RCIS RUSSIA-CIS Business Group

DT - Global Business Consulting

Advice for the 2017 Russia budget

Factors behind the numbers

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Curriculum Vitae of Dr Daniel Thorniley

Danny Thorniley is President of DT-Global Business Consulting GmbH (an LLC company) and co-founder of the CEEMEA Business Group which advises senior executives on global business trends. DT-Global Business Consulting is Danny's own consultancy company based in Vienna through which he works with some 330 key clients on business strategy in global, and markets and the CEEMEA region and Russia. The services he provides include written position papers, presentation slides and private client meetings as well as in-house presentations. He is also invited to make some 60 speeches/presentations by clients across the world on global business trends, business operations, emerging markets, corporate best practice.

Sir John Major, the former British Prime Minister has called Danny "The world's leading business expert on emerging markets"

For 23 years Danny was Senior VP at The Economist Group, Vienna on global corporate business trends.

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. 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.

He has worked on a personal basis with 330 companies operating in emerging markets for 27 years and has personal contacts with most senior western MNCs operating in the CEEMEA region and beyond. He makes frequent presentations at CEO and Board level (over 100). He has personal friendships with leading executives in Coca Cola, Procter & Gamble, Ernst & Young, Raiffeisen, Robert Bosch and many, many others.

He holds and has held a number of non-executive and advisory board memberships with major European and US corporations including the Global Advisory Board of the US company Aecom.

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.

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Factors to include behind the numbers - what's best practice?

The MD of one major FMCG company operating in Russia:

> The numbers in all of my last 20 annual budgets proved always to be wrong but I try hard to get the trends right! ☺

The regional MD of a major pharmaceutical company:

> The annual budget is a waste of time and everyone knows it. It's a corporate game we all have to play and that's fine. But much, much more important are the questions: do I have the right team in place in the right roles which can build a business and adapt to changing times and capture market share in good and bad times. Do I have an operation which is fit for purpose? If so, the numbers should follow.

The CIS MD of a major European industrial company:

> When we do budgets for Russia and Ukraine, I always use the F-word! Flexibility! ☺

The MD of a major US drinks company:

> It's very easy to make great short-term decisions that help the immediate bottom line. We can all do that. But I would argue that most great short-term decisions are bad medium and long-term ones. The long-term ones are the more important.

The MD of a major consumer products company noted a few weeks ago in Moscow in a humorous mood that:

> When you are making your business presentation to the Board always include in slide no 2 the following three elements: e-commerce, digitisation and efficient growth.

Another executive commented last week in Moscow on his three favourite buzz topics:

> For the Board you have to focus on localisation, diversification and market share.

We refer to these factors below again.

Key factors to consider in the 2017 budget process

- It's not just the annual budget: think long-term; what do you do in 2018-2020?
- BUT do not get fixated with rigid 5-year plans which are never fulfilled and always fall by the wayside.
- Manage expectations with global headquarters: a serious professional exchange is necessary.
- The Russian market has gone through about 6 "New Normals" in the last 2-3 years.
- The Russian market has changed and will need time to recover to an "OK" market: headquarters have to realise this and face the facts.
- The message is "we are not the glory boys of the recent past. But we can have a reasonably good business in this market in the next 15-30 months".
- A steady, moderate recovery is foreseeable and Russia can be a decent growth and profit market in the coming years on a middle scenario.
- **<u>Market share is the name of the game.</u>**
- The business cake in Russia will not boom in the coming years: aim for sustainable market share. What will be the drivers behind that?
- Plan the 2017 budget and any longer-term plans on the basis of scenarios: most companies tend to work through with "just" 1-3 scenarios.
- Last year one retailer was working on the 2016 budget with 12 scenarios! Fewer scenarios this year suggest and underline the feeling of <u>relative</u> stability this time round.
- Don't get fixated with one set of numbers: we all know about the budget trap and how budgets have become very quickly redundant in recent years

