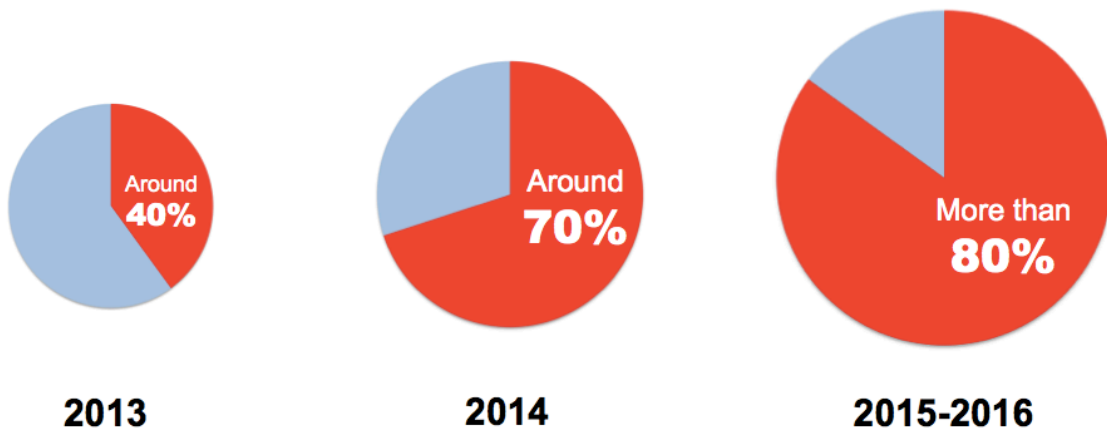
Foreign retailers' online sales of physical goods to Russia have grown considerably over the past few years. The market reached around \$4.3 billion in 2016, up from some \$3.4 billion in 2015 and \$2.2 billion in 2014.

Since mid 2014, only Chinese players have benefited from the growth of the Russian cross-border e-commerce market, leaving their western counterparts in the dust. In 2016, deliveries from China accounted for more than 80% of total fulfilled cross-border orders. Not only do Chinese sites offer unbeatable prices and assortment. Parcels are now delivered to Russia relatively fast, in a couple of weeks on average vs. up to several months in the past.

Cross-border sales volumes (physical goods)



Cross-border sales volumes (physical goods) estimated share of fulfilled orders from China



Source: NAMO and EWDN

4.2. LATEST TRENDS IN CROSS-BORDER LOGISTICS

The key current trends in the Russian cross-border logistics market can be summarized as follows:

- Currently, the demand for distance selling logistics services is growing mainly due to the flows of small packages from China (the flows from western Europe and the USA still being significant and growing, though, in terms of weight and value);
- The cross-border logistics capacities have improved considerably over the past few years, due to the combined efforts of the Russian postal and customs services and their foreign counterparts, and to the development of strong private players;
- Russian logistics hubs, and particularly Moscow, are used more and more efficiently as platforms for trading across Russia and to EAEC countries (Kazakhstan, Belarus, Kyrgyzstan as well as Armenia in the future) and to CIS countries (Azerbaijan, Georgia, Uzbekistan and Tajikistan);
- Foreign companies are gradually shifting from a remote model (cross-border shipments) to the establishment of warehouses in the country, which allows or makes easier cash-on-delivery options.¹

The shipment market is dominated by postal operators, which ship about 95% of the total number of parcels and small packages from abroad. Private operators focus essentially on parcels (2 kg and more). These account for less than 15% of the items carried, but offer more significant margins. In this specific segment, the volumes shipped by postal and private operators are of similar orders of magnitude.

A noticeable part (perhaps 10-15%) of postal flows to Russia are managed by the Finnish and Estonian postal services (under the Posti/Itella and Omniva/Post11 brands, respectively). These operators aim to position themselves as international logistics hubs in the region.

Among private operators, international ones (such as DPD, DHL, Fedex and UPS) do not play a leading role. Russian shipping companies (such as Boxberry, CDEK, Pony Express and SPSR) have got stronger traction over the past few years. Their rates are generally cheaper, though delivery time may be longer.

Although their share of the Russian cross-border e-commerce market has decreased considerably over the past few years, western online retailers have not lost interest in the Russian market. Among the latest examples is Spanish giant El Corte Ingles, which aims to sell clothing footwear and accessories to online consumers in Russia, Kazakhstan and Belarus, starting from early 2017, in partnership with Lamoda. Fulfilment operations will be run by Russian service provider Shiptor in a Berlin warehouse, with parcels being shipped further in partnership with several delivery subcontractors. Both prepayment and cash-on-delivery options will be offered — a rare combination so far in Russian cross-border e-commerce.

