CEEMEA Business Group

# Russia Business Gossip

Looking to a summer slowdown? What executives are thinking and saying. It must be a crisis because lipstick sales are up!

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## Content





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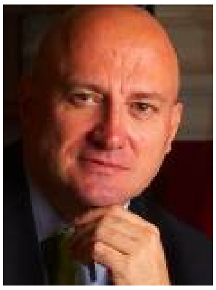

**Dr Daniel Thorniley**

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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.

## Introduction

One of the Group members in the cosmetics sector notes that lipstick sales are doing very well! There is a traditional economic analysis that lipstick sales always do well in times of crisis (they were strong in the USA during the 1929-32 depression for example). The theory, whether valid or not, is that women choose to wear more lipstick to keep up their own spirits by feeling attractive and with a view to cheering up their depressed men-folk! ☺

This report is based mostly on comments gathered from an executive working dinner of 15 managing directors from major consumer goods companies held in Moscow last week. As usual as professional courtesy, no company or personal names are mentioned. Our economic tables are provided at the end of the report for your reference and these will be updated and commented upon in my next report at the end of June.

## Executive summary

- The majority of companies experienced a soft April-May with many companies referring to a strong downward dip in May. This follows a comparative heathy Q1 for many companies.
- This applies to the B2C sector while in B2B the trend is a bit different: Q1 was very hard and with a bit better financing, Q2 now looks a bit improved for B2B but business is still tough for the industrial sector as we noted vividly in our previous report.
- One executive talks of a ”roller coaster” of emotions: December disaster, first quarter excellent but April and may disappointing.
- Wisely most companies did not upgrade forecasts at the end of the first quarter and in fact by mid-June some have started to reforecast a little downwards after a tough spring.
- This was summed up excellently with the comment that: “It pays off not to have over-reacted on the downside in December nor on the upside in April”.
- Many companies are budgeting for the rouble to average 62 to the Euro this year and about 56 to the dollar.
- Many companies are paying 7-8% salary increases this year which is about ‘inflation -7%’ and this matches precisely our Survey results.
- Many companies state they are thinking of 5-7% for salaries next year which with inflation average about 8-9% next year would remain below inflation for average white collar increases.
- As has been noted several times, the economic/consumer figures at the start of the year were very bad for retail, real wages and confidence and this ought to mean a softer Q2 especially for consumer product companies, but for those companies who are experiencing decelerating sales now, the BIG question is: just how long will the slowdown last?

  There is some room for optimism because if inflation continues to fall, then real wages after inflation will start to improve supported by a stable rouble at 56 to the US dollar. On this basis of stability, we expect the business climate to improve somewhat in the autumn.

- The MDs of two of the world’s major FMCGs comment that they are in a better position overall thanks to having very diversified product portfolios: you can pick your winners and losers.
- Some companies will try to protect volumes with affordable products and by moving more in to the mid- and discount sectors.
- The managing director of one cosmetics firm states that: “We are in a pricing war: price defines everything, not brand or quality”.
- But there is not usually one correct solution in choosing either volume or price. It is more a question of emphasis: aiming to maintain a right balance between price and volume in order of course to do the best for market share.
- One manger commented of an un-named competitor that his own company had been moderate in price increases and payment terms but that his competitor had been too aggressive and thereby lost market share.
- In some food sectors, imported products are doing poorly against localised producers whether they are western-localised or local Russians.

- As we have seen in other crises, mid-price and mid-brand for some companies are not doing well although companies do want to improve in this segment.
- Profitability is declining for most companies but equally it does remain at good/OK levels for many firms.
- CIS markets are also struggling a bit more now as consequence of the Russian rouble fluctuations; companies are seeing much more parallel imports and this is damaging the local markets quite severely.
- Russian retail is reforecasting downwards as the spring-summer blip continues.
- Russian retail is moving into the regions to get more business and a different kind of business and this is having a positive impact on FMCG sales in the regions.
- Executives report that thanks to the crisis, regional governments are more supportive.