- Stay close to customers and clients: make sure they know what you're doing and why.
- Build relationships with your Russian customers and partners: Never forget that Russians never forget!
- Treat them well and they will remember you forever.
- Look at customer segmentation in greater detail: slice and dice the consumer categories.
- CRM is more important now than ever.
- But CRM is not just about spreadsheets; it's about building real, long-term relationships in tough times as well as bad times.
- Find new consumer segments: sub-premium, premium, mid and low.
- Introduce more affordable or even upward innovation.
- Decide if the focus will be more diversified from pure premium: work out where you want to be on the brand/value spectrum.
- Brands remain very important but you have to work much harder to sell those brands now: it takes 3-5 times more effort, energy, time and money to do that now.
- Decide how you will grow your business: what will be the functions of volume and/or price?
- Make scenarios for phased price increases: but this depends on the rouble FX rate: most companies plan softer price increases in 2016 than 2015 and softer ones in 2017 than in 2016.
- Offer clients "solutions" and integrated systems and other after-sales servicing with it. If you are selling ball-bearings, then offer all the engineering kit that goes with it and the process systems that surround ball bearings.
- This deepens and tightens the relationship with clients rather than limiting the process to a one-off sale.
- Move quickly to streamline systems.
- Delegate responsibility as much as possible to your talented local teams.
- Offer managerial autonomy when you have faith in your team.
- But never compromise on compliance: this can be dictated and top-down from HQ but also instilling local initiative and implementing compliance programs.
- Is your operation in Russia "fit for purpose": you can't control the oil price or the rouble but you can make sure that your systems and process are right and that you have the right people in the right jobs --- then let it go and let it happen.
- As the MD of one pharmaceutical company once said: "We have the right structure and a sensible business plan for Russia. That's all we can do. The team is flexible and adaptable. That's' what we need, not 100 pages of sophisticated budget numbers".
- Flexibility in your team and in your plans is a key defining point: as the MD of a major consumer goods company once said: "When I look at the budget, I always think of the F-word! Flexibility!"
- Look at managing costs in the supply chain and manufacturing processes.
- Diversification is a winner: are you already diversified in your portfolio offering? Then, well done. If not, can you broaden the portfolio and spread the risk? Can you introduce new global products/services from your global palette of products?
- As you examine the Russian regions more closely, what does that mean for affordable innovation, route to market, marketing and pricing?
- Can you squeeze more juice from the Russian regions and from the CIS markets? We know it's not easy but….
- Localisation is at the forefront of business thinking: can you do more?
- Re-visit your sourcing strategy: can you realistically source more from within Russia? Look at Asia, China and SE Asia: this helps you in terms of costs and in presenting a good face to Russian authorities regarding sanctioning nations.
- Look at small bolt-on acquisitions: some European mid-size companies are doing just this.
- Acquire in order to tie in distributors and customers; acquire to capture a bit of market share; acquire to show long-term commitment to customers and to the Russian government.
- Invest in logistics and warehousing and distribution.
- Look at Russia as a market of channels: distributor, direct, key accounts, mix of own and distributor services; split distribution into consumer focused part and physical logistics part.
- Think a bit more about Russia as an export base but realise that it is not plain-sailing.
- For retail and FMCG there is a sub-set of factors to consider:
    - increase of home consumption
    - growth of modern trade
    - authenticity, trust sustainability in products; home-grown, nostalgia
    - cost-effective/smart shopping

  - growth of discounters, private label
  - more promotional pressure
  - On-line, e-commerce
- How to respond to these drivers and what balance to achieve?

Words of advice from senior executives

The retired EMEA president of one of the world's largest consumer goods companies told me:

- Delegate downward and try to avoid going through headquarters.
- Always innovate downwards – reach out to your customers.
- Control your working capital and protect your distribution network.
- Maximise your local content.
- If you have excess HR capacity, train them to do something else, something new. Don't abandon them.

The regional head of a European pharmaceutical company advised: Share the pain.

- Share the pain with customers and raise prices but explain how and why you are increasing those prices.
- Share the pain with distributors and the supply chain by discussing payment terms. But do not brutalise your distributors, you don't want to destroy them and end up with one distributor in Russia in 2016.
- Share the pain with your Russian staff and explain why salary increases will be below inflation again in 2016.
- And toughest of all, explain to your CEO and European Board that sales and profits will be smaller than in the past.

