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Russia Business Outlook

Is Business Slowing in Russia? Yes and No!



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About the author

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Danny Thorniley is President of DT-Global Business Consulting GmbH (an LLC company) which is Danny's own consultancy company based in Vienna through which he works with some 330 key clients on business strategy in CEEMEA, global and emerging markets especially Russia. These companies are part of the CEEMEA and Russia Business Group, which is an advisory and consultancy service. The services of the Group include written position papers, presentation slides and private client meetings as well as in-house presentations.

Danny writes a well-received monthly position paper on the Russian market as well as quarterly presentation slides on other CIS markets. He visits Moscow on business every 2-3 weeks and hosts 8-9 private meetings of the Russia Business Group annually. The most recent one was attended by some 140 senior executives. He is also invited to make some 50 speeches/presentations each year by clients across the world on global business trends, business operations, emerging markets, corporate best practice. Many of these speeches are focused on Russia and the CIS and he has made some 60 "Russia presentations" to visiting western CEOs explaining the positives of the market without being naïve.

For 23 years (until the closure of the Vienna office) Danny was Senior Vice President and Senior Consultant at The Economist Group, Vienna on global corporate business trends, with specialisation in BRIC.

Danny has exceptional skill sets in global business strategy, business in emerging markets and CEEMEA and hands-operational knowledge of business operations, distribution, partnerships, investments and human resource issues.

Danny is regarded as a charismatic speaker who can present detailed business and economic analysis in an easily digestible fashion with a great deal of genuine humour. Danny is renowned for not using powerpoint presentation slides - never. Dr Thorniley has also given guest presentations at Executive MBA courses on behalf of Oxford University, the University of Chicago, IESE (Spain) and the Central European University in Budapest. The executive MBA students at Chicago rated him "best speaker" on 12 occasions out of 12 over 5 years.

He has worked on a personal basis with companies operating in emerging markets for 26 years and has personal contacts with most senior western MNCs operating in the Russia and the CEEMEA region and beyond. He makes frequent presentations at CEO and Board level and has long-standing personal friendships with leading executives.

He holds and has held a number of non-executive and advisory board memberships.

Dr Thorniley was educated at Oxford University. He holds a Bachelor of Arts degree, a diploma and a doctorate degree in Soviet political economy.

He has published three books, including one on Russia with Macmillan (UK/USA) and two with Profile books on Doing Business in Global Emerging Markets.

His beloved daughter is called Natasha after he read Tolstoy's War and Peace when he was a young man. One of his other favourite books is Master and Margarita by Bulgakov.

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Executive summary

- A growing number of western companies are reporting mildly softening sales – about 40% of companies
- But no one is recording any serious crisis, not yet
- More companies are talking about a disjuncture between what headquarters wants to pay for staff compared with the "going rate" in Moscow
- Many companies pay salary increases at inflation and many others at inflation plus 1-10%
- As the market softens slightly more, companies are offering salary increases only at the current inflation level
- Last month we tweaked down our GDP estimates for 2013 and 2014
- Based on first results in 2013 we have now lowered our forecasts for industrial output and fixed investment in 2013 and 2014 (see economy section at end of paper)
- There are some bright lights in the infrastructure sector which until recently has been gloomy
- The Moscow city authorities are getting their act together under the new mayor
- B2B companies may experience more downward sales pressure in 2013-14 but infrastructure projects and public spending could help on the positive side
- Our estimates remain the same as in previous papers for inflation, consumption and the rouble
- The currency seems to have settled into a lower but manageable range; much depends on the oil price and global risk perception
- Shale gas remains a medium/long-term threat
- Chinese competition is increasing and obliging western firms to engage in affordable innovation

How much is business slowing in the Russian market

We have already noted in several recent position papers that the Russian market is starting to slowdown. First comments from executives were reported in late winter 2012 and most remarks alluded to a mild softening or a slowdown which would make ambitious budget targets for 2013 more difficult to achieve.

