CEEMEA Business Group

Russia Business Gossip Report

"Things are not bad, better than expected"
BUT is the Russian consumer getting tired?

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Content

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About the author

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Danny Thorniley is President of DT-Global Business Consulting GmbH (an LLC company) which is Danny's own consultancy company based in Vienna through which he works with some 330 key clients on business strategy in CEEMEA, global and emerging markets especially Russia. These companies are part of the CEEMEA and Russia Business Group, which is an advisory and consultancy service. The services of the Group include written position papers, presentation slides and private client meetings as well as in-house presentations.

Danny writes a well-received monthly position paper on the Russian market as well as quarterly presentation slides on other CIS markets. He visits Moscow on business every 2-3 weeks and hosts 8-9 private meetings of the Russia Business Group annually. The most recent one was attended by some 140 senior executives. He is also invited to make some 50 speeches/presentations each year by clients across the world on global business trends, business operations, emerging markets, corporate best practice. Many of these speeches are focused on Russia and the CIS and he has made some 60 "Russia presentations" to visiting western CEOs explaining the positives of the market without being naïve.

For 23 years (until the closure of the Vienna office) Danny was Senior Vice President and Senior Consultant at The Economist Group, Vienna on global corporate business trends, with specialisation in BRIC.

Danny has exceptional skill sets in global business strategy, business in emerging markets and CEEMEA and hands-operational knowledge of business operations, distribution, partnerships, investments and human resource issues.

Danny is regarded as a charismatic speaker who can present detailed business and economic analysis in an easily digestible fashion with a great deal of genuine humour. Danny is renowned for not using PowerPoint presentation slides - never. Dr Thorniley has also given guest presentations at Executive MBA courses on behalf of Oxford University, the University of Chicago, IESE (Spain) and the Central European University in Budapest. The executive MBA students at Chicago rated him "best speaker" on 12 occasions out of 12 over 5 years.

He has worked on a personal basis with companies operating in emerging markets for 26 years and has personal contacts with most senior western MNCs operating in the Russia and the CEEMEA region and beyond. He makes frequent presentations at CEO and Board level and has long-standing personal friendships with leading executives. He holds and has held a number of non-executive and advisory board memberships.

Dr Thorniley was educated at Oxford University. He holds a Bachelor of Arts degree, a diploma and a doctorate degree in Soviet political economy.

He has published three books, including one on Russia with Macmillan (UK/USA) and two with Profile books on Doing Business in Global Emerging Markets.

His beloved daughter is called Natasha after he read Tolstoy's War and Peace when he was a young man. One of his other favourite books is Master and Margarita by Bulgakov.

This report as usual is based on dozens of private conversations held in recent weeks in Moscow, telecom calls with senior managers and three major meetings in Moscow: one of 150 senior managers and one of 15 managing directors from the consumer goods sector and another working dinner with 45 managing directors from the B2B sector. <u>As ever, as a professional courtesy no company or individual names are used even when the remarks were made in public.</u>

This document focuses on anecdotes and comments from executives. For full sales analysis by sector, please look at the Business Survey findings and the regular reports which review sectors.

Some key points

1. Overall at our major executive event last week in Moscow the business mood was "not bad at all". Once again managing directors were saying:

   "We are doing ok."
   "We are doing better than ok."
   "We are making reasonable money, we are making profits and contribution."
   "We are doing better than expected but not as well as in the good old days."

   That's the good news and overall with lower inflation (7.3% this spring) and a more stable rouble and oil at $50 per barrel and with spring business trends quite reasonable and with the economic numbers improving, it's hardly surprising that there's a spring-summer mood in the air.

2. We repeat as ever that this does NOT apply to all business sectors: the automotive industry and supplies into it are still very tough; IT sales to the Russian government are quite bleak; medical equipment sales are very strained for most companies and reimbursed pharmaceuticals are not good. But most other business sectors are performing quite well with organic sales growth at 7-14% in roubles.

3. But the wear and tear of the last 2-3 years is perhaps starting to show in at least 3 ways:

   a) More companies are reporting over the last two months a slight deterioration in how distributors are building inventories and making purchases. This is not a collapse but a marginal worsening. But more executives do expect some short-term bankruptcies among the Russian supply chain.

   b) The situation with receivables remains quite good but again over the last two months a few more companies report a mild worsening while the number experiencing difficulties has risen from 2-3% to 8-9%.