Another way of saying this is:

- Don't cut costs so deeply that you damage long-term relationships with customers and clients.
- Don't cut cost so deeply that you damage relations with distributors and suppliers.
- Don't cut cost so deeply that you damage relations with your HR and talent whom you will need in years to come.

In closing, after a lot of basic, common sense advice, I would underline yet again that the name of the game is market share in Russia today and for the next 2-5 years (and by the way this applies to most markets in the world today).

Always watch out for the budget trap!

This year again in September when budgets are being drafted, the rouble is stable, the sun is shining in Moscow (yesterday!), the birds are tweeting… you get the picture! In 3 out of the last 4 years, executives in Russia and globally have been caught in some degree of a budget trap when the calmer times of autumn are quickly followed by the turn of the year when markets implode, global risk shoots up, commodities collapse taking the rouble with them.

Risk factors to consider

- Global GDP growth and business numbers globally are not surging.
- The business environment is tough.
- Emerging markets are not what they were 2-3 or 7-10 years ago.
- Emerging markets are benefiting this autumn from the search for yield from international investors: why accept negative interest rates in the West when you can obtain 8-14% on a stable rouble?
- But executives in Moscow still need to manage expectations downwards or underscore the "new normal" environment.
- Russian GDP will not boom in the coming years and will average 1.8% to 2.3% over the next 5-7 years.

- The best case is for steady and moderate high single digit rouble sales against a stable rouble background with moderate profit levels and a reasonable ROI - and that's not a bad outlook.
- But, while we think oil will average, $45-58 in the next 2 years which is also the consensus view, the rouble and business remains vulnerable to fluctuating oil prices.
- Any sharp downturn in China would take global growth down and the oil price and the rouble with it.
- When the Federal Reserve does raise US interest rates (and it will one day—turn of year?), then the financial markets may yet again freak out and run to the dollar undermining the rouble.
- And then of course there is President Donald Trump. If Trump does win on 8 November then the global markets will shoot all over the place and the Russian economy and currency will face 1-2 months of turmoil but Russia will not be alone! (We discussed the risk factors of a Trump Presidency in my Global Business Review. In brief: it won't be funny but perhaps with decent advisers, it may not prove so bad; also remember that Congress runs most of the economy; the US dollar could go one of two ways: dollar could collapse on US risk or the dollar could surge as investors look for the safety of US treasuries.
- Then there is Russian risk with any possible escalation in Eastern Ukraine (despite the current better US-Russian relations in most recent Syrian peace plan). Worse fighting would entrench sanctions, although we do not see much appetite in the West to widen sanctions.
- There is a 30% chance that European sanctions are diminished or modified to Russia's advantage at the start of 2017 and this would be a big positive psychological shift. If European sanctions are not removed at the start of 2017, there is a chance for summer 2017.
- We expect little change in US sanctions under a Clinton administration while there is some scope (but no certainty) for change with a Trump presidency.

