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Russia's war in Ukraine: Implications for western companies

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Introduction

Business as usual, as we knew it in Russia, is unlikely to make a comeback for years to come. Currently, the war in Ukraine continues to develop actively, and although negotiations between the two parties are ongoing, their positions are disparate, despite claims to the contrary.

For 30 years, since the collapse of the Soviet Union, Western companies and investors have been drawn to Russia and other former Soviet republics such as Ukraine and Belarus, seeking lucrative opportunities. On February 24, geopolitical risk skyrocketed following Russia's full-scale invasion of neighbouring Ukraine, while an unprecedented range of sanctions imposed on Moscow altered cost-benefit calculations for companies to operate in the Russian market for years, if not decades, into the future. Everything from freezing the assets of Russia's Central Bank, to severe export limitations, to Western companies' "voluntary" pullbacks from the local market have thrown the country's economy in turmoil.

Putin and his team had anticipated a Western response, knowing that their counterparts in the US and Europe would impose sanctions in case of a Russian attack on Ukraine. Preparation for a possible disconnection from SWIFT began in 2014, after the US threatened to disconnect Russia from this inter-banking messaging system following the annexation of Crimea. Nonetheless, it is unlikely that the Kremlin had anticipated that sanctions would be as far reaching as to freeze Russia's Central Bank assets held in the West, for a total of 300 billion USD. Considering that Russia has approximately 680 billion in foreign reserves, this action severely hampered the Central Bank's ability to sustain the value of the ruble in the forex markets, while also reducing the finances available to sustain the war effort.

Introduction

Furthermore, the withdrawal of hundreds of privately-held enterprises driven by profits in the Russian market (with the transfer of significant portions of their employees to countries in the Caucasus, Central Asia, and Central Europe) and the subsequent rapid deterioration in standards of living for millions of Russians came as a surprise. As the New York Times has noted, in the West, “society’s expectations for companies have changed since [the times when] Coca-Cola sold drinks in Nazi Germany and Heineken brewed beer in Rwanda during the genocide there.” The Russian leadership failed to realise this.

The evolution of risks for businesses in the post-Soviet space is hard to predict in the mid to long term, due to an array of independent variables involved. However, this is precisely what we intend to do in this article.

