

Russia Business Survey

Key factors driving business

Based on survey results (April 2015 - 10th Month)



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IN ASSOCIATION WITH:

BAKER & MCKENZIE



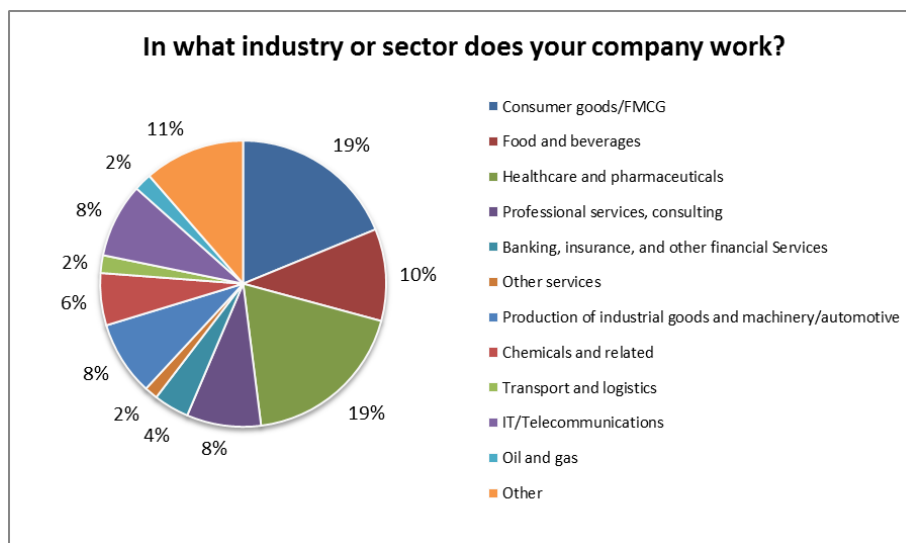
Background

This is a summary report of our findings from the 8th survey related to business operations: the findings are based on replies from some 220 senior managers working in western companies in Russia. The Survey was taken in mid/late-April 2015.

We think this report provides the most detailed hands-on current analysis available of what companies are thinking and planning regarding their business in Russia.

There is also much more general economic, rouble and business commentary added as well.

Thank you for participating.



Russia Business Survey: April results and commentary

Introduction

This Survey was conducted in mid/late April after a 7 week break.

In our February Survey findings we noted that there was some relative business stability appearing in the market but this was at strained and low levels but better than the trauma which took place in December and January. Now the outlook remains stable which means we have about 3 months of relative stabilisation “under our belts”. Several indicators in our Survey have ticked up marginally. It is clear that executives are feeling better than 8 weeks ago but they want more time and better trends to be sustained before they make any radical shift in their assessment: most executives are now cautiously and mildly upbeat but are in no way naïve and would not be surprised by further volatility.

Our Survey shows that a noticeable positive shift has started to be felt among executives but it is not yet sufficient to make executives alter their plans and forecast fundamentally (at least not yet).

The economic and business outlook does remain vulnerable to any negative trends in 1) the oil price 2) military action in eastern Ukraine and 3) related to the last point, any intensification in western sanctions.

One key comment over recent months and in our last Survey in late February has been that:

If the rouble does stabilise on average throughout the year or even appreciates a bit more, then the solid rouble sales forecasts of this year will translate into similar strong results denominated in FX. This is a big potential upside but with no guarantees.

This is what we are now hearing constantly from the majority of executives: business looks a bit better but there is no guarantee of sustainability and the year will still be tough. Nor should one get too carried away as some sectors remain strained for this year: in the B2B sector where financing is most challenging, 43% of all companies predict negative rouble sales and fully 50% forecast negative rouble profits. These companies will need a strong and sustained rouble shift to improve on these figures and most of all need better financing options which do not look quickly forthcoming.

Despite the rouble strengthening and some companies reporting a mini-rally, the year 2015 is going to be inevitably tough given the poor start to the year economically. The numbers in the first 3-4 months for inflation, real wages, consumer confidence were all bad or worse (all at or close to record 15-20 year lows) and the figures for investment and industrial output were poor as expected. The negative effects of this are still to filter though into the rest of the year and the two questions now are: how deep and how long will these effects be?

So, the current currency recovery is excellent and slightly unexpected news. Executives are delighted to take and accept this new positive scenario but it does not solve all business problems and engrained challenges. It's great to have and we'll take it, but let's see what's round the corner!

Executive summary

- 1) After a very hard turn of year, several indicators such as sales outlook, FX rates, receivables, downtrading, and route to market have all stabilised in recent weeks. The stability which started in February seems (for now) to be settling in. But as we note above and below, most executives are not making any major shifts in their business assumptions and planning and prefer to err on the cautious side.
- 2) Executive attitude (over the last 2 months) has improved markedly and is with this question where we have witnessed the biggest improvement: those who are much more pessimistic has fallen from 16% in February to just 2% now; those who are less optimistic have also improved from 34% down to 14% while

those who are more upbeat about the business outlook have jumped from 8% to fully 29%, and those whose outlook is stable have risen from 43% to 54%. This is a solid and clear improvement in perceptions.

- 3) Regarding how executives judge the full year 2015, these figures have further improved in the last 7-8 weeks: now almost 10% predict a good steady bounce back (with just 1% thinking in these terms 2 months ago); those predicting not much change from a (bearable) 2014 rises from 20% to 26% and those who see a major downturn this year has fallen from 12% of companies to just 5%. Those who forecast a worse year with weak business has improved a bit from 67% to 58% now. But this latter response shows again that while there has been some noticeable improvement in perceptions for 2015, the outlook is still extremely challenging. Executives can sense a possible improvement but they refuse for now "to bet the house on it"
- 4) Executives are reluctant yet to raise their forecasts and business plans. Nearly all MDs want to wait and see to judge whether the recovery proves sustainable. And given the tough economic start to the year, it is impossible that 2015 can turn out to be a "great year" but it is an open question to what extent the business results can beat expectations. Thankfully at many global headquarters, expectations have been well managed downwards.
- 5) Companies are trying hard not to cut their staff levels too quickly (63% making no staff reductions so far). But this number is diminishing each month (in February as many as 73% had no plans to cut). Executives did express their concern last December that as the crisis unrolled, so they would be obliged to make further headcount cuts and we are seeing this. Of those who plan to reduce headcount, 13% plan small cut-backs of 1-2% of total staff, while 23% now plan reductions of 3% or more of total staff. This is a worsening trend and reflects the bad economic start to the year.
- 6) Salaries are rightly under sharp scrutiny and have been for 12 months or more. More companies than ever are now planning to pay below inflation in 2015 (approximately 89%). Of course as inflation rises this year, real wages will fall in western companies but also across the Russian economy. So it is definitely not just western firms doing this. Also companies are currently tending not to raise salaries even though inflation is accelerating. This is the status for now.
- 7) In terms of business sectors: pharmaceuticals and health were the strongest sectors in 2014 and will hold on to this position in 2015 slightly ahead of the consumer product companies. Pharmaceutical sales have and will suffer from slow sales to federal authorities. Thanks to an end-year surge, consumer products finished 2014 strongly. The B2B sector also rallied relatively well at year-end but still produced the weakest results in 2014 and retains the softest outlook for this year.
- 8) The proportion of companies planning double-digit growth has risen from 29% in January to 41% in February but has moderated again to a still good level of 36% in April.
- 9) Planned rouble sales growth for 2015 is now similar to the results achieved in 2014 with a slight reduction in those looking to double-digit sales growth (36% of respondents compared with 46% last year); there is more clustering in single digits and flat sales with 44% aiming for this in 2015 compared with 36% who achieved such numbers in 2014.
- 10) In summary for 2015, some 36% of companies budget double-digit rouble sales growth this year (in roubles), 34% look to single-digit sales with 10% at flat levels and 20% forecasting negative rouble sales.
- 11) When we translate this to FX sales results, 19% expect to grow FX in single digits and 9% in double digits. But 16% expect flat results and 54% predict negative FX sales performance in 2015. These numbers feel about right (or maybe a little downbeat given current rouble strength) but everything (up or down) will depend on oil, sanctions and the exchange rate.
- 12) What is noticeable is that these expectations for sales in FX are barely improved on the findings in our February Survey taken some 7 weeks ago. It seems that executives are far from over-excited about current rouble strength and want to see sustained strength before they make any changes to their expectations.

Of course budgets will remain where they were set last autumn or at newly revised levels set in January this year. Summary: executives are not yet willing to tick up their FX results for 2015

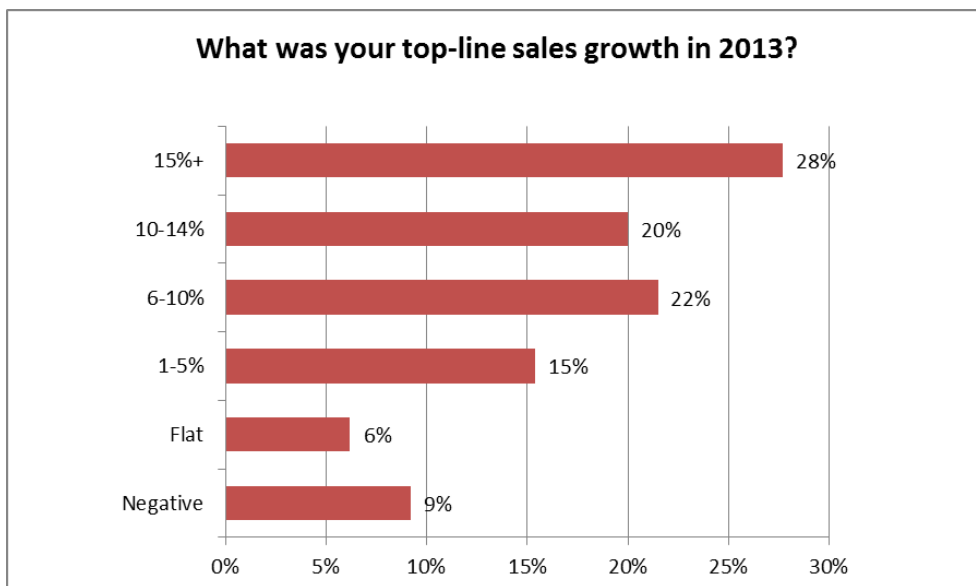
- 13) If the rouble does stabilise on average throughout the year or even appreciates a bit more, then the solid rouble sales forecasts of this year will translate into similar strong results denominated in FX. This is a big potential upside but with no guarantees. And as we note in our last point, most executives still do not see this trend as guaranteed, far from it.
- 14) It seems that consumer goods companies predict much weaker rouble profit trends in 2015 than for sales and this would indicate more downtrading and discounting which are rising as a trend and this is manifested in our Survey below and from anecdotal comments. For example among consumer product companies, 39% predict double-digit sales this year but “only” 26% look to double-digit profits. At the other end of the scale, 12% of consumer product firms forecast negative sales this year but a much larger 31% predict negative profits. So profits will be more squeezed from competition, own label and the shift to more affordable products.
- 15) The squeeze on profits is noticeably less in the pharmaceutical and health sector where profit expectations match fairly closely those for sales: 38% double digit growth, 47% single digits and only 16% flat or negative.
- 16) In the B2B sector sales are under pressure with 43% of respondents forecasting negative sales this year and profits match these numbers or are slightly worse with 50% of companies expecting negative profit growth this year.
- 17) Russia is the big volume market in the CIS and for more than 80% of companies it represents more than 75% of their volume of business. In terms of sales growth with Kazakhstan softening a little bit with possible devaluation concerns, Russia is now No 1 for sales growth prospects with Kazakhstan second followed by Belarus which is also “average/softening” and Ukraine only likely to start a business recovery in 2016, as the outlook for business and the economy has deteriorated in recent weeks even further.
- 18) **In another survey we conducted in early December, Russia remains by far the key priority market across the whole CEEMEA region for some 54% of companies thanks to its volume and potential.** The 54% figure compares with 34% who select Poland, 25% opting for Turkey and 22 choosing Kazakhstan (this is a multi-choice answer and so the total is over 100%. We will see in the summer whether Russia has been able to retain this No 1 spot given the remaining challenges and the relative strength of Turkey (mixed economic and business trends in the last 4-5 months while Poland remains looking very good while tight and competitive).
- 19) Executives anecdotally rightly fear escalating inflation. This ended 2014 with an average about 7.8% and finished the month of December at 11.3%. We expect prices to rise 12-17% in the first 4 months of 2015 and then much will depend on the oil price and the rouble. It now seems almost certain that 2015 average inflation will be over 10% at around 12%.
- 20) The supply chain has again stabilised in April/May with 11% frozen, 54% greatly reducing purchases but 34% buying as they did before the crisis. It is interesting that executive perceptions of what has happened regarding this question has improved quite significantly. But the actuality is still fairly tough.
- 21) Downtrading by consumers and customers is becoming more prevalent and while not yet at crisis proportions, now some 53% of respondents note that it is serious business issue.
- 22) The situation with receivables is not too bad either, not yet: some 34% see no deterioration during the crisis and 57% have only experienced small problems: but this latter figure has seen a soft deterioration since our last Survey with 57% responding like this compared with 47% some 7-8 weeks ago. As companies everywhere seek to manage cash and ask for favourable terms, this mild but noticeable worsening is not surprising. The good news is that bad debts remain almost non-existent.