Compared with other European, CEE and many other markets across the world, the sales growth and profitability in Russia remains comparatively very good but this does not hide some weakening.

We repeat that two companies, one in consumer products (a major global brand) and a construction have confirmed that the Russian market represents 17% of their global sales and 33% of their global profits.

In the first 6 weeks of this year I heard anecdotally more remarks from managing directors of softening. But then at our major executive Group meeting on 13 February in Moscow attended by 140 senior managers the mood was actually generally positive with a small minority of 5-10% alluding to any deceleration. Many companies at that time reminded me that their business was going extremely well and strong in Russia while Ukraine was sinking badly.

But at our next major Moscow gathering on 24 April a mild but further deterioration in business was noted. The 105 senior managers at that event were polled and answered as follows

1.	Are you seeing a mild softening of your sales and business?	45% replied yes
2.	You are seeing no noticeable slowdown and business is steady?	55% replied yes
3.	Are you seeing any serious slowdown in business?	0% replied yes

This does not automatically mean that no companies are experiencing a serious trend given that the sample polled was only just over 100 executives. But a serious deterioration of business is not at all the current experience. That said, executives are very concerned about the economic outlook and the news there remains uncertain and mixed, as we noted in last month's report.

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Executive comments - how managing directors judge the market

During three trips to Moscow in the last 6 weeks a number of executives have shared their assessments on where their business stands and the selections below are quotations from late April.

Consumer products and pharmaceuticals

We do not review these sectors in too much depth in this paper as they appear to be the ones that have held up reasonably well but with reports of mild slowdowns from some 20-25% of companies. Of course it also depends on categories as well. As is usual, food retail sales are rising much slower than non-food but reports from western food & beverages companies are generally stable (again with some softening). Several FMCG companies have told me that they are still growing at low double-digits on high volumes with good profitability. There is only a bit more price pressure. Companies continue to state that brands are performing well but that they need more sales and marketing time and energy to leave the shelves.

Several pharmaceutical and health companies have informed me in recent weeks that their businesses are holding up well and that the first quarter was good/very good or at least very steady.

Industrial/B2B

> The CIS managing director of one major European B2B conglomerate which supplies to several sectors of the economy noted: “Danny, our business is still growing very nicely indeed and at high double digits where it has been for over one year. We are at sales of many hundreds of millions and so this is a great story. However, yes, we are detecting some slight sales softening but not enough to worry about yet”.

This comment is quite typical and certainly the executive is not being naïve; he too is monitoring every piece of business data very closely

> The managing director of a major US chemical company confirmed that his business is good or even a bit better and profitability is certainly better, “The overall economy is not going to help us that much this year but agriculture is a good sector for us as are water processing solutions and even other commodity chemical businesses”.

Developing his comment on profitability, the executive continued that he is trying to keep a lid on costs and to create a “culture of cost ownership” to which Russian staff are not usually accustomed. His company is incentivising people on costs as part of their remuneration/bonus package.

The automotive industry is also slowing in Russia and following the global trend.

> One automotive supplier company stated last week in Moscow that, “New auto registrations were +11% in 2012 but we anticipate zero this year in a range of -5% to + 5%. The first quarter did actually see zero increase. As a company we have managed expectations down for organic sales growth from 0% to 5% in Russia this year which is low compared with some earlier bumper years but is better than our European outlook of minus -10%”.

IT and electronics

The managing director of a major US IT company confirmed that sales trends in Russia had slowed noticeably over the last 15 months since when many executives were reporting 30-45% top line growth and the number is now fluctuating in a 8-15% range. This executive went on to summarise his business as such:

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> "The public sector is still spending and there are projects in the pipeline for the next 18 months. Banks are still doing well and are investing in infrastructure and for CRM tools. Telecom is also ok but with much fewer transformational projects. But business has slumped in manufacturing, retail and transport".

