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The Outlook for Consumer Products in Russia: Death of the brands and distribution?

“We are cutting 66% of our distributors in the next 6 months”

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Introduction

- The business numbers are actually better than the mood in consumer products (CP) and all other sectors as well. That is certainly worth repeating:

The corporate numbers are better than the corporate mood

- But sometimes the numbers don't work either. As one MD of a major FMCG company noted:

For 2018 I want and believe that decent single-digit sales growth is doable but headquarters want double-digit growth

- Much of this stems from the fact that global HQs are stressed with global challenges and they communicate their disquiet, concerns and demands to all national offices including Russia.
- But at a recent executive dinner, many managing directors aired their growing concerns about consumer trends, e-commerce, and patterns in distribution and with brands.
- The first slides in this set refer to those remarks and then are followed by further commentary on business trends and an explanation of why some consumer product companies are struggling to meet targets in Russia when the economy is ticking up moderately.
- But before we get too gloomy: for 2018 only 7% of CP companies anticipate flat or negative sales for 2018 (organic top-line roubles) while 93% expect sales growth of which 30% forecast double-digits.
- Much depends on categories, route to market, current volumes, brands etc.

Classical distribution is finished? (1)

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- At several executive meetings in Moscow in the last 2 weeks, many MDs argued that the outlook for classical Russian distributors is far from rosy because more companies are cost-cutting, changing route to market, some are looking at doing more themselves, but one clear argument is that with e-commerce expanding rapidly, consumers will type in their orders on their phones, this will go to an automated sales platform and then logistics companies will distribute directly to the customers.
- This is a global trend and clearly there will be a need for some standard distribution (cross border expertise) and certainly the demand for logistics distribution is going to rise but this role is being filled by the large Russian and international logistics chains along with the Russian Pochta.
- The comments on classical Russian distribution were bleak. The MD of one major international food company claimed that:

"Classical distributors have had their day. We plan to cut 66% of such distributors in the coming months"

Classical distribution is finished? (2)

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- The MD of a major FMCG company stated that:

  "I spend 50% of my time on distributors and this should be 20%. **Many distributors will disappear and we have to be careful that we don't go down with them!"**

- "Omni-channel, dynamics in retail and of course e-commerce have changed everything in route to market".
- The MD of another food company commented that: "Some 30% of our business is distributor driven and that is the part which is really struggling".
- He also commented on internal corporate behaviours: "My motivated staff don't want to work on the "old, boring distributor business". They want to work on e-commerce or direct channels or key accounts. They sense that the distributor part of the business is the weak link".

Classical distribution is finished? (3)

- The MD of a major drinks company stated that: "Modern trade developed in the last 2-3 years much faster than we expected. If you focus on bigger key accounts and not thousands of little kiosks, what is the need and rational for distributors".
- Another executive running a large food & beverages company commented:

Once upon a time, you distributed your products to a standard shop, advertised products, customers came to a shop and bought them and took them home. Now the buying-selling field is so complex and confusing:

Different shops, different sizes, different locations, Hyper markets, mini-markets, convenience etc. Then you have the specific size of the store selling which types of categories and in which volumes and what do the different retailers want, what is driving them? Then you have multiple price points, changing consumer demands for price and some brands and 'good enough to have quality" at moderate prices and you have multiple categories and a lot of the business and marketing is now dictated by age rather than income. The matrix of how you target your customers is now so complex. And with all this, what is the role of the distributor?"

Are the big traditional brands going to die? (1)

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- Well perhaps they have got a good few years in them yet. BUT senior executives raised many questions about the changing global and Russian market and these are a mix of their comments related to brands.
- "It's no longer working out what your brands are. It's working out the age groups who buy your products and young and young-middle age people are now behaving differently".
- "Young people and young staff in our office don't really understand traditional brands".
- "Will a 19-year old today ever visit the website of a traditional FMCG company? I doubt it".
- There are mixed interpretations of how youngsters are behaving: Yes, they are very brand aware but they may well be not very brand loyal. They know hundreds of brands and have limited disposable income. Advertising on their phones disrupts them and fashion trends change by the week or the day.