23) Those planning to postpone investment has also stabilised and improved in recent weeks and is down to 31% from 36% some 7-8 weeks ago. Once again we see very distinct sectoral trends:

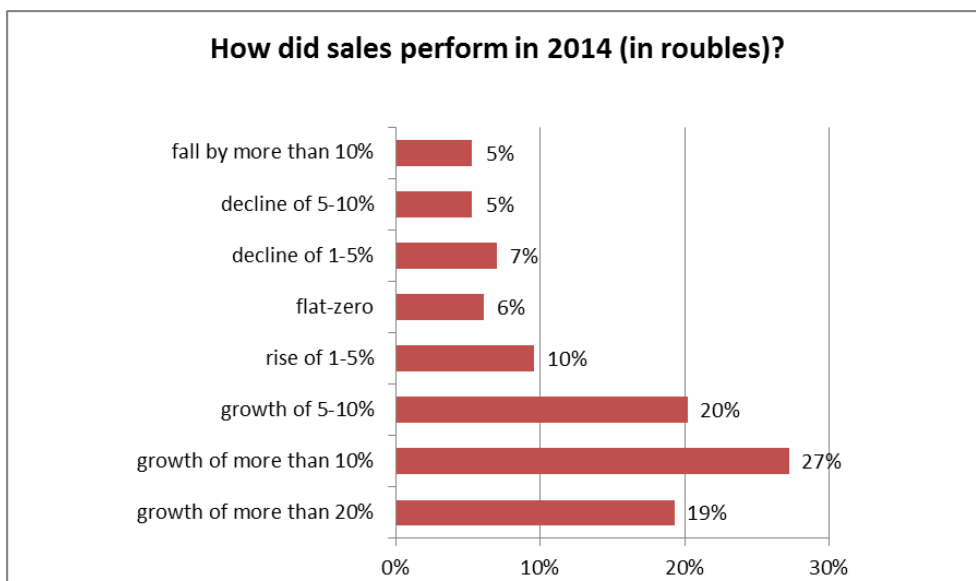
- Across all sector 68% plan to continue their investments.
- Among consumer products this rises to 75%.
- For B2B firms the proportion is much lower at 58%.
- While fully 81% of pharmaceutical/health firms will continue their localisation.

Introduction

For reference purposes: looking far back at 2013/2014



We perhaps need little reminding of the “good old days” and it is worth noting that despite the trend slowdown in business through 2013, fully 48% of companies reported double-digit sales growth with decent profit levels last year, while 37% recorded single-digit sales expansion. The gloomy side of last year was that 15% of firms finished the year flat or negative, which was a worse figure than in previous years when usually only 5-8% of companies reported such numbers.



Compared with results recorded in January, there was some slight tweaking by executives in their final results assessment but the dynamics remain very much the same. Some 46% were able to post double-digit sales growth (in local currency). Results improved markedly during November to the end of the year. So generally a curiously good end to 2014 but this is of course NOT sustainable.

The results for 2014 by sector are provided here in an easy-on-the-eye comparative table:

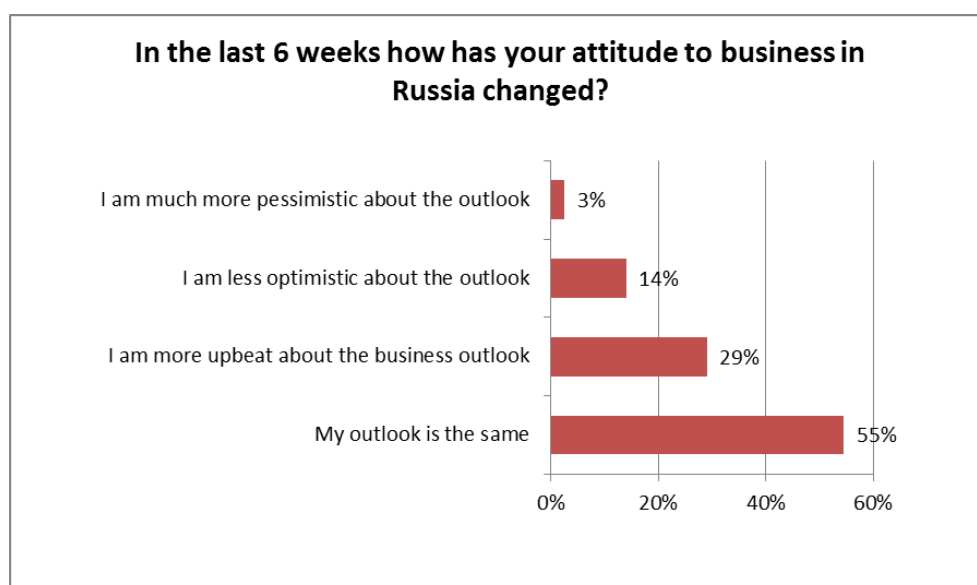
How did your sales perform in 2014 (in roubles)?

(Figures are rounded and therefore may not total exactly 100%)

| | 2014 results All sectors | Consumer products | Pharma/ health | Industrial/ B2B |
|------------------|------------------------------------|------------------------------|---------------------------|----------------------------|
| Growth of 20%+ | 19 | 25 | 11 | 25 |
| Growth of 10%+ | 27 | 37 | 33 | 12 |
| Growth of 5-10% | 20 | 8 | 28 | 25 |
| Growth of 1-5% | 10 | 12 | 11 | 0 |
| Flat-zero | 6 | 4 | 0 | 12 |
| Decline of 1-5% | 7 | 5 | 5 | 0 |
| Decline of 5-10% | 5 | 4 | 6 | 12 |
| Decline of 10%+ | 5 | 3 | 7 | 13 |

The categories are clear: pharmaceutical and health survived well on a declining trend and sales to the federal government were weakest, sales to the private health sector quite good as were retail/OTC sales. Consumer products started the year quite well and finished on a strong note and thanks to this closing trend and due to poor federal pharmaceutical purchases, the consumers sector actually ended 2014 even stronger than the health sector for sales. And even industrials performed better than expected as some Russian firms spent year-end budgets and dug out some final cash: so a consumer flurry and a pick-up in B2B which had struggled for most of the year.

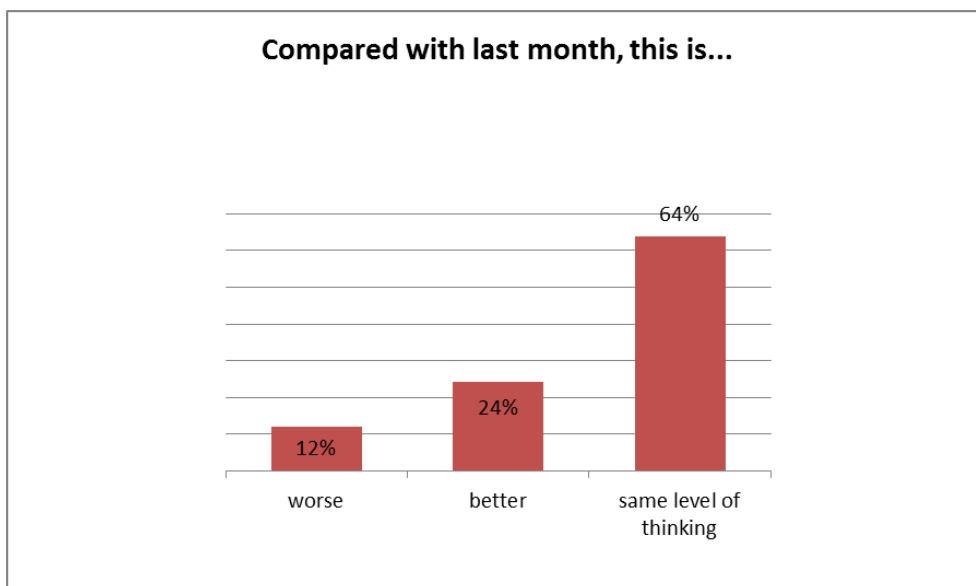
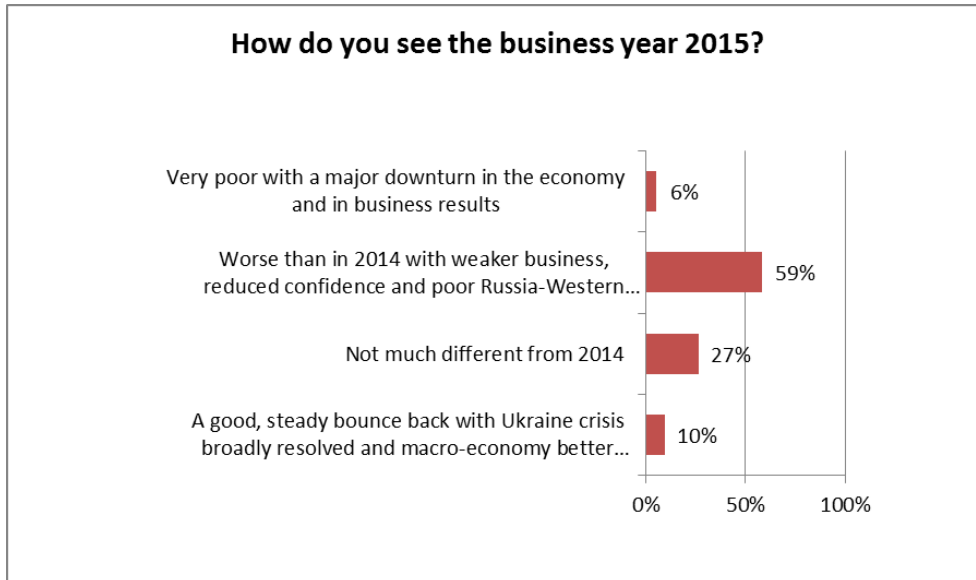
What is the 2015 outlook?



It is in this question where we have witnessed the biggest improvement in recent weeks since our last Survey: those who are much more pessimistic have fallen from 16% in February to just 2% now; those who are less optimistic has also improved from 34% down to 14% while those who are more upbeat about the business

outlook has jumped from 8% to fully 29% and those whose outlook is stable has risen from 43% to 55%. This is a solid and clear improvement in receptions.

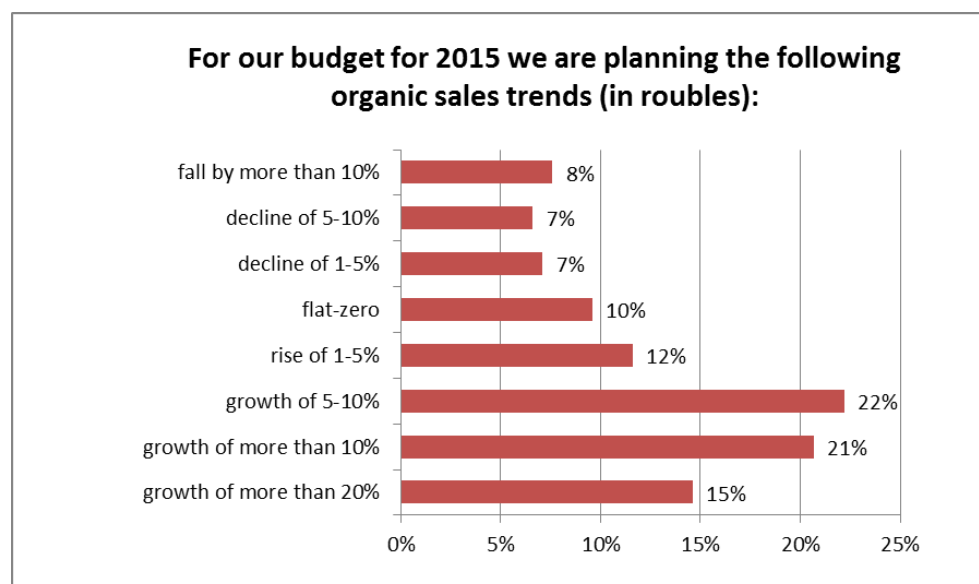
We stress again though that there is no naïve optimism among realistic management teams. We also repeat that while perceptions have noticeably improved, executives are refraining so far from making any significant upward reforecast to their business results. This may change for the better if the consolidation proves sustainable.



The outlook for 2015 worsened at the turn of the year but again this indicator stabilised in February admittedly at a low level with 67% then expecting this year to be worse than 2014. These figures have further improved in the last 7-8 weeks: now almost 10% predict a good steady bounce back (with just 1% thinking in these terms 2 months ago); those predicting not much change from a (bearable) 2014 rises from 20% to 26% and those who see a major downturn this year has fallen from 12% of companies to just 5%. Those who forecast a worse year with weak business has improved a bit from 67% to 58% now. But this latter response shows again that while there has been some noticeable improvement in perceptions for 2015, the outlook is still extremely challenging. Executives can sense a possible improvement but they “refuse for now to bet the house on it”.

