CEEMEA Business Group

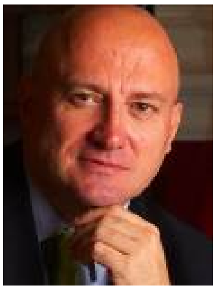
Advice for the 2016 Russia Budget

Factors behind the Numbers

by Dr. Daniel Thorniley
President, DT-Global Business Consulting
danielthorniley@dt-gbc.com

21 September 2015

About the author



Dr Daniel Thorniley

danielthorniley@dt-gbc.com

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.

Factors to include behind the numbers: What's Best Practice?

"It's very easy to make great short-term decisions that help the immediate bottom line. We can all do that. But I would argue that most great short-term decisions are bad medium and long-term ones. The long-term ones are the more important", the European regional manager of a US drinks company.

The most successful toy store in the world today is Hamleys, not the one on Regent Street, London but the one coated in Detskii Mir, Moscow (from an industry source)!

- It's not just the budget: think long-term; what do you do in 2017-2019?
- Manage expectations with global headquarters: a serious professional exchange is necessary.
- The Russian market has gone through about 6 "New Noramls" in the last 18 months.
- The Russian market has changed and will need time to recover to an "OK" market: headquarters have to realise this and face the facts.
- The message is "we are not the glory boys of the recent past. But we can have a reasonably good business in this market in the next 15-30 months"
- **Market share is the name of the game.**
- Plan the 2016 budget and any longer-term plans on the basis of scenarios: one number or one set of numbers looks unrealistic.
- Don't get fixated with one set of numbers: we all know about the budget trap and how budgets have become very quickly redundant in recent years.
- The business cake in Russia will not boom in the coming years: aim for sustainable market share. What will be the drivers behind that?
- Stay close to customers and clients: make sure they know what you're doing and why.
- Build relationships with your Russian customers and partner: Never forget that Russians never forget!
- Treat them well and they will remember you forever.
- Look at customer segmentation in greater detail: slice and dice the consumer categories.
- CRM is more important now than ever.
- Find new consumer segments: sub-premium, premium, mid and low.
- Introduce more affordable or even upward innovation.
- Decide if the focus will be more diversified from pure premium: work out where you want to be on the brand/value spectrum.
- Decide how you will grow your business: what will be the functions of volume and/or price?
- Make scenarios for phased price increases: but this depends on the rouble.
- Offer clients "solutions" and integrated systems and offer after-sales servicing with it. If you are selling ball-bearings, then offer all the engineering kit that goes with it and the process systems that surround ball bearings.
- This deepens and tightens the relationship with clients rather than limiting the process to a one-off sale.
- Move quickly to streamline systems.
- Delegate responsibility as much as possible to your talented local teams.
- Offer managerial autonomy when you have faith in your team.
- But never compromise on compliance: this can be dictated and top-down from HQ but also instilling local initiative and implementing compliance programs.
- Is your operation in Russia "fit for purpose": you can't control the oil price or the rouble but you can make sure that your systems and processes are right and that you have the right people in the right jobs --- then let it go and let it happen.
- As the MD of one pharmaceutical company once said: "We have the right structure and a sensible business plan for Russia. That's all we can do. The team is flexible and adaptable. That's what we need, not 100 pages of sophisticated budget numbers".
- Flexibility in your team and in your plans is a key defining point: as the MD of a major consumer goods company once said: "When I look at the budget, I always think of the F-word! Flexibility!"
- Look at managing costs in the supply chain and manufacturing processes.
- Diversification is a winner: are you already diversified in your portfolio offering? Then, well done. If not, can you broaden the portfolio and spread the risk? Can you introduce new global products/services from your global palette of predicts?

- As you examine the Russian regions more closely, what does that mean for affordable innovation, route to market, marketing and pricing?
- Can you squeeze more juice from the Russian regions and from the CIS markets? We know it's not easy but…
- Localisation is at the forefront of business thinking: can you do more?
- Re-visit your sourcing strategy: can you realistically source more from within Russia? Look at Asia, China and S.E. Asia: this helps you in terms of costs and in presenting a good face to Russian authorities regarding sanctioning nations.
- Look at small bolt-on acquisitions: some European mid-size companies are doing just this.
- Acquire to tie in distributors and customers; acquire to capture a bit of market share; acquire to show long-term commitment to customers and to the Russian government.
- Invest in logistics and warehousing and distribution.
- Look at Russia as a market of channels: distributor, direct, key accounts, mix of own and distributor services; split distribution into consumer focus part and physical logistics part.
- For retail and FMCG there is a sub-set of factors to consider:
  - increase of home consumption
  - growth of modern trade
  - authenticity, trust sustainability in products; home-grown, nostalgia
  - cost-effective/smart shopping
  - growth of discounters, private label
  - more promotional pressure
  - On-line, e-commerce
- How to respond to these drivers and what balance to achieve?

