RCIS RUSSIA-CIS Business Group

DT - Global Business Consulting

Russia business survey – key findings
2017 Russia/CIS budget

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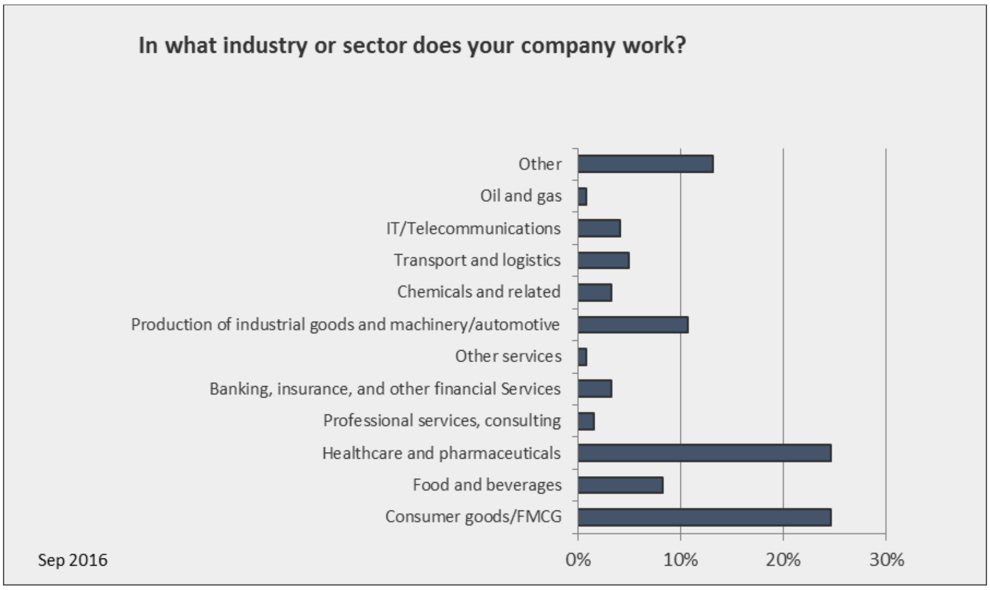
IN ASSOCIATION WITH: BAKER & MCKENZIE, CUSHMAN & WAKEFIELD, EY Building a better working world, Radius GROUP

Background

This is a summary report of our findings from our survey related to business operations: the findings are based on replies from some 121 respondents taken in August 2016.



We think this report provides the most detailed hands-on current analysis available of what companies are thinking and planning regarding their business in Russia.

The 2017 Russian Budget executive summary

2017 Budget: The Mood

In the run-up to the budget process company expectations have improved notably across all sectors in the last 4-7 months for some 80% of firms.

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. But for many there is a sense of we may have survived the worse (again). But hardly anyone is naively optimistic about the business and sales perspective in 2017. It will go in the right direction but any decent business recovery will require 3-4 more years.

But we can refer to……

5 in 5.

Approximately in the last 5 months (April-August 2016) the Russian rouble has fluctuated in a 5% FX range versus the Euro and US dollar. Given trends in the last 2-3 years this is remarkably stable.

This sense of relative stability was fileting into the corporate mood this summer and continues in the early autumn and into the budget process season.

There is clearly a growing sense of stabilisation in the Russian market BUT executives are being cautious in their assessment for 2017:

- 28% expect a better and decent year compared with 2016
- 65% think it will be another business environment similar to 2016; manageable but tough
- 7% estimate it will be noticeably worse than 2016

The mood for 2017 provided in these figures is not much better than the mood music for 2016. The mood for 2017 is actually quite mixed with almost one-third of companies moderately upbeat but with two-thirds forecasting another challenging year but one which they will again survive or do a bit better than survive.

2017 Budget: The Numbers - sales and profits

- No respondent company in our survey is budgeting for negative rouble sales in 2017.
- Those budgeting flat sales falls from 8% in 2016 to 5% in 2017.
- Some 8% of all companies budget for rouble sales increases of 1-5%.
- This BIG cluster for sales forecasts is in high single-digits and low double digits: 44% plan for high single digit and 22% budget for 10-15% sales increases.

In 2017 some 66% of companies budget for rouble sales growth in a range of 5-15%

The main variances on 2016 expectations in the 2017 budgets are those budgeting for double-digit sales in roubles which softens in 2017 plans. More of the cluster in 2017 is in high single digits with scatterings in low single digits and low double digits.

As a possible central scenario for many months, we have argued that if companies aim for an achievable 5-13% rouble sales increase and IF, IF the rouble is relatively stable with FX, then it is logical that FX sales will be in the same percentage range as the rouble sales. This scenario is coming out very strongly in the 2017 budget.

Many companies are budgeting for significant improvements in FX sales in 2017.

In 2016 some 25% of companies recorded negative FX sales but the in 2017 budgets the number sinks to just 3%. In both 2016 and 2017 some 13-14% of firms predict flat/zero FX sales.

But while 30% expect single digit FX sales growth this year, the number of respondents budgeting at single-digit FX increases 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 obviously this is where the risk lies for getting caught in a 2017 budget trap.

This 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: 90% of executives will use a budget exchange rate for the rouble which is very close to its exchange rate at the start of September 2016 i.e. 70-75 to the Euro and 65-70 to the US dollar.

Some executives understandably include a slightly weaker rouble variant about 4-5% weaker than the current level.

These FX rates are plausible and reasonable based on the consensus view of the oil price in 2017 of $47-55.
In honest layman terms, this is “the best one can come up with”.

But clearly this is where the big risk always lies in making a Russian business budget.

> If the world freaks out at the turn of the year and FX rates plunge for emerging markets, then the Russian rouble will be dragged down again and companies will have to reforecast fast.
>
> But such a cataclysm is not my central global forecast either. In fact the rouble has been buttressed in recent weeks and months by the fact that portfolio investors globally are desperately searching for yield when in developed markets returns and interest rates are zero or negative.
>
> Recently emerging market currencies and assets have been in a sweet spot and unless the US Federal Reserve jacks up US rates ahead of expectation, this benign situation could last longer.

The budgeted profit outlook remains good for three-quarters of companies and this matches many anecdotal comments.

For 45% of companies, profits will continue to rise well; for 52% of respondents profits will fall or stagnate at decent levels.

But for 22% profits will fall badly or even collapse.

In 2016 and 2017 Russia will represent 82-86% of total sales revenue from the CIS markets. In addition to being the huge volume market, Russia sales trends in both 2016 and budgeted ones for 2017 are stronger than in other CIS markets. Russia is the “big baby”.

In local currencies, projected 2016 sales are not bad in other CIS markets but not as strong as Russian ones. All CIS markets are now suffering from devalued currencies and weaker demand.

<u>The CIS markets are no longer acting as a marginal support for slowing business in Russia.</u>

Trade between Russia and Ukraine is slumping due to regulations and demand: one quarter of companies have seen much of their business collapse with a decline of more than -50%. Another 42% of companies see their business down by at least -20%. Around one third have been able to weather the Russo-Ukrainian storm quite well so far. Much depends on the sector, geographic proximity, distributors and their links and informal relationships.

2017 Budget: HR summary

In terms of salaries 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.

The figure is set close to inflation or just above in 2017 while in 2016 it was set more at inflation or below. The reason it remains the same absolute number is that average inflation will fall from about 8% in 2016 to 7% in 2017.

Companies are not planning excessive cuts in headcounts and if they make their budget numbers in 2017, we anticipate noticeably fewer staff cuts than in 2016. Even in 2016 such cuts have usually been limited except in business sectors which have been badly hit.

2017 Budget: operations and environment

Investment in Russia

The positive trend in investment plans continues.

> As in 2016, some 33% of companies plan/budget to make NEW investments in manufacturing, logistics and warehousing in 2017. This percentage has fluctuated at 26-30% over the last 12 months or so.

This does fit in with the executive comment of: "Localise or die!"

Sales, marketing and office space costs

As many as 40% of companies plan to expand spending in sales and marketing to grow sales and acquire market share; 50% of respondents budget for the same expenditure in 2017 while only 11% of companies are budgeting for cut backs in sales and marketing

Companies will be looking at saving money on office rental space:
- 41% of companies have already received rent reductions in 2015-16
- Another 44% budget for big or moderate rental cuts in 2017

E-commerce and digitisation

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. It is perhaps more interesting that 44% will make only a small start and 18% are not sure. One might have expected a flurry of activity on these fronts.

Price increases and the consumer

Price increases in 2017 are planned to be more moderate than in 2016 and certainly less aggressive than in 2015: whereas some 20% of companies plan price increases by more than 10% in 2016, this falls to 5% in 2017 budgets; companies preferring more moderate increases (in single digits) jumps from 48% in 2016 to 73% of companies budgeting thus in 2017.

Obviously this could change and deteriorate depending on any weakening in the rouble and inflation.

Executives talk of a growing degree of weariness in the resilient Russian consumer and due to this and the stronger rouble and softer inflation at 7.3% in recent months, more companies plan to hold back on price increases in 2017 compared with 2016 and in 2016 compared with 2015.

Russia as your export base? Not yet.

Companies (36%) do use Russia as an export base and another 20% are considering the option. Of those which do export, 88% export to other CIS markets with just 12% exporting to western Europe and the US and Asia. Bureaucracy and VAT and quality control could prevent much further expansion of exports but more managers will at least review the export options for 2017-18.

Working with partners: government and distributors

Most companies (57%) see little change in the attitude of the Russian government to western business, while just 9% feel a more friendly atmosphere and 34% sense more negativity: B2B companies are more upbeat on this indicator while pharmaceutical and medical companies are much more pessimistic with 67% sensing a more negative attitude towards them.

Regarding increasing red tape and bureaucracy, some 32% of companies do not see this as an issue; 40% witness an increase but to manageable levels while 28% perceive this as a bad and worsening factor for business. Once again it is in the pharmaceutical sector where 62% of respondents see this as a serious problem.

But overall these numbers on red-tape are curiously not that bad.

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.

Route to market has generally stabilised and is quite complex with companies increasing or decreasing the number of distributors but 53% are satisfied with what they've got. This is the kind of response that we would have anticipated. Some 44% of companies are satisfied with what they've got having made adjustments over the last two years. The rest of the picture is fairly mixed as companies adapt to a volatile and changing market, route to market and different consumers. Some 9% will increase the number of distributors while 13% will decrease; some 7% will take on more of their own distribution and only 8% will be mixing things up. All this goes to show the complexity and challenges (both positive and negative) facing route to market.

Receivables remain good: 46% of executives see no change; 49% perceive a mild but manageable deterioration while just 5% have serious issues.

A few more companies are moving from FX invoicing to rouble ones.

Corporate structure for Russia: where do you report to?

Your corporate structure: interestingly 28% of companies report from Moscow to global headquarters. Some 14% report into the old/standard CEE headquarters while almost 50% report into CEEMEA/EMEA HQ located in Western Europe. So far only 8-9% report into Dubai or other "exotic" locations!

2017 Budget: The Process

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

Relations over the 2017 budget with headquarters are not bad at all: almost 50% of HQ management understand the "new normal" in Russia and 20% of Russia MDs actually believe they can succeed in obtaining a softer 2017 target, while 17% of global management are still pressing hard and squeezing the Russia market for sales and profits.

Benchmark for the 2017 Budget: looking back at the 2016 numbers

- For 2016 some 63% of companies will be on budget or above for rouble sales and if we include those who will be just behind, then the number rises to 88%.

- As the rouble has stabilised in recent months, the FX numbers, while not great, have been on an improving trend: 27% of companies will be ahead of their 2016 FX budget, 28% will be on budget for this year BUT 43% will be behind their 2016 FX budget.
- It is this latter figure, the FX one, which has been the strain of the last couple of years.

Russia in comparison with other CIS and CEE markets

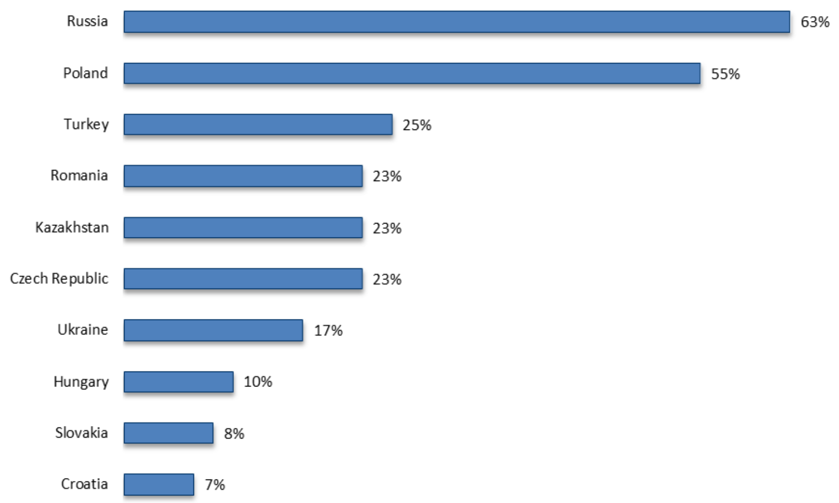
(The following pages 4 to 6 are updated from our last report in case any reader missed them as they are full of excellent benchmarking data. They will be updated in our next survey)

Russia is the No 1 market for everything (!) including good and bad factors.

The chart below is extremely revealing and the findings have been the same for the last 5 -10 years. Despite all the political, financial, commercial, currency turmoil, Russia remains the No.1 priority market for the huge majority of companies across the whole CEE region and also the MEA region. No other market combines the local currency growth and the volume of business that Russia does. However, we do note that in the last 6 months Russia has fallen as priority market for executives from 75% to 63% and Poland has risen from 40% to 55%.

Which are your priority markets for the next three years?