After all this commentary it still remains to be said that “until today” many companies have survived (quite well) or better than expected. But (very) tough times still lie ahead. Business results will depend in large part on how the rouble fares and so much of that will depend on the external factor of the oil price.

Once again, we advocate along with many Group members “Never waste a crisis” and staying close to customers, partners and staff through the difficult times remains best practice in Russia and anywhere else. Russians are like elephants. This is not an insult! It merely means that they have good memories and will remember how you treat them in these hard times.



The forecasts for rouble sales in 2015 are quite strong and similar to the final results achieved in 2014 and it seems companies have used the 2014 results as a strong bench-mark for this year: “Let’s repeat (in roubles) what we managed last year and that will be something”. Presumably much of this rouble growth will come from price increases: obtaining strong volume growth will be harder and of course when translating these results into FX, all depends on the oil and rouble price and exchange rate. We also note below that achieving profit growth to match sales growth is very hard in the consumer products sector and also within B2B while pharmaceutical and health looks a bit stronger and suggest steady demand in that’s sector and/or the willingness to pay for pretty products. However, tighter federal reimbursement will prevent any overall profit “boom”.

It’s worth repeating: forecasts are quite solid and could become harder to achieve especially with a bad start to the year presumed. However, anecdotally and from our Survey it seems the first quarter has turned out more mixed for companies rather than being an overall slump.

What is your budget for sales in 2015 (in roubles)?

(Figures are rounded and therefore may not total exactly 100%)

| | 2015 results All sectors | Consumer products | Pharma/ health | Industrial/ B2B |
|------------------|------------------------------------|--------------------------|-----------------------|------------------------|
| Growth of 20%+ | 15 | 10 | 19 | 6 |
| Growth of 10%+ | 21 | 29 | 20 | 12 |
| Growth of 5-10% | 22 | 30 | 39 | 7 |
| Growth of 1-5% | 12 | 13 | 8 | 25 |
| Flat-zero | 10 | 5 | 3 | 6 |
| Decline of 1-5% | 7 | 0 | 3 | 18 |
| Decline of 5-10% | 6 | 5 | 5 | 6 |
| Decline of 10%+ | 7 | 7 | 3 | 19 |

Consumer product companies are aiming for double-digit sales increases in 39% of companies while another 30% aims for high-single digits. Some 5% predict flat sales and 12% budget for negative rouble sales trends. Compared with last year and even this February, more companies are forecasting single-digit growth rather than double digits and this is presumably based on not repeating the year-end 2014 flurry of consumption. More companies are now clustered around the 10% growth level, just above or just below.

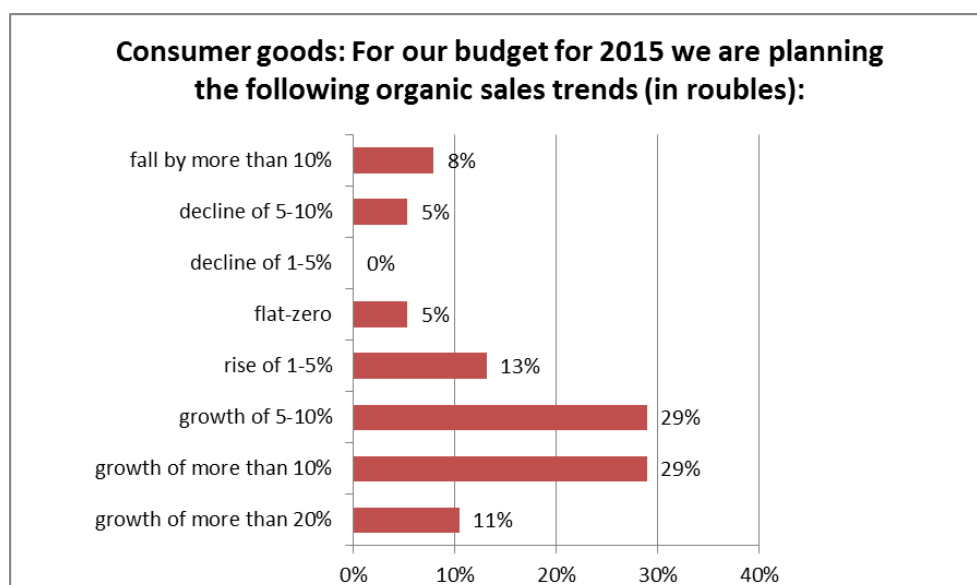
Given that companies predict mostly negative consumer spending in 2015, much of the planned sales increases will have to come from price rises and we know that most consumer product firms implemented their first set of price increases for 2015 in February followed by at least another set later in the year: one single price increase often ranges at 6-16%. Despite this, many consumer goods companies predict a tough profit outlook: with some 31% forecasting negative profits this year and only 26% aiming for double-digit profits while 39% budget for double-digit sales increases. Clearly sales look like being easier to achieve than profits.

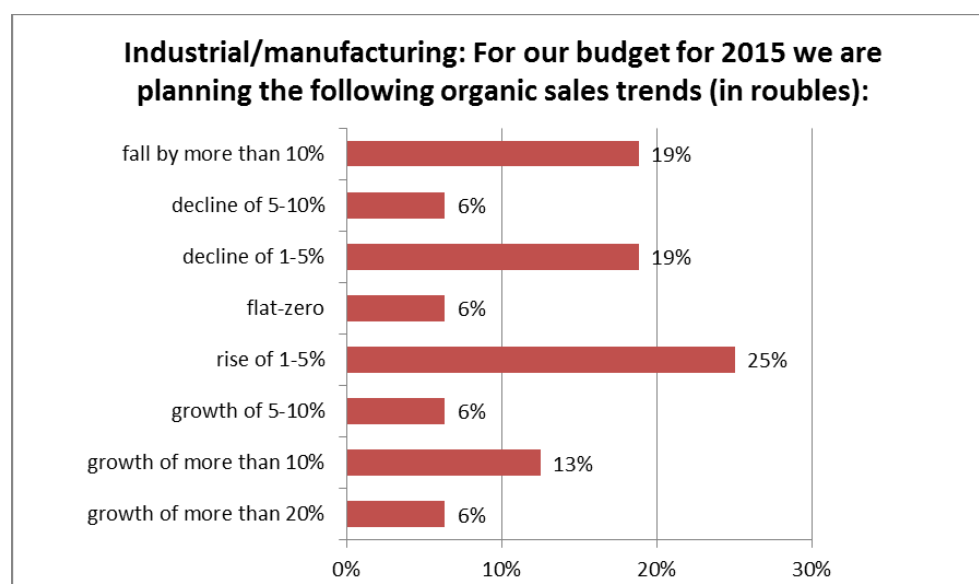
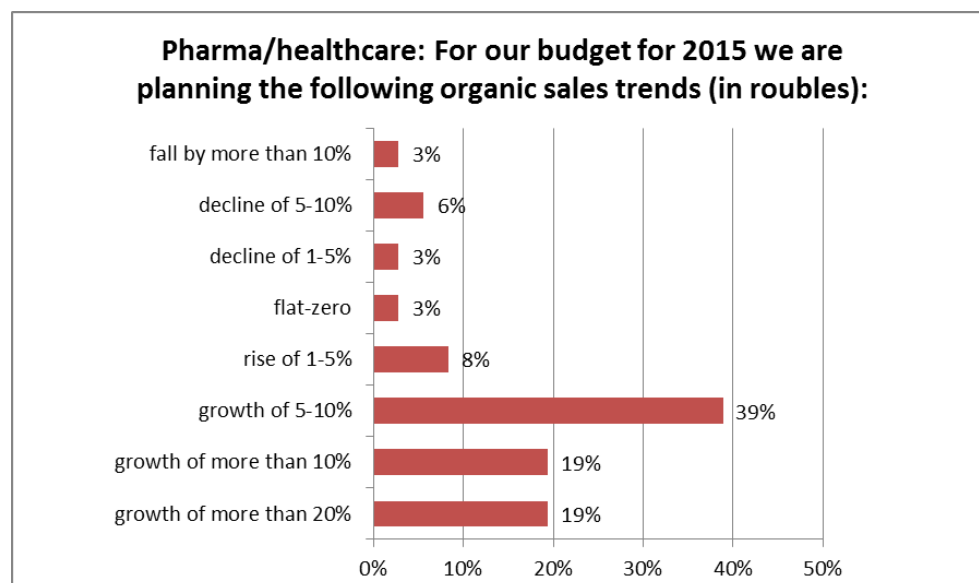
However, given the recent strengthening of the rouble, this forecast for weak profits in the consumer goods sector and in B2B as well could turn out to be too gloomy: some companies after raising prices in February on the back of a rising rouble are now facing possible windfall profits!

Remarkably pharmaceutical and health companies are budgeting for stronger numbers than in 2014 at least at the double-digit growth level and unless federal spending kicks in, this looks like a stretch unless companies plan significant price increases in those sectors where they can do so. But several pharmaceutical sectors are unable to raise prices by law. Almost 40% of companies in this sector forecast double-digit sales with a similar number predicting strong single digit sales. Now 14% expect flat or negative sales trends in 2015.

The outlook is more thoughtful in the industrial sector thanks to interest rates, financing access, sanctions and business confidence: automotive and IT could possibly recover from the bad lows of 2014 but 43% of firms predict flat or negative sales which is the worst sectoral forecast by far. And profits are strained at the same levels too. Industrial and investment trends will hold back business and financing will be extremely tough. On the plus side, companies in this sector will also benefit from increasing import substitution and western companies will supply the equipment for Russian firms to become more self-sufficient and given that some

companies have a conglomerate structure supplying to different customer bases, this may explain why 18% are upbeat looking to double-digit sales growth this year with almost one third clustered in single digits and mostly in low single digits.





2015 sales projections for CIS markets (in local currency):

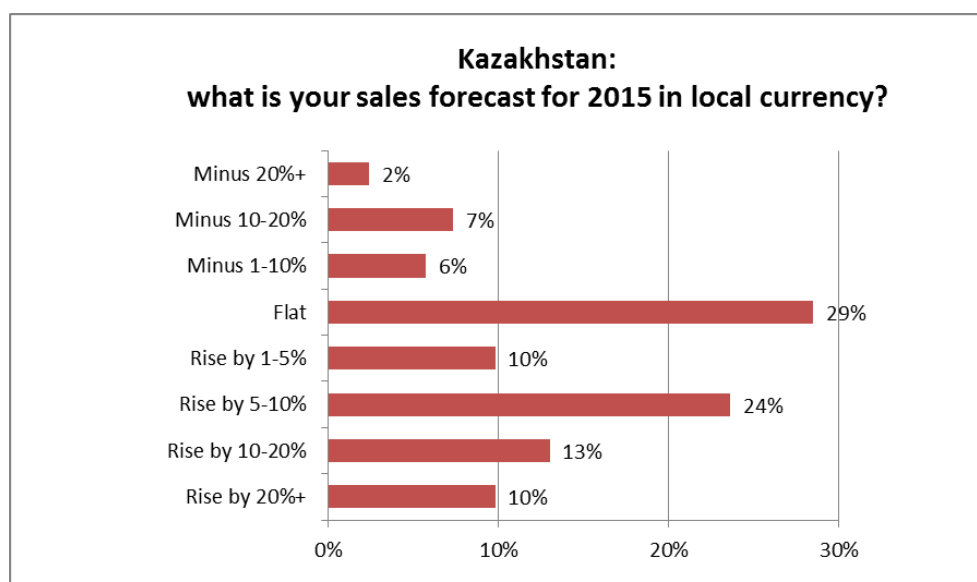
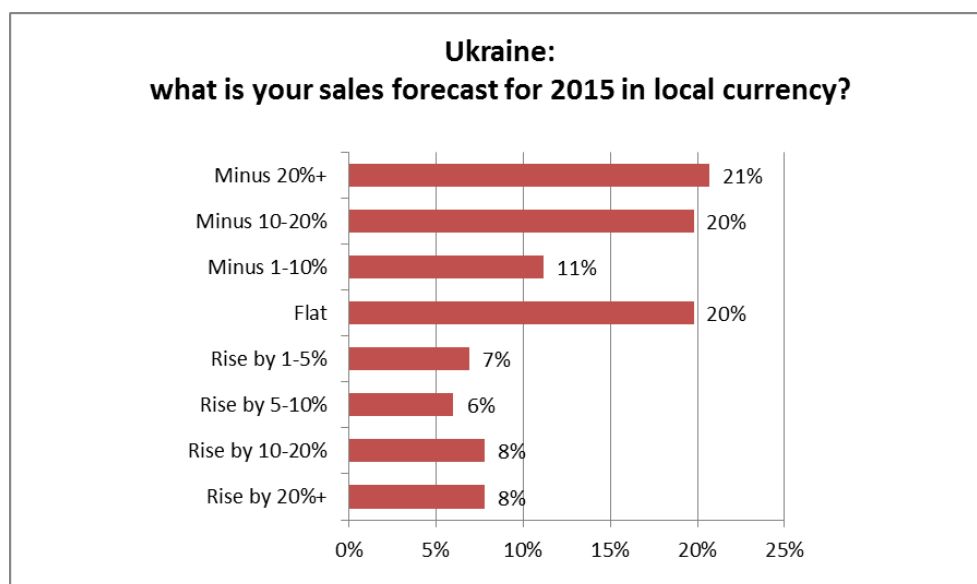
| 2015 results | Russia | Ukraine | Kazakhstan | Belarus |
|------------------|--------|---------|------------|---------|
| Growth of 20%+ | 15 | 7 | 10 | 7 |
| Growth of 10%+ | 21 | 7 | 13 | 15 |
| Growth of 5-10% | 22 | 6 | 24 | 19 |
| Growth of 1-5% | 12 | 6 | 9 | 15 |
| Flat-zero | 10 | 20 | 28 | 27 |
| Decline of 1-5% | 7 | 11 | 6 | 11 |
| Decline of 5-10% | 6 | 20 | 7 | 4 |
| Decline of 10%+ | 7 | 21 | 2 | 1 |

