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Russia is fantastic!

28 business and economic reasons why this is so

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Introduction: What's the problem?

> If you do business in Russia, you will lose all your money because your business partner will steal it from you! And, you will die, because when you visit Moscow the Russian mafia will murder you in your hotel bedroom!

This is the standard view in the western media about business in Russia and it's about 97.3% wrong, rubbish, garbage. More rubbish is written and spoken about Russia than any other country on planet earth, and this paper will help prove that.

Because of many prejudices and misconceptions, the current cost of capital for Russia sits at an illogical 14-16%, which is damagingly high and is not justified based on the following comments and data.

This paper is designed to help country and regional managers explain the positives of the Russian market. It is crystal clear that Russia is a good, but not easy, market. While parts of this paper will tend to whitewash the Russian market, my advice to readers is to take this whitewash, then combine it with the regular blackwash that you see daily in the western media and mix it together: you will end up with "greywash", which is exactly what Russia is.

> Russia is a big, fat, normal, difficult, emerging market. It is not the Wild East and I know 200-300 western companies who run highly successful, solid-growth and high-profit businesses in a compliant fashion.

We are NOT being naïve. This is not a blind apologia for Russia and we will address some of the concerns and reservations that remain valid about the market at the end of this paper. We also review the potential downside for the Russian economy in the medium terms of shale gas and fracking.

In addition we have to add that the market is also slowing down in a number of sectors such as B2B and IT and country and regional managers are obliged to manage expectations downwards after several bumper years. The trouble is that just when global management makes more demands on the Russian results to compensate for global weakness, some sectors are falling in back in their rate of growth. Moreover, GDP in 2013 is being pulled down and some 25-35% of western companies and investors are reporting by summer 2013 a mild or moderate slowdown in sales. But in relative terms and in comparison with other emerging markets, BRIC and those in CEE and Europe, the Russian market appears either good or much better.

28 reasons why business in Russia is fantastic

The bullet points are divided into two sections: one on business and market breakdown and one on economic outlook.

If your company has a global strategy, then Russia has to be a part of it; if your company has a European strategy, then Russia has to be a priority in any growth strategy.

Part 1: Business and market dynamics

1. Russia is the largest market in Europe, with 142m people

The demographics have improved remarkably in the last 7-10 years with the average mortality for Russian men rising from a pitiful 57 years a decade ago to 63 years in 2011 (while average mortality for white men without university education in the US has sunk to 67 years over the same period!).

> **If current trends continue in the next 10 years, then by 2022 the average Russian man will be living longer than the average white American male (without university education).**

Life expectancy in Russia has now reached 75 for women (the same as in China; in Brazil it's 77). The overall death rate has also fallen from a high of almost 18 per thousand in 2000 to 13 per thousand last year (in Hungary it's 12, Poland, 10, China, 6, and Brazil, 6).

2. Russia is the best GDP growth market in Europe

Russia is pulling away from the rest of CEE and continental Europe in terms of GDP and business growth.

The outlook for the Eurozone is bleak and it will only grow at best by 0.5-1.2% annually over the next five years. Core CEE is struggling in its wake with projected GDP of about 1.3%, while Russia looks set to grow at 2.5-3.5% over the next 2-4 years – the only other market in Europe that will match this is Turkey (among the "BRICs", Brazil will also be in this range).

3. Russia is the best sales growth market in Europe

While western Europe becomes a market where sales are flat or rising a mere 1-2%, and with sales in CEE invariably in LOW single-digits for 80% of all companies operating across all sectors, Russia will retain good sales potential in 2013 and for several years. None of our Group members foresees flat/negative sales in Russia in 2013, whereas this percentage rises to 5-20% of members across the rest of the CEE region.

For 55-60% of consumer product and pharmaceutical companies, Russia is shaping up as a growth market of 8-15%. In the B2B sector, which is weaker globally, 48% of firms expect single-digit growth in Russia, but 55% foresee average double-digit sales growth of about 12-14%.

> Russia is a market where 40% of companies are still able to manage double-digit growth and where the rest are growing in HIGH single digits.

In terms of growth performance across sectors in the CEE region, Russia ranks as follows:

	2012	2013
All sectors	1	1
Consumer products	2	1
Food & beverages	2	1
B2B	1	1
IT	2	3
Pharmaceuticals/health	1	2

Source: CEEMEA Business Group, Business Benchmarking Survey, June 2012

4. Western companies sell on average 6-12 times more per capita in Russia than they do in China and India

With their much larger populations, sales volumes in China and India can match or exceed the business in Russia, but not on a per-capita basis.