Top 10 responses; countries ranked by number of responses

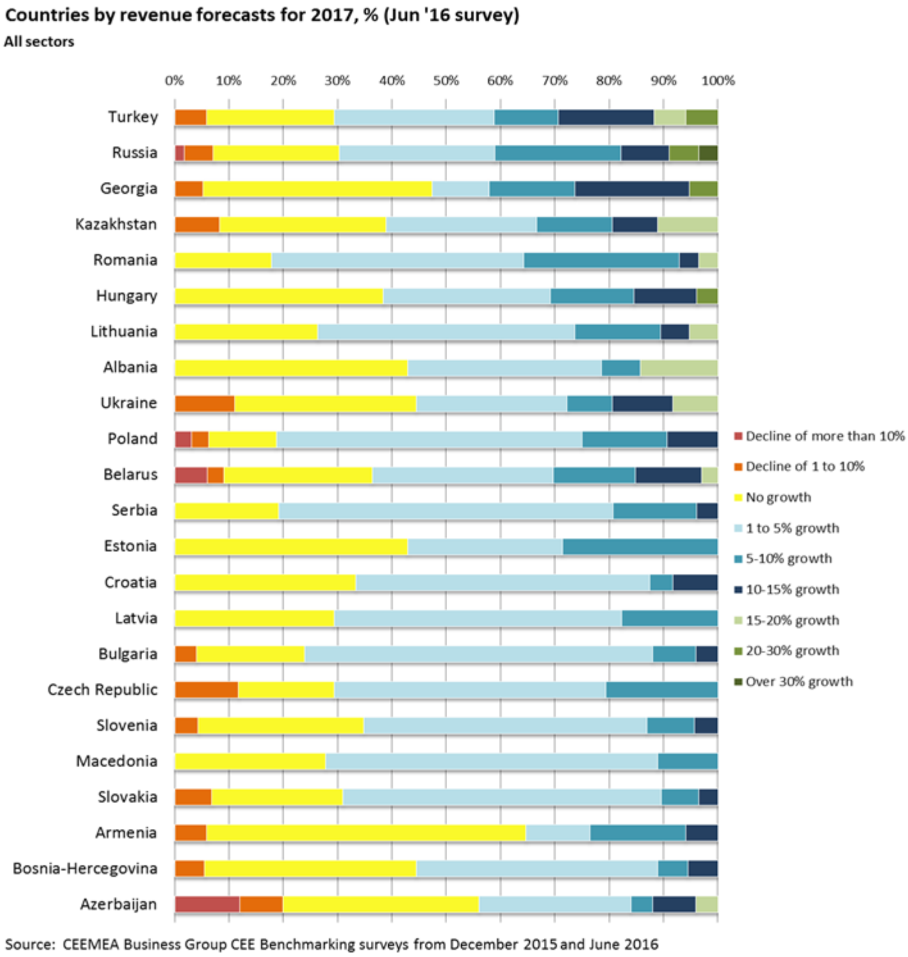


Source: CEEMEA Business Group CEE Benchmarking Survey June 2016

Note: the chart above is a multiple choice option and so the totals exceed 100%.

The following two tables show that Russia remains a key growth market for the "rate of sales growth in local currency" (NB the percentages in these tables may differ marginally from the precise figures in our Russia report below given the different sample but the trends are similar). In terms of the rate of sales growth and profit creation, Russia is still No 2 in the region just behind Turkey. Many markets in the region will see a large proportion of companies growing top-line sales at flat levels or in low-single digits.

> **One thing to remember is that most CEE and global markets are single-digit sales growth markets and often in low single digits. When Russia is humming along, it is a great market; when Russia is stumbling along, it can still rank high in comparisons.**



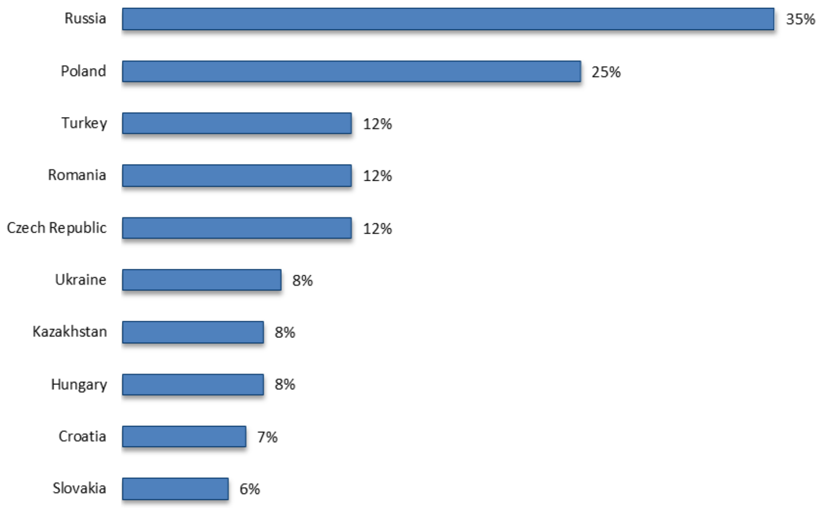
In terms of comparison, the following chart is also extremely revealing and shows that despite cut-backs and salary freezes at inflation, companies are still looking at raising their headcount in Russia.

> **But do bear in mind that Russia is a market of extremes. Even though headcount cuts are planned to be limited in Russia (see below), it still ranks as No.1 where companies plan to CUT staff.**

Russia also ranks among worst 5 markets when it comes to cutting back on marketing and sales costs or trends in downtrading. None of these are yet at deep crisis levels, but again it shows that things happen at the extremes in Russia compared with other markets.

In which markets do you plan to hire people over the next 12 months?

Top 10 responses; countries ranked by number of responses



Source: CEEMEA Business Group CEE Benchmarking Survey June 2016

HR summary 2017 salaries and headcount

- In comparison with 22 other CEE markets, Russia is the market where companies will hire most new staff and cut-back on headcount!
- 63% of companies plan no lay-offs in 2016 and in 2017.
- In 2016 staff cuts have so far been on a small scale, mostly below 10% of total staff and any cuts in 2017 set to be similar: 32% of companies plan such limited cuts this year. Only 8% plan anything deeper for now.
- This remains much the goal in 2017 with 65% of companies planning no staff cuts.
- In 2016 most salaries (65%) were below inflation and the rest set at inflation or just above (33%).
- In 2017 the numbers are reversed a little in that more companies (64%) plan at inflation or just above with “only” 33% now looking at below inflation

The number is still 7%!

But the trick here is that inflation will fall in 2017 from about 7-9% in 2016 to about 7% in 2017.

> This means that when you balance the planned rises to falling inflation, most companies averaged about a 7% pay increase in 2016 and the absolute percentage will be very similar in 2017 i.e. about 7%. Of course the range will be 6-9% for nearly all companies.

So while companies are paying a bit more over inflation in 2017, the absolute amount stays at around 7% due to a lower inflation figure!

- Planned salary increases in Kazakhstan and Ukraine are equally tight or tighter.
- Companies in 2015 and 2016 and in 2017 budgets do NOT plan salary increases for much above inflation for average white collar employees.

- Western companies are being no worse (and perhaps a tiny fraction better) than Russian companies and institutions given that real wages are about flat now in the economy and thus nominal increases are running about 7%.
- Based on our survey and in contradiction to most anecdotes, **<u>talent is NOT moving that much.</u>** Normally our surveys match the corporate gossip but in this case that is not so: 45% see little talent movement; 41% have not lost any regretted talent and only 5% feel that talent is on the move while another 9% have lost talent.

At the start of 2015 some 80% of companies did NOT plan staff cuts; for 2017 this number is down to 65%. However, staff cuts which have taken place to date are limited: 32% of companies will confine cut-backs to below 10% of total staff and only 8% of respondents plan deeper cuts in 2016. Many cuts are natural attrition and removal of poor performers. But some companies have started initial serious cuts to normal staff. However, if the business outlook turns bleaker (which is not the budget of most companies), then more staff cuts will be implemented.

Overall, the clear conclusion for now remains: companies are trying hard to protect their headcount but are determined to manage their costs and will keep salary increases close to inflation.

Nearly all companies and organisations in Russia will be giving salary increases in 2016 below inflation or just close to inflation.

There are variations of course and these are averages, and white collar covers a large number of positions. To assist you in 2017 budget planning, the following two tables compare previous periods (benchmarked to inflation) and also show what companies did in 2014 and 2015 in absolute percentage terms and budget for 2017.

Salary comparisons 2014-2017 in absolute terms i.e. the percentage increase

What salary increase in roubles did you pay in absolute terms in 2014 and 2016 and do you budget for 2017?

	2014	Feb.15	Jun.15	2016	2017 budget
Plus 10%	3%	12%	6%	12%	3%
5-10%	27%	55%	53%	59%	63%
1-5%	15%	16%	18%	21%	22%
Flat	20%	13%	22%	6%	7%
Negative	0%	4%	1%	1%	3%

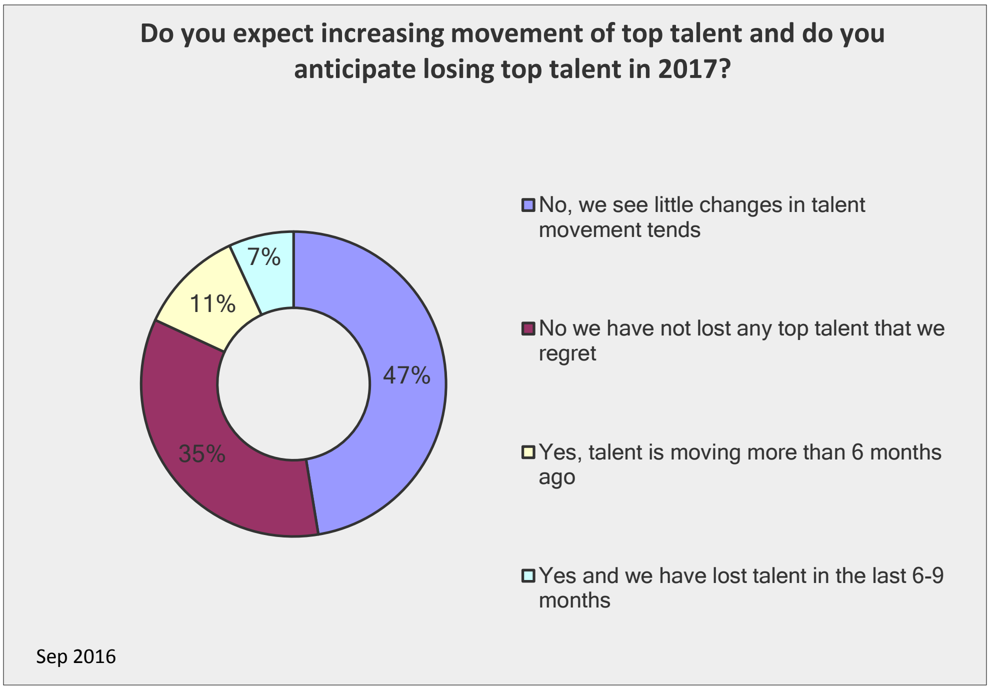
What salary increase did you pay in 2013-2016 and what do you budget in 2017?

Salary comparison over time benched to inflation - “average” white collar staff members, % of companies

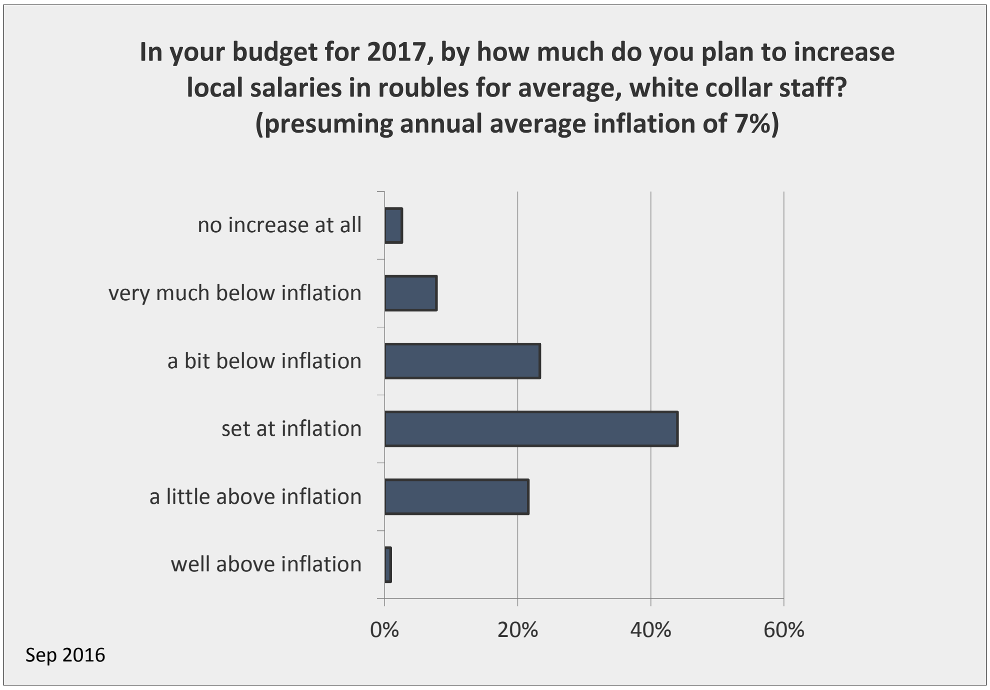
	Jan 2013	Jan 2014	Jan 2015	2016	2017 budget
Salary below inflation	3%	14%	89%	65%	33%
Salary at inflation or + 1-3%	70%	80%	11%	33%	64%
Salary at inflation +3-10%	25%	6%	0%	2%	3%

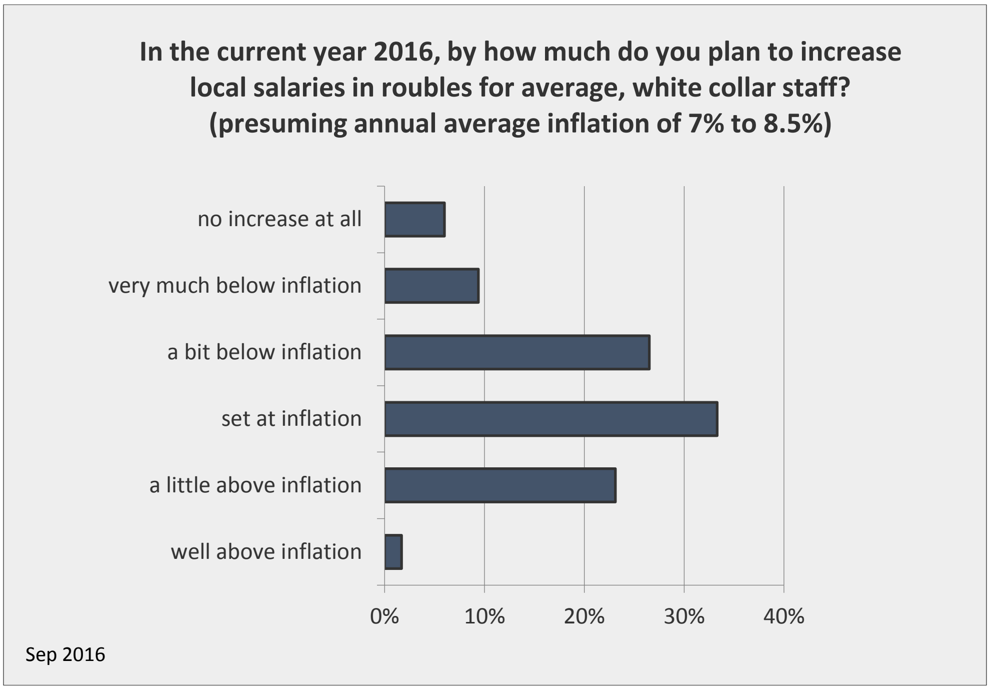
Instead of cutting staff numbers, companies are offering lower salary increases for “average” white collar staff.