The brief executive summary from our September survey for the 2017 budget

- Through the late spring and high summer of 2016, the business mood has stabilised in Russia for at least 80% of companies. Tough sectors remain automotive, IT sales to the Russian government and reimbursed pharmaceutical and medical equipment sales especially to the government.
- In the last 5 months (April-August 2016) the Russian rouble has fluctuated in a 5% FX range versus the Euro and US dollar.
- Some 62% of companies send in their 2017 budget to HQ during September and October and by end of November almost 84% of respondents have wrapped up the budget process.
- 60% of respondents make 2-3 economic-business scenarios in their 2017 budget while another 38% confine themselves to one.
- Some 28% expect a better and decent year compared with 2016 while 65% think it will be another business environment similar to 2016; manageable but tough.
- <u>No respondent company in our survey is budgeting for negative rouble sales in 2017.</u>
- Some 8% of all companies budget for rouble sales increases of 1-5% in 2017.
- This BIG cluster for sales forecast is in high single-digits and low double digits.
- **In 2017 some 66% of companies budget for rouble sales growth in a range of 5-15%**
- **<u>Many companies are budgeting for significant improvements in FX sales in 2017.</u>**
- While 30% expect single digit FX sales growth this year 2016, the number in 2017 jumps to a massive 62% and a further 23% forecast sales increases in FX over 10% in 2017.
- These are strong budget numbers and this is where the risk lies for getting caught in a 2017 budget trap.
- The FX sales outlook is (and has to be) based on the presumption that the rouble will be very stable versus the Euro and dollar in the coming year.
- The budgeted profit outlook remains good for three-quarters of companies and this matches many anecdotal comments.
- In 2016 and 2017 Russia will represent 82-86% of total sales revenue from the CIS markets.
- The CIS markets are no longer acting as a marginal support for slowing business in Russia.
- Some 45% of companies still keep Ukraine in a CIS structure reporting to Moscow.
- In terms of salary increases budgeted for 2017, the magic number remains for the third year at 7-8%. This is the average percentage increase that companies will pay for average white collar staff in Russia.
- As in 2016, some 33% of companies plan/budget to make NEW investment in manufacturing, logistics and warehousing in 2017.
- 41% of companies have already received rent reductions in 2015-16; another 44% budget for big or moderate rental cuts in 2017.

- Some 44% of firms budget for significant investment in e-commerce and digitisation while another 30% will make a small start and 18% are not sure.
- Price increases in 2017 are planned to be more moderate than in 2016 and certainly less aggressive than in 2015.
- Companies (36%) do use Russia as an export base and another 20% are considering the option.
- Regarding the status of distributors and their inventories and purchases, we have seen a very slight deterioration in mid-summer but think that a better economic climate and stable rouble could help a bit through the end of the year.
- Receivables remain good: 46% of executives see no change; 49% perceive a mild but manageable deterioration while just 5% have serious issues.

Economic backdrop to the 2017 budget

(Based on the oil price averaging $46-55 per barrel)

Our regular economic updates point to a softer recession in 2016 than in 2015, see tables below but GDP growth this year will still be negative at about -0.7% clocking up a second year of recession after -3.8% in 2015.

Investment and industrial output are still the weak links of growth but retail sales and household spending are still negative this year as well.

We except lower inflation to help real wages to pick up which in turn will assist consumption and household spending.

The central interest rate at 10.5% will be cut again later in 2016 and through 2017 presuming lower inflation and a stable rouble. Interest rates could be as low as 9.0% in mid-2017 or even lower which ought eventually to help investment and industry. Industrial and manufacturing output have been helped to some extent by 1) import substitution 2) defence spending and 3) some growing links with other markets in Asia and especially China. But none of these three provides a golden solution to Russia's economic challenges.

We should not forget that the Russian economy started to decelerate in January 2013, some 15 months before Crimea and events in Ukraine.

Central Scenario - 2017 economic outlook (oil averages $46-55)

GDP	1.3%
Inflation (year-end)	5.5%
Inflation (average)	6.6%
Consumer spending	1.6%
Investment	2.2%
Industrial output	1.7%
Rouble to US dollar average	64-69
Rouble to the Euro average	72-77

Economic scenarios and the rouble for 2017 at different oil prices

Average oil price 2016	GDP	Inflation average	Rouble/US$ Average	Rouble/€ Average
$80-85	3.3%	5.8%	45-52	52-58
$70-80	2.8%	6.0%	52-57	58-64
$60-70	2.4%	6.4%	57-60	64-66
$55-60	1.8%	6.6%	60-63	66-69
$50-55	1.3%	7.0%	62-67	69-73
$45-50	0.3%	7.7%	64-69	72-77