Words of advice from senior executives

The retired EMEA President of one of the world's largest consumer goods companies told me:

- Delegate downwards and try to avoid going through headquarters.
- Always innovate downwards – reach out to your customers.
- Control your working capital and protect your distribution network.
- Maximise your local content.
- If you have excess HR capacity, train them to do something else, something new. Don't abandon them.

The regional head of a European pharmaceutical company advised: Share the pain!

1. Share the pain with customers and raise prices but explain how and why you are increasing those prices.
2. Share the pain with distributors and the supply chain by discussing payment terms. But do not brutalise your distributors, you don't want to destroy them and end up with one distributor in Russia in 2016.
3. Share the pain with your Russian staff and explain why salary increases will be below inflation again in 2016.
4. And toughest of all, explain to your CEO and European Board that sales and profits will be smaller than in the past.

Another way of saying this is:

- Don't cut costs so deeply that you damage long-term relationships with customers and clients.
- Don't cut cost so deeply that you damage relations with distributors and suppliers.
- Don't cut cost so deeply that you damage relations with your HR and talent whom you will need in years to come.

In closing after a lot of basic, common sense advice, I would underline yet again that the name of the game is market share in Russia today and for the next 2-5 years (and by the way this applies to most markets in the world today).

Preparing the 2016 Budget: harder or easier this time?

Preparing 2016 budgets is going to be more than usually challenging after such a volatile 12 month period from October 2014 to October 2015. There is, as ever, a big threat of falling into the infamous budget trap if trusting that events and trends will be business supportive. But actually this year more executives than usual will tend to the side of caution and want to present conservative scenarios. And after the turmoil of the last year, it's possible that some European and global headquarters may be more sympathetic to listening to these scenarios. As the MD of one major industrial conglomerate company noted last week in Moscow:

> We have been "all over the place" in the last 12 months and global HQ is actually slightly more conservative than I am which suits me fine! They don't want to get trapped in too high figures.

This theme of needing to be careful about getting caught in the budget trap was echoed by the MD of a major European consumer product company with sales of 1.3bn Euros:

> Even though the numbers are not what they were, Russia remains a very important volume and profit market for our company. It's still in the top 5 priority markets for Europe, at least for now! This means global management take great care when doing the Russian numbers. If the budget is missed badly, it's not just my neck on the line. A lot of other senior European managers in different functions have to "carry the blame" with me. This helps for a more realistic approach.

Also from conversations it seems increasingly that business results stem from the leadership stance of management in Moscow and at European, global headquarters.

The brief executive summary from our September survey

- Most companies budget for some moderate rouble sale increases in 2015.
- There is a big positive shift in 2016 budgets for FX growth and improvement on 2015.
- Some 44% of companies budget for FX sales growth while 71% budget for FX sales as growing or flat.
- Such a result would require a more stable oil price and consequent stable rouble.
- Profits in FX for 2016 are also budgeted at better level than FX sales or last year's FX profits: this means that companies plan to continue cost reductions while maintaining some price increases.
- A sizeable majority of companies predict and budget for a better 2016 while remaining cautious.
- One quarter of companies have on-going foreign direct investment in manufacturing or logistics/warehousing.
- This rises to 39% among consumer product companies.
- One quarter of respondents plan new FDI in 2016 and that is 34% for consumer product firms. This is mildly, positively surprising.
- Given a better budget outlook in 2016, fewer companies plan layoffs in 2016: in 2016 some 70% plan no lay-offs at all compared with 51% in 2015.
- Staff cuts have so far been on a small scale, mostly below 10% of total staff and any cuts in 2016 are also aimed to be below 10%.
- Salary increases in 2016 are budgeted to be below inflation once again for 70% of companies BUT more companies (29%) plan salary increases at inflation or just above.
- This is happening because inflation will come down from 14% in 2015 to 9% in 2016 and also because some companies plan to tweak up white collar average salary increases.
- BUT hardly any company plans solid above inflation pay increases and most will cluster at about a 7% nominal pay increase which was also "the average figure" in 2015.
- Pharmaceutical and health is softening this year but looks to some improvement in 2016.
- B2B industrials budget for moderate improvements in 2016 after a very tough 2015.
- Consumer products still look good next year in roubles but cluster more at single digits.
- Indeed many companies are clustering in high single digits.
- Receivables are still under control.
- Executives predict the rouble to finish 2015 close to its levels of early September.
- Anecdotally executives are complaining about the extreme economic and business volatility experienced in 2015.

