

Russian Defence Industry in the Era of Putin

Eugene Kogan

There is a preconceived and very inaccurate perception in the West at large that the Russian Military-Industrial Complex (MIC) has and will continue to have difficulties in the coming years because Russia faces domestic economic challenges caused by the low price of oil, continuing economic sanctions imposed by the EU and the US and the breakdown of defence industrial relations with Ukraine.



Photo: Spurnik

KURGANETS-25 armoured personnel carriers with medium-category caterpillar chassis at the military parade in Moscow on 9 May 2016

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There is very little understanding in and by the West at large that for President Vladimir Putin the issue of rearmament and, as a result, the correctly-functioning MIC enabling the planned delivery of weapons systems to the armed forces are of crucial importance, and that the Russian president is not ready to yield an inch in tenaciously pursuing his ambitious domestic agenda. What is more, as Alexandra Suslina, an economic analyst said: "The economy is far from the government's priority. They do not even pretend it is". Putin is also ready to back up a properly functioning

MIC financially even if Anton Siluanov, Minister of Finance, continues to baulk. Furthermore, Putin and his ambitious agenda are tacitly supported by the Russian population, that perceives the West at large as its major adversary. And the Russian population is ready to tighten its belt further and at the same time financially to support MIC operations. To a Western audience the sacrifices made by Russians for the sake of the MIC operations may sound like a paradox: however, for Russian patriots sacrifice and support are one and the same thing. It also needs to be remembered that the

MIC employs four million workers, who pay taxes, get subsequently a monthly wage, and, as a result, support a stable purchasing power of the population and at the same time stimulate trade and services. Not surprisingly, on 5 March 2016 Tatyana Shevtsova, Deputy Minister of Defence for Defence Expenditure, said that: "The Russian president agreed that cuts in the rearmament programme may undermine national security and must be approved by the Security Council, taking into consideration existing threats". On 21 September 2016 Nezavisimaya Gazeta online published an article entitled "[Defence] Expenditure for Rearmament is not Going to Suffer a Cutback". On 31 October 2016 Nezavisimaya Gazeta online published an article entitled "The Budget 2017 in the Regime of Demilitarisation", stating clearly that the allocations for na-

Russian Defence Industry is not Floundering but Prospering

Despite domestic economic challenges, the Russian defence industry is prospering since the government financially supports a massive (re)armaments programme that has escaped state spending cuts, while at the same time Russian defence companies are exporting a large quantity of weapons. The national defence export agency, Rosoboronexport (RoE), supports the current trend and is also interested in attracting a number of new customers for Russian arms worldwide. For instance, while in 2015 RoE sold arms worth US\$14.5Bn, during the first eight months of 2016 RoE sold arms worth US\$8Bn and plans to sell arms for additional US\$5Bn before the year end.

First Deputy Director-General of KRET, "The current 22% of its US\$1.9Bn revenues will be increased to 37% by the end of 2017".

The United Shipbuilding Corporation (USC) is the world's largest exporter of ship hulls, exporting US\$900M worth of submarines and US\$400M worth of surface vessels in 2014. On 4 October 2016, in an e-mail to the author, Ilya Zhitomirsky, USC Communications Director, wrote that: "The corporation's net profit in 2014 stood at RUB11.4Bn (about US\$165.6M), with revenues of RUB260.7Bn" – about US\$3.6Bn. On 29 September 2016, in an e-mail to the author, Zhitomirsky wrote that: "The company revenues in 2015 were RUB304.3Bn, of which RUB20.7Bn was net profit." Financial data for 2016 is not yet available.

The United Aircraft Corporation (UAC) saw revenues rise 7% to US\$6.2Bn in 2014, while in 2015 the revenues slightly decreased to US\$5.8Bn. In the first six months of 2016, the corporation's revenues increased by 24.3% to RUB128.6Bn (US\$2Bn). The RAC MIG, part of UAC, saw revenue increase by 13% to RUB44Bn in 2015.

Russian Helicopters saw revenues rise 16% to US\$3.96Bn in 2014 and slightly decrease to US\$3.6Bn in 2015. The net profit of the company in the first six months of 2016 was RUB9.8Bn (US\$150.5M). It can be said that Russian Helicopters remains successful. According to the Rostvertol report, the net profit of the company, one of Russia's largest helicopter manufacturing and repair facilities, part of Russian Helicopters, for 2014 increased by 83% to RUB5.6Bn from RUB3.1Bn in 2013. Net profit for the first half of 2016 has reached RUB17.9Bn (US\$275.3M).