  - **Youth are very brand aware but which brands: new ones, mini-ones, fleeting ones**
  - **Youth are very brand aware but less brand loyal**

- The MD of one CP company declared: "Television is dead!". Another MD jokingly contradicted that: "TV is not dead. But it is dying".
- "The model of putting more money into media and then getting return growth is DEAD".
- Media price inflation is about 5-10% and most executives agree that this feels high given the diminishing returns on traditional media and TV.
- Videos and U-Tube and Facebook are good BUT the key now is recommendations from friends.

Are the big traditional brands going to die? (2)

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- “But in response to these changes and price pressures, we have to be very careful about not commoditising brands”.
- “Yes, but we can and should try to introduce sub-premium brands”.
- “I also think that we need to stretch the brand without undermining it”.
- The problem with traditional brands was underlined by the MD of cosmetics company: “Core brands are growing only mid-single digits while niche, innovatory brands are doing double digits. The latter benefit from customers wanting something different”.
- On the plus side, the consumer does want value and does enjoy promotions but “brand awareness is still there” and this distinguishes Russia still to some extent.
- <u>The Russian market does still have brand leverage.</u>
- But things are changing.

Brands under pressure from promotion

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- The MD of a major food company noted that: “In Russia now brands appear in Surveys only number 3-4 in terms of importance compared with price, innovation, health aspects. This is very low for brand appreciation and the lowest it has been in Russia in 25 years.” He continued:
- “Price is the number 1 driver and we have to do everything on that”
- “But with brand appreciation so low, should we really invest so much in those brands?”
- One company director noted that: “When mothers are shopping for food for their children or their babies, 86% of them will go from store to store comparing prices. Price is the name of the game, not brand and quality and upward innovation”.
- The MD of one cosmetics company noted that:
- “If it’s not on promo, then they won’t buy. Some 70% of our business is now sold on promotions”.
- The MD of a major food company said last week: “I have been here about one year and I am shocked by the changes in promotion in this period”
- The challenge of constant promos and discounts by Russian retail is “ruining business for everyone”.
- One MD of a major FMCG notes that promos are 30-45% of the market now, the MD of a cosmetics company says that her company sells 45% on promo while the MD of a drinks company records 70% of sales on promo.
- It’s once again mid-price and mid-brand that is getting squeezed and the “problem child” for business.
- Another MD of a major FMCG firm argued that: “The proportion of promotion at 45% to 75% or even higher is unsustainable for the FMCGs and the retailers and we have all walked into his trap together. Getting out of it will be harder”.

Promotions and discounts: where does the problem lie?

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- Regarding promotions and prices, one MD of a major FMCG took a thoughtful and unusual stance on the problem:

  “We can moan as much as we want about prices, discounts and promotions. The promotions are NOT a problem, they are a fact of life. The consumer is indicating what price they want and are willing to pay and the suppliers offer this. The real problem lies within our own companies: headquarters has definite expectations about pricing and profitability and these do not match what the consumer wants. This is the mis-match”

- Perhaps this executive was being diplomatic when he did not state that it is the managing directors who find themselves in the middle, between a rock and a hard place: between consumers who now expect a certain price range and HQs who refuse to accept the reality on the ground.
- He did continue though and asked how do we address this mis-match?

  1) companies engage in cost cutting to square the circle but how sustainable is this after years of cost efficiencies?

  2) we can try offering super-upward-innovation to command better pricing but most of us know that upward innovation does not command the ROI that it once did and regular price increases now do damage categories and market share.

