CEEMEA
Business Group

Russia Business News

Hanging in there

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

16 March 2015

IN ASSOCIATION WITH: BAKER & McKENZIE · EY Building a better working world · Radius GROUP

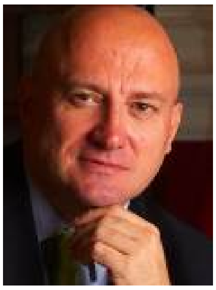
Content

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

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.

Executive summary

- Executives are thankful for the current relative stabilisation but many are concerned about potential very weak business results this spring.
- Managers working in Moscow have to provide their global headquarters with some sensible reassurance
- One regional manager noted last week: **<u>“Do things right in the short term for the long term”.</u>**
- “We cannot fix the short-term problems without doing something very drastic which will surely damage the business long-term.” This is a key issue to which we have alluded to on several occasions in recent months.
- Some companies are taking costs out of their companies but going too far and creating operational dysfunctions.
- Many (most?) executives believe things will get worse this spring and continue through much of 2015 while a few executives expect some mild/moderate improvement by the autumn-early winter.
- Some very well-experienced executives wonder if there could be another strong rally/mini-boom in the next 12 months based on previous crises in Russia - but scepticism about this is higher this time round.
- Regarding February price increases, a few companies state that these are being less well absorbed by the consumer as volumes and categories start to fall more.
- The traumatic December 2014 did impact consumer confidence which fell to a multi-year low in the final quarter of 2014.
- Consumer indicators have started to match the weakness shown before in investment and industry: real wages and retail sales in the opening weeks of the year were very negative. Spiking inflation is kicking into spending patterns.
- One regional MD of a western drinks company said: “We are raising prices but it will take us about 18 months to fully recoup our business through prices”.
- Business confidence is declining but not as steeply as consumer sentiment.
- Companies continue to focus on the Russian regions and this is “a given”.
- Localisataion remains a key part of business strategy for many companies: those who are pulled on-shore by the Russian government and those who want to capture more market share.
- One B2B company is keeping US content below 25% to get ahead of any future Russian formal or informal limits on foreign input.
- A small but growing number of companies are considering using Russia as an export base (one pharmaceutical company will be producing insulin for export to Germany).
- Diversification is still a good place to be: being a conglomerate is helpful in spreading risks and ensuring business in some remaining good sectors.
- 2014 was still a good year for some/many companies in roubles and for a few in FX.
- “Consumer tourism” trends are helping some consumer product companies in Russia: Russians are staying at home and spending in Russia rather than in Cyprus or Turkey and Finns are crossing the border to buy “cheap” Russian products.
- Some companies note that more newcomers are entering the market or taking a look as the cost of entry declines and some openings are appearing; Russian companies may also choose to “fight back” if they can get hold of financing.
- Selling to the Russian oil and gas sector is extremely tough.
- Best Practice does remain, trying to protect the supply chain while remaining efficient: “I don’t want to end up with three distributors in Russia” said one pharmaceutical MD.
- “Price is easier to achieve than volume” and some executives argue forcefully for price and FX; while others worry more about volume and wonder when it will come back.
- <u>Some mangers think that introducing many affordable brands and categories will mean that volumes do not decline so much as in earlier crises but price and profits will be hurt.</u>
- Industrial output softened in January as anticipated but was not worse than expected because defence spending and procurements were brought forward into January and thus the budget deficit also expanded in January to still manageable levels.
- Financing may get a little easier as the Central Bank cut interest rates again in March to 14%.
- Inflation leapt to 16.7% in January from 11.4% in December.
- Most companies plan below inflation salary increases this year. BUT they were probably planning with 2015 average inflation at 8-9% instead of the current forecast of 10-13%. Staff may ask now for inflationary compensation adjustments.

- One consumer product managing director reiterated this point with qualification: “We will raise salaries by about 8% this year, so below inflation. But this is based on consumer spending falling by 5-10%. If consumption collapses more by about minus 15-20% we would have to review salaries downwards and/or let more staff go”.

Four features

1) The market mood and rouble appear to have stabilized, at least for now.
2) Executives are more accustomed and adjusted to the new, new normals of the Russian market.
3) While the market is showing some signs of stabilising at deteriorated levels, many executives believe that this spring will be a tough period for business as inflation stays elevated and the Russian consumer feels the pain and changes spending patterns and purchasing behavior.
4) There are mixed views about the short/mid-term outlook: some executives think the tough times will flow through into spring next year with a challenging start to 2016, but some other executives think that in a central scenario some business sectors can stabilise further and even rally in late summer/autumn.
5) Companies are managing costs tightly but most companies have not yet engaged in deep HR reductions and instead are controlling salary increases holding them firmly below inflation levels.

The regional manager of a US consumer goods company with 25 years’ experience in the Russian market noted sensibly that:

> We all know that in the past the Russian economy and consumer market bounced back from previous recessions after 1998 and 2008-09. We know that things look different this time but I wonder whether the Russian consumer can “pull something out of the bag” and whether we may just experience a strong rally within the next 12 months.