Among established providers of cross-border fulfilment services is Germany's Bertelsmann. On the Russian side, integrated services — spanning from logistics, to IT, to marketing — are offered by such providers as Otto Group subsidiary eSolutions, as well as some Russian e-commerce players, to help international players enter the Russian market.

This section includes expert contributions from Alexander Ivanov, president of industry association NAMO, and Konstantin Yakunin, founder and CEO of RMS Express.

1. COD is the rule in domestic e-commerce. It is still rarely available for cross-border shipments, but increases significantly the number of orders.

INTERVIEW



How Next switched from cross-border to domestic fulfilment operations

An interview with Olga Evteeva, Site Manager at Next Russia

– Please tell us a bit about Next’s “Russian story.”

Next has been present in the Russian market since 2011. From 2011 to 2015, Next delivered to customers directly from the UK. During this time, Russia grew to be one of the largest markets amongst all the international countries for Next Directory, our online channel. In 2015 Next launched its in-country warehouse to improve the service to Russian online customers.

There are also 24 stores that sell the Next brand in Russia. These came about by working jointly with a franchise partner.

– Did you feel a significant impact from the latest crisis?

Over the past twelve months – from February 2016 to January 2017 – we dispatched over 2.2 million items.

Russia used to regularly be in first place in our internal country sales ratings in 2013 and 2014. Right now Russia is moving between 2nd and 4th places with sales volumes amounting to some 9% of the total international sales volume for Next Directory. Russian sales volume dropped when the pound-to-ruble rate changed dramatically and our goods became more expensive for Russian customers. So, yes, the crisis has impacted us. But the last thing people will stop buying is food and clothes, especially if it is for kids. We continue to develop our business in Russia and expect the volume to grow in future.

– During the cross-border phase, until 2015, how did you organize fulfilment operations?

The cross-border phase lasted until the end of March 2015. We have been working, and still do work, with SPSR-Express. This provider is responsible for the clearance of our parcels at the Domodedovo airport [serving Moscow] and for further delivery to the customers within Russia.

We experienced a few issues with customs clearance of our parcels, particularly in regards to capturing customer IDs during the online order procedure, but we managed to solve them successfully with our partners.

Someone said, “to be able to conquer Russia you need to conquer the Russian customs.”

– Why did you decide to switch to domestic operations?

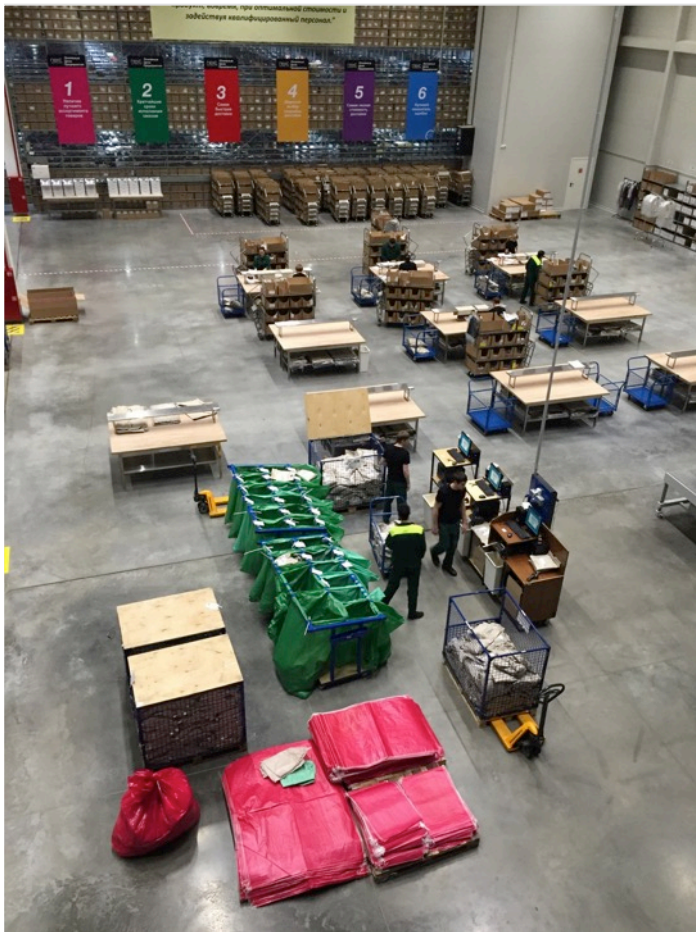
Next is known in the UK for fast delivery. One of the key issues for cross-border operations with Russia was the long shipment time from the UK to the end-customer delivery point in Russia.