Also note that 92% of companies are not compensating Russian staff for the devaluation of the rouble.



These replies point to a good stability in talent but do tend to contradict many anecdotal strikes from executives who suggest that top talent is moving around rapidly. Conversely, the picture is complex because anecdotally executives also say that it is hard to find top talent. These numbers show that only 18% of respondents are witnessing anything special with talent moving; whereas more than 80% see little movement and have been little affected by losing good talent.





The numbers: key tables and findings

Organic sales growth in Roubles, 2016 and 2017

	All companies		Consumer products		Pharma/health		B2B/industrial	
	2016	**2017**	**2016**	**2017**	**2016**	**2017**	**2016**	**2017**
20%+	10	8	28	13	8	3	8	11
10%+	27	22	37	28	32	21	32	0
5-10%	30	44	21	50	36	53	35	54
1-5%	13	8	4	7	20	9	19	13
Flat/zero	8	5	4	0	4	0	4	12
Minus 1-10%	6	0	5	0	0	0	2	0
Minus 10%+	2	0	3	0	0	0	2	0

- In 2016 some 37% of companies are excepting double-digit rouble sales growth while 30% budget this level for 2017.
- But there is a bigger clustering in 2017 in high-single digits with 30% expecting this level in 2016 while this jumps to 44% in 2017 and low single digits represent 13% this year and 8% in 2017.
- Another way of slicing these numbers is to say that two-thirds of companies budget for a sales range in roubles in 2017 of 5-20% which is a strong positive range.
- Even if we tweak this down conservatively to 66% aiming for 5-15%, it is a good level compared with other global markets.
- Some 89% of all managers still think they will make their 2016 roubles sales budget or get very close to it; only 11% forecast a large shortfall. This indicator improved through 2016.

How will 2017 shape up for business compared with 2016?

	Consumer products	Pharma/ healthcare	B2B
Good or better	33%	24%	22%
Same	60%	73%	74%
Worse	7%	3%	4%

Consumer goods companies survived 2015 in reasonably good shape and many had a decent Christmas period and 49% achieved double-digit sales in 2015. In 2016 this number climbs even further to 65% (much of this growth stems of course from price rises). Given that the Russian consumer may be softening at the margins (NOT collapsing) it's wise that executives in CP soften budgets for 2017 with "only" 42% forecasting double digits. A solid 50% budget for high single digits. This makes the CP sector the strongest for sales growth in 2015 and 2016-17.

***Note**: several executives in the food & beverages sub-sector of consumer goods argue forcefully that such growth figures are unattainable in their category given on-going trends and likely consumption patterns.*

Pharma/health companies had to diminish their forecasts through 2015 after starting that year with high expectations. 2016 still looks decent with 40% in double digits and another 36% expecting high-single digit rouble sales. But budgets for 2017 are softer with 24% looking for double digits and 53% clustered in high single digits for the 2017 budget.

As ever in this sector, much will depend of course on trends in federal/reimbursed sales, developments from localisation and price increases in the OTC sector. Generally, retail/OTC has been doing much better and we will see whether the Russian consumer can stay the course in 2016.

Relatively, the B2B sector is the toughest due to financing, investment and confidence issues (and this is the case globally). 2015 was generally a very tough year for most, but 2016 saw noticeable improvement with 40% of firms expecting double digit rouble growth and 54% in single digits. As with the other sectors executives budget for slightly less dynamic sales growth with only 11% budgeting for double digits and 67% clustered in single digits in the 2017 budget.

FX sales outlook in 2015 – 2017, all companies

	2015	2016	2017
+10%	7	20	23
5-10%	3	18	34
1-5%	10	22	28
Flat/zero	13	13	14
Minus 1-10%	20	12	0
Minus 10+	45	13	3

- Meeting FX targets looked very tough indeed at the start of 2016 but the outlook improved through 2016.
- By September 2016 27% of respondents expected to be above budget for the year in FX with another 28% on budget and 24% just behind FX 2016 budget.
- This meant that "Only" 19% of companies would be very far behind their FX budget.
- The rouble stabilisation over the last 5 months has obviously been a massive factor in this shift of expectations and we see that vividly in the quite upbeat budget forecast for 2017 FX sales targets.
- <u>Whereas 25% of companies expect negative FX sales this year, only 3% budget for this in 2017.</u>
- The number budgeting for single-digit FX sales growth leaps from 30% in 2016 to 62% in 2017.
- A further 23% forecast double-digit sales growth in 2017.
- We have discussed all this above including the possible risk factors.

FX sales outlook 2015 and 2016, by sectors

	Consumer products		Pharma/Health		B2B/ Industrials	
	2016	2017	2016	2017	2016	2017
10%+	18	26	8	9	8	26
5-10%	19	42	27	50	26	18
1-5%	7	33	11	23	11	27
Flat/zero	18	0	21	10	23	28
Minus 1-10%	21	0	24	0	26	0
Minus 10%+	14	0	21	3	4	0

The improvement across sectors for FX results is also clear and pharma/health and B2B have caught up a bit with positive trends in the consumer product sector. *Note: several executives in the food & beverages sub-sector of consumer goods argue forcefully that such high growth figures (whether in roubles or FX) are not achievable in their category given on-going trends and likely consumption patterns.*

BUT still 30-40% of companies will be reporting negative FX sales this year. The trend is an improving one but still “nothing to write home about” in FX terms.

BUT the positive trends in FX sales improves remarkably into 2017 budgets when instead of 30-40% of companies predicting negative FX sales, hardly any company has such expectations for 2017.

Will you invest in Russia? Will you make new FDI in 2017?

During 2015 some 23% of companies had on-going investments in Russia, most of which had been signed off in 2013-2015.

During 2016 the number who planned “new investment” in manufacturing, logistics and warehousing fluctuated around 24-32% of respondents.

This proportion was stable and high.

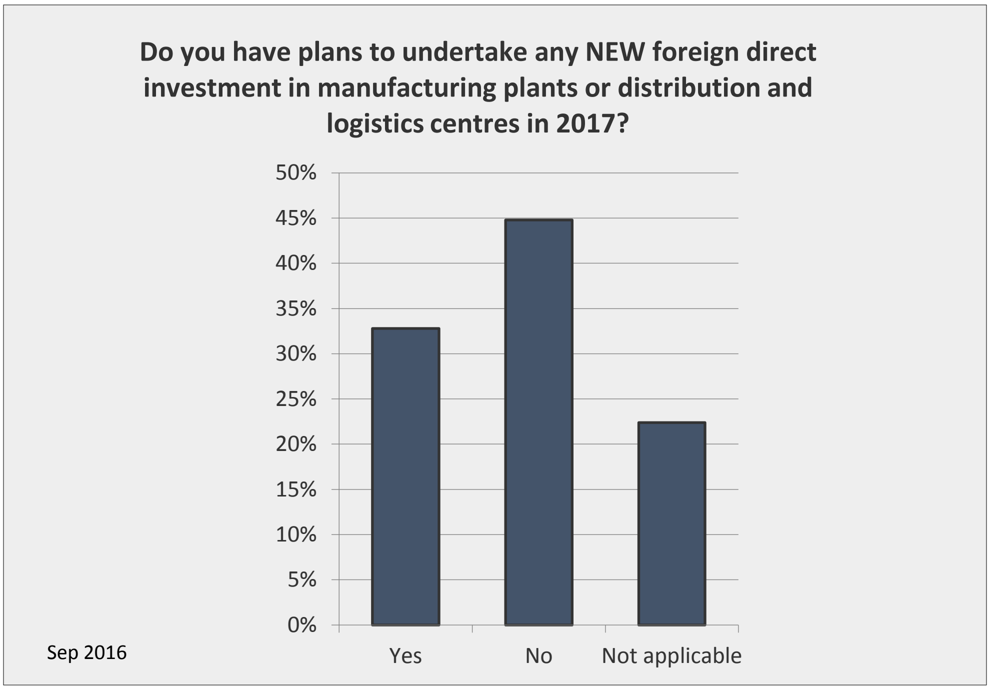
In 2017 Some 33% of all companies plan NEW investment in manufacturing, logistics and warehousing.

This remains a positively shocking figure with 45% having no such plans (for some 22% of companies the question is not applicable).

By sector the numbers are as follows for 2017 and very similar to 2016:
- 30% of pharmaceutical companies plan direct investment in manufacturing, warehousing or logistics
- 41% of consumer products companies
- 22% of B2B companies

The numbers are high when you consider that some/many companies were localising already in 2015.

We estimate that the majority will be looking at logistics and warehousing rather than building massive new factories when demand is down. BUT companies are also planning for expanding market share in Russia over the next 3-7 years rather than in the next quarter, AND many companies realise that to stay competitive with a weak rouble, they need to localise as much as possible. Others are moving on-shore to meet Russian regulations on tenders etc.



CIS 2016 budgeted sales

In 2016 and 2017 Russia will represent 82-86% of total sales revenue from the CIS markets. In addition to being the huge volume market, Russia sales trends in both 2016 and budgeted ones for 2017 are stronger than in other CIS markets. Russia is the "big baby".

2016 sales budgets for CIS markets (in local currency)

	Russia		Ukraine		Kazakhstan		Belarus	
	2016	2017	2016	2017	2016	2017	2016	2017
Growth of 20%+	10	17	6	6	9	10	6	11
Growth of 10%+	27	21	30	32	22	23	28	20
Growth of 5-10%	30	25	8	23	18	35	12	24
Growth of 1-5%	13	11	8	6	5	12	12	13
Flat-zero	8	9	26	25	32	19	27	26
Decline of 1-5%	3	4	5	2	4	0	4	0
Decline of 5-10%	3	4	6	3	4	0	4	5
Decline of 10%+	2	4	16	4	8	2	12	0

Some quick comparisons can be made:

Russia remains clearly the strongest market even in terms of the rate of organic sales growth. Other CIS markets slumped badly in 2015 and through the first months of 2016. BUT we have seen some recent stabilization as the oil price has rallied helping Kazakhstan, and Ukraine continues its slow recovery.

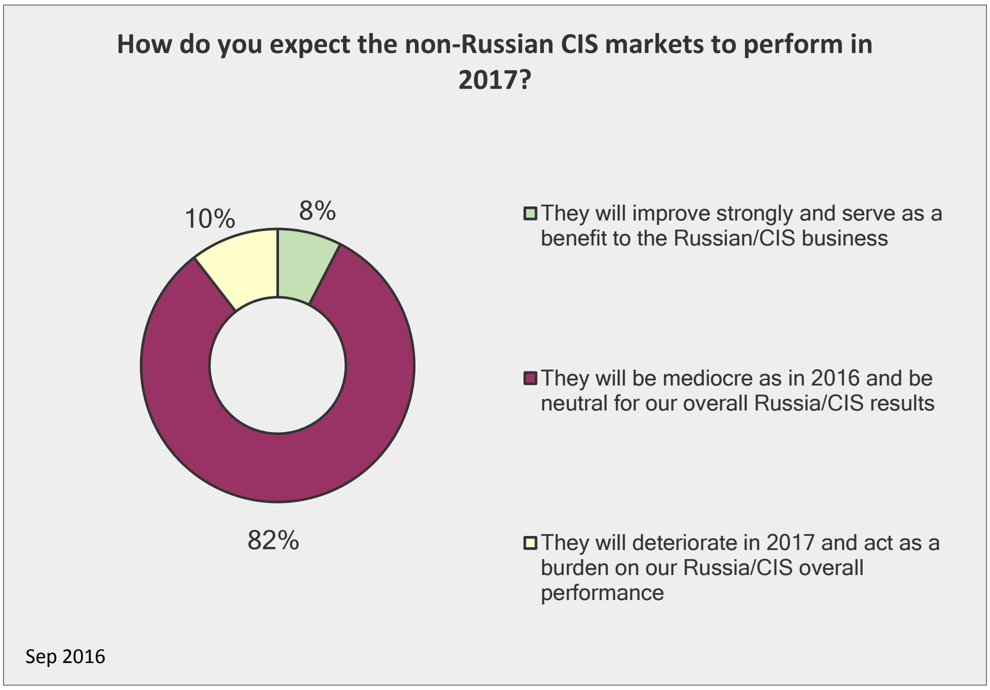
Sales forecasts for 2016 improved recently but this stems from the fact that companies will have to raise their local currency prices (and revenues) in order to compensate for the quite brutal devaluations in Kazakhstan and Belarus and also in Azerbaijan.

The three other CIS markets we review here are "catching up" a little on the Russian numbers but Russia is still ahead and of course represents about 85%+ of the total CIS sales revenues.

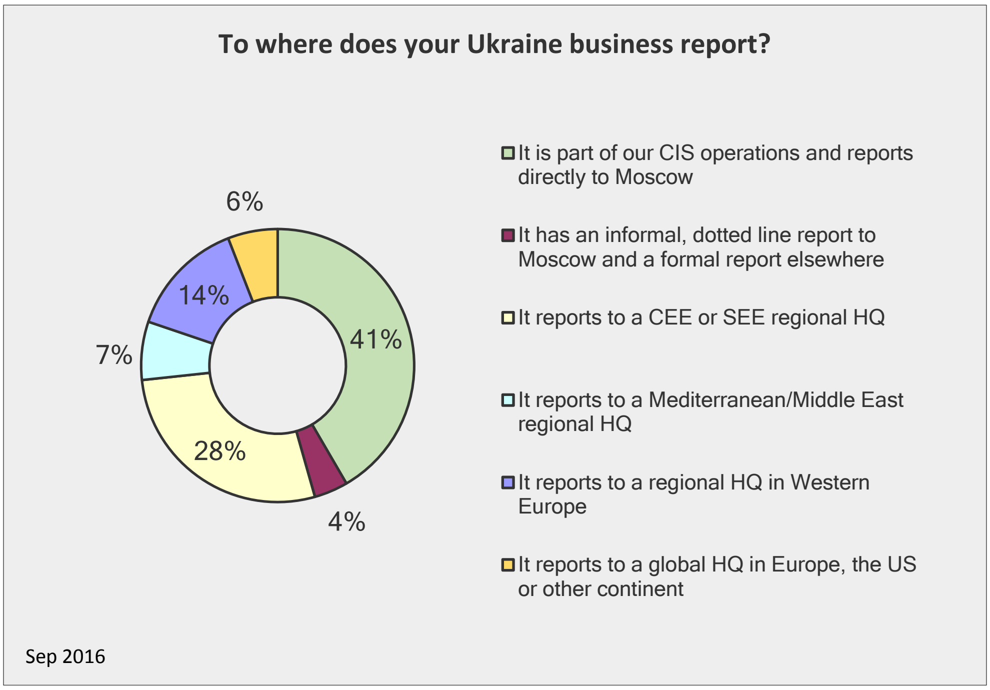
Kazakhstan: expectations for 2016 are much lower than 4-8 months ago as the devaluation has bitten into business and as we say above, much of the current growth stems from price rises. BUT expectations for double-digit growth are decent in both 2016 and 2017 with over 30% of companies predicting such numbers in both years. The market was the joint best-performing one in the CIS with Russia at the start of 2015 but has now fallen behind Russian projected sales for 2016 and 2017. The tenge was devalued in August 2015 as we predicted in our central scenario and depreciated since then further. For the time being and the next 12-18 months, Kazakhstan will remain the No.2 market behind Russia. Some companies have even argued that now that the devaluation is behind them, there is a sense of more stability in the market and some projects and tenders are being "unfrozen".