These trends are fairly typical for the IT industry and reflect the late arrival of the IT sector into the global crisis: consumers and customers were willing to buy a lot in 2010 and 2011 to gain efficiency and productivity but after 5 years of crisis IT budgets are squeezed.

The regional director of another US IT company commented in Vienna two weeks ago that:

> "Across CEE and Russia we are seeing sales slowdown. Volumes are holding up better than prices but we are getting hit by all sorts of newcomers in the market including Chinese companies who compete brutally on price".

Regarding this point about Chinese competition, a major US B2B supplying to the agricultural sector and construction industry is manufacturing loaders in Russia in an attempt to create affordable innovation for its B2B customers. One of the drivers here is cheap Chinese trucks and loaders taking away market share. This US company wants to offer the full portfolio of top-quality higher priced trucks, combines and loaders as well as these new cheaper versions.

The EMEA director of a major European electronics/telecom company reported in Moscow in late April that:

> "Business for us is still very good indeed and Russia is a top market for us with China and Brazil. I would note that China is hugely less profitable as a market than Russia for us".

This company is doing better than "pure" IT companies and avoiding the core IT trends given the company is situated in a related sector where demand is still strong. His point on Russian profits is well taken and one we have made for some 20 years.

Infrastructure

There seem to be a few growing bright lights in the infrastructure sector with several knowledgeable executives talking up investment and plans announced by the Moscow city authorities. Another executive in construction advisory services pointed out that the railways are being developed which is a huge business sector, sports facilities are being built and the famous Zil automotive factory is being refurbished. The country MD of a major consultancy/support firm for real estate, facilities and construction argued that:

> "There is finally seem positive movement in infrastructure and we are even seeing elements of less corruption and better overall project management and Russian partners are asking the right sort of questions instead of the wrong ones!"

Another senior manager from this sector corroborated that, "A lot of better things are coming out of the Moscow city authorities and they are behaving in a more open fashion". He explained that the Moscow city and oblast authorities are engaging in international roadshows for investment.

Service industry

The service industry is coming under pressure as the market softens and this has been a feature at least since last summer.

> The senior partner of one major law firm commented in late April that, "2012 was not a great year and the start to this one is difficult. After 20 years of double-digit growth we now see a change and have to manage expectations for a different kind of business".

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The senior partner of a major accounting firm also noted last week that, "We have been growing at 20-30% for many years but our financial year which just finished saw revenues rising barely at double digit levels".

This trend in accountancy was substantiated by the managing partner at another firm who noted last week that, "Business is changing and there is strong competition from local players and we have to watch our pricing structure very closely".

Global headquarters relationship could get a bit more testy and difficult

Many executives around the world find themselves in a budget trap having set budgets for 2013 in autumn (September) 2012 when the global outlook was brighter. Since then a global deterioration, especially in the final quarter of 2012, has meant that budgets set last autumn are much more challenging to achieve today. Additionally CEOs and global headquarters are demanding more from Russian (and Turkish) MDs. The evolution and potential conflicts go like this:

- CEO and Board finally realise that business in the developed market is going to be a long hard slog with low growth, heightened competition and profit squeezes. Good organic top-line growth is a thing of the past
- Global headquarters realise they must do more in emerging markets
- CEOs and HQ finally overcome their prejudices regarding the Russian market and start or upgrade plans for investment and expansion
- Unfortunately the timing is not optimum (and a similar trend occurred in Turkey when global headquarters turned to the Turkish market in late 2011 just before the Turkish economy took a cold shower in 2012). Just as global headquarters turn to Russia and ask for more from local MDs, the latter have to reply that rather than organic sales surging upwards, they are on a softening trend
- This displeases executives at HQ!
- One vivid example of this is of a consumer product company which was growing at 14% in 2012 on $1.7bn sales and the MD was told by global headquarters to raise the bar for organic sales to 22% which turned out to be impossible.
- HQ executives then respond by saying that if you are slowing on the top-line then you have to manage the bottom line better with overall cost cutting "which reminds us about our global salary schemes that require global salaries to rise in all markets by 1.27%". Local managing directors then spend weeks or months begging, pleading, and demanding that such a scheme is modified and Russia is made a relative exception and finally some compromise is reached. But this is such a waste of emotional management time and invariably the Russian staff discover that such management negotiations are taking place and the number of CVs leaving the office accelerates and staff motivation is severely damaged.