## Business quotations

…from managing directors of consumer product companies in Moscow early/mid-June.

- “There may well be some more bad months ahead”.
- “Autumn will be the Rubicon and then we will know if we have gotten through the crisis”.
- “Trying to import product from Ukraine is over. You can’t build a sustainable business plan on that anymore”.
- “Super-premium is not booming anymore. When an official couldn’t travel so much, they stayed at home and bought luxury gifts. Now they are traveling a bit more”.
- “It’s no longer the stomach making the decision but the pocket”.
- Two views: “Premium is not dead” but also “Premium is slowing down and our business future or more accurately growth in the next 18 months is in the middle or at the bottom”.
- “Consumers are resilient but they are just getting even smarter in their purchase choices”.
- “I still think the consumer is great and I am amazed that categories are only down by -2% to -3% and we can grow more than that and acquire share”.
- “You have to keep the volumes up. Further price increases will be rejected by the supply chain if the rouble stays at 55 to the dollar”.
- “Input prices remain high and it won’t get cheaper quickly. Local suppliers will need another 2-3 years before they can provide a reasonable range of inputs and the prices will probably still be elevated for the quality”.
- “The crisis was a blessing as it allows you to do things that you can’t in normal times”.

## Business gossip

**The managing director of a major US FMCG** outlined his business thus. The executive in question has proven very perceptive as he predicted in mid-January that the first months of the year would be good but that then pressures would build up in May and he has been proven very accurate.

> We are growing about 7-8% and with better profit improvement. On the point of profit, we are coming off superb levels and these have declined but I am still in the top 30% of markets globally for our corporate profits. To achieve these profits we have trimmed a couple of distribution centres but still retain 6-7 of them. We announced a re-sizing in April and plan about 20% staff cuts but 10% of these will be natural attrition. We are better than budget thanks to such cost management as well as some category rises and improving our market share.

This executive reports that premium is holding up (which is about the same for other companies) but he also reports that more consumers are shifting into “mainstream products” and the mid-range where this company is quite strong in its portfolio. The company has seen such mainstream sales increase well during April-May and this helped moderate the spring down-turn (and this is less typical of other firms who report a ‘weak middle”).

This managing director also noted that:

> Private label is OK and its quality is improving but thankfully when the Russian consumer is faced with this option, she/he is sticking with our mid-range products.

Regarding market share the executive went further:

> You have to keep the volumes growing, and further price increases will be rejected if rouble stability is maintained. We have been moderate in price increases and payment terms but one of our big competitors has been more aggressive and we have gained from that.

But the issue is also more complex than this. The executive explains:

> We stick with our plan and raised prices in February. Looking back now, those increases appear small and quite frankly given probable resistant to further price increases in the near future, we will simply wait and see what we do with prices---it depends on so many factors.

On the point of consumers he added:

> Consumers are resilient but also just getting smarter. Consumers are changing (again) their products and their shopping outlets.

**The managing director of a European confectionery company** summed up his business as follows:

> We were growing at +25% at the end of 2014 but in recent weeks we have experienced a volume decline. We produce locally but some 70% of inputs are imported. Despite recent weeks, we are not altering our long-term volume targets. We may need to look at pricing (maybe downwards) or more affordable products to ensure that volume.

Regarding value and brands, this senior manager noted that:

> Consumers are less willing to test new brands whereas traditional brands are holding up better as consumers stick with the quality they know. But there is a downward trend and consumers are making decisions now less with their stomach and more with their pocket.

This manger also noted a common trend that: “Our profitability used to be among the best in the Group but now we are closer to the average corporate profitability levels”.