Ukraine: as the market and economy stabilises, it is becoming "relatively" more attractive, and as the hryvnia is "relatively" more stable compared with hugely volatile CIS currencies, then business is starting to plan a tentative and slow recovery. But 2016 will be another tough year. Most companies are struggling in hryvnia (48% will be flat or negative in hryvnia this year) and performing badly in FX. BUT some 36% now forecast double-digit sales coming from a low base. And anecdotally about 10-15% of western companies are doing very well in local currency and even not bad in FX, but we stress they are a minority: their success is due to the large black economy and incomes stored there and also due to some western Ukrainian factories being able to benefit from the weak currency to generate some export earnings. The 2017 budget numbers seem to match 2016 expectations. The BIG story will be whether there is enough FX stabilisation to ensure that these local currency numbers translate into FX results.

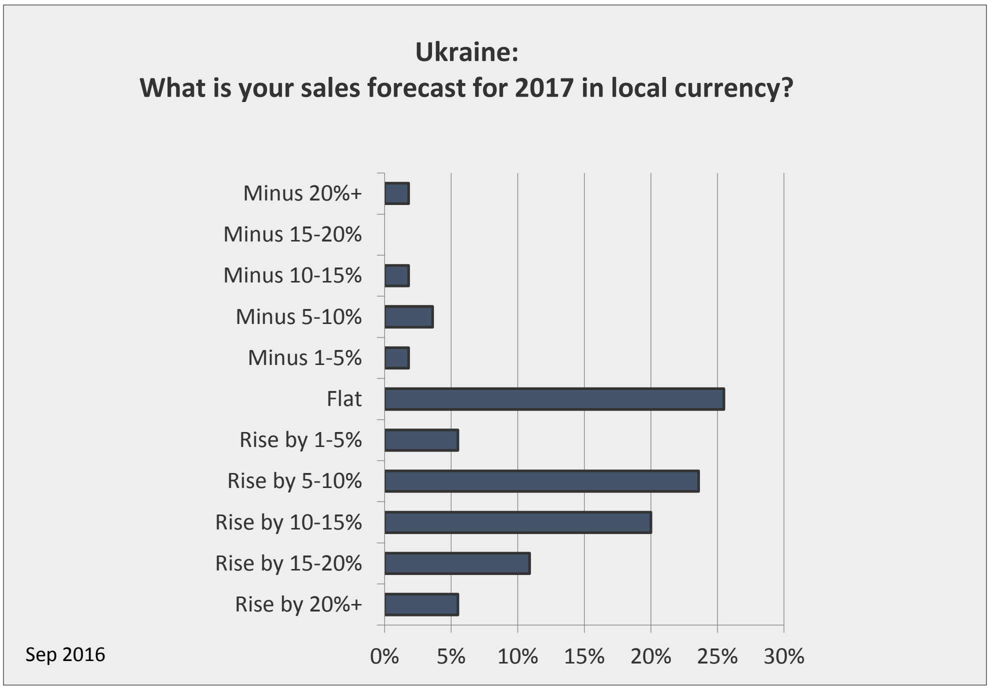
Belarus is a small market and results are worsening compared with 2014 and 2015 due to the recent devaluations. We stated some months ago that risk was to the downside and this proved correct. On the plus side, we have seen a mild improvement in sales expectations in the last 6 months with 34% looking to double digit sales increases in local currency. As with the other markets, the 2017 budget forecasts mirror 2016 expected results closely and once again all will depend on the FX rate which could be under some maintained pressure.

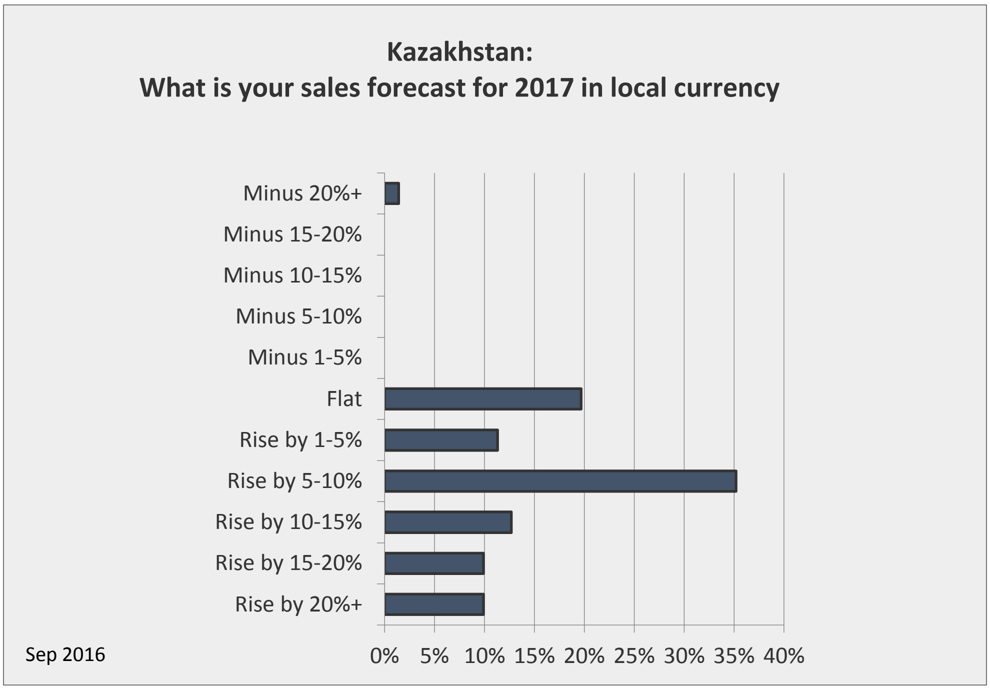


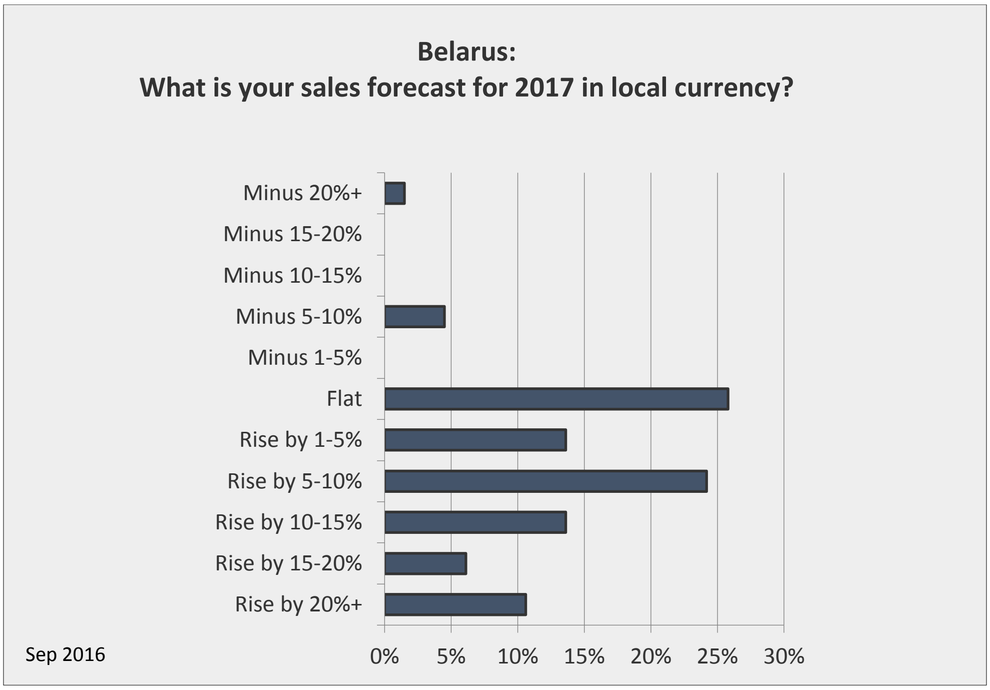
This chart underlies anecdotes from executives: in parts of 2014 and 2015, the CIS markets especially Kazakhstan and Azerbaijan and to some extent Belarus were markets which, at the margins, helped to compensate for the slowing sales and profits in Russia but from mid-2015 as their own economies and especially currencies came under pressure, they lost much of their appeal. At the start of 2016 one regional manager based in Moscow commented about his business: "Kazakhstan in 2014 paradise; Kazakhstan in 2015 hell"!



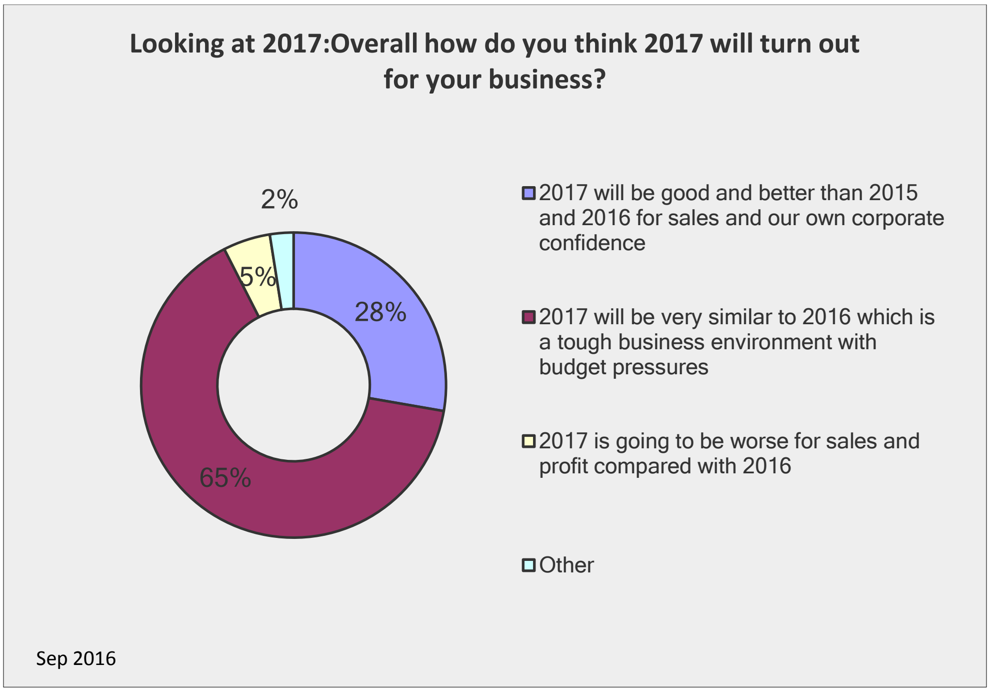
- This chart is revealing in two ways: it shows how many companies have taken Ukraine out of their CIS corporate structure and it shows how many have kept it in!
- We presume that the slow drift of detaching Ukraine will continue but the fact that 45% of companies retain some link proves that it has been a good model and executives are reluctant to change.
- When companies do detach Ukraine, then there are several options and the most popular is to stick Ukraine into a CEE/SEE structure.

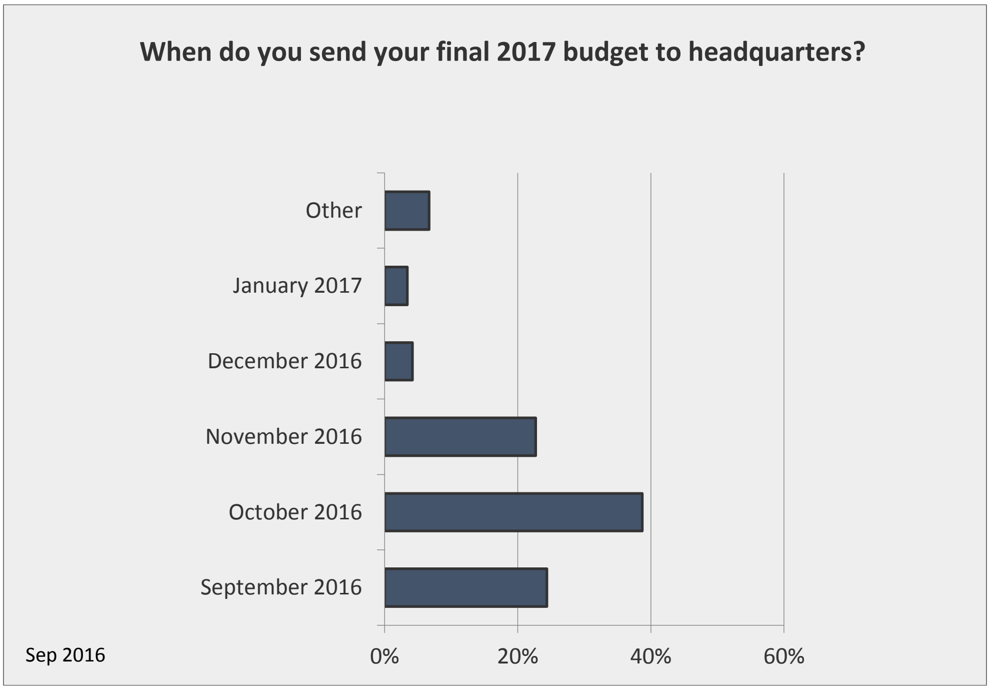



Kazakhstan:
What is your sales forecast for 2017 in local currency
Minus 20%+
Minus 15-20%
Minus 10-15%
Minus 5-10%
Minus 1-5%
Flat
Rise by 1-5%
Rise by 5-10%
Rise by 10-15%
Rise by 15-20%
Rise by 20%+
Sep 2016
0% 5% 10% 15% 20% 25% 30% 35% 40%