The United Engine Corporation (UEC) saw a 25% increase over 2013 revenues to US\$3.3Bn in 2014. The company's net profit for the first half of 2016 has reached RUB7.7Bn (US\$118.4M). The Radio Technical Engineering and Information Systems' (RTI) revenues saw a 15% increase to US\$947M in 2014. In 2015, RTI's consolidated revenues were US\$1.050Bn, including US\$660M from the sale of military goods. The aforementioned companies represent the crème de la crème of the Russian MIC.

In the words of Alexander Scherbinin, Deputy Director-General of Russian Helicopters, "In the next two years (namely 2016-17) the company plans to keep the order book at the current level and sell between 230 and 280 helicopters annually". Besides the order book, Russian

Photo: Rosoboronexport



Rosoboronexport (RoE) as the national defence export agency supports the acquisition of new customers for Russian arms worldwide.

tional security will be maintained at the same level as before. Siluanov said that: "Despite (mounting) difficulties we will continue modernisation of the armed forces". Thus, both recent articles reinforce Putin's preferences loud and clear, so any discussions pertaining to revision of the rearmament programme are aimed towards the Western audience that should be reassured that Russian economy cannot sustain its high military spending for long, and that the MIC is unable to cope with the procurement targets. The reality as presented below is indeed very different, and on this point other experts in the field may disagree with the author.

In addition, reforms to Russia's (arms) export laws, enacted in mid-2014, have also allowed a small group of defence equipment manufacturers to engage directly in pursuing service and support contracts without having to go through the RoE. As a result, a number of companies – ranging from Russian Helicopters to the Russian Concern for Radio-Electronic Technologies (KRET) – are currently able to lower their overheads and pursue direct contracts with equipment operators. By way of example, in 2013, KRET made US\$2.4Bn in revenue. In 2015, KRET's consolidated revenues were US\$1.9Bn, including US\$1.6Bn from the sale of military goods. According to Igor Nasenkov,

Helicopters began actively to develop post-sales service centres and opened two such centres in Egypt and Iran in 2015, in addition to six centres already operating around the world. It should be remembered that over many years the Russian Achilles heel was the lack of a proper maintenance base and timely delivery of helicopter spare parts to customers worldwide. Apparently, Russian Helicopters learned the right lesson.

Although the Russian annexation of Crimea and the ensuing war in the Eastern Ukraine has contributed to the breakdown of ties between the Russian and the Ukrainian MIC the performance of the Russian MIC as presented above was not affected and the necessary production units were moved back to Russia. As General Yuri Borisov, Russian Deputy Minister of Defence for Procurement, said on 29 December 2014: "Production of main propulsion units for frigates was moved from Zarya-Mashproekt in Ukraine to the NPO Saturn plant of the Russian UEC in 2014. Diversification efforts have included moving Mi-8/17 engine production from Motor Sich in Zaporozhye to Klimov in Saint Petersburg, shifting the production of low-value components to Belarus and China and also moving naval turbine production from Zarya-Mashproekt to the Zvezda plant of the USC". The production of these items in Russia is likely to pick up pace from 2017 onward, while according to General Borisov defence industry imports from Ukraine will be completed by the end of 2017. The General further said that: "The import replacement programme is being carried out, and all activities with Ukraine should be completed by 2018".

Current Critical Problems and the Way Ahead

It should be emphasised that in the post-Soviet era the MoD has made very few investments in the defence electronics sector, which has been unable to keep up with the rest of the world. The defence electronics companies became too dependent upon sourcing many electronic components from outside Russia. The case of RTI presented below supports the author's assertion. Sergey Boev, Director-General of RTI, said: "Electronics of all Russian-made radars will be free of imported components in the near future, but it will be hard to substitute VHF microchips". In mid-August 2015 Boev further reiterated his company's dependency on imported electronic components by saying that: "In 2016 the situation



Photo: Russian Helicopters

Russian Helicopters military aircraft participating in the "Victory Parade" on 9 May 2015

compared with 2015 will be more difficult, because 70% of our equipment consists of imported components". The Russian Ministry of Industry and Trade plan shows the proportion of imported components in the electronics industry should be halved by 2020. In several areas, such as integrated microchips, imported components are supposed to be reduced from the current 85% of the total to 45% by 2020. In the case presented above, solutions are not immediately available and require more time to be mastered compared with other branches of the MIC.