How long will it last?

The uncertainty continues. For how long? We don't know: it's uncertain!

The MD of a major industrial producer asked last week: "Just how long will it last?" As this executive knows, the challenging times will not disappear quickly. The global and domestic economic outlook will provide at best mild solace and support over the next 6-18 months. But most executives are planning for mild business improvement next year based on the presumption of less volatility and a somewhat more stable rouble. If that scenario fails to appear, then business will of course remain in a strained situation as it has been for much of 2015.

There is going to be no big economic bounceback and so there will be no big business pick-up. But we still believe that there is scope for moderate rouble sales growth (some limited FX improvement) with profits at lower but respectable levels and with ROI less exciting than in the past but again at reasonable levels.

As the MD of a European pharmaceutical company said last week in Moscow:

> The next 6-18 months will still be tough but I think that in a time-scale beyond 18 months there is certainly some hope for stabilisation at quite decent levels of business.

Economic Backdrop to the 2016 Budget

(We will supply some more economic update in our next paper later this week)

In recent weeks and months I have been marginally more downbeat than the consensus view on the economic outlook for 2015-16. Now the consensus is moving toward my own assessment.

The Budget 2016 will depend on scenarios and here we append our oil scenarios table for 2016 and our current central economic scenario for 2016.

Economic scenarios for 2016 at different oil prices

Average oil price 2016	GDP	Inflation	Rouble/US$ Average	Rouble/€ Average
$80-85	2.30%	5.80%	42-48	46-55
$70-80	1.90%	6.00%	48-52	55-59
$60-70	1.80%	6.60%	53-58	59-64
$55-60	1.40%	7.50%	58-65	64-69
$50-55	0.20%	9.00%	65-72	69-75
$45-50	-1.50%	13.00%	72-75	75-82

Central Scenario - 2015 economic outlook

GDP	-3.7%
Inflation (year-end)	12.5%
Inflation (average)	14.5%
Consumer spending	-6.3%
Investment	-9.5%
Industrial output	-3.0%
Rouble to US dollar average	64-68
Rouble to the Euro average	73-77

After a slightly better than expected fourth quarter GDP results, expectations for quarter two were not met and since then the slumping rouble and negative global environment suggest that the economy will stumble along at current levels.

We expect that the first positive GDP figure swill appear at the end of this year or first months of 2016 but we underline again that the recovery will be mild: -3.7% GDP growth this year and +0.6% in 2016. Risks are evenly balanced but perhaps to the downside. Note that the Russian Central Bank is now more sober than we are: the Bank now predicts oil closer to $50 per barrel rather than $60 and has thus reduced its estimates for this year down from -3.2% to a range of -3.9% to -4.4% which fits with my own thinking that risks are slightly to the downside.

Macro-economic data 2009-2019

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
GDP	-7.9	4.3	4.3	3.4	1.3	0.6	-3.7	0.6	1.9	2.6	2.7
Retail sales	-5.5	6.3	7.2	5.7	3.9	2.5	-5.8	1.5	2.4	2.8	2.9
Household spending	-7.6	5.5	6.8	7.9	4.7	1.8	-6.3	1.0	2.1	2.8	3.0
Real wages	-2.8	4.4	4.9	8.2	5.2	1.9	-8.3	0.0	3.0	3.0	3.3
Disposable income	1.0	3.7	2.8	3.7	3.3	2.1	-3.3	1.0	2.4	2.9	3.1
Inflation (year-end)	8.8	8.7	6.1	6.6	6.5	11.4	12.5	7.7	6.6	6.3	5.9
Unemployment rate	7.9	7.6	6.5	5.3	5.5	5.3	5.9	5.8	5.7	5.5	5.4
Gross fixed investment	-17.9	5.6	9.8	6.0	-0.3	-4.8	-9.8	-1.2	3.2	4.2	3.9
Industrial output	-10.8	8.3	4.7	2.6	0.3	1.1	-3.0	0.7	2.4	3.0	3.1
FX reserves ($bn) year-end	447	485	510	528	509	385	340	330	350	360	370.0
Rouble/$ (year-end)	30.3	30.4	32.1	30.4	32.9	58.0	68.0	70.0	72.0	75.0	79.0
Rouble/Euro (year-end)	43.4	40.0	41.5	40.1	45.1	72.0	76.5	75.6	76.3	79.0	83.5
Budget balance (% of GDP)	-6.3	-3.5	-0.2	0.0	-0.5	-0.5	-3.2	-1.9	-1.0	-0.5	-0.2
Current-account balance (% of GDP)	3.8	4.9	4.9	3.6	1.6	2.7	3.6	3.3	2.8	2.2	1.0