5. Russia is one of the best profit markets in the world

Because companies can invariably charge premium prices and raise prices to consumers, Russia ranks among the top three profit markets in the world and in Europe for around 80% of companies.

Return on equity by sector, 2012 estimates

	Russia	Europe
Chemicals	23	14
Base metals	26	17
Transport	20	7
Consumer products	20	19
Banks	20	3
Media	20	13
Retail	17	14
Telecom	16	14
Energy	14	14
Steel	8	1
Real estate	6	-2

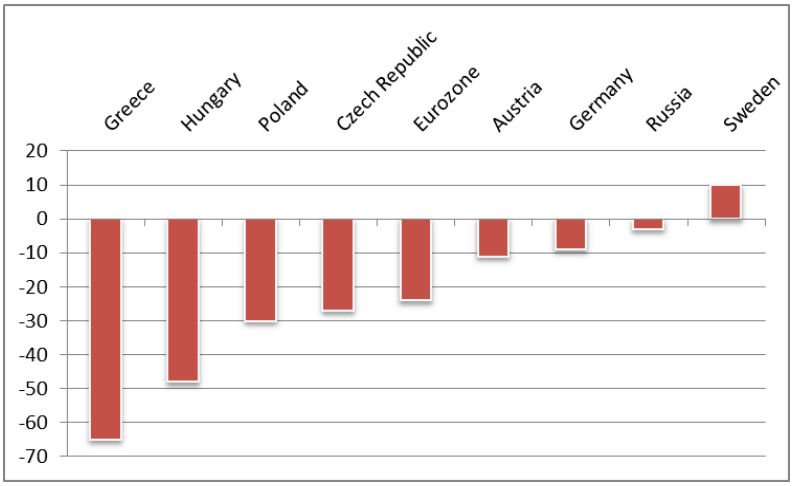
Source: Citi Research

6. Consumers are among the most confident in the world and by far the happiest in Europe!

Consumer confidence in Europe plummeted further in autumn 2011 and has generally stabilised at weak levels across the entire continent: people have gotten used and accustomed to being very miserable. This is not the case in Russia and only Swedish consumers are more upbeat in Europe, while Chinese ones come close to Russian optimism globally.

In the chart below, a score of zero reflects very strong consumer confidence and a positive score reflects very happy people indeed! A score of -15 or lower indicates a strained and negative consumer outlook.

Consumer confidence indicators April 2013



Sources: Eurostat; Rosstat

7. It's the business place to be!

Recently in Moscow, the MDs of two major consumer product companies, the CFO of a major European retailer and the MD of a global B2B company repeated the same sort of phrase:

> "I am so glad I am running a business today in Russia and not somewhere else in the world!"

Another striking comment from that meeting was that of a regional MD for a European service company, who said that:

> "Some 80% of our business in CEE is now coming from Russia. The CEE region as a whole is very challenging and south-east Europe is almost dying for us. We are not closing offices there but we are almost freezing them and transferring the staff to Russia or using the staff to work on Russian projects."

The regional manager of another global service sector player echoed this thinking recently in Vienna:

> "If current trends continue, we will have to let some staff members in CEE and SEE go, or transfer them to Moscow where the business is."

8. Russia is the second-largest automotive market in Europe (2.7m in car sales in 2011, behind Germany with 3.1m)

On current trends Russia will be the largest market in 1-3 years.

9. Russia will be the largest consumer products market in Europe in 10-12 years time

10. It is the largest mobile phone market in Europe today, with a saturation of 230m phones (compared to 100m in Germany)

11. Companies can still hope to double the business in five years

While top-line sales are among the best in the world, several sectors are reporting slowdowns in the rate of growth, e.g. in the IT sector from 40% in 2011 to 25% in 2012 and in B2B from 35% to 13-18% in 2012.

> But Russia is still one of the very few markets in the world where companies in some sectors can double the business in 5 years, i.e. grow at 20%+ per annum.

Admittedly this is now more the case for small companies without market share leadership, is confined to some sectors and depends on investment. But even with these provisos, it is a true statement and makes Russia quite distinct.

12. Russia is becoming a strategically important market for a growing number of companies

Given trends in developed markets and in the neighboring CEE region, Russia stands out as a growth market. Companies from Western Europe and the US are reviewing their Russia options more closely. For most of the major global MNCs it is already in the top three, five or 10 global markets for expansion and priority.