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The normalisation of business

The above discussion is exemplified in how over the last 12-18 months senior executives have talked about the "normalisation of business" in Russia. We have discussed this on several occasions and the brief summary is:

1. Given global downward pressures, global headquarters is no longer asking for good top-line from Russia but is asking for 18-25% instead of 10-15% organic growth

2. At the same time the local Russian management is told that the bottom line must also improve (even when Russia has long been one of the most profitable markets in the world). Squeezing the orange dry?

3. Additionally global headquarters also demand that the market share is increased

4. And more recently the Moscow office is told that it must improve its cash management and receivables which have long been among the best in the world; admittedly with some softening recently, just like everywhere else in the world

Some executives confess this is merely the normalising of the business in Russia as companies' size and revenues get very serious. But other executives worry that Russia should not currently be treated as "normal" and more focus is required on growth and investment over the long-term. I tend to share this view in the debate and would always put emphasis on growth and market share because if you get these two factors right, then profits should follow well.

Related to the above is a comment made a few months ago by an executive in the B2B sector which we have quoted before and the remarks were heart-felt:

> "Danny, sales trends are softening in B2B and while I do not forecast any slump, I am a little worried about how companies will respond. What we must not do is behave how we have all done in western Europe and most of the CEE region and that is engaging in brutal price wars to undercut each other all the time. This would be a tragedy in Russia. We all know that this can be a premium and highly profitable market but once a few companies go down this route, they will take many more with them. I just hope Russia maintains its different status".

We certainly all hope that Russia can maintain its positive exceptionalism!

Salary trends and human resources/talent management

Based on anecdotal information and polls at our executive meetings in Moscow, we draw the following conclusions:

1) Some 40-45% of companies are now offering salary increases just on a par with inflation which is currently running at 6-7%.

2) The remainder of companies (45-55%) are paying salary rises of inflation plus 1-10% with more clustering at inflation plus 1-5% as the slowdown in business picks up.

3) We know of two cases where global headquarters are trying to impose salary freezes totally i.e. no pay increase at all, which with inflation at 6-7% entails a pay cut of that amount. This approach seems extreme and will certainly have highly negative long-term effects on staff morale, loyalty and motivation. Such behaviour threatens to put short-term finances before the long-term health of the business.

4) Indeed other Surveys conducted in the market point to "little slowdown in salary trends with continuous salary growth".

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5) This is true but also anecdotally some executive search companies maintain that, “Salary levels for top talent are still extremely high but perhaps not accelerating at the same rate as 3-9 months ago”. But here it is more a question of the rate of acceleration rather than any downturn.

Our advice, shared by many managing directors, is that if you have to make cost cuts, then endeavour to make the last ones in staff salaries. Hopefully there is “some fat” elsewhere in the system, procedures, route to market which should leave salaries relatively sacrosanct.

The managing director of a major IT firm spoke about motivation at our mid-April meeting and stated that:

> “Whatever we did in the past for motivation is not enough today. When we are being forced to manage salaries very tightly, this removes one obvious tool. We are looking much more at internal promotions and creating new tiers in the business to create and justify new promotions”.

On other points concerning HR and talent management:

> The local head of a major executive search company noted in late April that, “Russia is different and more positive because talent is in demand as business continues to grow. In the CEE region business is down and only 10-15% of our recruitment business is for new positions and the rest is purely replacements. But in Russia the proportion of our work devoted to new positions is as high as 30-40% which shows the liveliness of the Russian HR market”.