$35-45	-1.3%	8.2%	63-69	74-78
$25-35	-2.5%	11.5%	80-84	86-92

Economic outlook to 2020: key indicators

Key indictors based on monthly data

Macro-economic indicators 2009-2020

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
GDP	-7,9	4,3	4,3	3,4	1,3	0.6	-3,8	-0,7	1,4	1,8	1,9	2,0
Retail sales	-5,5	6,3	7,2	5,7	3,9	2,5	-8,8	-2,5	2,1	2,8	2,8	2,9
Household spending	-7,6	5,5	6,8	7,9	4,7	1,8	-8,5	-2,8	1,8	2,6	2,6	2,8
Real wages	-2,8	4,4	4,9	8,2	5,2	1,9	-9,2	-1,7	2,2	2,7	2,9	3,2
Disposable income	1,0	3,7	2,8	3,7	3,3	2,1	-4,0	-2,5	1,8	2,2	2,6	2,7
Inflation (year-end)	8,8	8,7	6,1	6,6	6,5	11,4	12,9	6,8	5,5	5,3	5,2	5,0
Unemployment rate	7,9	7,6	6,5	5,3	5,5	5,3	5,4	5,8	5,6	5,5	5,4	5,3
Gross fixed investment	-17,9	5,6	9,8	6,0	-0,3	-4,8	-7,6	-3,2	2,4	3,5	3,9	4,0
Industrial output	-10,8	8,3	4,7	2,6	0,3	1,1	-3,4	-0,2	1,7	2,5	3,1	3,3
FX reserves ($bn) year-end	447	485	510	528	509	385	365	410	390	400	415	420
Rouble/$ (year-end)	30,3	30,4	32,1	30,4	32,9	58,0	73,0	68,0	71,0	76,0	78,0	79,0
Rouble/Euro (year-end)	43,4	40,0	41,5	40,1	45,1	72,0	78,0	74,0	77,0	82,0	84,0	84,0
Budget balance (% of GDP)	-6,3	-3,5	-0,2	0,0	-0,5	-0,5	-3,6	-4,1	-3,2	-2,6	-2,2	-1,8
Current-account balance (% of GDP)	3,8	4,9	4,9	3,6	1,6	2,7	4,3	4,1	3,8	3,2	2,5	1,9

Key statistics by year and monthly

	2012	2013	2014	2016								2017						
	year	year	year	Q1	Q2	July	Aug	Sept	Oct	Nov	Dec	Jan	Feb	March	April	May	June	July
Disposable income	3,7	3,3	2,1	-1,4	-2,3	-2,0	-4,9	-4,3	-5,6	-6,5	-0,7	-6,3	-6,9	-1,2	-7,1	-5,7	-4,8	-7,0
Real wages	8,2	5,2	1,9	-8,6	-9,2	-9,2	-9,8	-10,4	-10,9	-10,4	-10,2	-6,1	0,6	1,6	-1,7	-1,0	1,4	0,6
Real retail sales	5,7	3,9	2,5	-6,7	-9,4	-9,1	-9,1	-10,4	-11,7	-13,1	-15,3	-7,3	-4,3	-5,8	-4,8	-6,1	-5,9	-5,0
Unemployment	5,3	5,5	5,3	5,7	5,6	5,3	5,3	5,2	5,5	5,8	5,8	5,8	5,8	6,0	5,9	5,6	5,4	5,3
Industrial output	2,6	0,3	1,1	-0,4	-4,9	-4,3	-4,3	-3,7	-3,6	-3,5	-4,5	-2,7	1,0	-0,5	0,5	0,7	1,7	-0,3
Fixed investment	6,0	-0,1	-4,8	-6,0	-6,5	-6,8	-6,8	-5,6	-5,2	-4,9	-8,7	-8,4	-8,4	-8,4	-4,8	-4,8	-4,8	-4,3
Consumer prices	6,6	6,5	11,4	16,2	15,8	15,8	15,8	15,7	15,6	15,0	12,9	9,8	8,1	7,3	7,3	7,3	7,5	7,2
Budget deficit (running)	0,0	-0,5	-0,5	-1,7	-2,3	-2,9	-3,1	-3,0	-3,0	-3,3	-2,6	-1,8	-1,9	-2,6	-1,4	-3,0	-3,2	-3,3

As ever, I hope this report proves helpful for you in creating your budget/business plan for 2017. If you have any comment or queries, do get in touch daielthorniley@dt-gbc.com.

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