But perhaps the third and biggest recent change coming from anecdotes from western managing directors is that:

- The Russian consumer may be tired and flagging and less resilient than in the last 2-3 and 6-7 years.
- The Russian consumer is exhausted.
- The Russian consumer is now almost completely "normal" i.e. westernised.
- There is a healthy correction and the consumer is more normal and uncertain whether you like it or not.

The Russian consumer has of course changed radically in recent years and now looks more for value, promotions and discounts and chooses to or is obliged to downtrade. All these factors are clear. However, for the last 5-7 years most managing directors of consumer product companies have been positively amazed at the resilience and survivability of Russian consumers which has generally helped many consumer product companies to flourish or do reasonably well.

Executives in this sector are NOT suggesting that the Russian consumer is on the verge of collapse, only that finally after so many years, there is a sense of some fatigue and this is hardly surprising given the economic shocks that have been endured in recent years and months.

As we noted in recent reports, numbers for retail sales and real wages and consumer confidence at the turn of 2015-16 were among the worst in 15-20 years with real wages down by -10% and retail sales -15% in December; but by early spring real wages had turned slightly positive in March and retail sales were negative by only minus 3-5%.

So the bad news is that executives (see below) think the Russian consumer is flagging but the good news is that most macroeconomic indicators are picking up. We may be able to conclude that this disparity may not last long and that the flagging Russian consumer may be able to tick up again in the coming weeks/months if inflation stays low and the rouble stabilises…. which is our and the consensus view.

One note: several consumer product companies have spoken of a softer month of May and they are probably comparing like to like but we all know that May is a month full of holidays in Russia and this could certainly impact May retail sales compared with April ones.

The consumer goods sector

- More executives think the Russian consumer is tired (see above).
- Many companies are growing rouble sales at 5-15% or less in food and beverages.
- Profitability is not bad.
- Pushing through price rises is now more difficult.
- Promotions are increasing and eating into consumer product (CP) margins.
- Russian retail is getting very tough as traditional trade shrinks.
- Distributors are also getting tired and slightly more strained.
- Receivables are good but mildly worse this year.
- Small size packaging is important.
- Localisation in many sectors is critical.
- "If you don't have a warehouse, you have to build one".
- E-commerce is small but increasing rapidly and companies are not confident about their approach.
- Executives look at Russia as a base for outsourcing.
- "Russia is an attractive location for shared services centres".
- Most executives are pleased with how their Russian staff are responding to the new environment.
- But staff and executives are also "getting tired" after 2-3 years of slog.

One of our major themes here will be that the Russian consumer is showing signs of fatigue but this does not yet mean that consumer products (CP) companies are posting bad results:

- One of the world's largest FMCGs had results on target in the first quarter and they except a better second quarter.
- A major tobacco investor also reported an excellent first quarter with the best profit results in the world for the company.
- A European food and beverages investor also posted very good results in 2015 and in Q1 of this year: "We have met almost every single indicator and target and are quite satisfied".

But some luxury companies are reporting declining sales, but not all (see below).

Three overall points to begin with:

1. Senior managers discussed the never-ending tension between short-termism and long-termism and complained of the need to meet short-term targets. One MD summed it up as: "HQ is basically telling us to deliver for 2016 and worry about 2017-28 later", which as this executive noted, may not be the best approach. Another MD from a European food company remarked that: "You have to meet the short-term targets in order to get the necessary investments from HQ".

2. More CP companies are looking to localise and outsource. As one MD put it: "There is a concern that some local distributors could go bust and localisation will protect you somewhat from this".

3. Most companies are satisfied with how their staff and teams have responded to the recent shifts in the market. One MD commented that: “The global HQ has recognised just how good the Russian team is”.

As a final introductory remark, several managing directors from consumer product (CP) companies joked at a working dinner last week that when they have to make PowerPoint presentations for headquarters, the three key themes on the key slide are:

Digitisation, innovation and efficient growth!

So long as you include those on the slide, the meeting will go fine! ☺

Comments from senior CP executives

The MD of a major drinks company commented over coffee last week in Moscow:

> We thought 2015 was tough and that 2016 would be easier but this is not quite so. This is a second year of struggle and we are hoping for an easier 2017!
>
> People are buying on price and not with their stomach or tongue! Our concern is that once they downtrade, will they ever come back up? We do not think that they will all come back for sure. The brands are doing well but this has to be:
>
> **Brand at the best price.**
>
> We are even seeing some weakening in super-premium which is rare and there are changes in frequency and volume.