Belarus:
What is your sales forecast for 2017 in local currency?
Minus 20%+
Minus 15-20%
Minus 10-15%
Minus 5-10%
Minus 1-5%
Flat
Rise by 1-5%
Rise by 5-10%
Rise by 10-15%
Rise by 15-20%
Rise by 20%+
Sep 2016
0% 5% 10% 15% 20% 25% 30%

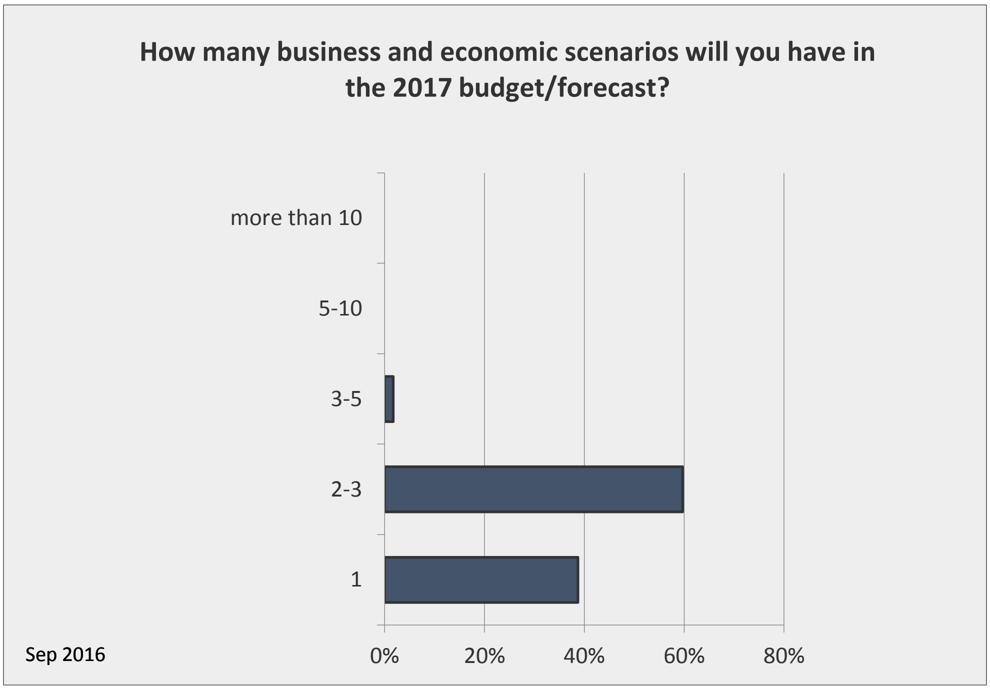
The 2017 Budget - charts and analysis





- 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.

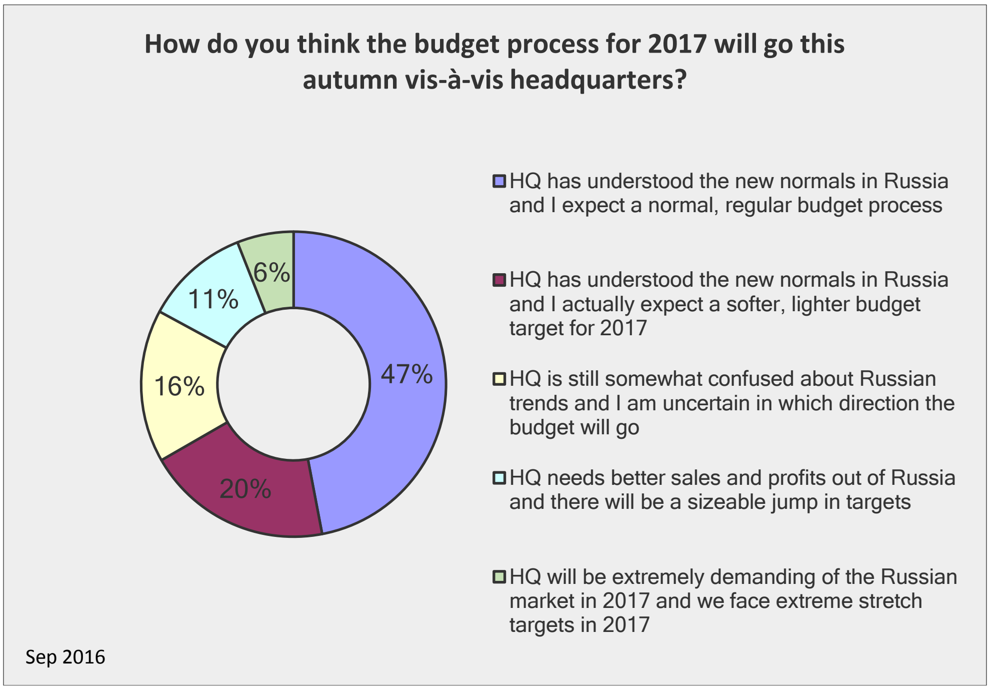
As we all know the danger in recent years and the future is getting “caught in the budget trap” when September feels stable and upbeat only to be followed by global weakness and volatility in Russia during November to February each year.



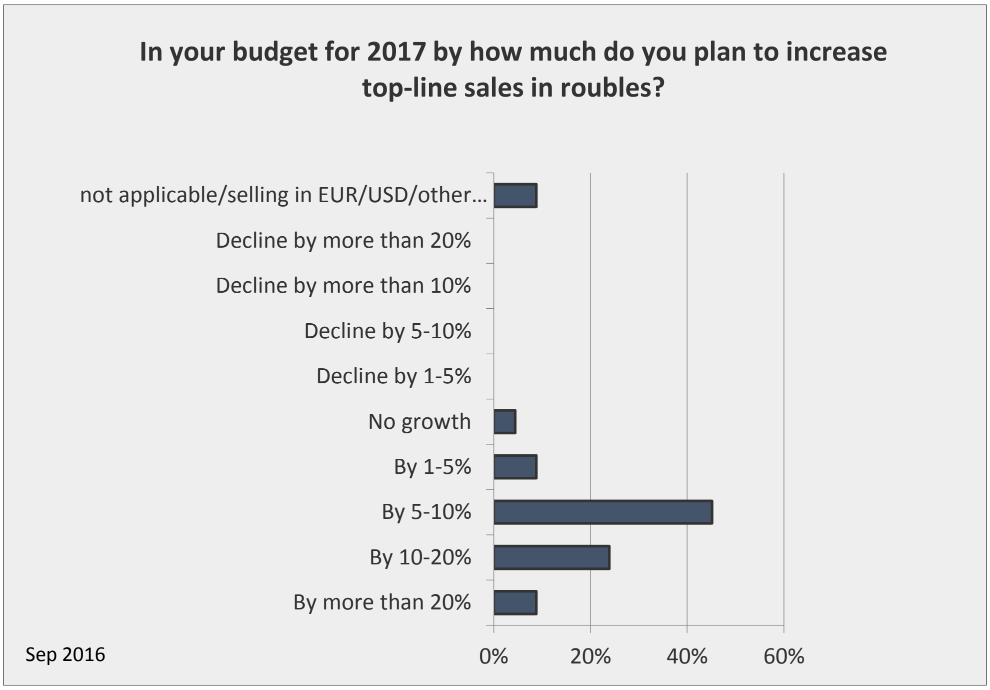
The results show that there is a great deal of similarity in some key indicators with many companies budgeting for rouble sales growth of 5-10% in 2017 and excepting an FX rate to the dollar and Euro pretty close to today's levels (early September 2016).

Given volatility in recent years, I am perhaps marginally surprised that more companies do not have slightly more scenarios in the budget process but on the other hand 60% do process 2-3 scenarios and if the number is 3, then we presume "best, middle, worst" options.

Perhaps my attitude is coloured by one managing director of a retail company who used 13 scenarios for their budget process last year in September 2015 for the 2016 budget. Then again, this just shows that there was much more volatility 12 months ago than there is today.



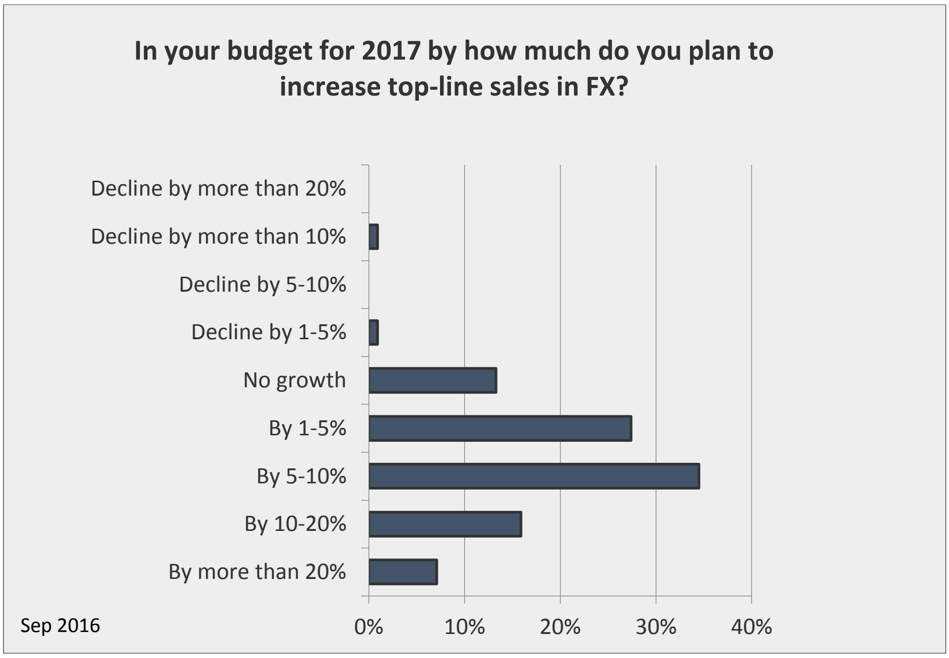
Relations over the 2017 budget with headquarters are not bad at all: almost 50% of HQ management understand the "new normal" in Russia and 20% of Russia MDs actually believe they can succeed in obtaining a softer 2017 target, while 17% of global management are still pressing hard and squeezing the Russia market for sales and profits.



- No respondent company in our survey is budgeting for negative rouble sales in 2017.
- Those budgeting flat sales falls from 8% in 2016 to 5% in 2017.
- Some 8% of all companies budget for rouble sales increases of 1-5%.
- The BIG cluster for sales forecast is in high single-digits and low double digits: 44% plan for high singles and 22% budget for 10-15% sales increases.

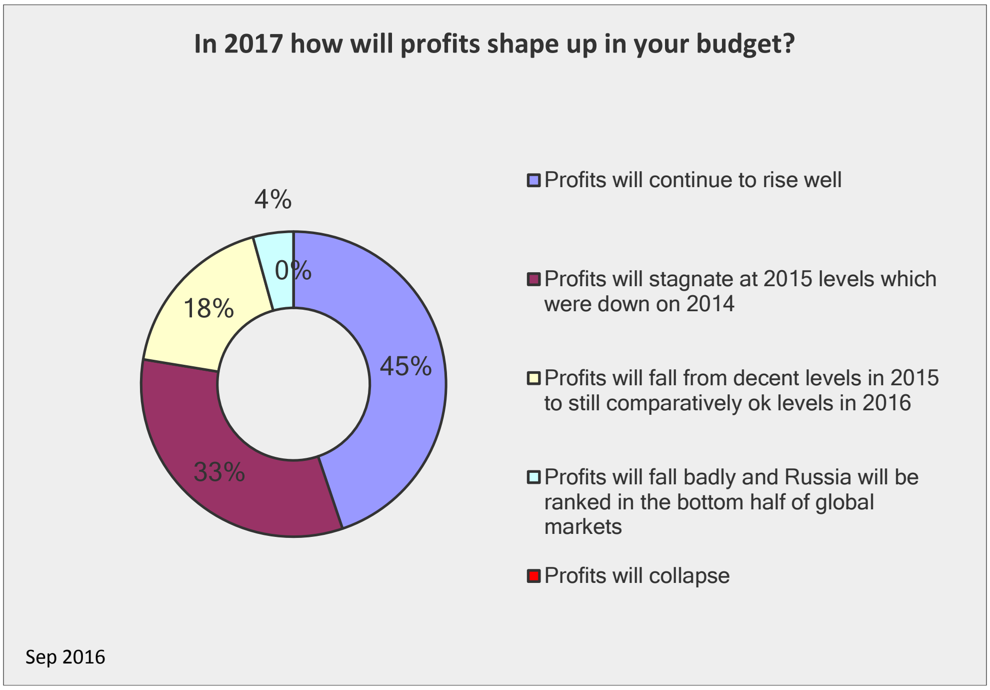
In 2016, 66% of companies budget for rouble sales growth in a range of 5-15%

The rouble budget sales for 2017 are very similar to those excepted for 2016.



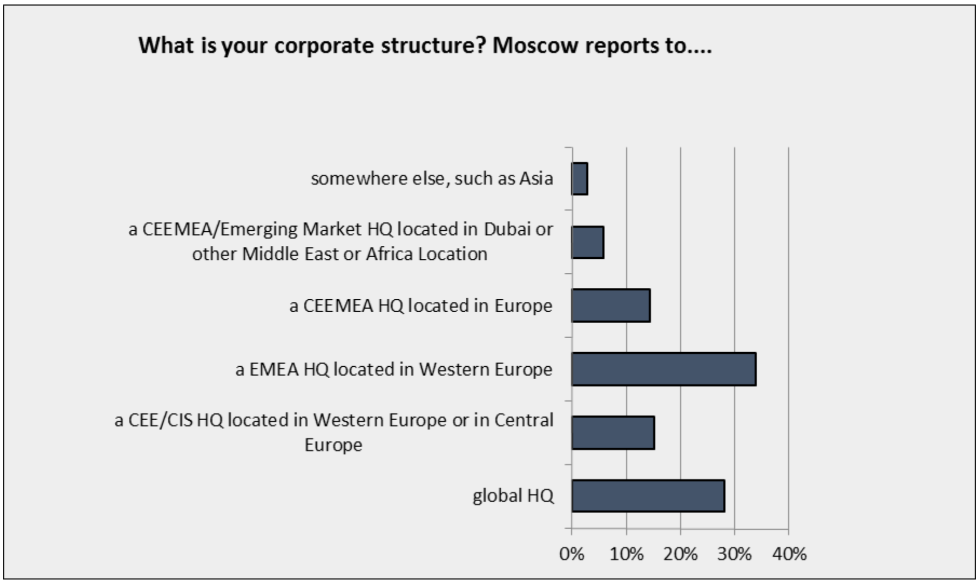
Many companies are budgeting for significant improvements in FX sales in 2017.