In the past (5-6 years ago) Russia used to account for 20-28% of total CEE business for the average western company but this has now expanded to 35-55% for many players especially major companies.

One problem/risk is that if "anything goes wrong" with the Russian market in a severe way, then the total CEE business of many companies is wiped out and even total European business stakes a hard shake. In February 2013, the country MD of one of the world's major branded companies told me in Moscow:

> "Russia now accounts for 17% of our total global sales and for some 33% of our global profits".

The country manager of a major European construction company echoed similar numbers as well in the same month.

After major acquisitions for companies like Danone and PepsiCo, Russia ranks as their No 1 or 2 market in the world, with multibillion dollar sales.

- For companies such as Japan Tobacco International, Tele 2, Raiffeisen and OTP Bank, the Russian market represents a significant share of global profits.
- For Oriflame, it makes up more than 50% of global sales.
- For Inchcape, Oriola and Gedeon Richter, it accounts for a sizeable proportion of global sales.
- For Metro, Scania and MAN, it brings in a solid part of global sales.

13. There is huge scope for further market penetration and brand development

In comparison with the EU market in 2011, several sectors in Russia have minimal levels of penetration given population and capacity:

Less than 5-7%	Mortgages, credit cards, office space per capita, health spending per capita, retail loans as % of GDP, container traffic, retail space, hypermarket space
Less than 30%	Broadband, smart phones, cars per 1,000 population, quality housing in square metres, supermarket space
Less than 60%	Internet usage, corporate loans
100% or more*	Cigarettes, alcoholic spirits, beer consumption, meat, cement, media spending as % of GDP, mobile phones

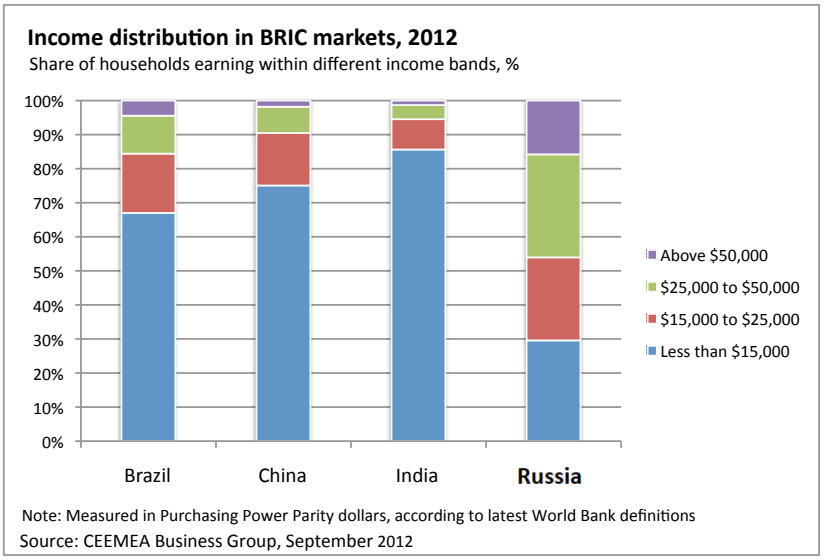
Source: Citi Research

*Perhaps Russians consume too much of the wrong stuff!

14. Russia is the middle class BRIC

This is proven by the fact that western companies sell so much more per capita in Russia than in China and India, and noticeably more than in Brazil.

