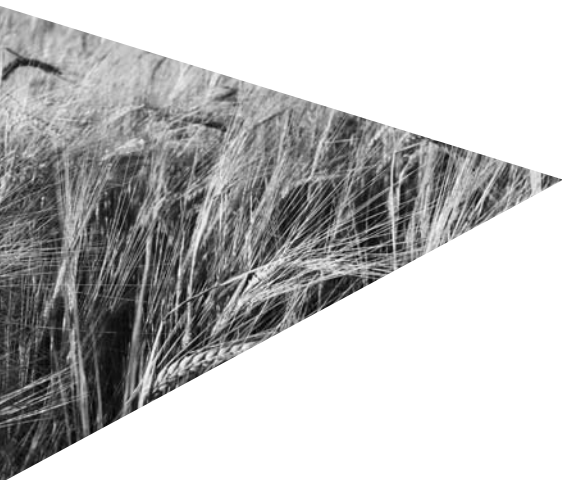


Russia: bouncing back?

Local perspectives on prospects
in the consumer products sector
January 2010



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There is little doubt that Russia remains a key strategic market with massive penetration opportunities. However, in the last year performance across categories has been mixed, downtrading has put margins under stress and other emerging markets have started to catch up. The key question for the headquarter functions of global consumer products companies is – when will the Russian market bounce back and to what degree?

Against a backdrop of uncertainty over how the market will develop, particularly over the next three to five months, we canvassed opinions from 15 country chiefs from some of the world's largest consumer products companies operating in Russia. Working with Daniel Thorniley, President of DT-Global Business Consulting, we hosted a dinner in December 2009 in which we and leading executives explored a number of key themes shaping how companies view this rapidly evolving market.

Our view is that despite continuing concern that Russia has not performed in line with expectations, it is a strategic 'must have' that will bounce back in the longer term. As one senior executive said: "It will be a good market but a different one." We also believe that the Russian market of the future will address the whole customer pyramid, not just the top end, encompassing both premium and affordable products. As another senior executive outlined simply: "We need a product for everybody." For some companies, this means accelerating the execution of existing strategy. For others, it means a more fundamental business model review.

Whatever the future holds for your business, I hope that you find these perspectives of interest. We welcome any views or opinions that will help us broaden the debate on this challenging market.



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Russia is a key strategic market

Despite the fact that Russia was hit hard by the economic downturn in 2009, it remains a key strategic European market for consumer products companies. The market fundamentals are good - GDP (gross domestic product) and real incomes look set to rise, consumers are not heavily indebted and appetite remains for Western brands. It's just the timing and scale that are giving some countries pause for thought. As one executive put it: "A big company today cannot be big without Russia. We are suffering but growing. The cost of growth is higher than before and the margins are less. We have to make it work in Russia."

Economic snapshot

After a tough 2009, Russia looks set to be one of the bounce-back economies in 2010:

- ▶ While GDP fell to -7.8% to -8.3% in 2009, it looks set to rise to +3% in 2010 (or as high as +3.8%, presuming the oil price averages \$75 per barrel).
- ▶ Real wages fell by 4.5% in 2009, closely mirroring the fall in household expenditure. Real wages are expected to rise by 1.5% to 3.0% in 2010, helped by falling inflation. Household consumption is expected to rise in the same range or even higher.
- ▶ Unemployment will be a critical indicator in 2010 for consumption patterns. The good news is that the rate has stabilized at 7.8% when it looked like it would hit 10%. However, hours worked are falling, while wage arrears are rising.
- ▶ The outlook for 2010 is for overall growth, after a slow start. The first quarter will be weak for sales, but they should then pick up from the spring and build strongly after that.
- ▶ Much depends on the oil price and China's growth. China is expected to grow over the next 3 to 5 years by 8.5% to 10.0%, and on the back of that oil will fluctuate at USD\$73 to USD\$85 per barrel or higher. On that basis, Russian GDP growth should average out at +4.0% to 5.0%.

Source: Daniel Thorniley, DT Global Business Consulting

The consensus of the executives was that although Russia may be suffering now after a period of sluggish sales, it will bounce back. GDP is expected to rise from -8.3% at the end of 2009 to +0.75% in 2010. This gives real cause for hope. "We are all putting money in this country and there is still underlying optimism. Our global

HQ says that 120 million people in Russia is better than 7 million in Austria," said a senior executive from a major fast moving consumer goods (FMCG) company.

The difficulty that many local leaders face in "selling" Russia at a headquarters level is that it compares less favorably with other emerging markets. "Chindia" (China and India) are definitely the current favorites. The Managing Director (MD) of a food company pointed out that: "The gold rush days are over. ... As Brazil and India get their acts together, Russia is going backwards. But this will only affect the pace of business in Russia for my company - not the fundamentals."