Consumer-related statistics: by year and monthly

	2012	2013	2014												2015							
	year	year	Jan	Feb	Mar	Apr	May	June	July	Aug	Sept	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	June	July	Aug
Disposable income	3.7	3.3	-1.5	1.0	-6.8	1.9	5.8	-2.9	2.3	3.4	0.6	2.1	-4.7	-7.3	-0.8	-1.6	-1.8	-4.0	-6.4	3.5	-2.0	-4.9
Real wages	8.2	5.2	5.2	4.6	3.1	3.2	5.0	2.1	1.4	-1.2	1.5	0.3	0.5	-4.7	-8.0	-7.4	-10.6	-13.2	-7.3	-7.2	-9.2	-9.8
Real retail sales	5.7	3.9	2.4	4.1	4.0	2.6	2.1	0.9	1.2	1.4	1.7	1.7	1.8	5.3	-4.4	-7.2	-8.7	-9.6	-9.2	-9.4	-9.1	-9.1
Unemployment	5.3	5.5	5.7	5.6	5.4	5.3	4.9	4.9	4.9	4.8	4.9	5.1	5.2	5.3	5.5	5.8	5.9	5.8	5.6	5.4	5.3	5.3
Industrial output	2.6	0.3	-0.2	2.1	1.4	2.4	2.8	0.4	1.5	0.0	2.8	2.9	-0.4	3.9	0.9	-1.6	-0.6	-4.5	-5.5	-4.8	-4.3	-4.3
Fixed investment	6.0	-0.1	-7.0	-3.5	-4.3	-2.7	-2.6	0.5	-2.0	-2.7	-2.8	-2.9	-4.8	-2.4	-6.3	-6.5	-5.3	-4.8	-7.6	-7.1	-6.8	-6.8
Consumer prices	6.6	6.5	6.1	6.2	6.9	7.3	7.6	7.8	7.5	7.7	8.0	8.3	9.1	11.4	15.0	16.7	16.9	16.4	15.8	15.3	15.8	15.8
Budget deficit (running)	0.0	-0.5	0.4	0.3	1.4	-0.4	-0.1	-0.1	-0.1	-0.2	-0.4	-0.5	-0.6	-0.6	-1.6	-1.8	-1.8	-2.1	-2.5	-2.3	-2.9	-3.1

Inflation is proving slightly more sticky than anticipated due to the weakening rouble in mid/late August and to hikes in administrative prices in July: inflation has stayed in a range of 15-17% since the start of the year and did not fall in August and remained at 15.8%. We still presume some slight softening to 12.5% in December presuming no further serious rouble deterioration. Thus average inflation this year will be 14.5% and then decline to 9% average in 2016 and 7.7% in December 2016.

Industrial and investment numbers remain stressed and weak against backdrop of sanctions, relatively high interest rates, financial challenges and remaining weak confidence. Consumer-related indictors followed suit from the start of this year. Real wages are still close to -10% in August and this combined with negative new bank credits will hold back retail sales at -9.1% in August. We see household spending falling by -6.3% this year before turning slightly positive in 2016 at +1%.

The Central Bank's key interest rate was left untouched on 11 September at 11.0%. Given sticky inflation and threats to the rouble, we imagine that the Bank will be cautious about any quick and big cuts but imagine that there is a 50% chance that the rate could be down to 10.5% or 10.0% by the end of the year

As ever, I hope this report proves helpful for you in creating you 2016 Budget/Business Plan for 2016. If you have any comment or queries, do get in touch daielthorniley@dt-gbc.com

21 September 2015

Contact: Dr Daniel Thorniley, President, DT Global Business Consulting GmbH
E: danielthorniley@dt-gbc.com / www.ceemeabusinessgroup.com