**The managing director of a European cosmetics and consumer products company** portrayed his business as follows:

> We experienced a great first quarter but a disappointing April and a worse May. We are seeing a serious deceleration in markets and categories. Our Q1 was very good because we didn’t raise prices too aggressively and took a lagging approach. Our budget was set at a time of optimism and the goal is still to grow by 15% this year. We may be able to make it but we would need the summer to turn around.

| | | |
|---|---|---|
| This company originally assumed at the end of Q1 that in 2015: | Volumes stable | Value +12-14% |
| Now it will probably turn out: | Volumes -6% | Value +5-7% |

The executive underlined one of his themes that input prices are not falling and just the opposite, and he confirmed a continued trend of the shift from traditional retail to modern retail. (On the question of input cost, other executives confirmed this: **the MD of a European food producer** in the upper-middle sector reported that his business is positive in roubles but that input prices are rising at 60% and they have ratcheted up prices by 30% to compensate and are still profitable thanks to cost efficiencies).

This executive also shared some interesting insights into regional business trends:

“Moscow and the Far East are performing poorly” This tends to contradict the trend that Moscow usually does well because the consumers there are stronger than in the regions and the regions tend to shrink more quickly at a time of crisis. But the executive has a valid explanation for this:

"The huge territory of middle Russia is being supported by Russian retail moving into these regional markets and this compensates for what otherwise would be declining markets". This is an interesting point and one shared by other executives when they commented on Russian retailers.

The executive summarised his thoughts of the past volatile months when he noted that:

> It paid off not to over-react on the downside in December and on the upside in April.

He is indeed correct as the roller coaster goes up and down.

**The managing director of a food/pasta company** who produce locally notes that thankfully they had localised mostly some two years ago and were installing a new pasta line in December 2014. Russia is the third largest pasta/macaroni market in the world after Italy and the USA and the Russian market is currently increasing 10% in volume and 15% in value. But the executive notes that foreign imported brands are losing 40% of their business as they are outplayed by localised western and Russian competitors. Because of his positive position, this managing director believes his company can grow 30% this year in volume. He continued to state that:

> We aim to achieve more market share and to protect the bottom line but we have to balance this with the top-line as well. So far our business is quite good in roubles but weaker in Euros. Consumers are indeed downtrading and we have seen a move to smaller sized packages for example from 500 grams to 400 grams. We don't plan to sacrifice on media/advertising and the prices for this now (in FX) are more bearable. Yes, April was weaker and May quite bad. We are offering 10% salary increases this year.

And it was this executive who said that:

> Autumn will be the Rubicon and then we will know if we have gotten through the crisis.

**The regional President of a major food & beverage company** shares the overall view that "April and May will be just the beginning of several months of downtrading". He continued by saying:

> We are quite a diversified company and so the devaluation has affected us differently in different categories with negative impact ranging from 30% to 80% of the value. Some categories are down -15% but others are ok at 0% or +5% and we focus on supporting the key brands. We have been moderate in our price increases this year with 11% to 16% and not more aggressive.

This executive also saw the upside of the crisis:

> The crisis was a blessing and allowed us to do things which we couldn't do before. We had perhaps gotten fat and inefficient. We have been able to introduce efficiencies but we have NOT cut training for HR. Usually marketing and training are the first to be cut but we support the key brands and support staff development.

**The managing director of one major US international FMCG firm** commented thus:

> We are seeing premium holding up and not surprisingly discount is going strong but once again it is the middle sector which is struggling. Volumes are so far holding up and value hypermarkets are soaring but this is not a disaster year for us and we still push advertising

**The regional director of a European FMCG firm** with a diversified portfolio outlined his business in these terms:

> We enjoyed a honeymoon in Q1. We are a conglomerate as well and our consumer side is obviously out-performing our B2B products. We are looking forward at the value segment and portfolio management but aiming to maintain a right balance between price and volume in order of course to do the best for market share.