Participants agreed that for many businesses it was question of "holding their nerve." One company reported that opening up channels of communication had helped in getting the message across: "Now we are reporting [directly] to the global CEO we are never challenged on any dollar invested - by reporting [directly] to the CEO, we are left alone."

Attendees supported the view that Russia remains a key strategic European market, and stressed that consumption levels and sales per capita are still much higher in Russia than in China and India. For example, before the crisis, several large FMCGs were selling as much in Russia as they were in China - where the population is 10 times the size. They estimate that from 2011, "Russia will become again the fastest top-line growth market in Europe."

"Russia will bounce back, but it will come back only after the spring."

Uncertainty in the short-term

The downside is that there is still great uncertainty about the short-term in consumer products. Although results are holding up fairly well in the sector compared to others, such as industrial or IT, executives are unsure what the next three to five months will hold.

Many MDs are very cautious and reported some recent developments that give cause for concern:

- ▶ Sales slowed from September through October, perhaps because consumers had gone through their savings.
- ▶ Chocolate companies noticed slack sales in the usually busy month of October and the run-up to Christmas.



- ▶ Several companies noted that distributors are tending to buy only what they want, when they want and in the specific quantities they want. Inventories are rising while distributors doubt that end consumers will buy up all of the stock.

Some companies also noted worrying overall trends. As the MD of an FMCG company said: "We are seeing huge fluctuations in our monthly results, up and down and, disturbingly, we don't know why."

"The key question is: what percentage of your consumers will reduce their spending and for how long?"

Performance varies across the sector

In addition to the general high level of uncertainty, companies also reported a wide range of experiences, with some businesses and sub-categories doing much better than others. Results also depend of course whether they are measured in volumes, rubles or foreign exchange (FX).

Over the year, businesses generally fluctuated between highs of 5% to -10% and lows of -5% to -15% in volume terms. The food sector did best, as expected, with companies that offer cheaper food ranges in the strongest position. One food executive said that the business was performing very well. "There are a lot of opportunities for us. We have built distribution, gone to the regions and built awareness. Our categories are growing [in] double digits."

The bottom end of the spectrum was consumer electronics, which declined by 5 to 25% in volume. Other CP sub-sectors fluctuated between these highs and lows.

It is important to note, however, that profitability for all businesses had been helped by the price increases made largely in the first half of 2009. Consumers broadly accepted those increases, which helped protect profits in the second half of the year. The strengthening of the ruble also helped boost margins.

Consumers are resilient

A big plus for the Russian market is that its consumers appear to be fairly resilient, and their spending may hold up better than in other markets. Key differences between Russian and global consumers noted by executives included:

- ▶ Russian consumers went into the financial crisis with very strong real wages, and therefore had decent levels of savings on which to fall back.
- ▶ They were not highly leveraged with debt and they tend not to have high mortgages (or mortgages in foreign currencies, unlike their counterparts in the Communauté Economique Européenne (CEE) region)
- ▶ Only 800,000 Russians owned shares of stock, so they were hit less hard by the 75% fall in the stock market. The market is now up, but it is still 35% away from its former peak.

However, unemployment remains a concern. The prediction for Russia, as the rest of the world, is that it will rise before it falls and the psychological impact of this on Russian consumers remains to be seen.

Downtrading may continue

One of the big appeals of the Russian market has been strong consumer appetite for premium products (Russia was one of the top-three premium markets in the world). Russians appreciate quality and are prepared to pay for it – even if they buy less often than their western counterparts. "Russia is a good market for '[our premium product]' but they use on average 6 blades per year vs. the Americans using 22 per year," said one senior executive.

But Russian consumers are not invincible and there has, inevitably, been some downtrading – although not as much as in more established markets. Some executives expect this trend to continue, although encouragingly, they did note that when consumers do trade down, they often do so within a company's own products or to another western supplier.

There is also a view that, because Russian consumers really appreciate good quality products and brands, they will return to them as soon as they can afford to. However, many executives think that it will be one to three years before the market gets back to "what it was – if it ever does."



Affordable innovation is key

The current trend towards downtrading in Russia means that companies have to become more versatile and look at the whole spectrum of consumers and potential consumers. As the premium end of the market is already well catered to, the future for businesses is innovation downwards.