How the war began

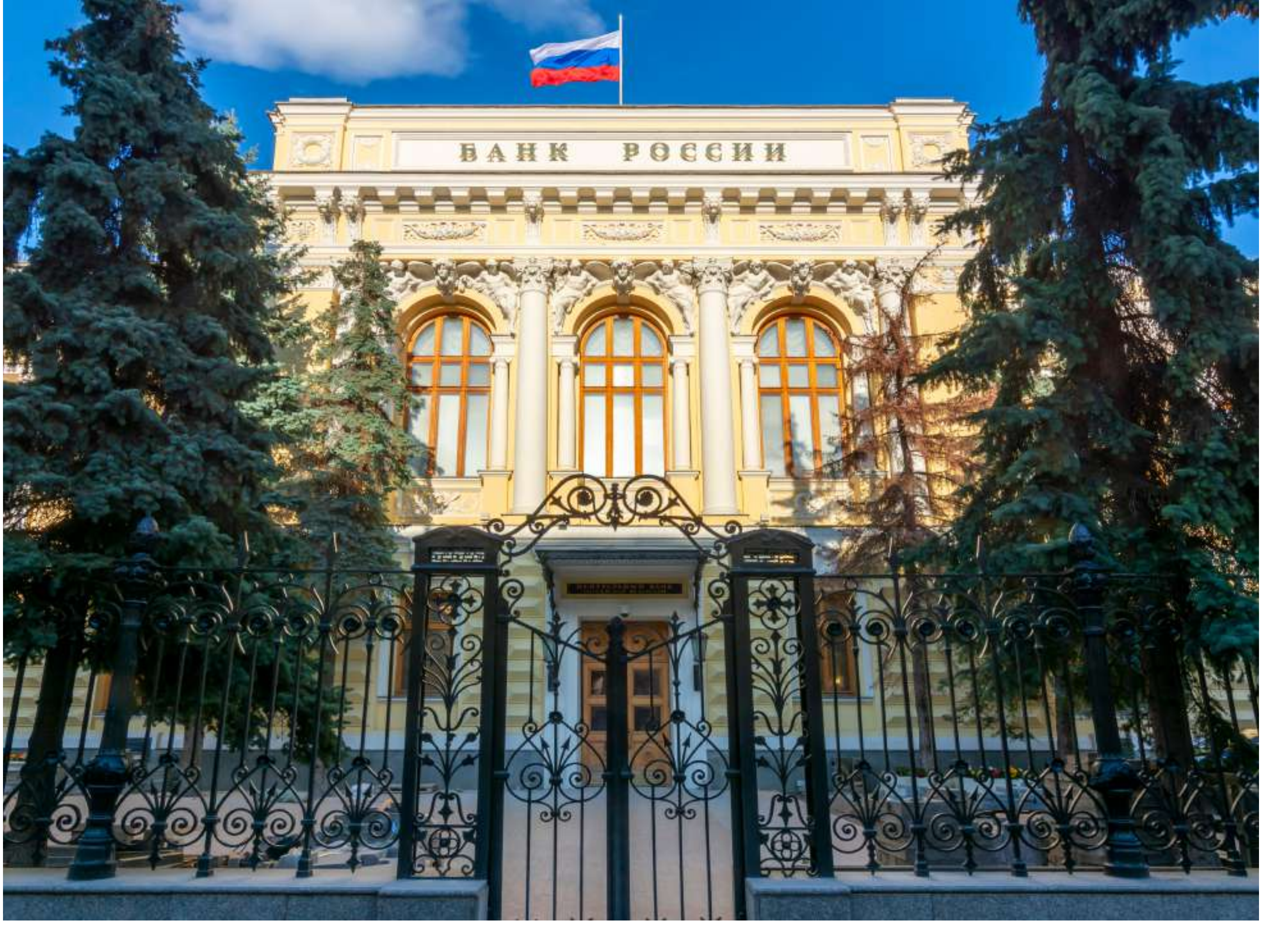
In November 2021, satellite imagery began to appear showing a vast massing of Russian troops in various locations inside Russia, not far from its borders with Ukraine. According to different estimates, the numbers of military personnel varied from between 70.000 and 114.000. Soon afterward, negotiations for “legally binding security guarantees” between Russia and the US began, upon Moscow’s request. In parallel, intelligence agencies in the United States and the United Kingdom warned of a possible, and then “imminent” Russian attack on Ukraine, with the likely aim to topple the government and impose pro-Russian leadership. Until the eve of the conflict, however, Ukrainian President Volodymyr Zelensky himself, as well as members of his administration, continued to deny that they saw immediate and credible threats to the security of Ukraine.

On February 21, 2022 Russia recognised the independence of the Donetsk and Lugansk People’s Republics in the East of Ukraine. On February 24, a barrage of ballistic missiles struck targets across Ukraine. In parallel, Russia began advances on three separate fronts. In the South, forces advanced from Crimea, aiming toward the Ukrainian city of Kherson. In the East, troops mobilised to encircle Kharkiv, Ukraine’s second-largest city, located less than 30 km from the Russian border. Most notably, in the North, an airborne assault on the Antonov International Airport in Hostomel, near Kyiv, took place in tandem with a land invasion through the Chernobyl exclusion zone.

Economic sanctions

The Western response came in steps. On Tuesday, February 22, EU foreign ministries unanimously agreed on the initial set of sanctions in response to the recognition of the breakaway republics in Eastern Ukraine. 351 members of the lower house of the Russian parliament who voted in favour of the recognition, alongside other prominent regime supporters, saw their assets in Europe frozen and their mobility limited as travel bans were imposed. Additionally, limitations imposed on the trading of Russian state bonds hampered the Kremlin's ability to finance its policies. EU members also forbade trade with the separatist entities.

Following the full-scale invasion of Ukraine, European leaders invoked additional measures against Russia. Most notably, as European Commission president Ursula Von Der Leyen stated, 70% of Russian banks were placed under various types of sanctions, further limiting Russia's capability to finance its policies. Some were disconnected from SWIFT, the inter-banking messaging system. The total number of individuals and entities who saw asset freezes and a prohibition on making funds or economic resources available to them was brought up to 654 and 52, respectively. Notably, Vladimir Putin was sanctioned directly. Restrictions took effect, barring the export of various items and technological exports to Russia, including electronics, computers, telecoms, information security, sensors and lasers, navigation and avionics, marine, and aerospace items, all of which could have dual military use. Various exceptions were introduced, such as devices for medical use or consumer electronics.