This MD went on to make an excellent point about brands and sub-premium etc. She noted that:

> Yes, we are diversifying and introducing sub-premium products because the consumer is trading in and out of categories and is much more volatile.
>
> **But we are also starting to stretch existing brands as well as introducing new ones.**
>
> By this I mean we keep existing brands but stretch them in terms of price at the margins and perhaps package sizes so that the consumer can stay loyal to them if he/she wants to.

She made another excellent comment when she remarked:

> We do have to diversify but we also need to be careful and protect the brands. We don’t want to disturb the consumer excessively and to confuse them with “over-choice”.

The MD also noted that:

> We are working closer with the local drinks industry as we all need help adjusting to regulations and Trade Laws. Affordability is increasing and that makes profitability lower but the good news is that headquarters finally understand this point. We are constantly reviewing prices and FX rates to cushion the blow to FX results without losing market share and destroying the categories.

This manager also alluded to challenges among distributors who are “facing a real dog fight”. Other managers have commented on how some distributors will go to the wall.

The MD of a major US FMCG company noted the following trends at dinner last week in Moscow:

> We had a weaker month of May after a good first quarter. I am a bit worried that maybe the consumer has had enough and perhaps the first quarter good sales were consumers stocking up or have bought on promo. Overall I do think:

> **The Russian consumer has had enough.**
>
> It is getting tougher to pass on price rises; it is possible but the environment is not lending itself to this. We are careful about price rises. We don't want to confuse the consumer with prices going up and even down and don't want to frighten or alienate the shopper.
> It's not just the consumer who is flagging but
>
> **My team is also getting tired after the last 2-3 years!**
>
> The last 18 months have tempered expectations and we have made budgets accordingly. Our plans are lower than in the past but still good.
>
> Any fluctuation in the rouble causes wobbles for our business and results. Last year the consumer was very resilient for soap and personal care products and was cutting back more on entertainment and restaurants. They are trading down and are more careful. They are pickier but I have to say that our sector of personal care is still good.

This MD also made the excellent point that:

> If you don't have a warehouse, you have to build one. We are now a hub and supply 10 countries and HQ will look at local manufacturing or outsourcing.

(See our note above explaining why May is probably a weaker month than April but equally there could be something more serious going on).

The MD of another CP company in the personal care sector remarked:

> Yes, consumers are very price sensitive. Pricing is a key driver of share and volumes. You have to be very precise in your pricing policy.
>
> **You can't have a price differential of 10 roubles with competitors.**

You also have to reflect what kind of price differential your brand can command.

This executive argued that one company had been too aggressive in price increases and had lost 30-40% market share as a result!

The MD of a major food and beverages investor also echoed some of the above trends and thoughts:

> The month of May this year was the first flat year for us in value terms for two years. After a good first quarter, Q2 may be a bit softer and we are discussing whether to invest or not. I have decided not to invest in some marketing of certain categories and we need to manage our prices, brands and promotions.
>
> **So after a good two years, there is some new uncertainty and where is this going?**
>
> As with other companies, we are more concerned about the sustainability of our pricing policies.

The MD of a Scandinavian food company reported some similar trends and one success:

> 2016 is another tough year but with less panic than in 2015: we know what this is, this is the new normal. Like everyone, we see downtrading but our brands hold up quite well. As a response we have introduced a new sub-premium brand and this has been one of the most successful launches in the company's history globally!
>
> We are seeing consumers react more to price increases now and so we introduced our increases early and quickly and we have to do trial and error with pricing now.

The MD of another European food company outlined business in the pasta sector:

> Our industry is holding up well with volume up double digits and value up more than that! In the food sector you have to be localised and we built two plants in 2013 and thank God! We are relatively niche and you cannot be successful without localistion in our business. Our consumers, all of them, are shopping on promos and discount.
>
> Two years ago I was more pessimistic but I have learned that if you have good brands and manage prices and promos, then you can do well.
>
> Private label in our business is about 30% of the market and the major driver of growth.