As one executive said: "Future growth is likely to come from the mid- or lower-mid tiers of the pyramid." Pre-crisis, it is estimated that there were 350 million citizens in the CEE region, including Russia and Ukraine and that 200 million of those were above the poverty line, but below the median income level. Out of the 200 million, 80 million lower and lower middle class people live in Russia with another 25 million in Ukraine. With slower GDP growth, this proportion of the population will remain sizeable and probably not shrink much in 2010-2013.

The growing importance of the middle and lower tiers of the pyramid means, as one executive put it: "There is now equilibrium between demand and supply. We need to focus on what the consumer can afford. Every season, we used to be out of stock and we raised prices two or three times a year. Now, we have over-capacity. The next 10 to 15 years will be an environment of affordability." As a result, he noted, competition among western players – and with local Russian companies – will intensify.

Some of the attendees were concerned about how they can adapt their business models to include revamped products, new products and new price points to get to this market segment. However, some are already leading the way. One company said: "Many of us have already tiered down."

Another company said it is putting affordable innovation into action in January 2010. "We are creating a new range of products (competing with western competitors at the lower price range), which is more affordable. We will test this in the market in the new year; if it proves successful, it could be another business sitting alongside our other premium business."

While this is encouraging, companies may need to go even further. As in other emerging markets such as India, companies need to understand their consumers 'inside out' and ensure they are genuinely catering to their needs.

One executive explained: "Most companies have applied the same strategy in Russia as in Europe. However, in India and China, companies are looking at smaller packets and moderate prices for moderate quality. We need to apply the same psychology as in emerging markets. We need to go back to the real purchasing power of our consumers and change strategy."

"We need to focus on what the consumer can afford."

Costs are increasing

Despite the enormous opportunities inherent in the Russian market, challenges remain. One of the foremost is the expense of doing business in Russia, which is partly down to poor infrastructure, supply chain inefficiencies, and small-scale corruption and malpractice. This has historically put pressure on companies to try to keep prices high to offset costs.

Infrastructure remains a real issue; attendees said that they are increasingly concerned about the state of infrastructure in the Russian market.

Also, while most executives agreed that Russia is a very expensive market in which to operate, they acknowledged that "there is a huge amount of inefficiency," which has been built over the 'boom' years, mostly in the supply chain, logistics and production areas. As one executive said: "We spend as much in logistics as we do in marketing. We have all created this environment." Another concluded: "We need to rethink the cost of doing business."

"There is a huge opportunity to improve operational excellence."

Lobbying needs to increase

Few executives are convinced that there will be any quick and comprehensive improvement on this front. As one executive said: "It costs twice as much to build a factory in Russia as it does in the US or Europe. We need to lobby to help our productivity (talent, infrastructure, competition, etc.). It takes time to build infrastructure – we need to put the pressure now." Even if government policies are efficiently implemented and properly financed, it will take several years to see substantial, tangible benefits that help western businesses.



“Executives also noted that they are seeing negative trends in terms of small-scale interference and malpractice in Russia. Until 2008, this area had been steadily improving, but one executive said: “Customs procedures have always been a headache but they are getting worse again. It’s still manageable, but not nice.” This suggests that although the situation has not yet got beyond control, the customs authorities tend to revert to the approaches they used a few years ago.

“We need to give stronger messages to the government that modernization is critical.”

Legislation is adding pressure

There are growing attempts to impose more regulation in the consumer products and retail sectors as part of Russia’s draft trade law, particularly in the food sub-sector and in beer where excise taxes are set to rise. These changes are likely to increase the pressure on western manufacturers.

However, in Russia, draft legislation is often diluted into better shape as it becomes law, but of course, there is no guarantee that this will happen with the trade law.

Critical success factors

Pulling together some of the key themes from this meeting and drawing on our experience of working with consumer products companies in Russia, we believe that companies that are already 'getting it right' in Russia are focusing on the following:

- ▶ **Building strong consumer insights.** This is essential in order to really succeed in this unique market. As one company put it: “We need to understand who our consumers are, why they buy and when – consumer insights are becoming critical.”
- ▶ **Shifting the focus within the consumer pyramid.** Russia used to be all about premium products, but the economic downturn has taken its toll and businesses need to cater to the whole spectrum. One company we spoke to said: “We need to readjust our business model to get to the lower end of the pyramid.”
- ▶ **Improving logistical and operational efficiencies.** As Russia remains a relatively expensive country in which to do business, optimizing any efficiencies is key. “There is a huge opportunity to focus on operational excellence – logistics and implementation,” according to one consumer products company.
- ▶ **Increasing lobbying.** Successful companies are increasingly lobbying the Russian government about the need to modernize and improve infrastructure. As one executive said: “The government needs to modernize the country and develop entrepreneurial spirit.”

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