However, the following actions would result in the most severe and long-lasting impacts for Russia's economy. The US, EU, UK, and Japan, among others, enacted upon Russia a collection of sanctions targeting its Central Bank, the scale of which is comparable only to that levied upon countries such as Iran, Venezuela, and North Korea.

This is unprecedented for a major economic power like Russia, a former member of the G8, from which it was expelled following the annexation of Crimea. In fact, all of Russia's gold and foreign currency reserves held abroad in Western central banks have been frozen. Roughly, this constituted half of all of Russia's $680 billion in reserves.

Subsequently, an additional package of sanctions was introduced by the EU, which included further bans on imports, exports, and investments in specific industries, as well as personal sanctions against Russian public figures. One of those figures was Russian technology firm Yandex's executive director and deputy CEO Tigran Khudaverdyan, who, as a result, immediately stepped down from the company. Yandex is known colloquially as the "Russian Google".

Russia's response

On February 28, being deprived of half of its Central Bank assets, Russian financial authorities ordered domestic exporting companies to sell 80% of their foreign exchange revenues accumulated since January 1, forcibly converting them into rubles. This unprecedented move can be considered as a de-facto seizure of private property. Worryingly, former Russian President Dmitry Medvedev, a close Putin ally, had previously threatened to nationalise foreign assets. As a preliminary step in this direction, the Kremlin blocked all foreign currency transactions out of the country and limited the ability of foreign investors to liquidate their assets held in Russia. Vladimir Putin also endorsed the idea of "external administration" for companies that would pull out of the country.

Crucially, authorities announced the Moscow stock exchange would remain shut until March 5, yet it remained closed until 24 March. On March 25, the stock exchange reopened only for four hours, but with severe limitations to the sale of assets, since stocks of Russian companies can only be bought and not be sold by foreigners. Furthermore, the Russian government started purchasing billion of USD in stocks which, due to limitations to sale, led to an artificial spike in their value.

These limitations were implemented because of the worry that, if the sale of assets was allowed on the MOEX, panic might spread amongst the population if all Russian stocks were to plunge. To give an idea of the difference between the value of stocks in the Mosco Stock Exchange (MOEX) and their real value, we can take Sberbank (SBER) as an example: while in the MOEX the value was of 132 rubles (1.3 USD) on 25 March, down from about 200 rubles on 23 February (the day before the invasion), their value on the London Stock Exchange (where they can be sold) dropped from 10 to 0.5 USD over the same period of time. Also in London, on March 3, trading in stocks of 27 companies linked to Russia was suspended altogether after their value came close to 0.

Additionally, in response to some American sanctions, Russia enacted personal sanctions against US President Joe Biden, Secretary of State Anthony Blinken, and 11 other American officials, banning them from entering Russia. The Russian Ministry of Finance also proposed redistributing budget expenditures to reduce the impact of sanctions.

Companie’s reactions

While the Russian government might have envisioned, at least partially, a breadth of sanctions imposed by Western officials, as set forth in the introduction, Moscow arguably did not anticipate neither the scale of the sanctions, nor that privately-held Western for-profit enterprises would depart the country “en-masse”. In fact, there were no orders for McDonald’s to completely shut its Russian operations, just as there were no legal sanctions against tech companies for selling their products in Russia. Specifically, the Kremlin did not anticipate how anything Russia-related simply turned “toxic”, with companies rapidly exiting the market primarily to avoid reputational risk, the impacts of which immediately deteriorated the standards of living for millions of citizens.

Currently, about 400 corporations announced their withdrawal from Russia. Crucially, however, not all companies have left Russia in the same way. As clarified by Yale University professor Jeffrey Sonnenfeld, some have honestly halted their operations in Russia, while others “threw up a smokescreen by making refugee donations but continuing their business” almost as usual. Four broad categorisations can be made regarding corporate reactions: full withdrawal, suspension of operations, reduction of activities, economic collaboration.