Income distribution in BRIC markets, 2012

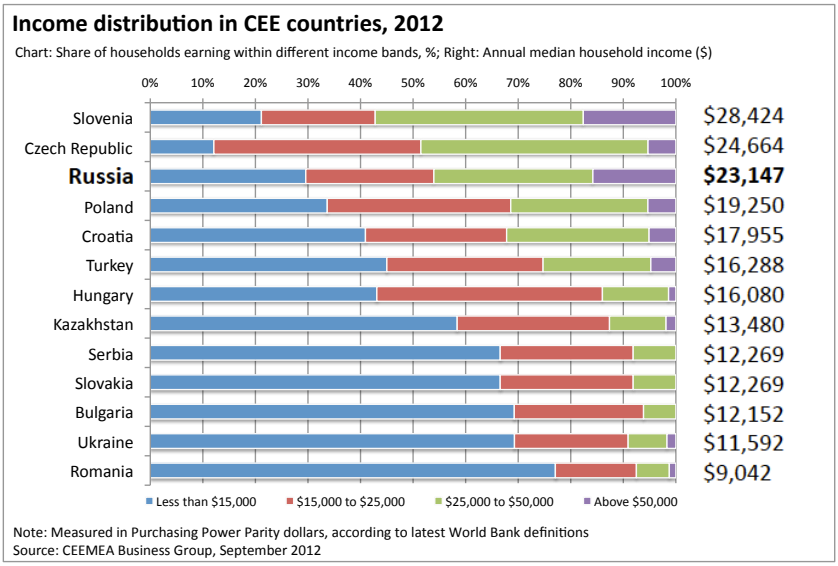


Based on $15,000 annual median household income as defining a middle class household, then in Russia fully 55% of households are middle class, whereas this segment represents only 21% in China, 11% in India and 30% in Brazil.

Wealthy households are more predominant in Russia compared with other BRIC countries, with 15% recording incomes of more than $50,000; in China this is a mere 2%, while it is barely 1% in India and is just 5% in Brazil.

These numbers mean that Russia is already a premium price market, but also has the potential for being/becoming an affordable innovation market where companies can aim at the aspiring lower middle class. There are very few markets in the world today that can combine premium market with affordable innovation opportunities.

Income distribution in CEE countries, 2012



Even within the CEE region, Russia is a wealthy economy and lies third in terms of annual median household income of $23,147 and lags only behind Slovenia and Czech Republic (two markets which are currently struggling).

15. Consumers did downtrade during the crisis, but less so than in other markets, and they started to uptrade more quickly than elsewhere

16. Russian human resources are still among the best in the world

Russia is still one of the best markets in the world for local human resource talent and more than 90% of companies agree with this. The quality of Russian staff places it invariably among the top three to five markets in the world. The Soviet education system contributed a lot to this and of course the effects of that system are diminishing with time. Companies have reported a deterioration in the quality of local staff over the years, but this still remains at the margins. Local staff now want challenges, career progression, work-life balance…and also a lot of money!

Part 2: The economy is in comparatively good shape

As long as oil remains at about $100 per barrel or above, then the Russian economy trundles along quite happily and western companies will see their business out-perform other markets with steady, sustainable growth. Even at $93-95 per barrel, the economy can survive well with some international downward pressures. The economy does come under strain below $90 per barrel, but the country has enough reserves to protect it from the worst impacts.

17. Russia performed relatively best during 2012 among BRIC markets

China is going through a managed downturn, which is causing concern among western CEOs; India has had a desperate 12 months with GDP falling to a 10-year low; and Brazil has struggled as a consequence of weaker exports to China. Comparatively, Russia has had a good economic period. The trend is reflected if we look at the fall in the rate of GDP growth for the BRIC markets and Turkey:

GDP growth and decline in growth 2010-12, %

	2010	2012	fall in GDP growth in two-year period
China	10.3	7.8	-2.5
India	8.4	5.2	-3.2
Brazil	7.5	2.0	-5.5
Turkey	9.8	3.2	-6.6
Russia	4.3	3.8	-0.5

18. GDP per capita is 3-9 times that of China and India

At current US dollar exchange rates, GDP per capita is two-and-a-half times that of China and more than nine times that of India. Even accounting for differences in costs of living it is twice that of China and five times that of India!

GDP per capita in 2011

	Russia	China	India
In US dollars	$13,000	$5,400	$1,400
In PPP dollars*	$16,700	$8,400	$3,700

* Accounts for differences in cost of living, Source: IMF

19. Russia has one of the best budget balances in the world

The budget balance in 2012 was zero compared with -5.0% in US and -6% in UK and -4% to -6% in CEE; only Switzerland and Sweden are in better shape.

This has huge business consequences because the Russian government has the CHOICE whether to increase spending or not. In fact, a very public debate is currently taking place about future budget spending with more government ministers, as well as President Putin, now calling for more public/social and infrastructure spending.

This makes Russia a massive positive exception in a world where some 80 governments are planning continued austerity packages of slashing expenditure and destroying public and private consumption.

20. New bank credit growth is one of the strongest rates in the world

Russian banks are lending, unlike in some 100 other markets of the world. New bank credits are down 4% in the Eurozone and growing just 1-2% in most developed markets and in much of CEE. Banks are not financing any recovery.

But in Russia lending is very strong (though may slow over the next six months): bank lending to consumers was rising 40% in summer 2012, with lending to corporations up 20%. We forecast new lending to increase by about 15-20% in 2013. Other markets where bank lending is up 15-20% include China, India, Brazil and Turkey. This testifies that bank lending is one prerequisite for GDP recovery.