The consumer product business outlook in Russia (1)

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- Remarkably 30% of consumer goods companies reported flat or negative rouble sales in 2017.
- BUT many such executives have quickly grown accustomed to this new normal and still many CP companies (50%+) report good results or better.
- In 2017 about 30-45% of senior managers at consumer products companies operating in Russia were disappointed with business and expectations had not been met. After surviving 2015 and 2016 in reasonably good shape, 2017 did match up to overall economic growth.
- One of the top-12 consumer product companies operating in Russia also reports widely varying results as reported by the MD:

2017 turned out better than I expected and I still don’t know why! Distribution kicked in nicely and we found that our innovatory and quality products held up well: such products saw sales increases of 20 - 30% but some of our bulk food and bulk drinks were much softer at 1-3%. But this meant that on average we grew in 2017 by 7-9% which is very respectable given our scale. My only problem is that I have grave doubts that we can repeat this in 2018. I know that the economy will provide us with a bit of support but the consumer and retailers are more volatile.

The consumer product business outlook in Russia (2)

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- But the 2018 results show a clear improvement for most in the industry: only 7% report flat or negative for 2018 and of the 93% that expect growth, 30% are in the double-digits.
- The largest consumer product companies face the biggest challenges to grow sales in high single digits.
- Some big CP companies increase sales 2-5% on large volumes but that is not good enough for venture fund investors in the West.
- As we noted above:

> “I can grow decent single digits but HQ wants higher single digits or even double digits and on these volumes in this market, that is hardly feasible”

- Food and beverages and the larger players are under most pressure.
- Companies are making good revenue in Euros but the worry is about rouble sales, volumes and underlying business.
- HQ is asking searching questions. Venture fund investors are making unrealistic demands for top and bottom line on all emerging markets and not just Russia.
- And since mid-2016 raising prices above inflation has become much more difficult or nearly impossible.
- FMCGs could raise prices in 2014-15 by 10-30% and solve quite a few problems but those days are gone.

So, why is business for CP companies getting tougher? (1)

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- **<u>The Paradox</u>**:
- Executives were/are puzzled that the Russian consumer is not spending more as the economy ticks upwards in 2017 and 2018.
- Curiously when the economy and incomes were bad in 2014-15 and first half of 2016, many CP companies survived well on a combination of price increases and cost cuts. But that model no longer exists. This is well pointed out by one MD who expresses his dilemma thus:

  "If I don't raise prices, then my profitability is hurt and my HQ complains. If I do raise prices now, then my categories and market share are hurt as well"

- Another problem is that consumers are "buying into the concept" of upward innovation much less than in recent years.
- One MD comments thus: "We used to be able to claim quality innovation and push the price up and after a little while sales and profits would rise. But this process has decelerated and virtually stopped. The ROI on upward innovation is noticeably less now".
- **<u>Consumer products companies have lost their pricing power.</u>**

So, why is business for CP companies getting tougher? (2)

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1. The Russian consumer has changed radically in the last 2-3 years making business tougher for FMCGs.
2. The Russian consumer is less resilient and more normalised (western).
3. The stronger rouble means that more tourism abroad takes place and Russians spend some of their disposable income outside Russia.
4. When consumers have spent money on their holidays or 2-3 short foreign holidays, they are and they feel less rich.
5. Promos and discounts….consumers have gotten used to this and will find it hard to change habits.
6. Government spending is not supportive of consumer spending. Government fiscal policy has been austere in 2014-18 and interest rates tight. Proportionately less spending has gone on education and health.
7. This means that consumers need to save “for a rainy day” and think of covering their own health and educational needs. They spend on health and not detergents or chocolates.
8. Consumer credit is now rising by more than 10% in 2018. BUT most of this goes on mortgages and cars. So, once again the consumer has less disposable income to spend on other consumer items or only wants to buy cheaply.
9. E-commerce could be a help or, as we see in other slides, a disruptive threat.

So, why is business for CP companies getting tougher? (3)

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10. The Russian consumer in some age categories is getting increasingly worried about their pension outlook and rightly so. This dampens spending patterns.
11. Recent price rises (since autumn 2016) are much tougher to get through thanks to the stronger rouble and lower inflation.
12. The Russian consumer has been getting more “tired” since about 2016-17. The consumer went through 2013-16 quite well and proved resilient for western FMCGs but that cycle has run out of steam along with the ability to raise prices. The consumer is more demanding and wants good quality at a cheap price.
13. The Russian consumer is getting less loyal??
14. BUT the good news is that the macroeconomic outlook of lower inflation, rising real wages and some GDP growth will be supportive to Russian consumption. That is very good news; it’s just a pity that consumer behaviour has changed for the worse for western suppliers.