Clear patterns can be found industry by industry. For instance, it is much easier for accommodation provider AirBnB to suspend all bookings in Russia, for the company owns no property; in contrast, a halt to operations for car manufacturer Renault impacts its 40.000 employees in the country. Morever, Renault has a joint venture with Russian company Avtovaz and 10% of its revenues are generated in this market.

Full withdrawal applies primarily to professionals such as consultants, accountants, and lawyers, as well as some digitally native companies. For example, management firm Boston Consulting Group plans to transfer its Russian employees to Azerbaijan, Uzbekistan, and Kazakhstan. Some energy giants such as British Petrol, Exxon, and Shell also fall in this latter category.

Those who suspended operations are, for example, automotive companies with large sales teams in Russia, but with no significant manufacturing presence, as well as investment-intensive manufacturers and brick-and-mortar retailers. Often, they have a large workforce in the country, or their brands are associated with the bridging of the East-West divide after the call of the Soviet Union. This latter categorisation includes consumer brands such as Adidas, Levi Strauss, Xerox, and Ericsson.

Those who reduced current operations and suspended future investments fall within a variety of categories. Pharmaceutical companies such as GSK, AbbVie, Johnson & Johnson, and Pfizer cite humanitarian concerns for their decisions to remain active, but limit operations. Other consumer product companies, such as Danone, Barilla, Kellogg, Nestle, Unilever claim to be providing only “essential” goods to the market.

Those who did not significantly alter business operations in Russia include Asus, Auchan, Cloudflare, Glencore, Koch Industries, LeroyMerlin, Raiffeisen Bank, and Societe General, among others. This category constitutes a heterogeneous mix of enterprises, some with significant operations, whose closure would significantly damage their businesses, while others are most likely betting on avoiding reputational and legal risks linked to continued operations in Russia. As far as some banks are concerned, they have $20 billion+ worth of exposure on the Russian market.

Variables & Scenarios

Having assessed what has happened so far in terms of the beginning of the military offensive, the sanctions imposed by the West, Russia's counter-sanctions, and Western companies' reactions, it is crucial to look to the future and establish a framework for decision-making and forecasting of possible future scenarios. There are four key variables, which could intersect in a myriad of ways, to understand how business risks (and opportunities) will develop in Russia and neighbouring regions. Namely, they are:

1) How long will the war last? Will the war end soon? Will the conflict continue for weeks or even months to come? Could it drag on indefinitely with low intensity?

2) How will the conflict end? Who will win? Will there be a coup d'état inside the Kremlin? Will Ukrainian President Zelensky be assassinated? Will the territories currently occupied by Russia be returned to Ukraine as part of negotiations? Will Ukraine recognise Russian sovereignty over Crimea and the independence of the Donbas Republics?

3) How will the West continue its sanctions policy? Will there be new measures put in place to, for example, severely limit the purchase of Russian oil or will they be limited to gas? Will certain businesses return to Russia once “things calm down”? How will this affect inflation and unemployment inside Russia?

4) What will be China's role? Will the “friendship with no limits” be upheld, or will Beijing turn its back on Moscow?

There are no certain answers to these questions, but in the scenarios below, we aim to make educated assumptions and explore their potential implications.

Scenario 1: A quick end to the war

This scenario takes place under the assumption that the war ends quickly, between the end of March and the first half of April. The war could end if Putin and Zelensky decide to meet, as both the Russian and Ukrainian presidents realise that their losses are too heavy and agree to find a negotiated solution. Russian sovereignty over Crimea is recognised, as well as the independence of the Donetsk and Lugansk People's Republics. Ukraine enshrines "neutrality" in its Constitution, signalling that it is dropping its ambitions to join NATO, but still seeks to join the EU. Russia, on its side, agrees to pay at least partially for war reparations to finance the reconstruction of Ukraine. In this outcome, the role of China is negligible on the first level of analysis.

In this scenario, the West does not impose additional sanctions. After one year, the assets of the Central Bank are unfrozen, and the risk of a foreign currency default for Russia returns under control. However, most other sanctions remain in place, until Russia makes significant progress on its promises made during the negotiation process. Western companies that have made a definitive cut with Russia will not review their positions for some time, and the standards of living of Russians will continue to fall. Possibly, some sanctions more directly affecting regular citizens are lifted, and some companies resume operations, such as Boeing and Airbus, with air travel over Russia being restored.