The MD of a major tobacco company made the following remarks at dinner last week in Moscow:

> Our global CEO visits the market and is very satisfied and we plan further investments for the long-term. The growth of modern trade is extreme at 30-60%, and traditional will soon be gone! But the demands of modern Russian retail trade on western FMCGs are unsustainable and something will break. We are looking at more price increases and our route to market.

This executive also made the sound remark with which others concur:

> If you localise now, you do improve your relations with the Russian government.

The MD of a European packaging company related the key elements of his business as follows:

> Consumers are reacting differently to “local” or “international” brands and of course some local brands are now international. The consumer is obviously much more complex. In the past we used to grow at 10% in value terms and now 2-3% is acceptable. HQ is pushing but they realise they cannot squeeze our brains out! We also see the current climate as a good one to capture good talent and we are working on that.

We noted above that some luxury goods companies are seeing declines but this is not a total trend. One US company reports good trends. The MD commented at dinner that:

> The first 5-6 months of the year have been very strong and well above our expectations. Russia is actually compensating and balancing weaker trends in China and other emerging markets in volumes and profits. There is less foreign travel and therefore more in-bound spending. We are seeing a marginal pick up in Chinese consumers but nothing massive. And I would say that strong brands are able to survive better.

Another executive in this sector of cosmetics and related products concurred:

> The total beauty market is growing by 16% in roubles and luxury by 20%; volumes are stable or in slight decline and growth stems from price increases. Our own results in the first quarter were 35%+ in retail sales and this was mostly price but with some volume.

This executive commented in contrast to those above:

> The consumer is absorbing all this and it’s amazing.

But he did go on to question:

> It’s amazing, but how long can it last?

This executive and two other managing directors from other CP companies confirmed our long-held view regarding different consumer segments. The summary of comments goes like this:

> Premium is holding up but we have to introduce sub-premium; categories and volumes have held up but growth has come through price and especially the second-tier brands and mid-price and mid-brands are those that have struggled and continue to struggle.

Several executives also reiterated the key point about diversification and also route to market:

> We are not a one-brand company, thank God. We have multiple brands and can and do "play with them" shifting and swapping and adapting but we do try to avoid confusion and of course do not discredit the various brands.
>
> And in addition to all this, we have multi-channels with own stores, some under-developed brands which can be pushed and we should also consider more e-commerce.

On this last point estimates suggest that e-commerce accounts for 3-4% of retail sales in Russia compared with 12-14% in developed western markets. The growth rates though are of course very large indeed from the small base: one logistics company noted that e-commerce companies in Russia are growing 60-70% per annum and that this could accelerate.

E-commerce also raises many issues and 2 executives confessed to being perplexed:

> Omni-channels and e-commerce all sound great but our company does not really understand it in Russia and globally; we are learning around the world. What does a key account manager do for omni-channels in Russia?

Another MD summed it up as follows:

> We lack the staff to manage e-commerce which is 3-4% of our business but growing at 60-100%!

The pharmaceutical and health sector

Generally reimbursed sales are tough; sales to local municipalities and hospitals are mixed and sometimes challenging; sales to the small but growing private sector are good while OTC and retail sales have performed much better.

The MD of one medical supplier commented thus:

> Yes, government sales are very hard as there is not much new health construction going on. Government wants local products and in this sector is buying "funny products' and this is not just driven by price but by "informal recommendations".
>
> The private sector does understand quality and is looking for it. But this segment is relatively small and does not compensate for our losses in the state sector. For example, a very large private hospital is 100 beds with an average of 40-60.
>
> Just some/few major institutions do the surgery and much of this is paid out of patients' pockets and occasionally with insurance but if it is a routine procedure then invariably it's paid out of pocket. An important question is: when will the private sector start to grow more quickly given that restraints on federal budgets seem to be in place for some time? At the moment, legislation helping such private developments is not encouraging.

A more upbeat picture came from the MD of European pharmaceutical company which has more focus on OTC sales:

> The year started well and we made budget without too much pain. As we are already in the premium sector we didn't really have to raise prices much which also helps. But it's good to know that premium OTC is surviving well. One area I need to improve is growing the categories. We still think consumers are resilient when it comes to health spending and they will forego other purchases in our favor.