21. WTO entry in 2012 will be a positive, but perhaps not a big, quick one

Estimates suggest that the growth potential could amount to an extra 0.2% to 0.5% addition to annual GDP growth, providing the Russian government adopts the right attitude and legislation: average tariffs will fall, trade ought to increase, Russian companies ought to see improved allocation of resources to stay competitive, and portfolio inflows should rise. Eventually WTO entry could reduce the cost of capital (as imports will be cheaper). But most companies have factored WTO accession into their planning and most agree that big, positive short-term impacts will be limited.

22. Inflation is under control

Inflation last spring-summer 2012 was at a 20-year record low of 3.6%. As expected, this climbed back up to about 7% in late spring 2013 but we foresee this falling below 6% by end of 2013 and then to average 5-6% in the next 2-3 years. The outlook is moderate and we expect no unusual inflationary threats.

23. Thanks to its energy earnings, Russia will retain a positive current account balance of 4.0% this year and 2.5% next year

24. Russia holds the third-largest hard currency reserves in the world

Russia's FX reserves currently amount to $510bn, and the central bank also holds some $150bn in roubles in domestic reserve funds. As in 2008-09 it can turn to these funds to protect the rouble.

25. Unemployment, at 5.4%, is one of lowest rates in Europe

26./27./28. Russia usually ranks the lowest and BEST in the world for the following indicators:

Lowest level of household debt	Russia, 8% of GDP (Germany 65%, UK 100%, Netherlands 120%)
Lowest level of government debt	Russia, 6% of GDP (Sweden 35%, Poland 55%, Germany & UK 80%, Italy 102%)
Lowest level of corporate debt	Russia, 48% of GDP (Poland 80%, Germany 160%)

But a word on the Russian economy during any future global crisis

Our central scenario is that the global economy outlook will muddle through the next 3-5 years, avoiding a deep major crash because the major central banks of the world will pump in unlimited liquidity and buy unlimited amounts of those sovereign bonds under threat. In a mid-case, weak global outlook, similar to 2010-11, Russia will perform relatively well.

As we argue above, Russia's economic position ought to protect it in any worse global crisis, but this is not the track record.

The weakest link in the Russian economy in 2008-09 was Russian corporate borrowing abroad: Russian companies did not use Russian banks for loans, the rouble crashed and they were caught with their pants down – essentially the Kremlin bailed them out. The very good news is that Russian corporate debt held with western banks as a proportion of GDP has diminished significantly, and the structure of corporate debt is much better (i.e. more long-term than short-term). Does this mean that Russia will ride out the next global crisis with ease? Unfortunately not. When any global crisis occurs, output slumps, and the oil price with it. The western financial markets then attack Russian assets and the rouble. Thus Russia will have a roller coaster crisis again, but perhaps marginally less volatile. Executives should note that the Russian central bank has warned that in any future crisis it will let the rouble fall more than it did in 2008-09. This is bad news for executives and in this unlikely global scenario, executives would face a few uncomfortable weeks as the rouble fell to 34, 36 or 37 to the US dollar. The Russian central bank will not be focusing on the FX wishes of western companies. But there is significant good news in that the Bank also has the option thanks to its FX reserve levels to choose when to step in to hold the currency at a line of its own choosing.

What's less good or needs to be better understood?

The oil price

The oil price is the biggest potential threat to business in Russia and we have addressed that above. It goes without saying that if the oil price sinks below $90 or $80 per barrel, then Russia's economic situation deteriorates badly. But if oil ever sinks to these levels, it means the global economy is crunching downwards in tandem.

> There are risks for the Russian economic and political outlook, but most of these now stem from abroad, such as the threat from the Eurozone, the US fiscal cliff, and the Middle East.

Politics

Politics has changed in Russia since December 2011 and the fixed stability that companies were accustomed to has altered. However we do NOT envisage significant political risk in Russia. We do not foresee significant social strife (unless there are irrational government knee-jerk reactions) for one major reason: retail sales are rising 5-7%. This is not meant as a flippant comment. But popular revolutions rarely occur against that retail background.

The Russian administration (like that in China) has aimed for:

- Stability
- High GDP growth
- Solid consumer spending (to buy-off the middle class with consumer goods, property and foreign travel
- A nice amount of nationalism to make the country look strong

Putin has been a lucky politician because when he arrived in 2000, oil prices started to rise as well.