There is a part of this executive, and perhaps others, who want to prepare for another rally and understandably so.

HQ needs reassurance because Russia is important

We have spoken before how global headquarters requires sensible reassurance about the medium-term business outlook and a case/scenario can be made while risks cannot be ignored or down-played. Headquarters need such reassurance because other markets globally and within Europe are struggling; there are few easy options available.

Russia represented until recently 35-55% of greater CEE business in terms of sales (CEE/CIS and Turkey) and for some major players the figure rose to 60%+; the proportion of profits stemming from the Russian market was also extremely elevated. When Russia wobbles, then the whole CEE business structure is severely stressed and even pan-European and global results are affected for some companies.

> Last year one major apparel company informed me that 16% of its global turnover and 32% of its global profit came from Russia and these numbers were repeated by a German construction company. Russia was/is very important.

Russia in context

How markets are perceived a performing for sales outlook across all sectors:

Doing very well	Doing well	Surviving (well)	Struggling	Strained/severe strain
USA	Parts of CEE	Turkey	Brazil	Russia
	Poland	Slovakia	South Africa	Ukraine
	Czech Republic	China	India (Improving?)	
	Hungary	Saudi Arabia	Mexico	
	Romania	UAE	Egypt (Improving?)	
			Nigeria	
			SEE markets (improving?)	
			Levant markets	
			Most of Eurozone	

Most other Mid-East and Gulf markets find themselves as surviving or struggling and the same applies to many African markets although some African markets retain solid appeal as investment locations for current or future growth. But the end of the commodity cycle could take the shine off some African markets.

Syria and Iraq are civil war states and Iran remains under sanctions, although the latter could transform into a growth market if sanctions and tensions are removed.

Don't cut too deeply that you damage your business

The regional manager of one US consumer products company, when taking a strategic view of his business, argued well that he could make deep cuts to "make the bottom line" but:

> We cannot fully fix most of the short-term problems without taking steps that will certainly damage the long-term health of the business.

He really put his finger on the critical point when he said:

> We need to do things right in the short term for the long term.

And this is where usually tough discussions take place with European and global headquarters.

This fits in with our own long-standing view that cost efficiencies are required but MDs must be ultra-careful not to cut too deeply that they damage relations with customers, partners and their own staff.

A conversation with regional MDs of a western drinks company and European food company

The following remarks and references are a mix of comments from a recent breakfast meeting in Moscow.

Stocks and flows

Prior to February it was tricky to know how much of the business flow was due to stocks being filled up, although much of it was real consumption. But some companies now sense that the February price increases have now hit real consumption and it will get worse from here. December and January sales were strong because of two factors: consumers were still spending and distributors were still stocking up. One of the senior managers at the breakfast described the process well:

> Your stocks are going up and down like an accordion but at different levels and stages compared with real, actual consumption. This is a normal mis-match but at times of extreme fluctuations, it can become much more difficult to understand what the real business is.

Broadly the consensus seems to be: November-December-January saw real consumption with the necessary increase in stocks and February may be witnessing the first signs of slippage in consumption.

Prices and volumes

Many companies introduced their first batch of 2015 price increases in February. These followed price increases in 2014 in consumer products which ranged from 15% to 35% for the whole year: several food companies reported price rises of 33%+ last year while some tobacco firms raised prices by 35%+. B2B firms and IT saw generally lower increases of 5-25% and pharmaceuticals depended on which segment of the industry sales were made: pharmacies and OTC prices also rose by 10-25% in some cases while other products to hospitals and government were much lower or simply fixed.

Executives still debate vigorously whether volume or price is more important with some arguing that price has to drive the business and volume will follow later; others think that volume has to be the priority but appreciate that this is hugely difficult as categories decelerate.

> Of course all agree that market share is the name of the game

Several senior managers in the consumer goods sector have reported that overall the holidays in February and the 8 March celebration were disappointing for business (depending on categories of consumer products) while a smaller number said that "sales did hold up well in comparison with the same period last year and consumers are still able to spend the "last" parts of their savings". This would suggest that prices are finally starting to hurt and this could possibly be different and worse than earlier crises.

However, <u>some mangers think that introducing many affordable brands and categories will mean that volumes do not decline so much as in earlier crises but price and profits will be hit.</u> The regional manager of the western drinks company had some interesting analysis on this point:

> We are an industry of high margins and the size of the Russian middle class will continue to get better if at a slower pace now. But our industry and others are getting more adept at supplying affordable solutions. I am pretty sure that the value segment will be much bigger this time round and so overall our volumes may hold up quite well. But price and profits will not be as good as after 1998 and 2009.

This manager went on to benchmark the crises:

> Our price increases now are about 15% to 25% but back in 1998 we were looking at 65-90%. This should be a different (better) kind of crisis.