The managing director of one major IT company made several relevant remarks on HR and talent management. These included:

> “It is very challenging hiring senior sales people and mid-level management”.

These two HR segments have long been challenges; with most companies searching for great sales people, salary pressures are upwards. As companies get more sophisticated in structure and size, more middle managers are also required who expect high salary rewards. Middle management and the level just above middle management have long been a sticking point for recruitment and salaries.

> “Salary packages are high and taxes low and so moving staff around Europe is very difficult”.

This also points to a very keen issue regarding whether you offer to “net the salary” of Russian colleagues if you transfer them abroad which of course would entail big costs for the company. Opinions among MDs in Moscow are divided on this.

A countervailing tendency though is that some senior Russian staff do want to leave the country and are even willing to depart and accept a salary cut if they can be established abroad with their families. So there are two drivers occurring here depending on the staff in question.

The managing director of one major chemical company made the good point that, “Matrix systems are often a challenge and a fact of life”. This manager mentioned that some of the Moscow-based staff report to Turkey, USA or CEE and sometimes only see their direct manager once per annum. The MD in question says he tries to devote more time to such middle managers and to give them more mentoring to motivate them and combat any sense of isolation.

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Economic summary

(see also our April paper in this series for full analysis of economic trends in early 2013)

Macro-economic data 2009-2017

	2009	2010	2011	2012	2013	2014	2015	2016	2017
GDP	-7.9	4.3	4.3	3.4	3.0	3.6	4.0	4.3	4.0
Retail sales	-5.5	6.3	7.2	5.7	4.2	4.3	4.7	4.9	4.8
Real wages	-2.8	4.4	4.9	8.2	5.0	4.8	4.8	5.0	4.6
Disposable income	1.0	3.7	2.8	3.7	3.6	3.9	4.0	3.8	3.4
Inflation (year-end)	8.8	8.7	6.1	6.6	5.8	5.4	5.2	5.0	5.0
Unemployment rates	7.9	7.6	6.5	5.3	5.6	5.6	5.4	5.3	5.5
Gross fixed investment	-17.9	5.6	8.0	6.0	6.0	6.5	7.1	7.3	6.5
Industrial output	-10.8	8.3	4.7	2.6	3.0	3.5	5.2	5.3	4.9
FX reserves ($bn) year-end	447.0	485.0	510.0	528.0	545.0	563.0	580.0	600.0	615.0
Rouble/$ (year-end)	30.3	30.4	32.1	30.4	31.3	30.8	31.0	31.2	31.5
Rouble/Euro (year-end)	43.4	40.0	41.5	40.1	40.5	40.0	39.9	39.8	39.5
Budget balance (% of GDP)	-6.3	-3.5	-0.2	0.0	-0.3	-0.5	0.0	0.2	0.3
Current-account balance (% of GDP)	3.8	4.9	4.9	4.0	2.9	2.8	2.5	1.8	2.3

Consumer-related statistics: by year and monthly

	2011	2012												2013		
	year	Jan	Feb	Mar	Apr	May	June	July	Aug	Sept	Oct	Nov	Dec	Jan	Feb	Mar*
Disposable income	2.8	2	3.1	2.6	2.1	3.6	4.6	2.2	7.2	3.8	3.5	6.7	4.9	0.7	5.7	n/a
Real wages	4.9	9.1	13.3	9	10.4	12.4	12.9	8.1	7.3	4	5.2	7.3	5	8	5.2	n/a
Real retail sales	7.2	6.8	7.7	7.3	6.4	6.8	6.9	5.4	4.3	4.4	3.8	4.4	5	3.3	3	4.4
Unemployment	6.5	6.6	6.5	6.5	5.8	5.4	5.4	5.4	5.2	5.2	5.3	5.4	5.3	6	5.8	5.7
Industrial output	4.7	3.8	6.5	2.2	1.3	3.7	1.9	3.4	2.1	2	1.8	1.9	1.4	-0.8	-2.1	n/a
Fixed investment	8	15.6	15.1	4.9	7.8	7.7	4.7	3.8	2.3	-1.3	4.9	1.2	-0.7	1.1	0.3	0.8
Consumer prices	6.1	4.2	3.7	3.7	3.6	3.6	4.3	5.6	5.9	6.6	6.5	6.5	6.6	7.1	7.3	7.0
Budget deficit (running)	-0.2	0.5	0.3	0.2	0.3	0.1	-0.1	0	0.3	-0.1	-0.5	-0.3	0	-0.2	0	-0.1