Inflation is significant, between 20% and 40% yearly. In fact, it has to be considered that four days after the beginning of the war, the Central Bank of Russia already more than doubled the key interest rate, raising it from 9.5% to 20%. According to official statistics, inflation rose by over 2% between March 5 and 11.

This increase is the second-highest in two decades, falling behind only to the 2.2% rise registered a week prior. After the end of the war, the government convinces people that the worst has passed, and panic buying subsides. The social spending promises made to the population are honoured, and this continues to fuel inflation.

Also, growth in unemployment continues to register, with approximately 200.000 people losing their jobs by the end of 2023. Indeed, before the war, Russia had approximately 2.8 million people working for foreign companies and foreign-Russian joint ventures. However, this is all foreign companies, not only Western ones. Under this scenario, only a limited number of companies make a quick return to the Russian market, and the country continues to fall short of key imports and exports, leading to the closure of many factories.

Scenario 2: The war goes on for months

The war in Ukraine ends between late May and late-summer. Russian casualties continue to mount, Ukrainians remain resilient in spirits and continue to fight on the frontlines, while significant partisan formations emerge in the occupied territories, with assaults on the Russian occupying forces multiplying. In this scenario, Russia constantly continues to lose ground and fails to achieve any of its strategic objectives, registering well over 20.000 fatalities and a significant loss of vehicles, including aeroplanes and military vessels in the Black Sea. As sanctions start making their effect, Russian military manufacturers struggle to maintain production and reparation of vehicles, due to lack of components because of the ongoing sanctions, making the replacement of vehicles lost in the Ukraine war increasingly difficult, leading to a constant depletion of Russia's military capabilities. Therefore, on Russia's domestic front, pressure mounts as what should have been a short victorious "special operation" turns out to be a disastrous war.

In this scenario, Putin will seek to blame his subordinates for the failure of the war, becoming increasingly unpredictable and tyrannical. Fearing for their life, members of Putin's inner circle may decide to take action for fear of being purged and stage a coup against him, establishing a transitional government. A negotiated solution to the war is found, Russia agrees to return immediately all the occupied territories, possibly even the Donbas. The role of China, also in this scenario, is limited.

If such a scenario materialises, the West does not impose additional sanctions. At the same time, if a transitional government is established by a figure close to Putin, no sanctions are lifted as this person is likely to be considered a perpetrator of the same crimes of which Putin stands accused. During the chaotic period following the coup, panic may spread among the population, and street crime would increase, with assaults on Western citizens, who are seen as "rich" by definition.

However, over time, relatively free elections could occur, and a new president emerge. This could be someone who has never been a member of Putin's inner circle, for instance, an opposition leader like Alexey Navalny.

Subsequently, many sanctions could be lifted, not only those imposed on the Central Bank, but even those imposed in 2014 after the annexation of Crimea, if Russia and Ukraine find a comprehensive agreement, with Russia financing almost completely, for decades to come, the reconstruction of Ukraine. Under this scenario, stormy years lay ahead of Russia, as the free market thrives, but many of Putin's policies on the domestic front unravel. Hundreds of thousands of law enforcement personnel, no longer needed to prop up an authoritarian regime, are laid off, with some of them remaining unemployed and potentially turning to organised crime. In addition, growth is severely hampered by the financial commitments needed to rebuild Ukraine. Inflation stays above 40%, and unemployment remains high. This, in turn, may lead to political turbulence and potential attempts from members of the former elite to return to power via a military coup.

Scenario 3: The war drags on indefinitely

Under this scenario, the war does not end quickly, but drags on for months, possibly into 2023. Ukrainian will to fight decreases somewhat, as they see the devastation of their country grow, but significant civilian resistance continues to take place, making the occupied territories ungovernable for Russia. At the same time, Moscow transfers increasing resources into the military to finance its war effort. There are no winners in the war, as the two parties exhaust each other in a war of attrition. The regime in Moscow turns increasingly paranoid and totalitarian, and the economic situation deteriorates further.