**Russian retail outlook as seen by western consumer product managers:**

- Until some weeks/months ago, Russian retail seemed to be surviving well or even better.
- Until recently Russian retailers maintained extensive expansion plans for store openings.
- But Dixy has reported a downward trend in all indicators but this is after being very bullish before.
- Executives report that Lenta and Magnit are reforecasting downwards.
- Discount hypermarkets are not surprisingly doing well.
- Executives still see the continued shift from traditional retail to modern outlets.
- Russian retailers are pushing hard in the regions and thereby assisting western suppliers.

## CIS markets

We have noted in reports that other CIS markets are now also under pressure as the Russian rouble fell and other currencies devalued or as with the Kazakh tenge may do so.

One confectionary company summed up business for many with fairly consensus business results. Ukraine is down -45% to -60% and this company is keeping staff on for one year which is just about manageable, but when the new budget process kicks in, there will have to be more staff cuts. For this company, and others, after representing 10% of all CIS business, Ukraine only manages less than 5% as Kazakhstan becomes more interesting. But here too projects are being delayed as local producers wait for any possible tenge devaluation. Parallel imports are a growing concern in all markets and this company reports that in Kazakhstan sales, after growing 20% last year, are now flat in volume and in price.

The regional director of an ingredients and flavours company's noted that:

> Our business in Belarus is doing quite well and it is now respectable to be doing business there!

## Economic outlook tables

### Macro-economic data 2009-2018

| | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|---|---|---|---|---|
| GDP | -7.9 | 4.3 | 4.3 | 3.4 | 1.3 | 0.6 | -3.8 | 0.5 | 2.1 | 2.7 |
| Retail sales | -5.5 | 6.3 | 7.2 | 5.7 | 3.9 | 2.5 | -5.2 | 1.5 | 2.5 | 2.8 |
| Household spending | -7.6 | 5.5 | 6.8 | 7.9 | 4.7 | 1.8 | -4.8 | 0.9 | 2.3 | 2.8 |
| Real wages | -2.8 | 4.4 | 4.9 | 8.2 | 5.2 | 1.9 | -8.7 | 1.0 | 3.1 | 3.0 |
| Disposable income | 1.0 | 3.7 | 2.8 | 3.7 | 3.3 | 2.1 | -2.0 | 1.0 | 2.5 | 2.9 |
| Inflation (year-end) | 8.8 | 8.7 | 6.1 | 6.6 | 6.5 | 11.4 | 11.0 | 7.7 | 6.6 | 6.3 |
| Unemployment rate | 7.9 | 7.6 | 6.5 | 5.3 | 5.5 | 5.3 | 6.5 | 6.0 | 5.7 | 5.5 |
| Gross fixed investment | -17.9 | 5.6 | 9.8 | 6.0 | -0.3 | -4.8 | -8.5 | 0.5 | 3.2 | 3.8 |
| Industrial output | -10.8 | 8.3 | 4.7 | 2.6 | 0.3 | 1.1 | -3.0 | 0.7 | 2.4 | 3.0 |
| FX reserves ($bn) year-end | 447 | 485 | 510 | 528 | 509 | 385 | 310 | 290 | 270 | 280 |
| Rouble/$ (year-end) | 30.3 | 30.4 | 32.1 | 30.4 | 32.9 | 58.0 | 56.8 | 60.0 | 62.5 | 64.8 |
| Rouble/Euro (year-end) | 43.4 | 40.0 | 41.5 | 40.1 | 45.1 | 72.0 | 58.0 | 62.0 | 64.5 | 66.5 |
| Budget balance (% of GDP) | -6.3 | -3.5 | -0.2 | 0.0 | -0.5 | -0.5 | -3.0 | -1.9 | -1.0 | -0.5 |
| Current-account balance (% of GDP) | 3.8 | 4.9 | 4.9 | 3.6 | 1.6 | 2.0 | 2.6 | 2.2 | 1.8 | 1.8 |

## 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 |
| 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 |
| 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 |
| 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 | -9.8 |
| 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 |
| 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 |
| 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 | na |
| 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 |
| 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 |

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

 