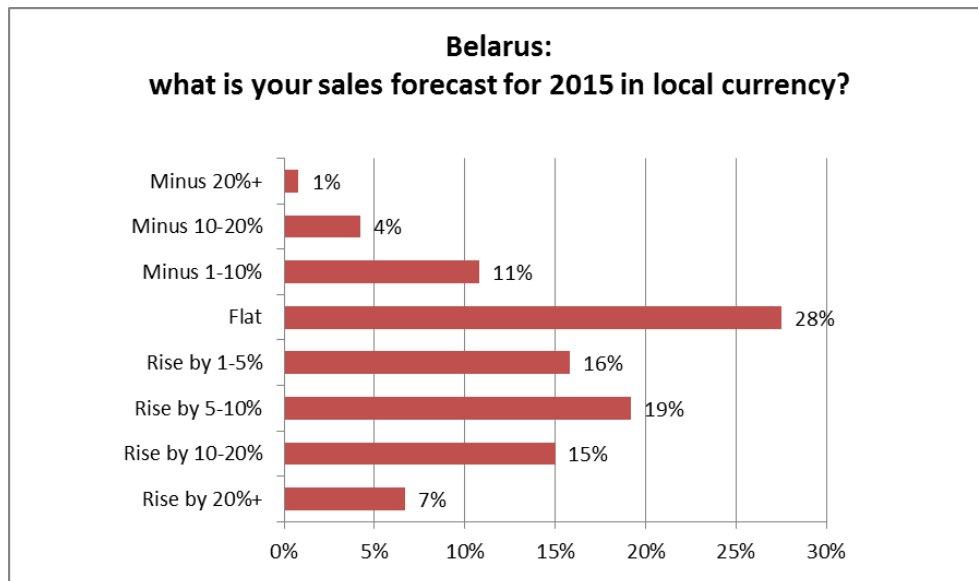
Some quick comparisons can be made:

Kazakhstan: expectations are starting to moderate as we suggested they would. The market was the joint best-performing market two months ago but as Russia seems to stabilise, in Kazakhstan those predicting strong sales growth have diminished. Still it is a good-looking market and this is backed up anecdotally. BUT there is a clear warning also that tenge devaluation is possible in the current environment and that would alter these numbers quite a lot. Such devaluation after Belarus and Azerbaijan would be no surprise.

Ukraine is looking very tough for another year and worse than in 2014 because there will be no good start to this year. We have recently downgraded our economic and business outlook for Ukraine (see our quarterly reports). 2015 will be much harder with perhaps some improvement in the last quarter. Much will depend on IMF support, whether a default occurs and whether there is a public easing of the conflict in eastern Ukraine. These numbers in local currency are not good and if the hryvnia depreciates badly this year (and of course with the free float it collapsed at the start of 2015), then FX results will be very bleak for a second year running and in FX terms Ukraine could show up much worse than even in 2014. A possible debt default (restructuring) could hurt confidence more but such an eventuality may be postponed to 2016 or not.

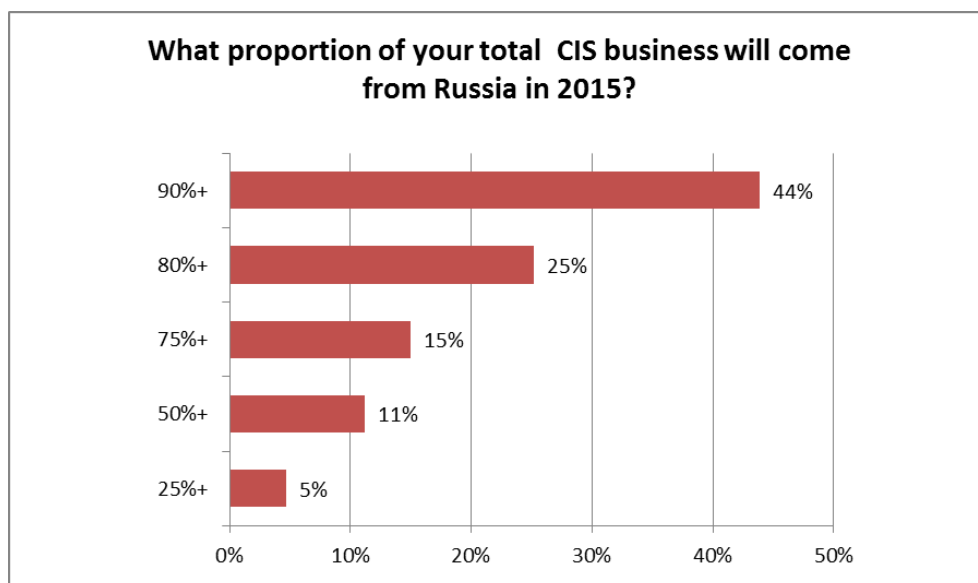
Belarus is a small market and results are worsening compared with 2014 as the Belarus rouble comes under increasing pressure. Executives have tweaked down their forecast marginally for 2015.





How big is the Russian market in the CIS?

Russia remains the huge, massive volume market. These numbers match anecdotal remarks we have used for many years. For some 84% of companies Russia represents more than 75% of their volume sales.

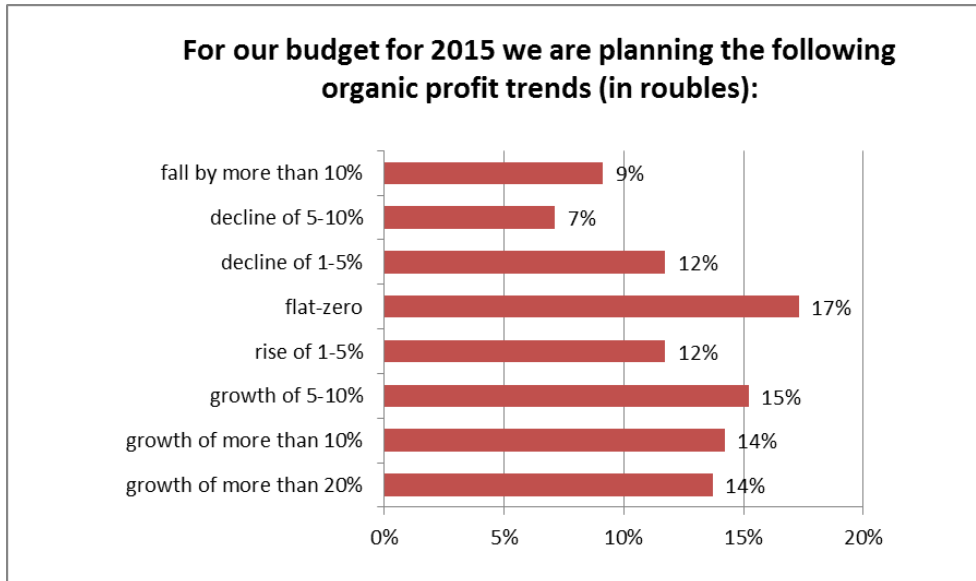


Profits in 2015 (in roubles)

For our comments on profits, see the executive summary above and remarks included in sales outlook for 2015 above.

In summary: profits could turn out to be tougher to achieve than sales especially in consumer products and B2B as consumers/clients want more affordable products and services. On the plus side, the strengthening rouble and the introduction of price rises could actually help profits become bearable or decent or even potentially

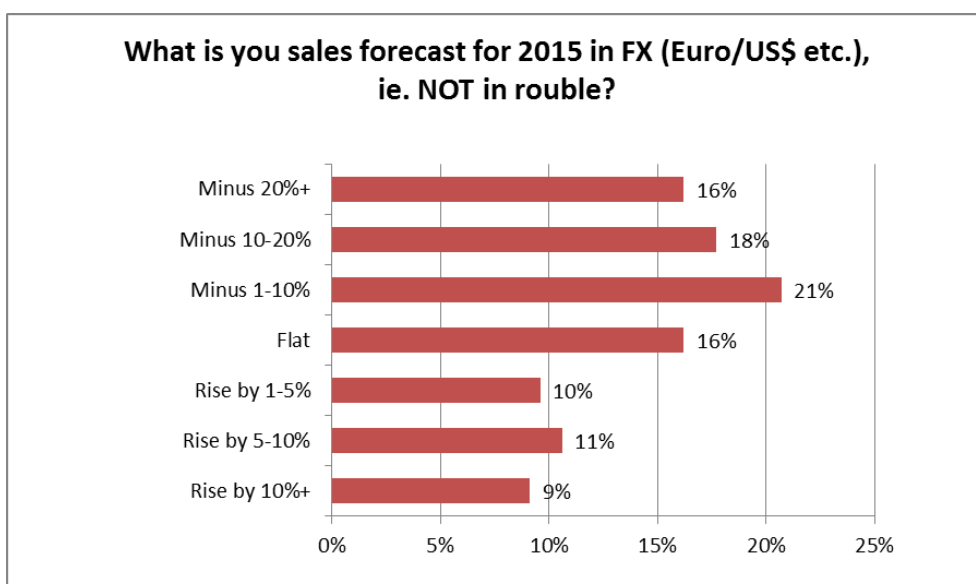
better than that. There is scope for windfall profits for some companies but we do not want to exaggerate this trend.



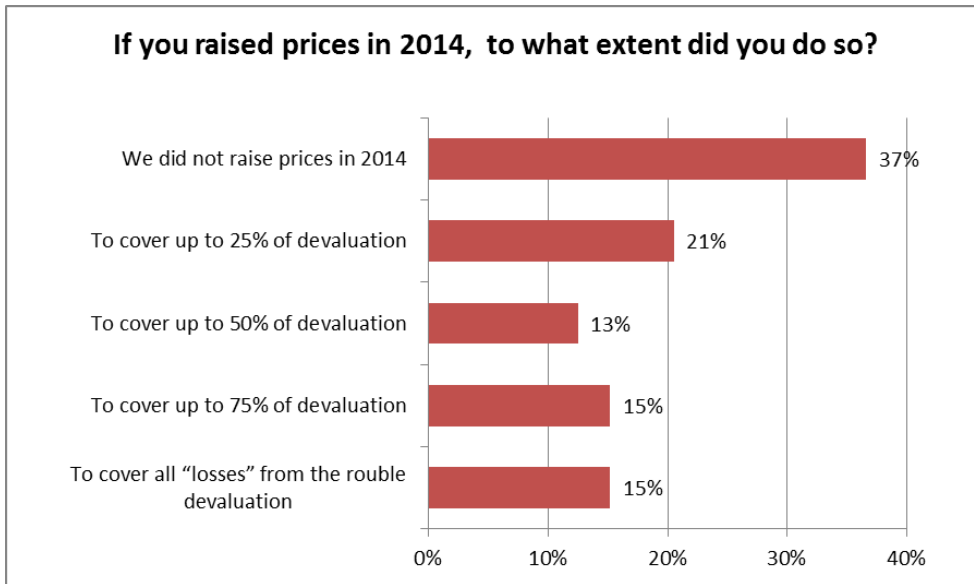
But looking at the numbers in FX and not roubles:

This is where brutal reality kicks in. Remarkably 28% of companies plan for sales increases in 2015 in FX but 54% look to negative FX results. Obviously everything depends on the oil price and the exchange rate. As we argued above, if things go right with oil or sanctions, then the rouble can improve a lot and quickly and FX results would turn around as well. Some companies will be predicting some stabilisation or decelerating rate of currency decline in 2015 and that's reasonable.