On this point, one western confectionary company noted regarding post 1998 and 2009 that:

> After both crises we raised our prices substantially and the Russian consumer absorbed everything. This meant that after each crisis our profits actually rose.

The regional MD of this firm doubts they can repeat that performance although he believes price rises will compensate for some/a lot of the down turn.

The consumer is clearly weakening but as the MD of the European food company noted:

> It will take time for price increases to flow though. I think we will see the effects and get more hits in the next 2-3 months.

But the executive from the drinks company with decades of experience working on the CEE and Russian markets argued that:

> Consumers will get accustomed to the price increases eventually. The next weeks and months will be the hardest but we also think that the government will boost some social spending in the summer/autumn and there ought to be some moderate "extra" salary increases then as well.

This points to a possibly better picture by the late autumn.

One executive in the food industry stated last week in Moscow that:

> The supply chain does seem now to be getting tighter and negative consumer effects may just now be starting to hurt inventories and the supply chain more. Our Russian partners in several categories in meat and dairy estimate that the categories will be down 25% to 30% this year with the worst impact in the first half of the year.

Brand and value

The comments above echo remarks we have noted in previous reports:

Many executives believe strongly that brands and premium-priced products will be much more difficult to "shift" than in recent years and during previous crises. Executives still have faith in brands and we presume that Russian consumers will prove yet again fairly resilient. But the majority of managers also believe that the impact on brands ought to be deeper in this crisis than in the past.

> This crisis comes at a time when the Russian and global consumer were undergoing a historical change in consumption patterns and behavior. Value and affordability will play a huge role in business now and for the next 5 years.

This will also have a major influence on how companies approach the Russian regions and develop their strategies there.

Consumer tourism issues

Several executives point to trends going on in "consumer tourism" which means the following:

- With the weak rouble fewer Russians are travelling abroad: this hurts outward bound tourism and related industries but helps and supports local Russian tourism and facilities.
- This also means that the money not spent abroad is expended in Russia or saved: in fact most Russians prefer to spend a weakening rouble.
- Western companies have seen temporary surges in spending on consumer durables as consumers "stock up against inflation" and also on products such as "Do It Yourself" items as Russians decide to "do up the dacha" instead of traveling abroad.

- Executives comment as follows: "My company chauffeur used to be able to afford 2 holidays in Turkey but not any longer". Another western MD echoed this: "My junior/middle managerial staff used to be able to afford 3-4 foreign holidays/long weekends each year but now it is either one or none". This will impact an influential layer of Moscow consumers when you add all the staff employed in Moscow by western companies.

A few words on HR

For our full Survey results on headcount, salaries and related issues, see our monthly Survey results and the summary report this week on these topics.

The MD of a major European executive search company could see some bright points:

> Danny, there is now some movement and good trends starting with our Russian clients. They are now starting to think about staffing up their operations and to bring in new talent where needed. They are reorganising their business now and no longer just in freeze mode or cut mode. Things are not great at all but they are hugely better than in November and especially December when most of our Russian market froze totally.

The regional MD of one western investors company commented on some of his current staff issues in Russia and his comments are in summary from here:

- My general philosophy is that if you cut staff or lose staff, then you don't have a full, proper team to manage the new type of business and to be positioned for any growth pick-up or to fight for market share.
- We have not yet cut any staff in Russia apart from some normal churn.
- As it happens, we have not fired anyone in Ukraine, but we have kept nominal salary increases down to 10% which is about -15% in real terms or worse. However, we have offered some extra, "special", ad hoc pay increases to compensate for the currency collapse and high inflation.
- We are increasing salaries nominally in Russia by about 8% without special increases and this also means salaries are well below inflation. This level for salary growth is based on our presumption that consumer spending will fall by about 5-8% this year. But if it were to collapse by 15-20%, then our business model would have to change and we would have to ensure tighter salaries and also start letting some people go.
- My view on any possible future headcount reduction is that we would have to sacrifice average performers in order to be able to retain and pay for the top talent.
- We have seen some "wanted" people leaving and that hurts and we are examining any and all issues around this. I reckon that some top talented people think they can survive anywhere and at any time and so don't feel the need so much for job security in "a safe and secure western company". We are offering good compensation packages but some of your top talent will be determined to maintain their former standard of living and are not willing to compromise and thus look for even higher paid positions and better overall packages, although these are much harder to find anywhere now as nearly all the corporate world in Russia is getting tighter on all costs.
- We have also seen some increased rotation in sales force employees which is less surprising.

This executive and others have also pointed to the worrying feature that many talented Russian are leaving the country for opportunities abroad. This has been a feature of the last couple of years but is kicking in more now. This is not exclusive to Russia and there is a mini brain drain taking place out of China. But the trend remains worrying for Russia's future and at a more mundane level in terms of supply and demand of good, well trained potential staff.

As ever, I hope you have found this paper useful and enjoyed it. If you have any queries or comments, do get in touch danielthorniley@dt-gbc.com
16 March 2015