E-COMMERCE WAREHOUSING & FULFILMENT IN RUSSIA

PART 4: CROSS-BORDER OPPORTUNITIES AND CHALLENGES

Most of the time was taken up by shipping from the UK and customs clearance. As we were already using the SPSR-Express premium delivery service, we couldn't improve the delivery speed much further. So the best option was to put a hub in Russia and therefore significantly reduce the delivery time as well as the cost.

When we decided in 2014 to open a warehouse in Russia, there was another reason. First, Russia was considering – and is still considering – to lower considerably the tax-free threshold for goods purchased from outside of Russia. We wanted to avoid this risk by having our operations done within Russia.



With these thoughts in mind, the project started in 2014 and we launched the warehouse on March 25, 2015.

Having done this, we hope to expand our business and restore Russia's first place in our Directory sales volume.

– What have been the challenges in this transition, and how did you solve them?

The challenge was actually to switch from cross-border to domestic operation without a transition period. We did this overnight when we were fully ready. The next day the goods were delivered from our Russian warehouse. The customers didn't notice anything except the delivery time became much shorter.

We had delayed the switch a few times as we needed to ensure that we held sufficient stock in our Russian warehouse – which took longer than expected due to various reasons, including, in particular, delays with customs clearance. As we are a bit unique in the Russian market, the customs agents needed some time to get used to us and to our stock. Also, we needed some time to adapt our processes to all the customs requirements.

What makes us different from other retailers in Russia is that we have only an online channel in Russia, which makes our fulfillment rules different. Our shipments contain many different types of items for our Russia customers. They are based on our sales forecast, so there is a variety of product types mixed up in each shipment, which makes the work of the brokers and customs officers much more complex.

Another key challenge was that Russian product certification rules are much stricter than in the UK, in particular for children's clothing. Some of our items were not compliant with Russian standards, so we had to remove them from the website. Our customers saw this when we switched from cross-border to domestic operation. However, since April 2015, our team has worked hard to address this issue, and we have managed to put back on sale the majority of the items that we had previously removed.

E-COMMERCE WAREHOUSING & FULFILMENT IN RUSSIA

PART 4: CROSS-BORDER OPPORTUNITIES AND CHALLENGES

– Do you aim to offer same-day delivery to your customers?

We also worked on offering more time flexibility for online orders. When we launched domestic warehouse operations, orders had to be made before 18:00 for next-day delivery in Moscow or for the Moscow region, and before 13:00 for delivery across Russia in 2-7 days. After a year of operations, latest ordering times have been moved to 23:00 and 14:00, respectively.

We aim to push the latest ordering time until even later, to 24:00. We don't offer same-day delivery yet, but this will be our next goal.

– To what extent are Russian warehousing and fulfilment conditions different from those in your other countries?

Stock fulfilment rules are very different from our Ireland warehouse, for example. As Russia is far away from the UK, getting the stock to our warehouse takes longer. This is why we need to have a larger quantity of each item in the warehouse. But on the other hand, if we don't sell the stock in a season or during the clearance/sale period, it's not an easy task to return the goods to the UK.

So the allocation of the quantity of stock for the Russian warehouse is a subtle exercise, balancing the risk of having too much or too little stock in Russia. If we have too much stock and don't sell it before the clearance then we have quite a large sale. This is good for the customers but not so good for the company, since these excess goods must be sold at reduced prices.

If there is not enough stock then we have to send the stock to Russia by air to fulfill customers' orders. Of course this is much more expensive than bulk shipping freight by road.

– Why did you split the online and offline channels in terms of logistics?

Next UK has a long-standing relationship with their Russian franchise partner. But this remain a completely separate business.



- The leading independent financial and corporate communications agency in Russia/CIS
- The only agency in Russia to offer a fully integrated PR and IR offering
- Deep sector expertise – tech, retail and consumer, banking and finance, industrials, utilities, infrastructure, oil and gas and oil services, metals and mining
- Our team has advised on more M&A, IPO's and other capital market deals than any other team



More professionals dedicated to Russia and CIS than any other international agency

- We work with public companies and help them with their on-going IR and financial market communications
- We work with privately held companies who have an eye on international and financial markets

- We help companies with their communications and risk management in times of conflict and crisis
- We help international companies to manage their reputations in Russia



Financial PR, investor relations, IPO and M&A transaction support, crisis communications, reputation management, strategic advisory

Contact details: / info@em-comms.com / Moscow: +7-495-363-2844 / London: +44-20-7920-2364