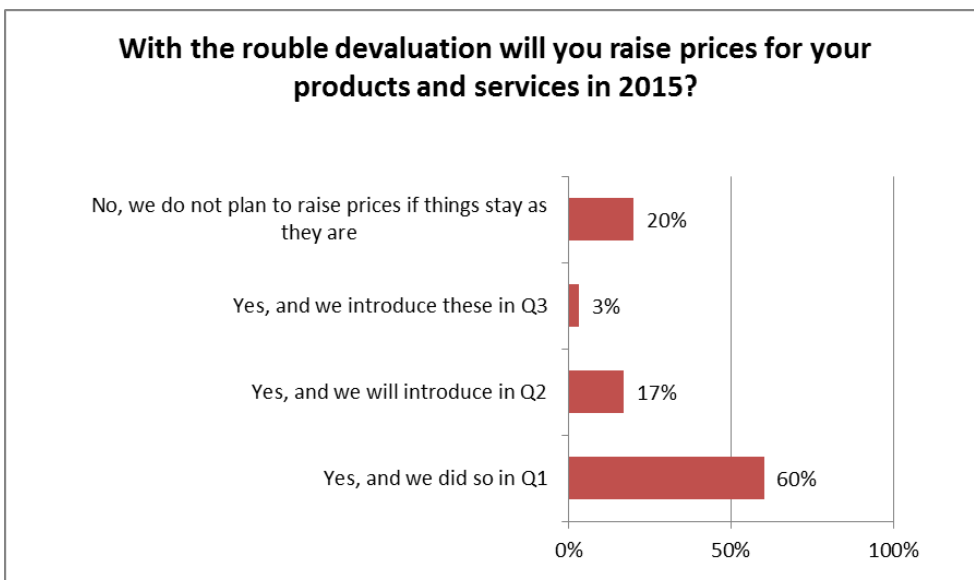
We have seen an improvement in this indicator in the last 8 weeks with more companies looking at losses around 10-20% (18% of respondents) and fewer looking at massive FX losses of more than 20% (this is down from 28% of companies to "just" 16%) and another 16% predict flat FX results. While the proportion predicting negative FX results remains stable at 54%, the depth of the losses has been somewhat mitigated.

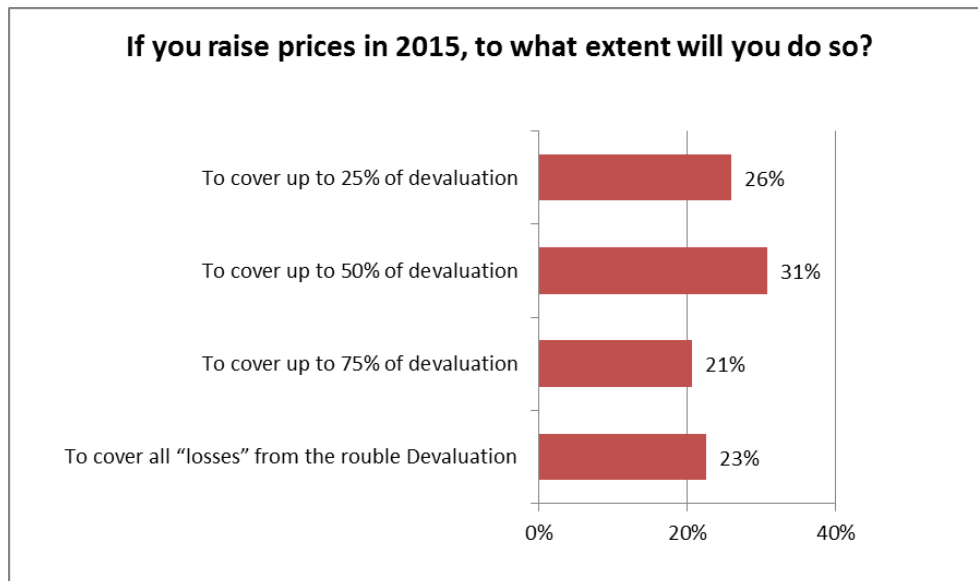


Raising prices to protect the business:



The surprising figure of 37% of companies who did not raise their prices is in part explained by those who invoice in dollars/Euros and by those who operate in some sectors such as reimbursed pharmaceuticals where price rises are not permitted in some segments. In plans for 2015, somewhat fewer companies (27%) plan to forego a price increase and the majority plan to bring in price rises in the first quarter of this year and we think many companies implemented these in February. Companies will now wait and see what happens with inflation but more importantly with the rouble. The outlook on price rises looks much more beneficial to companies now in the sense of profits stemming from them, but this seeming windfall increases resistance from the supply chain (see below). Some companies who did not introduce price rises in February-March are in a quandary now whether they should do so in this new environment. Resistance which be much more firm now than it was just few weeks ago.





One third (35%) of companies witness strong resistance to price rises and we imagine this will only become more stubborn from now if the rouble stabilises close to current levels and if inflation starts to trend downwards. Perhaps companies may be able to introduce smaller hikes than they had originally planned. Another 45% experience some resistance while 20% experience no resistance.

Those companies who brought in increases in February will be glad they could "get in under the wire" before the market turned against them.

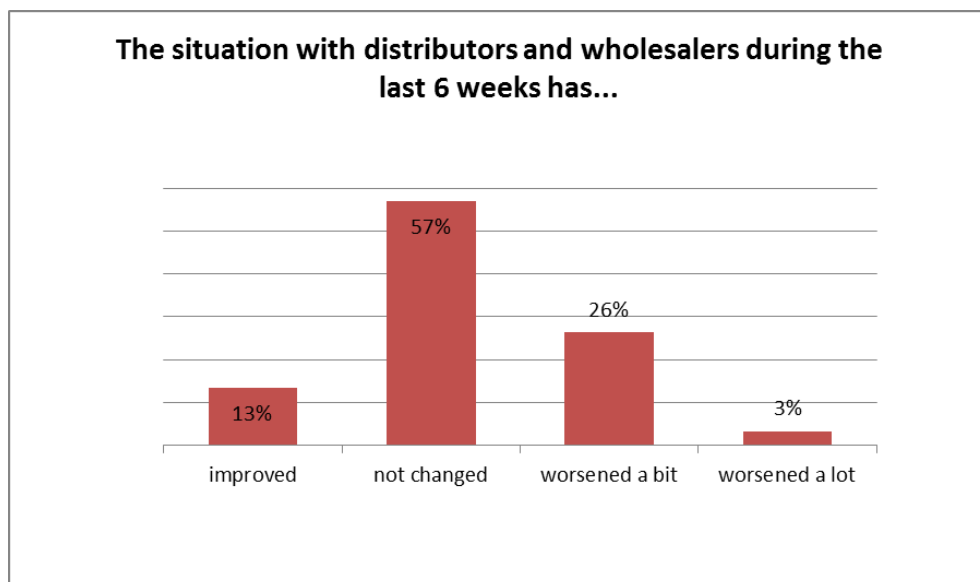
Working with the supply-chain

This indicator worsened in the summer 2014 and then stabilised in September-October followed by a mild deterioration to mid-November and then once again though it deteriorated at the turn of the year. However, as with several other indicators, we are now seeing some moderate stabilisation and an improvement for executive perceptions of what has happened in the last 7-8 weeks: some 11% of companies report the freezing

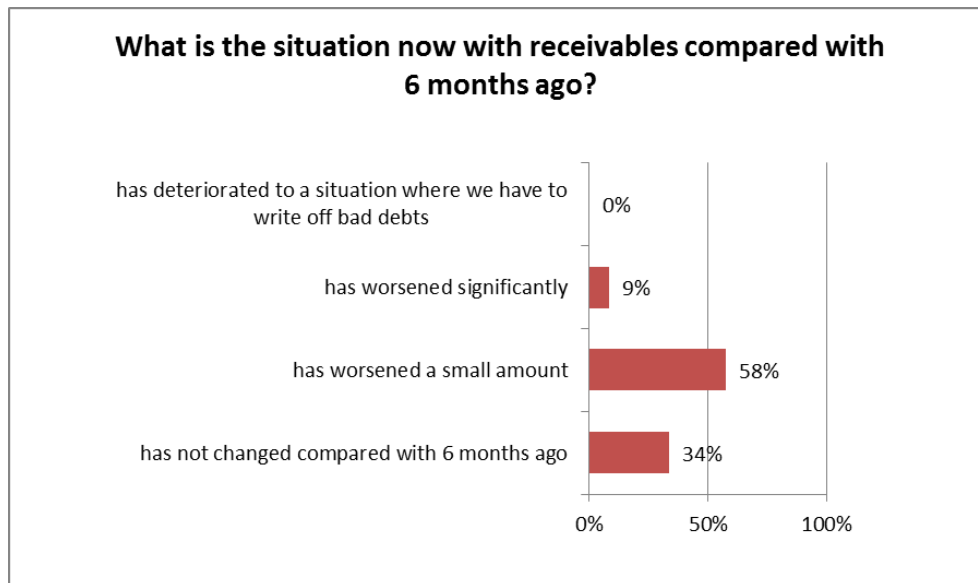
up of distribution while the number reporting “greatly reduced levels of purchases” stays at 54% and the number who see business as usual has stabilised at 34% today..

Fluctuations by business sector follow the usual pattern: pharmaceuticals come out best by far with consumer products not bad or mixed and with the B2B sector reporting more freezing and less improvement.

But the perception of what is happening has changed in the last 7-8 weeks: 13% now think the situation with the supply chain has improved (up from just 5% in our last Survey) and those who think has worsened is down from 60% in our last Survey to just 29% today. There could be a sense that regarding this question companies are “finding a bottom”. But tough financing conditions could see deterioration later this year and we should always remember that still 54% of respondents see “greatly reduced” activity from their suppliers and 11% report a freezing of purchases. The trends seem better but the actuality is still quite tough.

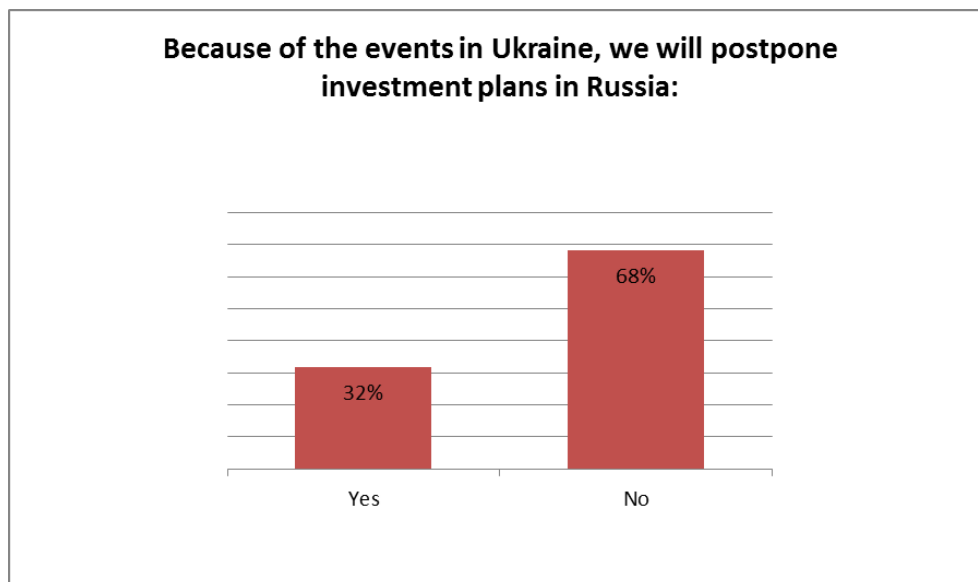


Receivables, investment plans and cost management trends



The situation with receivables is not too bad either, not yet: some 34% see no deterioration during the crisis and 57% have only experienced small problems but this latter figure has seen a soft deterioration since our last Survey with 57% responding like this compared with 47% some 7-8 weeks ago. As companies everywhere seek to manage cash and ask for favourable terms, this mild but noticeable worsening is not surprising. The good news is that bad debts remain almost non-existent.

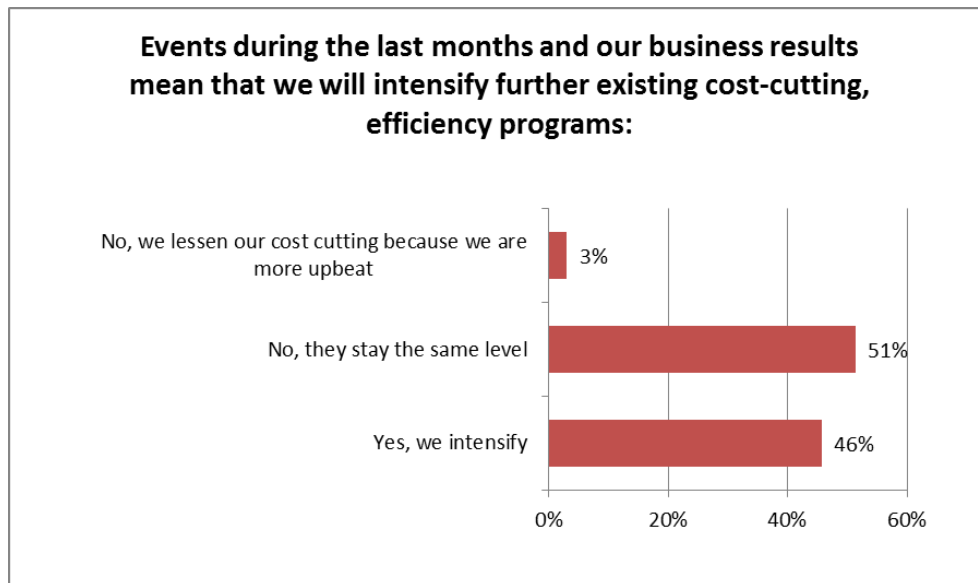
The payment morale generally for many years in Russia has been very good. But within the CEE region, Russia now ranks second worse in a table out of 23 markets surveyed. Within Russia there are no major discrepancies in the trends across different sectors.