Notes: * March indicators are generally not yet available but we will supply these in the next Russia paper

1. GDP growth will slow this year to at least a rate of 3% and could be lower; GDP growth in 2014 should rise to about 3.6% or possibly higher (similar relative trends are taking place in Turkey)
2. The first quarter economic performance of this year faces a harsh comparison with the boom first quarter of last year and explains some of the slowdown (the so-called base effect)
3. Government officials are engaging in a public debate about how much to spend (or not) given the current economic deceleration. As we reported in our April paper, the economy ministry tends to paint a gloomy picture to justify more spending while the finance ministry prefers to keep a tight rein on the purse strings. Officials may find a way to engage in extra spending this year with off-budget funds. We also think that the budget deficit could now widen to minus -0.3% to -0.6%, which would be no threat. Increased foreign borrowing is much more unlikely and not necessary.

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4. As predicted, inflation picked up in the second half of 2012 and reached 7.3% in February and then fell to a rate of 7.0% in March. We estimate year-end inflation at 5.8%, so a positive trend
5. We are presuming an oil price of $97-105 in the next 15 months which is close to the consensus
6. Industry and investment have had a bad start to 2013 and we have lowered our estimates for industrial output this year to 3% from 3.4% and for investment down to 6.0% from 6.6%. We feel that there are downside risks to these numbers and we have also softened our estimates for 2014
7. The economy does look "twin tracked" with consumer indicators faring relatively better than industrial ones: we forecast real wages and retail sales in a range of 4.5% to 5% for the next couple of years
8. Unemployment is in good shape and was down at 5.7% in March
9. Nominal wages (before inflation) are still rising in double-digits in Russia although these too are decelerating
10. The rouble has settled into a range about 31.3/31.6 to the dollar and 40.6/41.2 to the Euro as the dollar/Euro rate fluctuates at about 1.31. This is some 3-4% softer by than the previous range which lasted for much of the second half of 2012. The fall is mainly due to weaker oil prices, weaker Russian GDP and more fragile global risk perception.
11. Russian interest rates will probably fall in the summer and exert some mild downward pressure on the currency but interest rates are not the main influence on the rouble: these are the oil price and global risk perception
12. Capital flight slowed last year to "only" $56bn compared with $84bn in 2011. Early figures for the first quarter suggest that while the total amount may be higher than the last quarter of 2012, the proportion of GDP is 2.2% compared with 5% at start of last year. This is not the terrible economic feature as portrayed in many western media and we have highlighted in other papers that much of this so-called capital flight is normal debt repayment and purchasing of foreign assets in M&As. That said, yes, there is some real capital flight in these numbers and some flight takes place off the official books.

As ever, if you have any queries or comments about the content of this paper, do feel free to get in touch with me and also for any advice or inputs regarding the market: danielthorniley@dt-gbc.com

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DEER, BEAR, BULLFINCH AND HUNDREDS OF OTHER SPECIES CALL DOMODEDOVO HOME. WE PLAN TO KEEP IT THAT WAY.

South Gate is the first and only BREEAM certified warehouse park in Russia.
This certification acknowledges the sustainable practices and features of our buildings across a spectrum of key categories: energy-efficiency, health and well-being, ecology, transportation, water, management and materials. South Gate customers include John Deere, Decathlon, Paul Hartmann, Iron Mountain, FM Logistic, Tablogix and Volvo Trucks.

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