> We are also fortunate in that our HQ was careful with the 2016 budgeting and not aggressively ambitious: we are all thinking of stable, moderate growth and paying attention to market share without a mad race for massive and perhaps unsustainable growth.
>
> The pharma industry is surviving and quite well but of course it does depend on sub-sectors and if you are in the "right sector", then 15% rouble growth is certainly possible.

The B2B sector

At a working dinner 2 weeks ago some 45 managing directors took part from this broad sector and the business news was generally quite good and once again many executives noted that trends in 2016 were "better than excepted". The automotive sector remains strained and IT sales to the government are also stressed (see below).

But one supplier to the automotive sector explained that the sector was "no longer suicidal":

> We were down -45% in roubles 9 months ago and are only down -10% now on a rising trend. I think we are either at the bottom or may even have passed the worst. But I am not naïve about the future. It will take a long time (2-3 years) to get back to anything like former levels or even moderately good ones.

The MD of one industrial-automation company outlined business like this:

> Our HQ is positively surprised that we are not in negative numbers and the mood is more positive. I do get a 30 minute call from the US every week and they keep asking if they can help! But the help is mostly short-term orientated and the company struggles with the concept of localisation so I think we are in the middle of opinions in that debate.
>
> Without that localisation and being relatively mid-sized, we do lose out to some of our bigger competitors who can develop some leverage with local and federal authorities.
>
> While we are better than expected, we are far from carried away. Our budget for 2017 will be for no growth as the market is subdued and we face price wars and the first two quarters in 2016, while better, were not easy.
>
> Our customers now do have money but they are reluctant to spend and are postponing and waiting to see. In the oil and gas sector the big players do spend on protecting production sites but most business is frozen if the project is less strategic. We do have discussions with Gazprom but they ask if we are localised and when the reply is negative, they prefer someone who is local.
>
> We are facing a few more receivables problems because we invoice in Euros and we have to manage that. It's not a crisis, just a fact of life and current rouble stabilisation may help.

The managing director of one European company supplying to the heating and electricity sectors noted that:

> The start of the year was much better than expected and our products are large and can require some investment at $1-3mn for a system. We have been forced to wait for delays to come to fruition and that has tested our patience over 6-12-18 months. But some of these deals are now being finalised. I think the financial and interest rate environment is a little better and this is helping us.

Executives from 2-3 industrial conglomerates also reported steady business and summed it up thus:

> As you know Danny, diversification is often the key: we supply to 4-5 different economic/business sectors and that spreads the risk. On this basis we are growing 10-25% in roubles and almost growing in FX. We think we can increase FX sales in the second half of 2016 if the rouble stays steady.

Several executives also noted some caution:

> We are doing quite well with sales now positive in roubles at 7-15% instead of -10% last year. The mood is getting better but we are just concerned about how sustainable all this is.

Executives also noted that in their "industrial sector" any sub-sectors which were closer to the consumer tended to do better. Given the above comments about consumer fatigue, we will see if this continues.

The IT sector

The managing director of a major western IT company outlined his business extensively last week in Moscow:

> As you say, hardware sales to the government are very tough and down heavily. We obviously see that companies want efficiencies and the CFO of a firm wants a visible return in 12 months and we need to shift to offering a quick ROI.
>
> We are using outsourcing facilities in the regions and employ 400 people there; there is a definite trend to outsourcing in Russia. We have also made a $3mn investment in a client centre in Moscow and this is bringing good results. And we are shifting to new types of services and products and taking these from our global portfolio, so yes we too are diversifying.
>
> In 2015 we grew 15% in roubles but reported a solid decline in dollars and we see 2016 as more stable and the dollar decline will be much smaller. We didn't raise salaries in 2015 but plan an 8% increase in 2016 and we report low attrition and last year reduced staff by 5% and are implementing a hiring freeze at the moment.

The MD of another US IT company spoke over coffee last week in Moscow and commented:

> Yes, clearly sales to the government are brutal and the government has changed direction here. Actually though, the rest of my business is reasonably balanced: our business with banks is OK and the Russian telecom companies are open to innovatory solutions and therefore doing business with us. We too have to diversify if we want to retain market share and we are doing that.
>
> There is less overall competition as some companies "pull in their horns" and that also helps us with market share. But we are seeing more Chinese competition and that is challenging on price and their developing relations with Russian partners.

As ever, I hope you have enjoyed this report and found it useful. If you have any queries or comments, do get in touch at danielthorniley@dt-gbc.com

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