- In 2016 some 25% of companies recorded negative FX sales but in 2017 budgets the number sinks to just 3%.
- In both 2016 and 207 13-14% of firms predict flat/zero FX sales.
- But while 30% expect single digit FX sales growth this year, the number of respondents budgeting at single-digit FX increases 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 obviously this is where the risk lies for getting caught in a 2017 budget trap.

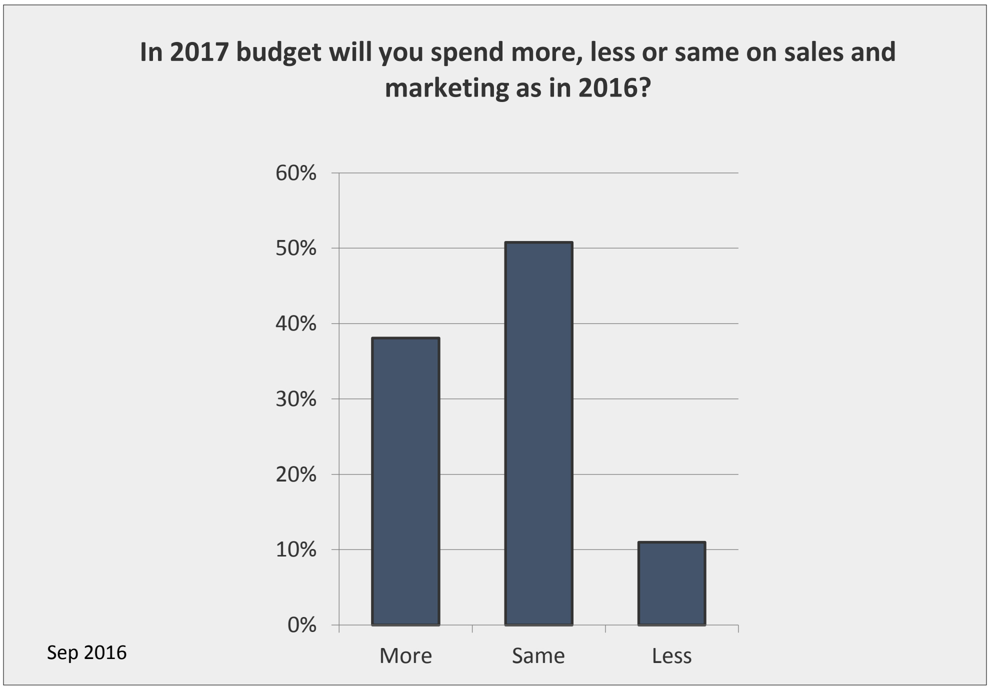


- The budgeted profit outlook remains good for three-quarters of all companies surveyed and this matches many anecdotal comments.
- For 45% of companies, profits will continue to rise well; for 52% of respondents profits will fall or stagnate at decent levels.
- But for 22% profits will fall badly or even collapse.

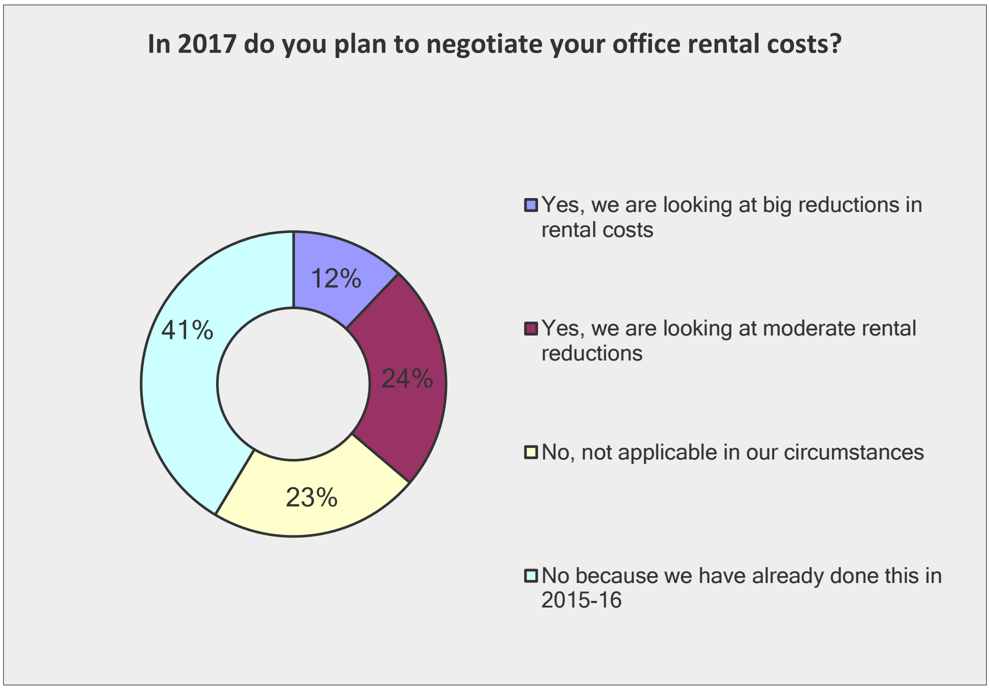
Corporate Structure: to where does Russia report?



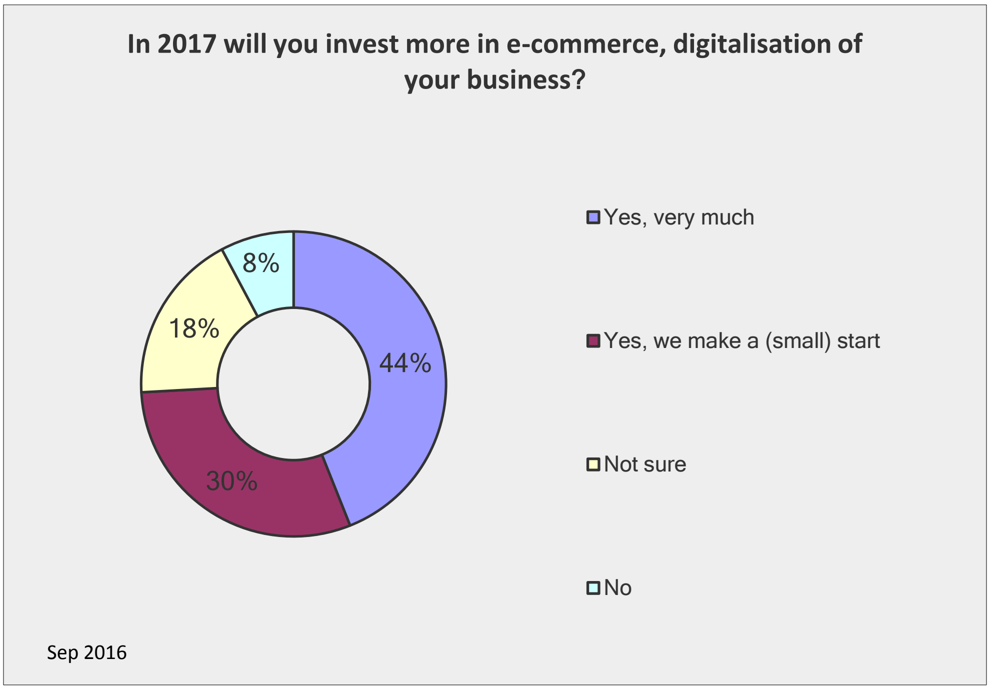
Interestingly 28% of companies report from Moscow to global headquarters. Some 14% report into the old/standard CEE headquarters while almost 50% report into CEEMEA/EMEA HQ located in Western Europe. So far only 8-9% report into Dubai or other "exotic" locations!



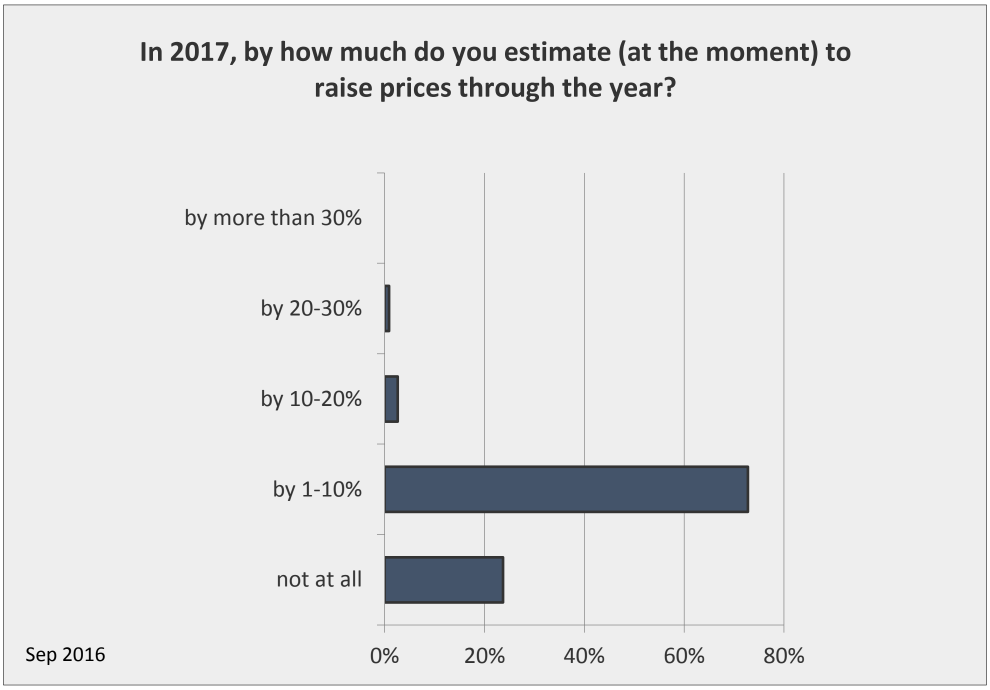
As many as 40% of companies plan to expand spending in sales and marketing to grow sales and acquire market share; 50% of respondents budget for the same expenditure in 2017 while only 11% of companies are budgeting for cut backs in sales and marketing



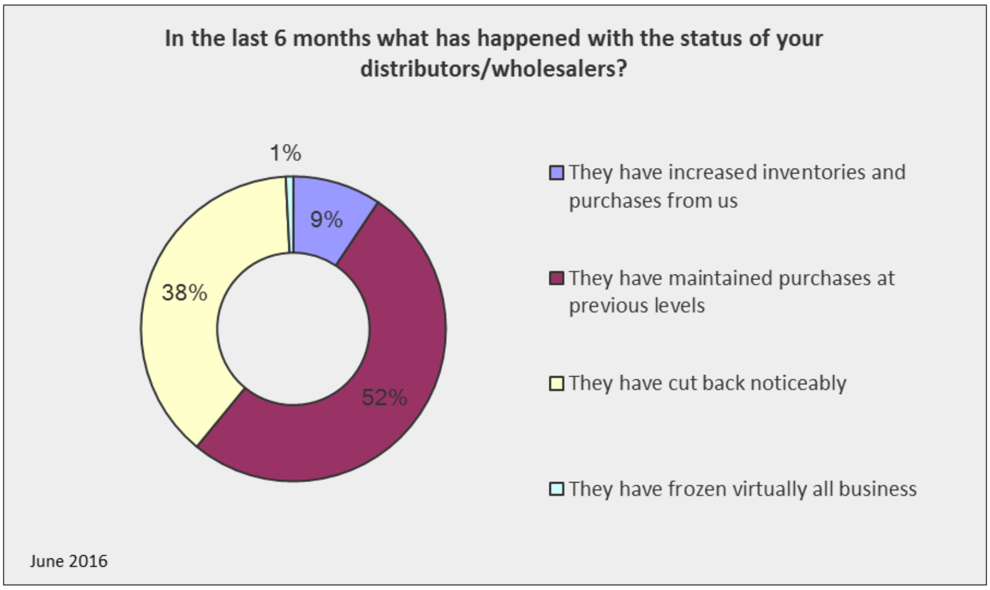
Companies will be looking at saving money on office rental space: 41% of companies have already received rent reductions in 2015-16. Another 44% budget for big or moderate rental cuts in 2017.



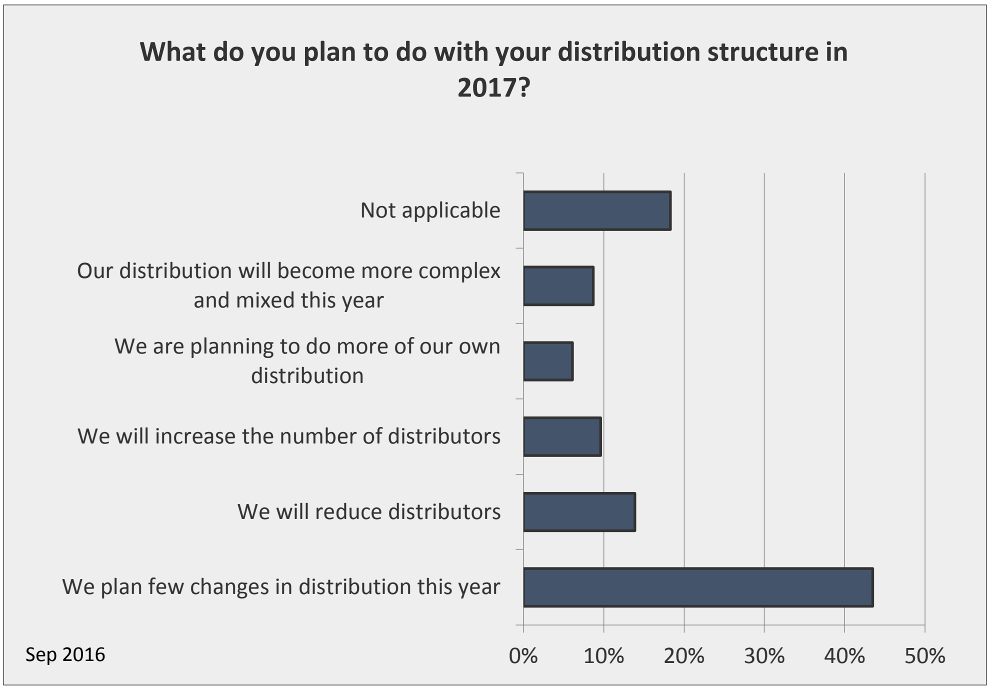
- Some 44% of firms' budget for significant investment in e-commerce and digitisation while another 30% will make a small start and 18% are not sure.
- It is perhaps more interesting that 44% will make only a small start and 18% are not sure.
- One might have expected a flurry of activity on these fronts.