Those planning to postpone investment have also stabilised and improved in recent weeks and is down to 31% from 36% 7-8 weeks ago. Once again we see very distinct sectoral trends:

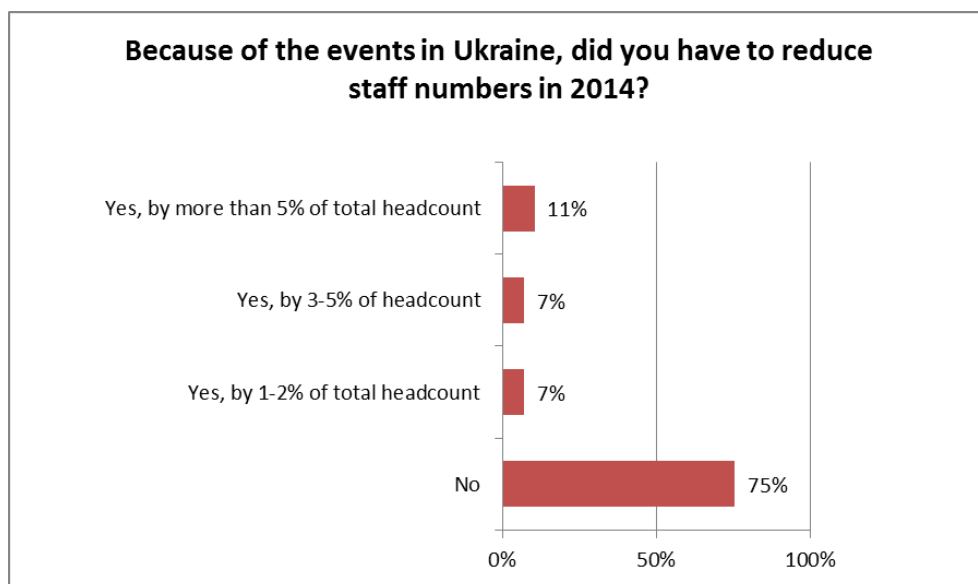
- Across all sector 68% plan to continue their investments
- Among consumer products this rises to 75%
- For B2B firms the proportion is much lower at 58%
- While fully 81% of pharmaceutical/health firms will continue their localisation

Some major market players with substantial market shares in different sectors are accelerating investment and becoming quite aggressive especially in building logistics and distribution centres and warehouses. Clearly this does not apply to the majority of firms and includes more FMCG and retail players.



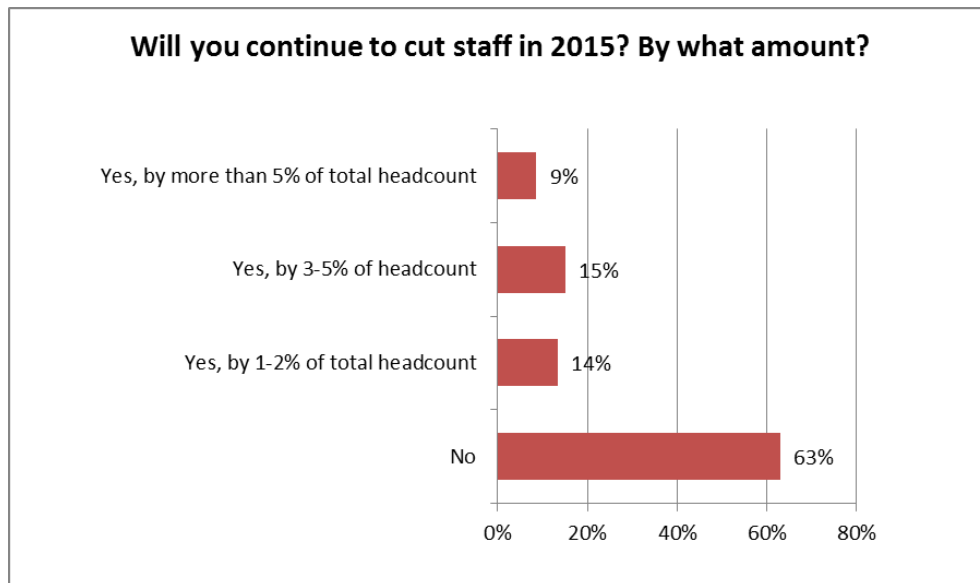
This indicator is another one staying fairly constant simply because companies are either indeed continuing to intensify or are maintaining cost cutting programs that were already introduced. Cost management is the name of the game. This will not go away and with focus on supply chain and manufacturing processes. Companies want to cut least in sales and marketing but are doing so in some cases. They appear to be holding back so far with staff cuts with the slight deterioration we noted above.

Looking after the headcount



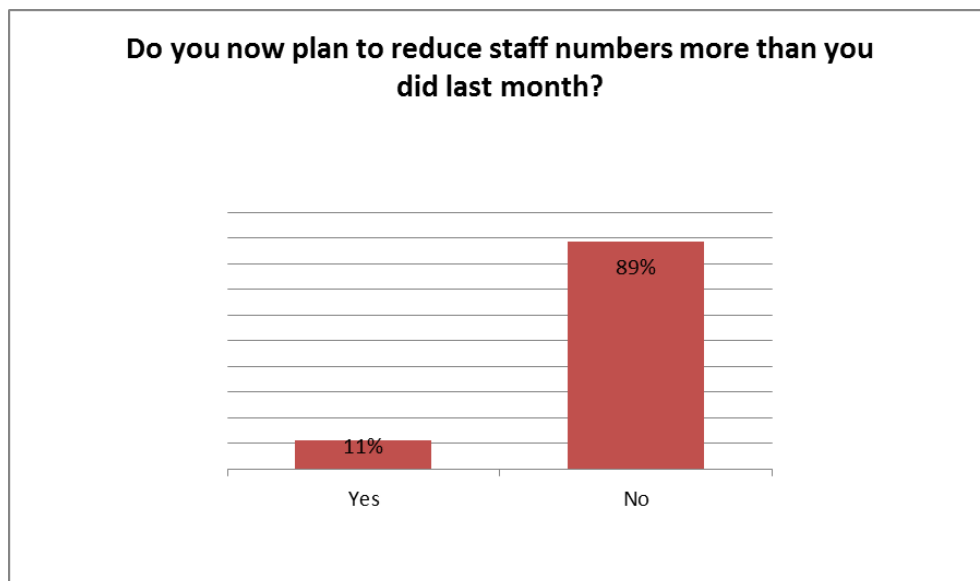
Last year companies were reluctant to fire staff and the proportion stating they have not done so is stable at 75% of companies. Some 14% of firms have made limited reductions of barely 1-5% of total staff and only 11% of companies have made cuts of more than 5% of total staff.

This approach is the best one and if sales and profits can be sustained at bearable levels, staff cuts may not become prevalent. But there is a clear risk that further staff reductions may take place and we are seeing this number creep upwards in the first 4-5 months of 2015.



Here we see that the number of companies not cutting staff is now down to about 64%, which is a 10% decline on 8 weeks ago and fits with our assessment that more companies “will have to reduce staff more this year”. Most of the planned cut-backs are moderate with 13% looking to reductions of 1-2% of total staff but now 23% are proposing deeper cut-backs. There will be some churn as some companies do plan new hires and replacement ones. This indicator could worsen over the summer.

However our other surveys show that (until December) Russia remains the No 1 market in the CEEMEA region where companies still plan to hire new staff over the next 3 years. We will judge over the coming months whether this positive trends is maintained and how much HR churn takes place. The demand for top talent is still relatively high.



Salary trends 2014 and 2015

Given that salary decisions are now set for 2015, there is little change in our indicators but we are seeing some marginal movement to raise salaries a little bit by a small number of companies and at the margins. But this movement is marginal and not enough to change the indicators below regarding trends in salaries above or below inflation. We are also seeing a slight tighter clustering of companies offering low single digits or flat rouble increases. In other words, companies overall have NOT decided to re-jig or increase their salaries to compensate for the rising adjustments in headline inflation.

Overall, the clear conclusion for now remains: companies are trying hard to protect their headcount but are determined to manage their costs and will keep salary increases firmly below inflation, which actually matches trends visible in the Russian economy overall and within the Russian civil service. It seems that everywhere real wages (after inflation) will now trend at -7% to -10% this year and were at -10% this spring across the economy.

The clear point about 2014 and 2015 is that companies will keep a very tight rein on salaries. For 2015 more companies are planning for below inflation pay increases as inflation rises further in Russia from an average 7.8% in 2014 to an average figure in 2015 which could range from a low of 9% to a worst case of 14-15%.

There are variations of course and these are averages and white collar covers a large number of positions. To assist you in budget planning, the following two tables compare previous periods (benchmarked to inflation) and also show what companies plan in 2014 and 2015 in absolute percentage terms.

Salary comparisons 2014-2015 in absolute terms

What salary increase in roubles did you pay (do you plan) in absolute terms in 2014 and 2015?

| | 2014 | February 2015 | May 2015 |
|----------|------|---------------|----------|
| Plus 10% | 3% | 12% | 7% |
| 5-10% | 27% | 55% | 50% |
| 1-5% | 15% | 16% | 23% |
| Flat | 20% | 13% | 18% |
| Negative | 0% | 4% | 1% |

While this table makes it look like companies are being more generous, this is not the case. Given that inflation is rising noticeably in 2015, when salaries are benchmarked against inflation, they are tighter (see the next table below).

What salary increase did you pay (do you plan) in the coming 12 months?

Salary comparison over time benched to inflation - "average" white collar staff members