Despite the full support that the government provides to its armaments programme and to arms export success, the personnel profile of the MIC is ageing; the average age is above 55 and that of the scientific research institutes is 60. However, over the last several years the government has begun to provide financial incentives to attract younger em-

ployees. For instance, according to (non-identified) government data, about one thousand MIC personnel, most of them young specialists, were awarded grants for their contribution in developing a technological breakthrough and the development of modern weapons systems. In mid-August 2015 Boev said that: "The Company implemented a new system for training and retaining prospective employees from the secondary school level, rather than only universities as it was in the past". As a result, RTI moved from 99th place on the Defense News top 100 companies in 2014 to 69th place in 2015. However, the above-mentioned trend is not observed, for instance, at the RAC MIG where the average monthly wage increased to RUB43,000 and the number of workers including young personnel and engineers are sufficient to maintain the company's growth.

In another example, despite a steady increase in revenues, in early November



Photo: Mod RU

Vladimir Putin's support for the domestic Military-Industrial Complex (MIC) seems to be backed by a large part of the Russian population.

Masthead

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2015 Russian Helicopters began to restructure one of its plants based in Kumertau, Bashkortan. The plant did not have a sufficient workload and, as a result, accumulated losses of about RUB2.5Bn in 2014. As a consequence, Kazan Helicopter Plant and Kumertau Aviation Production Enterprise are to merge and from 2018 a merged facility will manufacture a variety of civilian and military helicopters such as ANSAT, Ka-31/32/226 and Mi-8/17/38.

Following a decision by the Russian government, on 29 April 2016 NAZ Sokol in Nizhny Novgorod was merged with RAC MIG. According to Aleksey Beskibalov, Deputy Director-General for Corporate Finances, "The merger will have a synergy effect". In an interview with Vedomosti online on 22 December 2015 Sergei Korotkov, Director-General of RAC MIG, said: "The merger will lead to dismissal of between 5% and 10% of the company (managerial and administrative) staff, however, the dismissals will not affect workers and engineers".

The powerful Rostec industrial holding company, that controls about 700 companies in machine-building and MIC sectors, including RoE, is to eliminate about 40,000 employees from its corporate staff over the next two years. One of the follow-on effects of this downsizing is the liquidation of intermediary entity Oboronprom. This company originally controlled both Russian Helicopters and UEC, which were subsequently taken over by Rostec.

In other words, in order to infuse fresh blood into the MIC the government began to provide financial incentives, and also, as was highlighted in the case of RTI, expanded the pool of new employees for the company. In order to make the performance of the MIC enterprises efficient and profitable, ongoing mergers and restructuring are the way ahead out of the current difficulties.

Finally, the current rearmament programme foresees that the MIC will continue to deliver weapon systems to the armed forces up to 2020, when 70% or slightly more of the armed forces will be equipped with modern (and not modernised) weapons. According to Putin, "By 2020 the large-scale rearmament will be completed and the peak in deliveries will be over. Nonetheless, we will continue to improve the state of the armed forces, even though such a large-scale order for the MIC will be over". What the scale of orders will be for the MIC post-2020 is not yet known. As a result of that uncertainty, Putin suggested paying attention to the manufacture of civilian goods by the MIC. We need to remember, however, that the current Russian MIC, just as its Soviet predecessor, is not well-suited to the production of civilian goods. Past experience shows that Russian consumers were and still are not eager to buy domestic appliances. Whether or not directors of the MIC will heed Putin's orders is not clear at the moment. Furthermore, even the Russian civil aviation facilities have difficulty in manufacturing first-rate commercial aircraft such as the touted Sukhoi SUPERJET 100 (SSJ100) and the planned MS-21: domestic air carriers somehow prefer purchasing Airbus and Boeing craft despite the government imploring them to buy Superjets. Thus, the effort to diversify production for the needs of the civilian sector may not pay off even if Putin prods the directors of the MIC.

To conclude, until 2020 the MIC remains busier than ever before, delivering weapon systems to the armed forces and exporting military goods worldwide. Thus far this mixed strategy has proven to be successful. As for the era after 2020, it is too early to make a prudent forecast. One thing is certain: at the moment the blueprint for the MIC enterprises post-2020 is not ready. The talk about diversification of MIC products for the civilian market is cheap and useless. Russian patriotism preached by Putin to buy domestic civilian goods has a low appeal and the Russian population living in the larger cities has become used to foreign civilian goods bought over the last 25 years. On the other hand, Russian support for the domestic MIC is real and beyond any doubt. ■