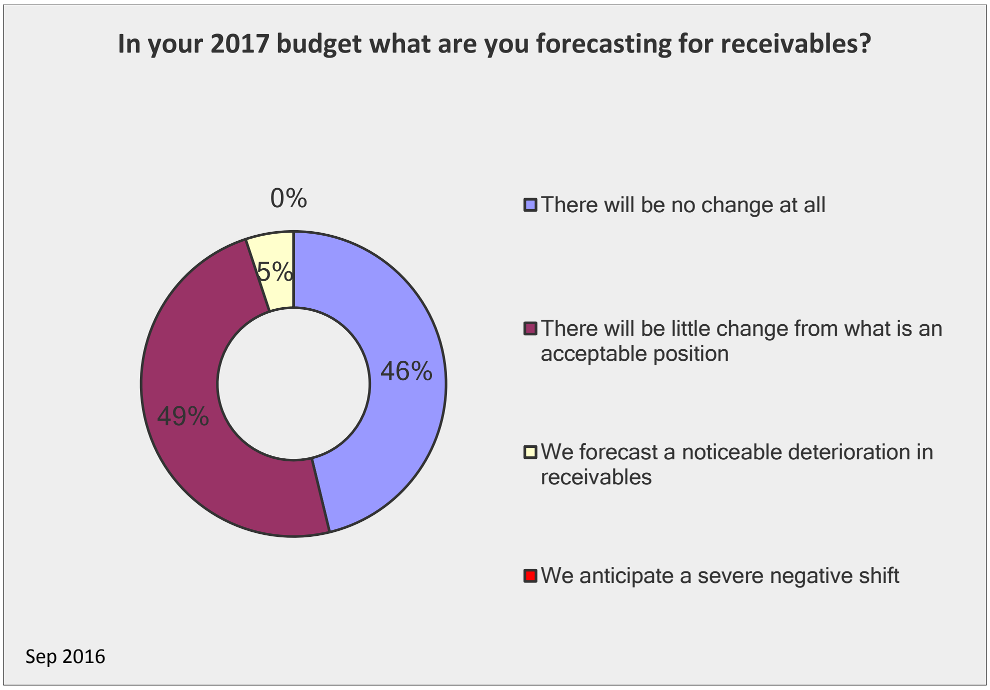
- Price increases in 2017 are planned to be more moderate than in 2016 and certainly less aggressive than in 2015: whereas some 20% of companies plan price increases by more than 10% in 2016, this falls to 5% in 2017 budgets; companies preferring more moderate increases in single digits jumps from 48% in 2016 to 73% of companies budgeting thus in 2017.
- Obviously this could change and deteriorate depending on any weakening in the rouble and inflation.
- In 2015 the average range of price increases was 15-28% with 3-4 price increases introduced through the year.



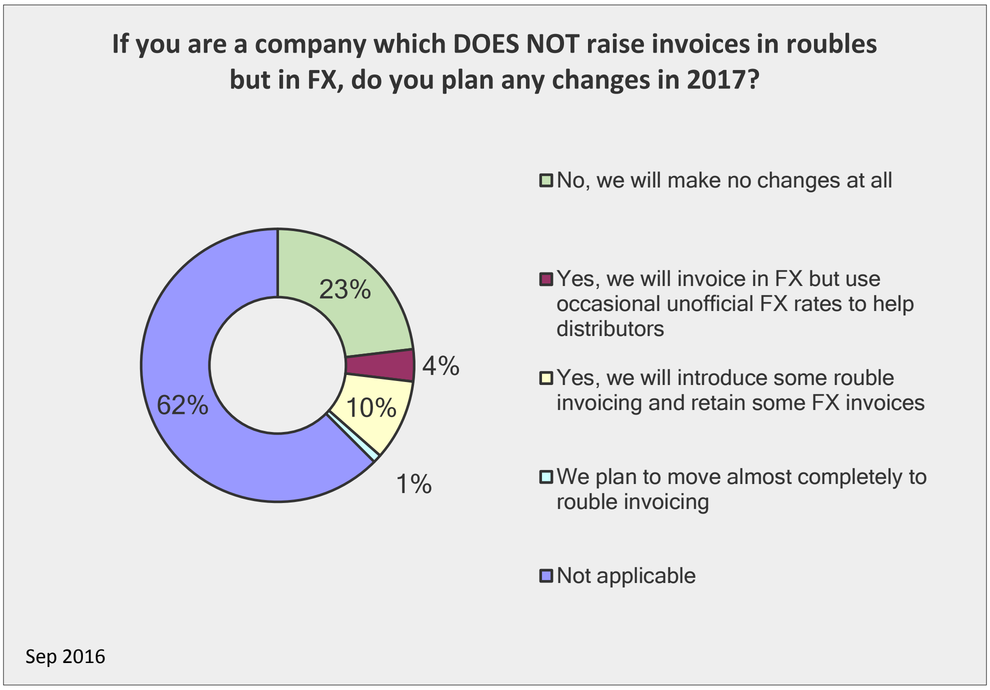
The situation here seems not bad but not good either and has deteriorated in the last 2 months as distributors become more "weary". Some 52% of respondents see maintained purchases (but this was 65% in the spring) and those who see noticeable cutbacks are worse at 38% compared with 27% in March. The B2B sector seems weaker with more distributors cutting back (44%) and fewer than average maintaining purchases i.e. 43% compared with 52% for all companies. This contributes to the overall softer B2B figures. But as the economy creeps up through the end of 2016 we could expect a small recovery in this indicator.



This is the kind of response that we would have anticipated. Some 44% of companies are satisfied with what they've got having made adjustments over the last two years. The rest of the picture is fairly mixed as companies adapt to a volatile and changing market, route to market and different consumers. Some 9% will increase the number of distributors while 13% will decrease; some 7% will take on more of their own distribution and only 8% will be mixing things up. All this goes to show the complexity and challenges (both positive and negative) facing route to market.

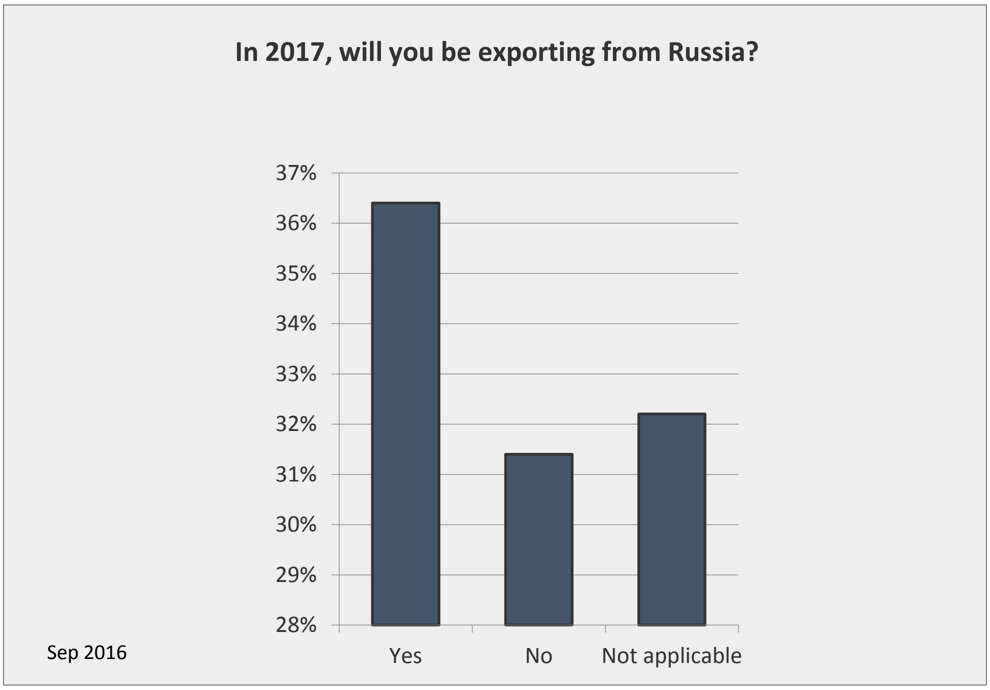


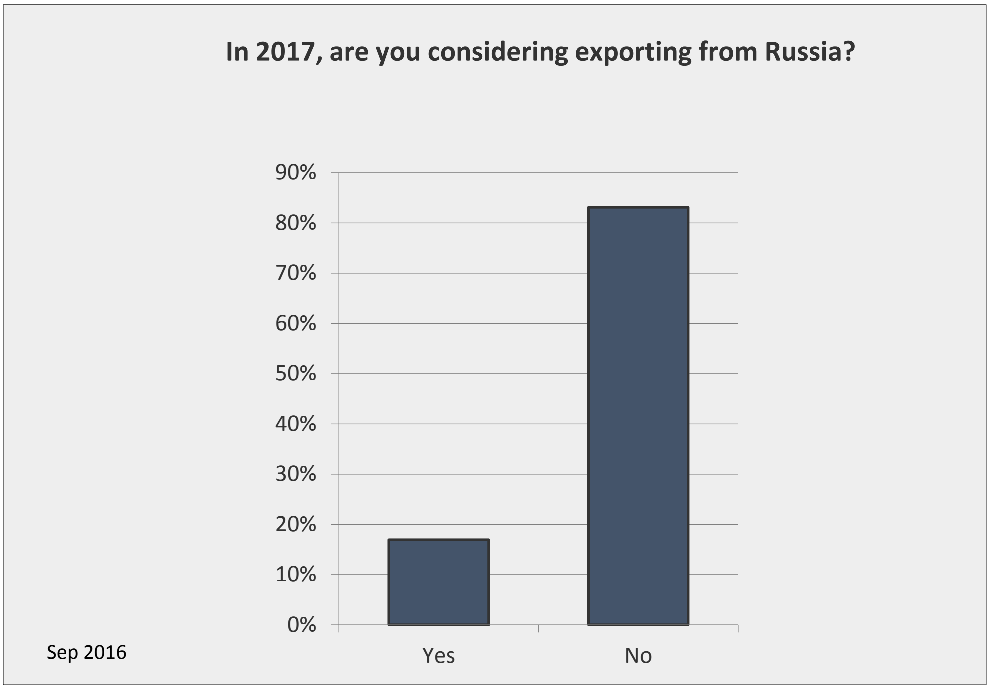
Receivables are generally OK and this has been the picture for 2-3 or even 10 years now. Some 46% of firms have no issues while 49% face some mild deterioration which is manageable. These numbers match anecdotal comments to me. In the summer there seemed to be a marginal dip with 9% reporting serious issues but this has declined again to just 5%. Overall then, reasonably good or better given the economic background in recent years.

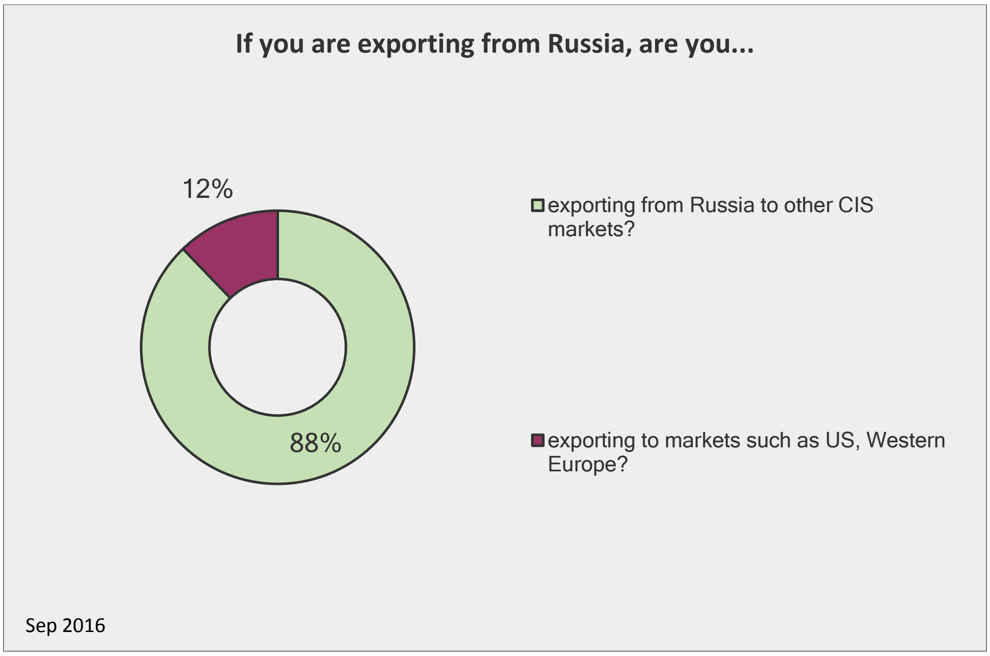


We see here a continuing trend. While 62% invoice in roubles, of the remaining companies, the majority will not make any further changes in 2017 as the rouble stabilises. BUT of those invoicing in FX about 40% will make adaptions to make their financing a bit more appealing.

Exporting from Russia in 2017



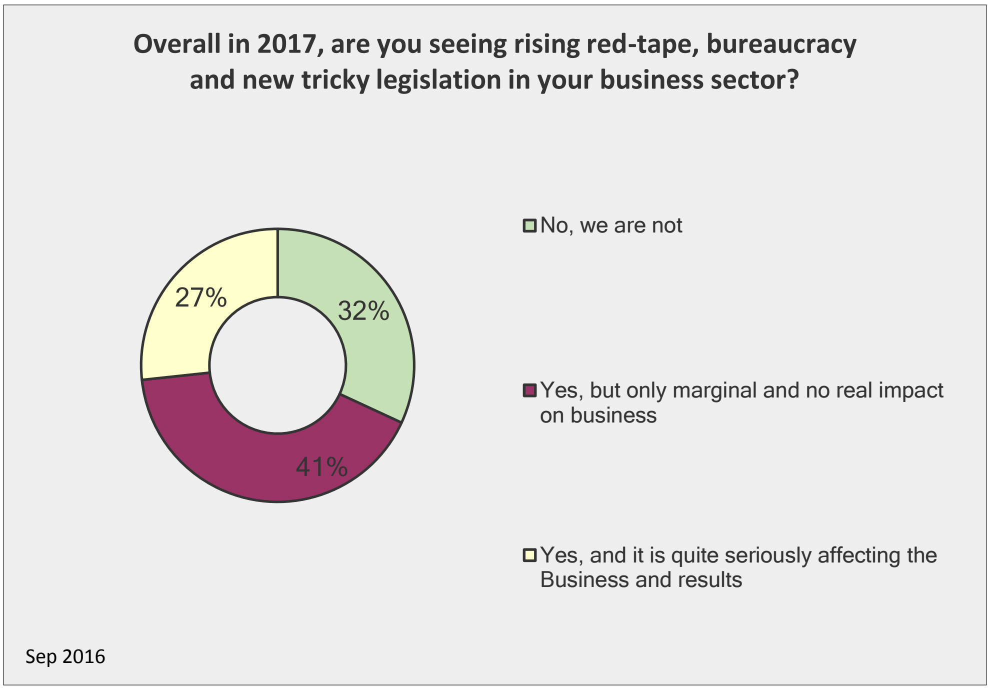




We have noted in other reports that historically in the last 20 years most companies invested in Russia to sell to the big and booming domestic market. Now companies are looking at alternative revenue streams and Russia is potentially interesting as an export base given low cost production structures and the high quality of HR. The proximity to Europe is another positive factor although red-tape, customs regulations, VAT rules and compliance issues complicate matters.