Commentators in the West have generally failed to report that the parties that did well against Putin's United Russia were the communists and Zhirinovsky's ultra-nationalists. These are not parties to boost social democracy and liberalism in Russia. Real liberal, pro-western parties only gathered about 10% of the vote. Admittedly the media was against them, but probably the real constituency for liberal parties is currently about 20-25% in Russia. Fewer people proportionally are watching state TV, and young urbanites rely more on the internet. But lower middle class citizens in mid-sized towns do watch TV and imbibe the state line.

So why the decline in United Russia and the street protests? Corruption: institutionalised corruption at many layers of society is frustrating and angering the majority of people. Poorer people, who have benefited from social policies, still see some officials cream off fortunes in corrupt practices. Small, petty corrupt actions by junior officials and police officers alienate people daily. And the educated middle classes are dissatisfied when they see manifest corruption. The middle class has done well in Russia but they now have higher exoetctaions of the state.

Corruption/compliance/ethics

Corruption and non-compliant activities have diminished consistently every year over the last 10 years. The business operating environment for western companies has improved in terms of distribution and cross-border customs, etc. The environment is not perfect, and paperwork and bureaucracy is endemic in the system. But the consensus is that western companies, by following their global compliance programs and taking advice from their legal and accounting partners, can run successful and compliant businesses in Russia. There are some sectors such as aerospace and clearly the energy sectors where political/commercial risk enters the equation, but this is not the norm in other business sectors. The trend of diminishing malpractice may have slowed or stabilised this year given the solid improvements of the past.

What we say above applies to western companies, but Russian ones are not always so fortunate and cannot rely on western compliance procedures. They can face a variety of extortion approaches.

Also, we cannot allude to a similar improvement in malpractice at government level as we can in the B2B sector. A growing number of our Group members have mentioned that they have had recent issues with government officials/bureaucrats. This is by no means endemic, but crops up more in anecdotes. Western companies can again stand behind their global requirements for compliance; a tactic that does not work for Russian companies.

Demographics

The demographic profile of Russia 10 years ago was disastrous. As we note above, the picture is far from perfect, but trends are moving strongly in the right direction.

Operating environment

Russia is an expensive place to do business and real estate, advertising, logistics, warehousing and salaries are expensive. Russian paperwork is infamously time-consuming and western companies have to hire more back-office staff. As one of our Group members once famously said,

"Russian paperwork is like the Russian winter. It is there and you have to live with it and through it."

In the World Bank's Ease of Doing Business survey, Russia is the second-best BRIC. China scores 91 in the most recent survey, with Russia on 120 (a high score is bad), but Brazil fares worse at 126 and India at 132 (for comparative purposes Czech Republic and Poland are at 62 and 64).

And shale gas

The recent and future development of shale gas (fracking) will have potentially massive impacts on the global and Russian economy in the mid-term future. This is just basic list:

- Already US gas prices have tumbled
- On current trends the US will transform from gas importer to a gas exporter in only a few years
- Ships filled with LNG are bobbing on the oceans with nowhere to go!
- Europe wants to buy gas form cheaper sources but Russian suppliers are insisting on their honouring current long-term contracts
- IF gas prices tumble and IF the correlation between gas and oil prices remains in place…. then energy prices are set to fall
- But the consensus view is not factoring this in for 2013 or 2014 yet. The mid-consensus for the oil price is $98 to $105 per barrel but the range of estimates spreads from $88 to $122. We have argued for some time for an average of about $100 but shale developments will increase volatility
- Those who are arguing against falling energy prices believe that with China growing at over 7.0-7.5%, the oil price will have strong support at around $100
- Clearly Russia, Qatar, Saudi Arabia and other major gas exporters will not sit idly by and watch gas an energy price collapse. They will have to respond eventually with quotas and supply restrictions etc.
- Once the US ceases to depend on Mid-East energy supplies, how will its foreign policy change?
- If prices fall, then China could buy more energy and pollute the world even more: what does this imply for climate change? Cheap energy, a route to faster and greater pollution?
- If energy prices fall sustainably, then would this perhaps be a catalyst for economic reform and economic diversification in Russia? In the past in Russian hardliners could always argue that any energy price falls were cyclical and would come back in Russia's favour. Shale developments could alter this paradigm.
- One thing is for sure: shale will ultimately prove a game changer. The only questions remaining are
- when, where and to what extent?