The West continues to support Ukraine financially and, in a more limited way, militarily. Additional sanctions are imposed on Russia, to the point that the EU, US, UK, and Japan stop buying Russian oil. China comes into the picture, covertly supplying Russia with the resources necessary to continue the war effort, and overtly supporting Moscow at the UN. Slowly, Russia becomes increasingly dependent on China, as it remains Moscow's sole major trading partner.

Under this scenario, very few Western companies return to the Russian market. The Russian aviation industry collapses as the world's two largest aeroplane manufacturers, Boeing and Airbus, continue not only to refuse to sell new aircraft to Russia, but also cease to service the existing fleet. Russian planes are not welcomed in other countries not only because of sanctions, but because they do not meet international safety standards.

The decoupling of Russia's economy from the West, in the short and medium-term, eliminates certain types of economic activity. In fact, in 2022, over 6 million Russians worked in the transportation and storage sectors, a significant share of which was linked by trade relations to the West. Those sectors re-emerge over the long run, but they are tied to China.

In the mid-term, unemployment rises to 7-8%, from under 5% in 2021. This would be a significant political and economic crisis, but less severe than what took place in 1998 when unemployment exceeded 13%. Over the longer term, a sharp fall in household spending power registers and credit conditions tighten. This affects not only international trade, but the broader construction and the services sectors, which employ a significantly larger number of people.

The black market for foreign currency, primarily euros and dollars, emerges and thrives as Russians lose confidence in their currency as a store of value. Under this scenario, a 2,600% inflation increase similar to the sort following the fall of the Soviet Union remains unlikely, but the number of people living in poverty will undoubtedly grow, leading in turn to an increase in petty crime.

Conclusions: Business and security implications

In reality, what is likely to occur is a scenario that combines elements from all of the above, in terms of sanctions, inflation, and unemployment, but in even more unpredictable ways. This said, there are common features that are likely to emerge under any scenario.

A brain drain has already started in Russia, and it will continue. The first movers were the people working in professional services and technology spheres. These are the less capital-intensive sectors, which employ the most highly educated workers, and for whom it is far easier to move staff around. Firms like Google, BCG, Accenture, and EY, just to cite a few, have already encouraged or offered options for redeployments for their staff to countries like Kazakhstan, Uzbekistan, Azerbaijan, Armenia, Georgia, Turkey, Poland, and Romania.

On the one hand, these countries are more than happy to welcome a highly qualified workforce, not only because of the benefits for their fiscal systems, but also for the spill over effects in terms of skill transfers to the local population. In fact, some have already put in place programs that welcome workers emigrating from Russia, Belarus, and Ukraine, offering help with visa applications, rent, and all necessary documentation. On the other hand, an influx of foreign workers entails significant risks. The most immediate for Russians and Belarusians is that they will be viewed as the aggressors in post-Soviet countries for years to come, with even considered risks for their physical safety. Additionally, as is the case with any foreign workers, some layers of the population will see them adversely for “taking out jobs”. Companies planning for staff relocation need to monitor these risks closely to comply with their “duty of care” obligations.

In Russia itself, staff security can also become a more pressing issue in the mid-term. There are two key considerations. The first one is that anti-Western sentiment could increase in the case of the war dragging on for an extended period of time, with propaganda shifting the blame increasingly on the West for Russia's failures. Indeed, Putin has already made remarks in this direction, saying that the Russian nation is purifying itself by "spitting out" the fifth columns in society--those that "live and make money here, but are mentally there [in the West]". Anti-Western sentiment could also grow, in case of an abrupt end to the war following a coup against Putin, if the reparation costs for the reconstruction of Ukraine were perceived as too burdensome by the general public. The second consideration to be made is that when living standards collapse, the number of people living in poverty increases, and those seen as living a Western lifestyle in Russia are perceived as inherently rich, and therefore possible targets for street criminals.

A third consideration, which is more of an opportunity rather than a risk, is that if sanctions are lifted to a certain degree in the mid to long term but living standards (and therefore wages) of the less educated continue to fall, making Russia and Belarus international manufacturing hubs, rather than final markets. In fact, over the past ten years, IKEA has already made Russia a crucial manufacturing location, producing, for example, wooden products in Siberia for export to China, a country that until recently was considered itself a traditional manufacturing hub. If wages fall further, more companies could follow in IKEA's footsteps.

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