What structure should you have for e-commerce?

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- One MD who has managed transformational success in e-commerce argues as follows:

  “You don’t want to have an e-commerce “channel” but you need an e-commerce company within your own company. Headquarters don’t understand this and they want to control things which usually means inadvertent sabotage. If you delegate upwards and let the centre manage and control it, they will kill it with bureaucracy so that from the word go, you will be a loser”

- Ideally it is best to have a corporate “protector” or “grandfather” ideally the company CEO who watches over the e-commerce “company” and lets it go full steam ahead based on different criteria and KPIs.

- Regular companies will come under fierce pressure from e-commerce companies in terms of product launches, CRM, route to market.

The disruption of it all
Can you launch a new product in one day?

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- Consumer product companies are being hit by changes from all sides.
- Among these disruptions, the biggest is e-commerce and speed of route to market.
- One MD asked: can you launch a new product in one day? “I ask because that is almost the challenge we face globally and that will arrive in Russia soon. With the new e-commerce start-ups and even established e-commerce firms, they are now able to launch new products within 1-3 days. They see that something is working or not working and they change and adapt immediately. I have seen new product variations launched within the same day”.
- On this point one MD based in Moscow of a major consumer products company acknowledged that:

  “Can we launch a new product in one day? Never”

  “In one week? Never”

  “In one month? Never”

  “In 3 months. No but maybe”

  “In 6 months. Yes, perfect!”
- He went on: “To launch a new product is a big deal for us and others. You get the data, look at the strategy, set up committees. Vested interests in the company have different interest and we argue. Headquarters referees the arguments. We do trials and test. Someone says that we have capacity for production which needs to be used and shipped from Alabama or from Munich and then we launch after 6 months. And we are 5.5 months too late”.

Executives on e-commerce (1)
“Massive disruption in FMCG and retail?“

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Other comments from a well-experienced executive from a major company operating in Russia are extremely revealing and cause for some concern:

- Most executives operating in Russia “don’t get it “
- We will reach the hockey stick inflection point for e-commerce in Russia anytime in the next 2-3 years and when that happens all bets are off
- I don’t think enough companies have learned lessons form recent business history
- In China in the last 5-year period most major consumer products companies have seen 15% of their business disappear/eaten up by e-commerce
- And the big point is that we will never get that back
- The same will happen in Russia and it’s only matter of timing
- E-commerce hits you everywhere: consumer relations, retail relations, pricing, marketing, logistics, HR – you name it!
- There is no full protection but companies can work on defensive strategies and also look to take control of some/a lot of it

Executives on e-commerce (2)

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- **This executive went on** to make the valid point that consumer goods companies globally are facing challenges from evolving retail, price sensitivity, promotions and discounts and while this causes tremendous downward pressure on the business, global HQ and activist investors are demanding big and quick top line and bottom line results.
- He questioned the viability and sustainability of the overall business model globally and also underlined the tremendous extent of promotions and discounts in Russia:

"This model can't continue. The Russian retailers - when speaking in private - know that it can't continue and MDs in Moscow know that the business model won't work if this promo trends continues apace".

- The point he makes is that the disruption of e-commerce is arriving when the overall business model (at least in consumer food and FMCGs) is being questioned.
- Not everyone has to agree with this view or the extent of it but it is very fair and sober "food for thought".
- We also know in the business world from several executives that: "Alibaba is here or Alibaba is coming" which makes many people either very excited or quite frightened!
- We saw above the overall growth numbers for e-commerce but it is rising rapidly in some categories by 50-75% per annum. The MD of one specialised CP company noted in Moscow last week that: "E - commerce represents 30% of our business in Moscow and 12% elsewhere in the country".

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