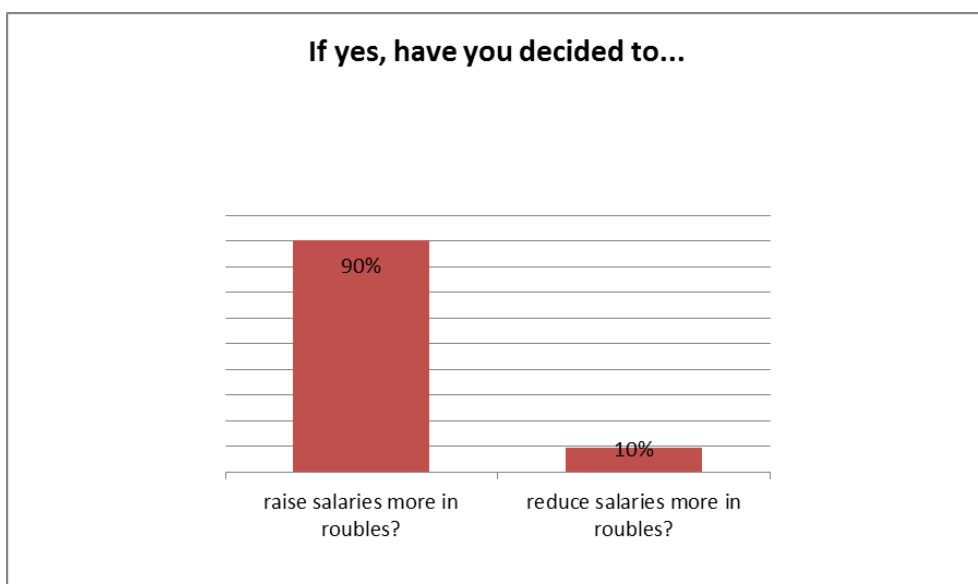
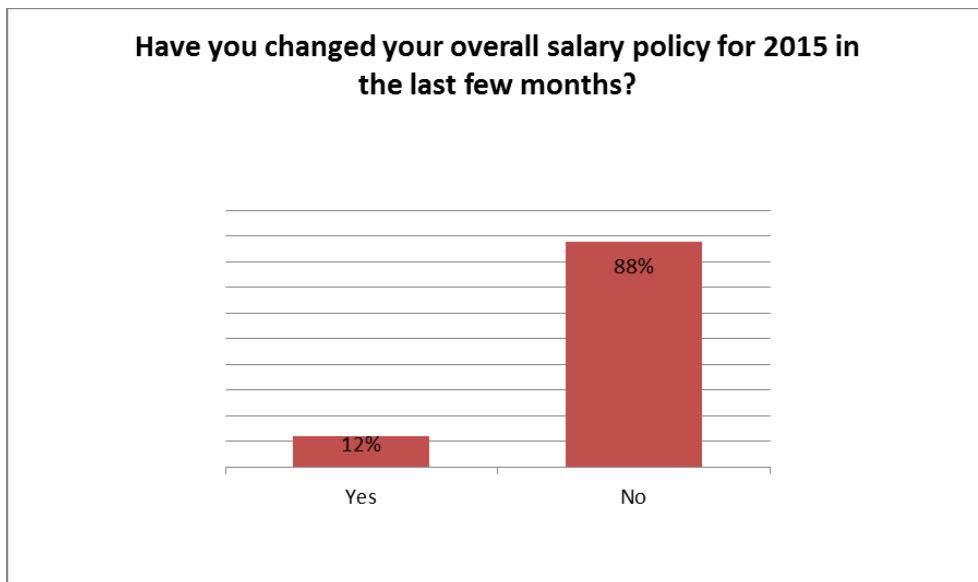
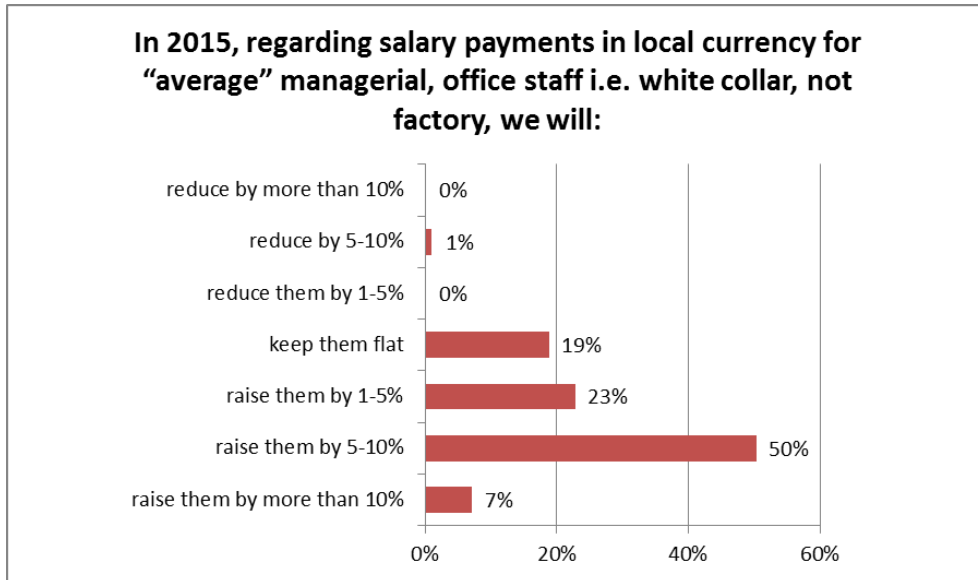
| % of companies | January 2013 | January 2014 | January 2015 |
|-------------------------------|--------------|--------------|--------------|
| Salary below inflation | 3% | 14% | 89% |
| Salary at inflation or + 1-3% | 70% | 80% | 11% |
| Salary at inflation +3-10% | 25% | 6% | 0% |

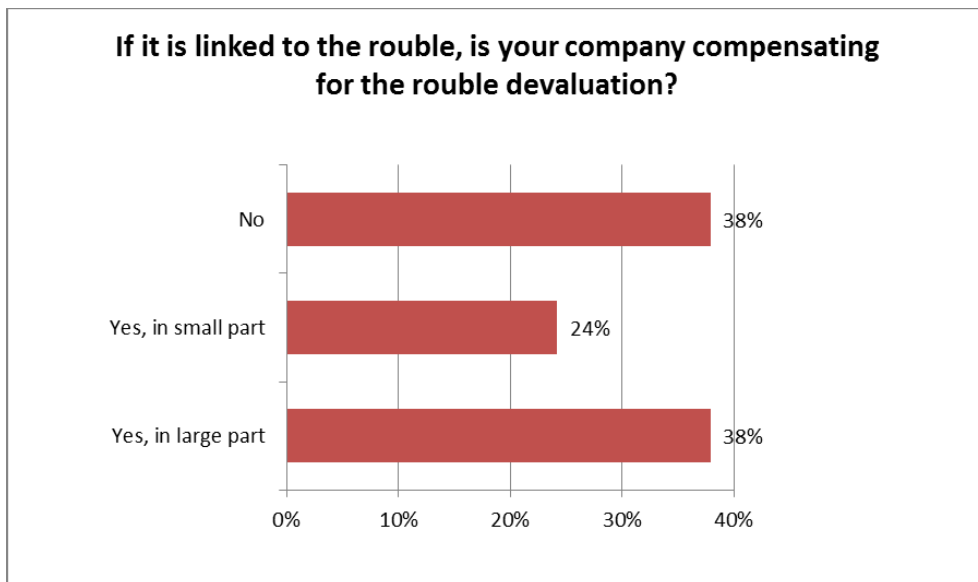
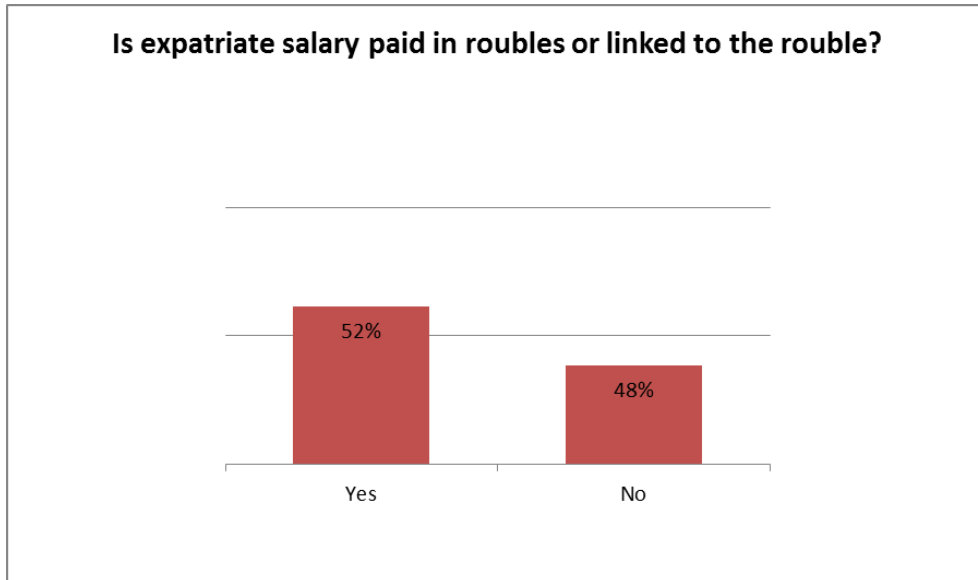
Source: Russia Business Group Surveys

The numbers in these two tables match up/correlate when we presume that inflation in 2014 will average about 7.8% and will average 11-13% in 2015.

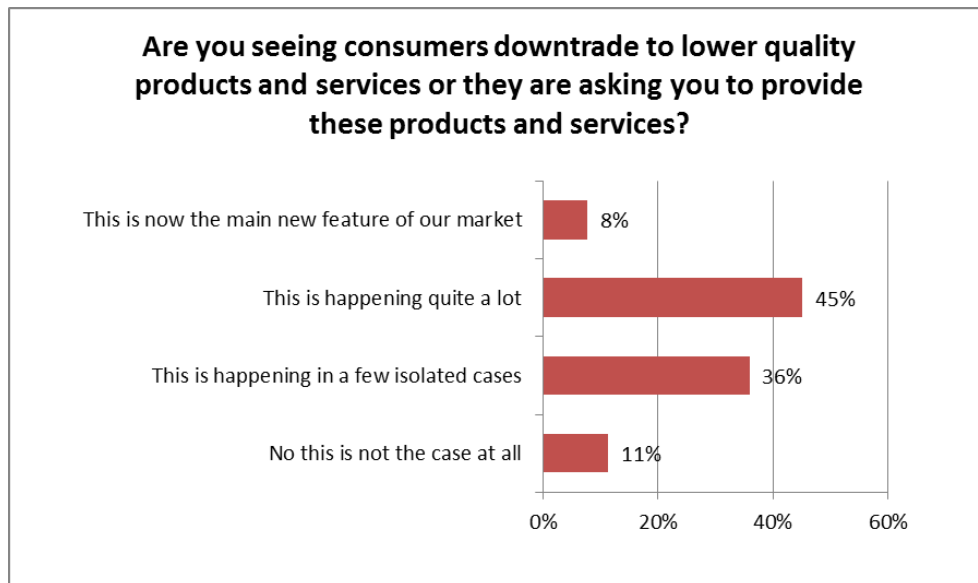
Instead of cutting staff numbers, companies are offering lower salary increases for "average" white collar staff. The upward pressures for top talent remain high but these very high levels have also declined and decelerated. What is very manifest is that while in January 2013 it was almost unheard of to propose salary increases below inflation, this has changed radically with 89% of companies now in this situation.

Also note that 81% of companies are not compensating Russian staff for the devaluation of the rouble.



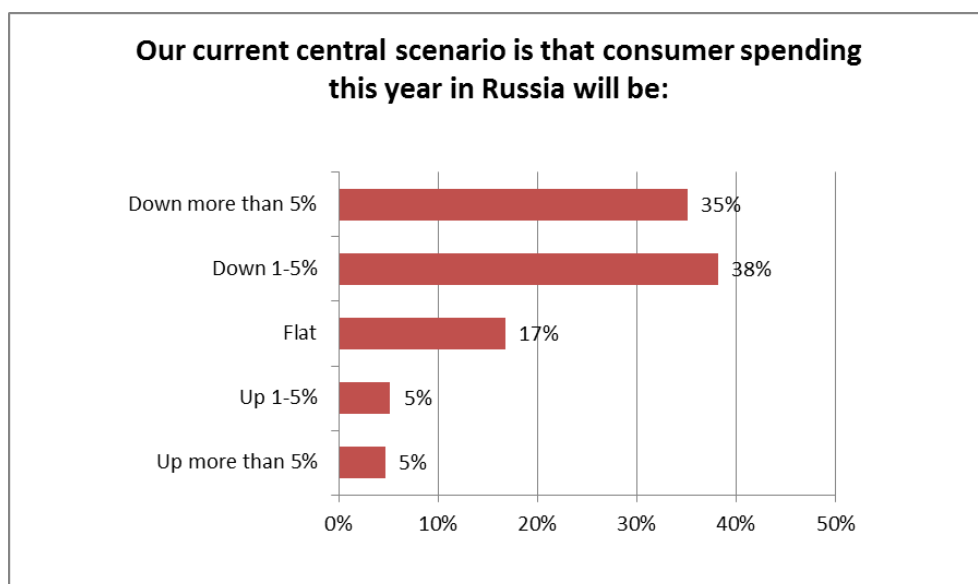


The Russian consumer outlook



This indicator had stabilised until February which we said was “perhaps surprising” given the economic numbers reported for inflation, real wages, consumer confidence and even unemployment at the margins. But now in this Survey we are seeing a bit of a further deterioration where downtrading is becoming more prevalent: strained consumers want value and choose to pay less or reduce their frequency of purchase.

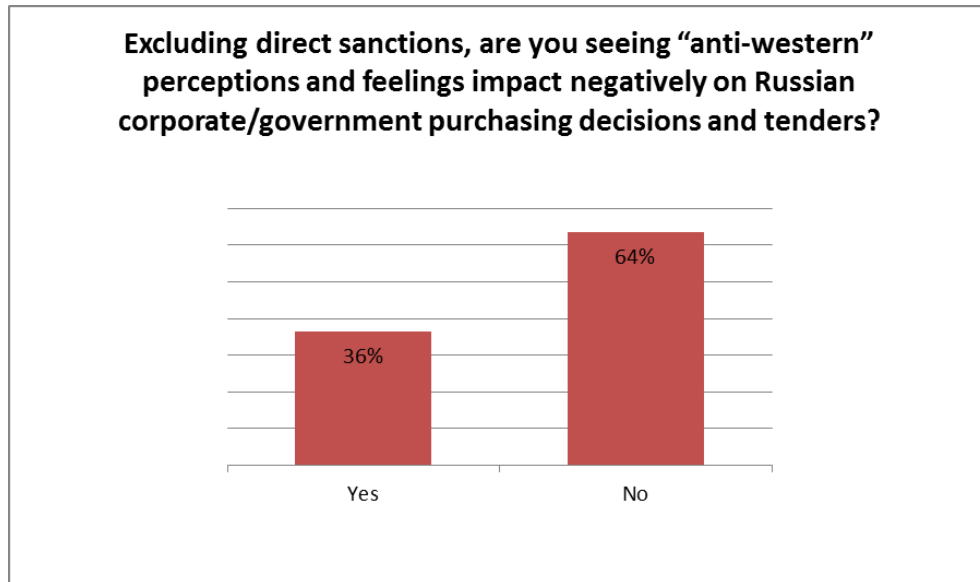
For some 53% of companies downtrading is a serious issue in their business (up from 39% in our last Survey). The trend takes place most of all in the consumer sector but we are seeing these pressures in B2B and IT as well and in government tenders of course. The number of companies affected has fallen from 19% last time to just 11% today. Those who state downtrading is isolated, has also worsened from 43% of respondents in February to 35% now. Compared with other CEE markets, Russia has worsened in this category while the toughest market for downtrading is not surprisingly Ukraine.



Given the rouble crash and slowdown in real wages and softening retail sales, this indicator deteriorated hugely during December to February. The end of 2014 finished very strongly for sales as consumers “bought ahead of inflation” but that is now over. Only 10% of executives think consumer spending will be positive this year with

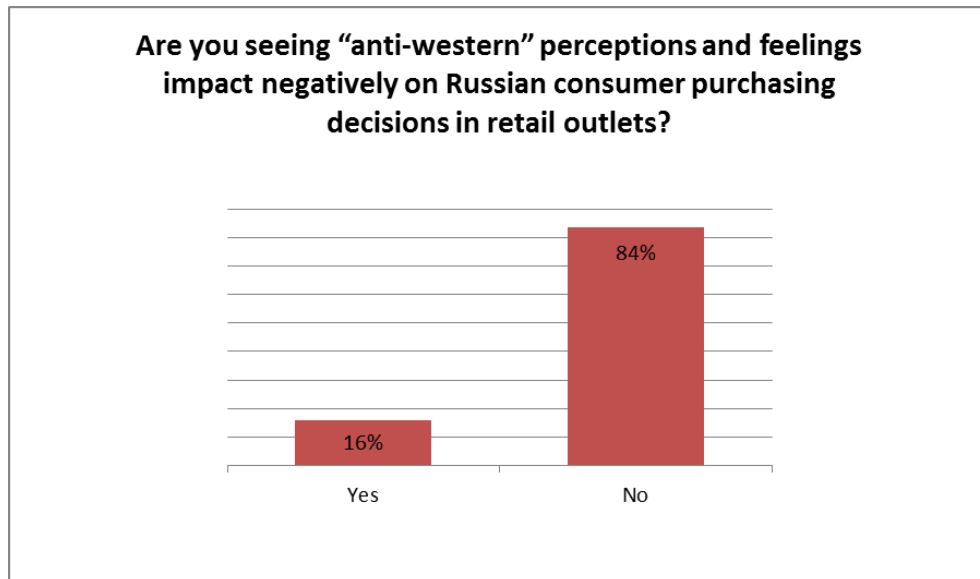
16% looking at flat expenditure. The number predicting negative spending did fall in our current Survey from 81% to 73%.

Spiking inflation, collapsing real wages and falling consumer confidence are all playing their part. This is why we noted above that consumer product companies will have to be very creative and raise prices as well to make their numbers. This is one of those indicators which has improved in only a tiny manner and shows that executives, while their own mood has improved, do not yet expect an immediate improvement in the market dynamics given the recent tough economic numbers.



This indicator stabilised at the turn of the year and has improved noticeable in the last two months: either the government and Russian companies are behaving less aggressively and/or western companies are getting accustomed to the new normal and this environment.

Some companies report losing one or two contracts which they think they would otherwise have won. But we are not yet seeing many companies reporting a large loss of business, although this remains a worse case that can develop. Companies are being asked, “Are you localised?” and then also asked “From where do you source your inputs?” and some companies are turning to Asian suppliers rather than regular western ones.



It is more difficult to gauge whether end-consumers in shops are actively deferring purchases of western products because of anti-western feeling. There may be more public talk of this than reality and it is a feature difficult to gauge and quantify. Consumers of course may be turning away from some western brands purely based on price/value decisions. But it is not a feature to be trivialised. Luckily here too we are seeing some improvement in how western managers judged this factor: 83% do not perceive this (improved from 75% two months ago) while 17% of respondents do report this trend (down from 25% last time).

The currency outlook

We have commented in recent reports explaining why the rouble has strengthened in recent weeks and here is a short summary:

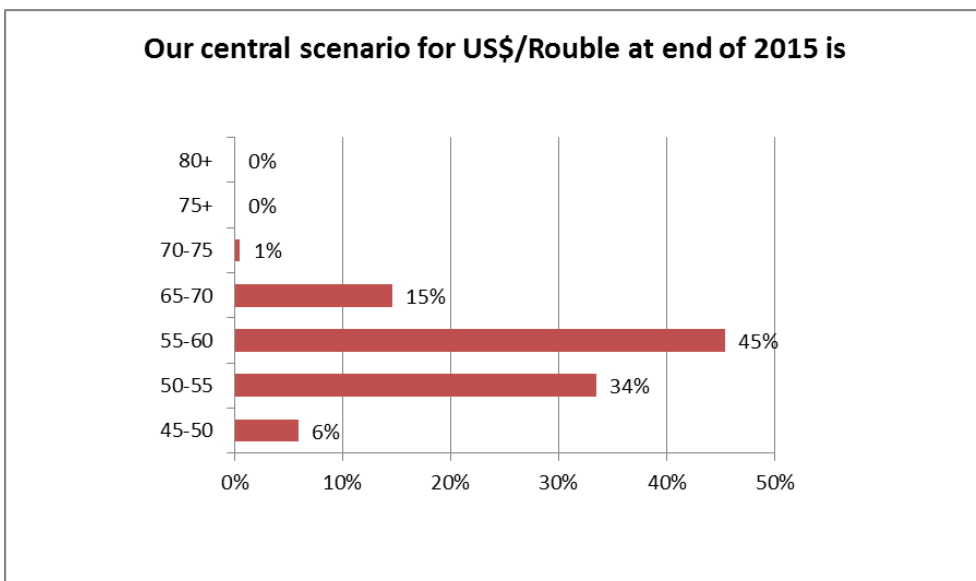
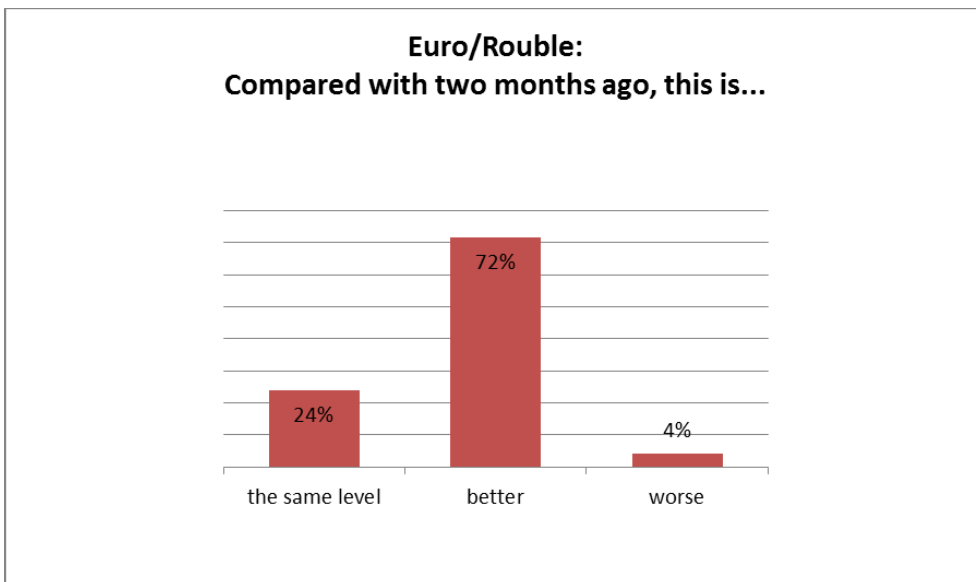
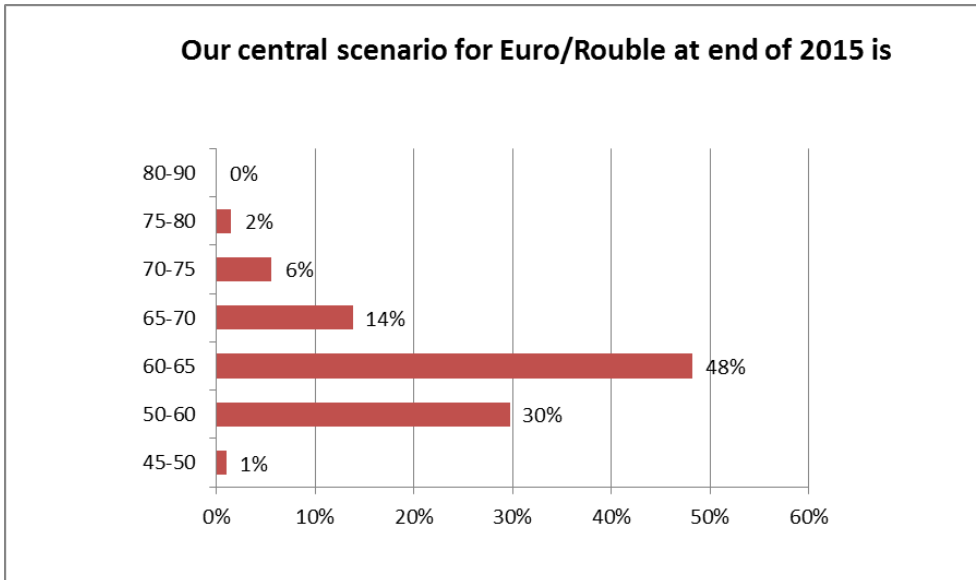
- In 2014 the Russian rouble was the world's worst performing currency
- In 2015 to date (9 April) it is the best performing currency in the world
- One thing is for sure: the rouble is the world's most unpredictable currency

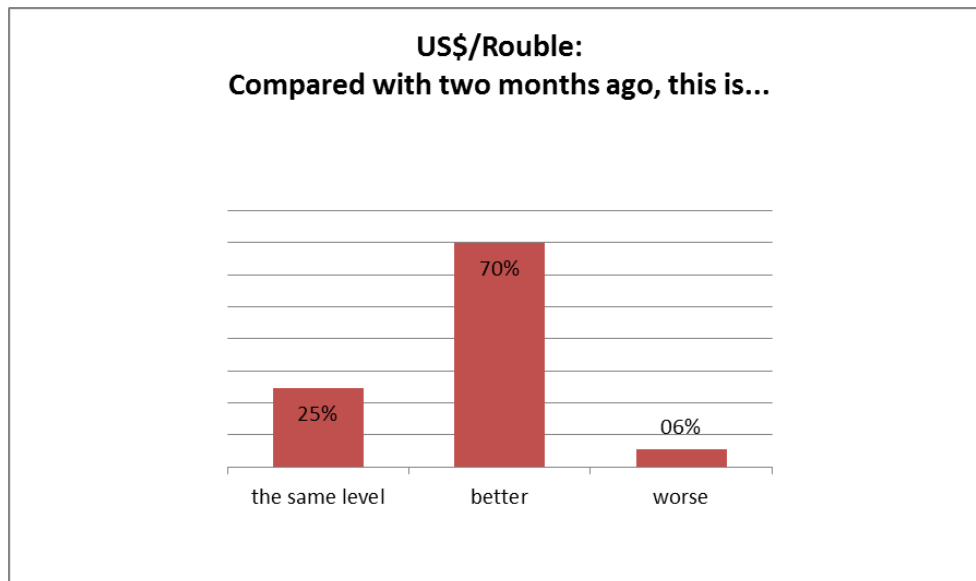
Why is the rouble rising now?

- 1) There is some stabilisation in the oil price at around \$58 to the barrel.
- 2) It is "apparent" to western media that eastern Ukraine has calmed down (whether that is the reality on the ground or not is almost irrelevant as it is perceptions which now count)
- 3) There is a sense that western sanctions are not going to intensify
- 4) It seems that households may now be re-converting back into roubles some of the \$25bn worth they converted in 2014 out of roubles
- 5) The Central Bank has been working hard with repo rates to manage the currency upwards
- 6) There is also just a sense of "the worst of December 2014" is over. This becomes a self-fulfilling prophecy and the market mood turns positive
- 7) The end of 2014 was also impacted by large debt repayments which came due for Russian companies to pay back to western creditors
- 8) Since a series of December and March debt repayments have now passed, the debt repayment curve for the rest of 2014 is more evenly spread and there appears to be less risk
- 9) However, the rally could be temporary and due to "mood" and to foreign investors closing long positions on the rouble and when this latter feature terminates, then the current rally could fade

On account of all of the above, almost 50% of executives think the rouble will average this year at 60-65 to the Euro which is lower than its current rate today but also seems a plausible assumption. Almost 30% of respondents see the rouble averaging 50-60 against the Euro and most of these are closer to 60 than 50 and again this is a not unreasonable assessment. This is a huge improvement on rouble/Euro perceptions some 7-8 weeks ago.

Of course the same has happened with the dollar: almost 80% of executives now see the rouble averaging against the dollar between 50-60 rate with a larger portion among these forecasting a range of 55-60 which is again weaker than at current rates at the start of May, but we think an element of caution is sensible approach.





If you have any queries or comments, do get in touch at danielthorniley@dt-gbc.com.

3 May 2015

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