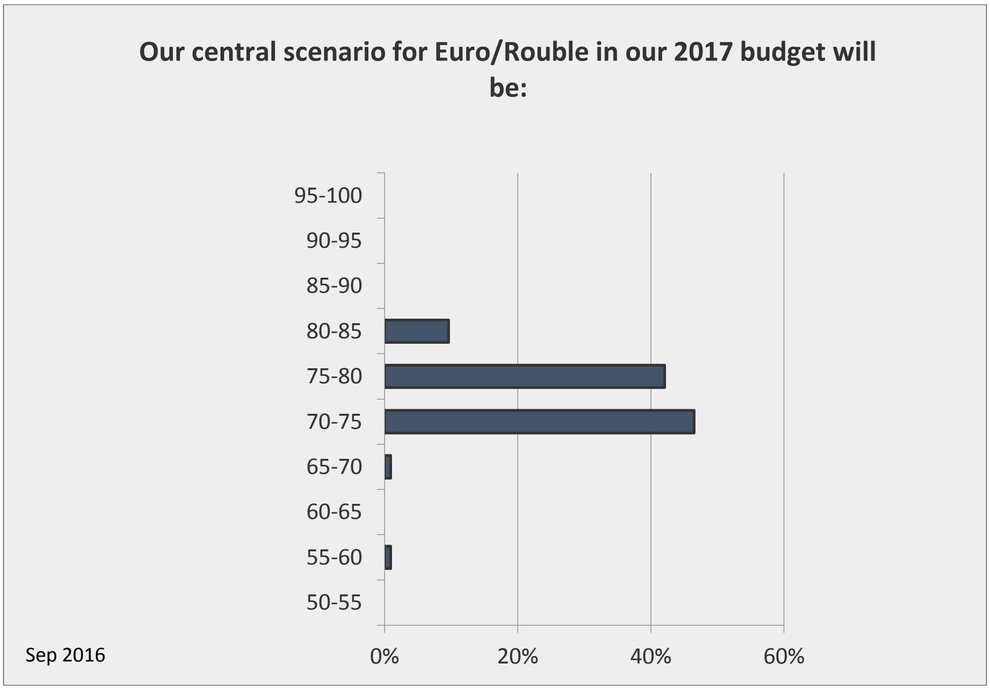
Some 36% of companies are exporting from Russia but 88% of those confine themselves to other CIS markets.

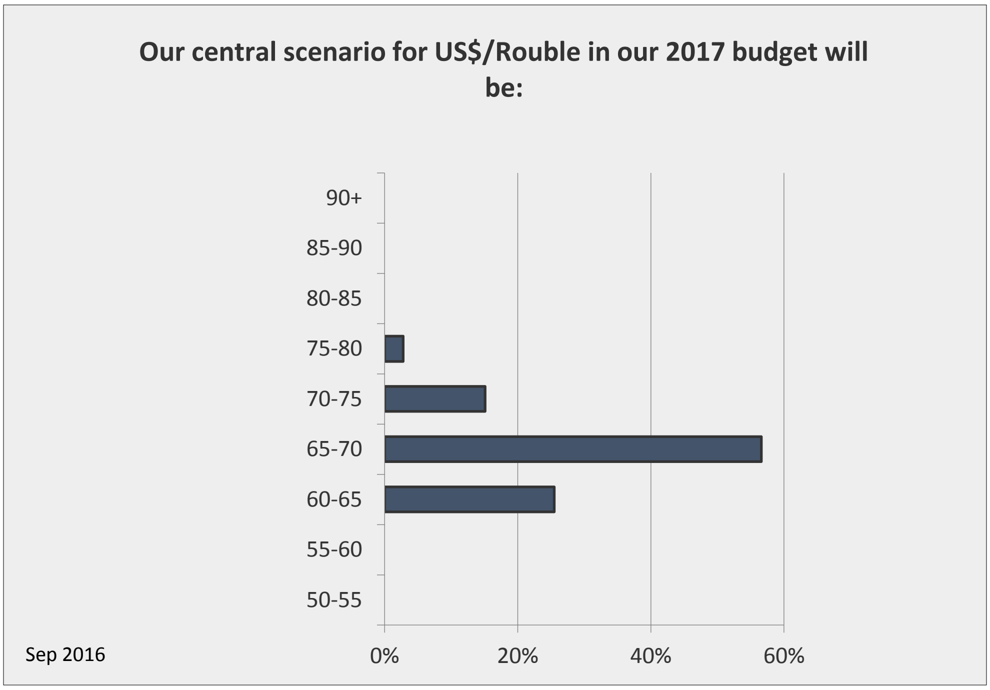
So the number exporting to non-CIS markets remains small. But more executives will be considering the export option (to anywhere!) especially given relatively low cost production possibilities.



Responses vary by sector and certainly the pharmaceutical industry sees itself under most strain regrading access to markets and rules over tenders. With more companies in this sector localising, one senior manager told me that: "Now that we have localised we want to work closely with the government and ensure good professional relations".

Euro/Rouble, US$ Rouble

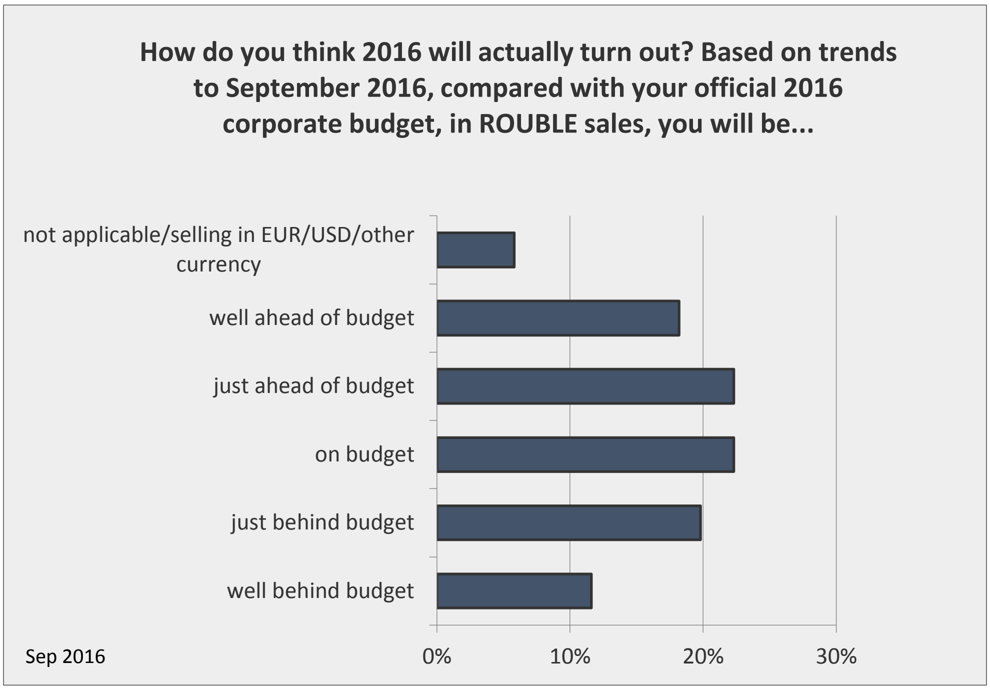


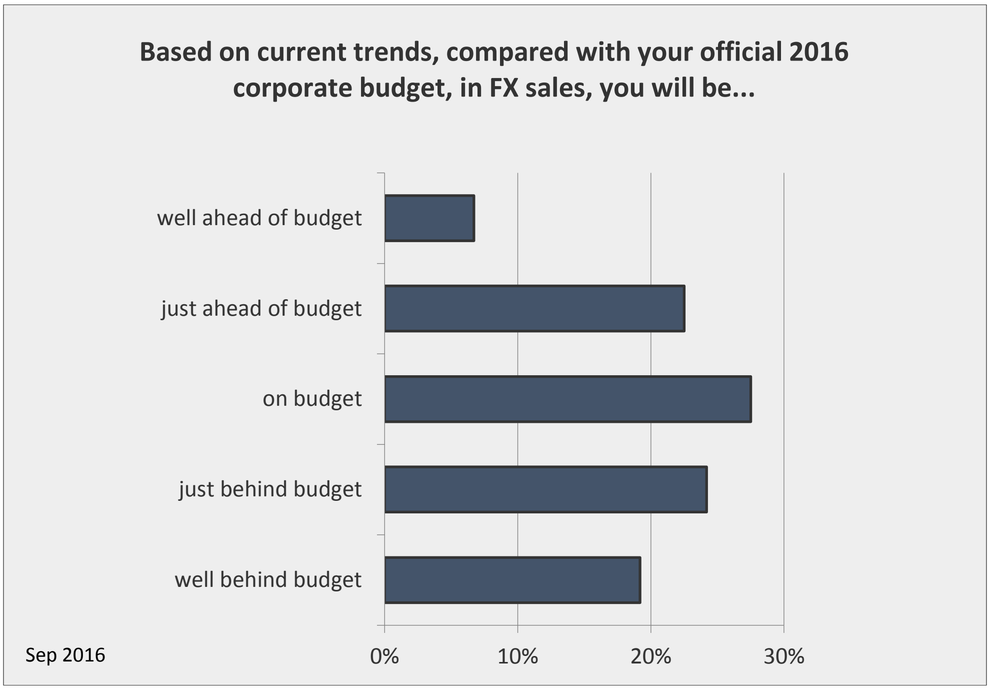


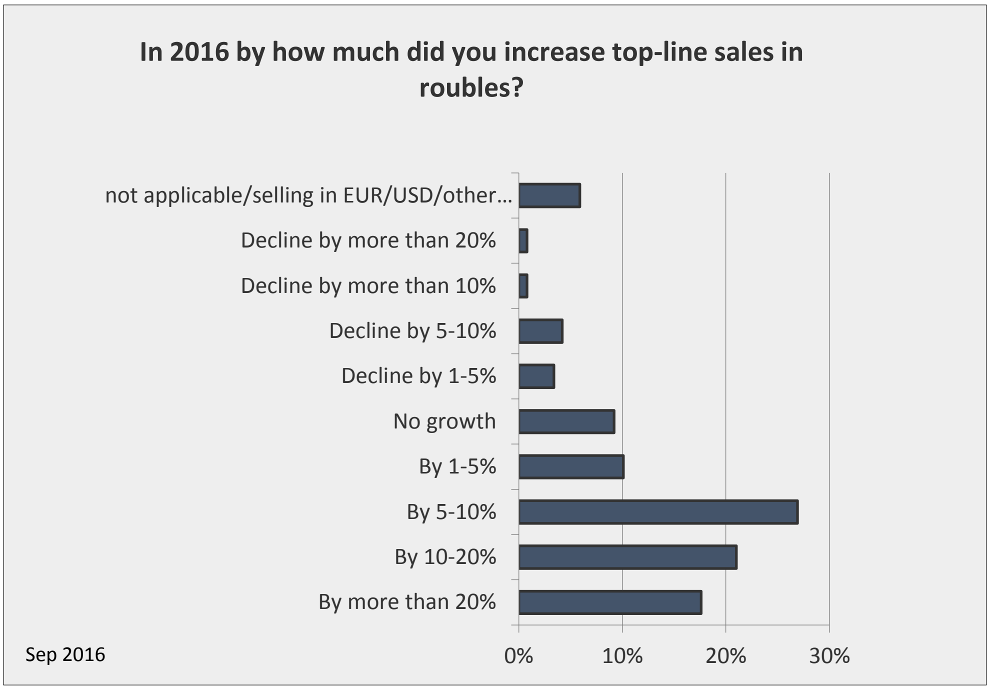
- As we noted above in the summary, the large majority of executives are budgeting for a rouble exchange rate very close to the current rate at the start of September 2016 or at a rate slightly worse by 3-7%.
- This seems the "best route to go" and we allude to possible risk to this scenario above.
- This probably explains why many companies have 2-3 scenarios.

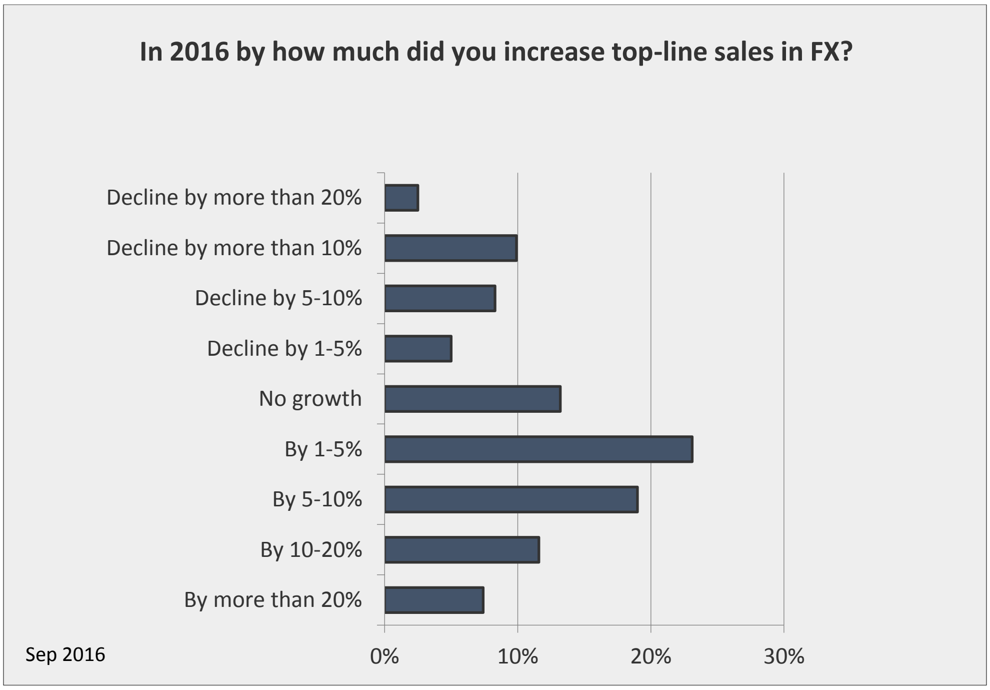
Appendix – background charts

Wrapping up 2016: reference charts

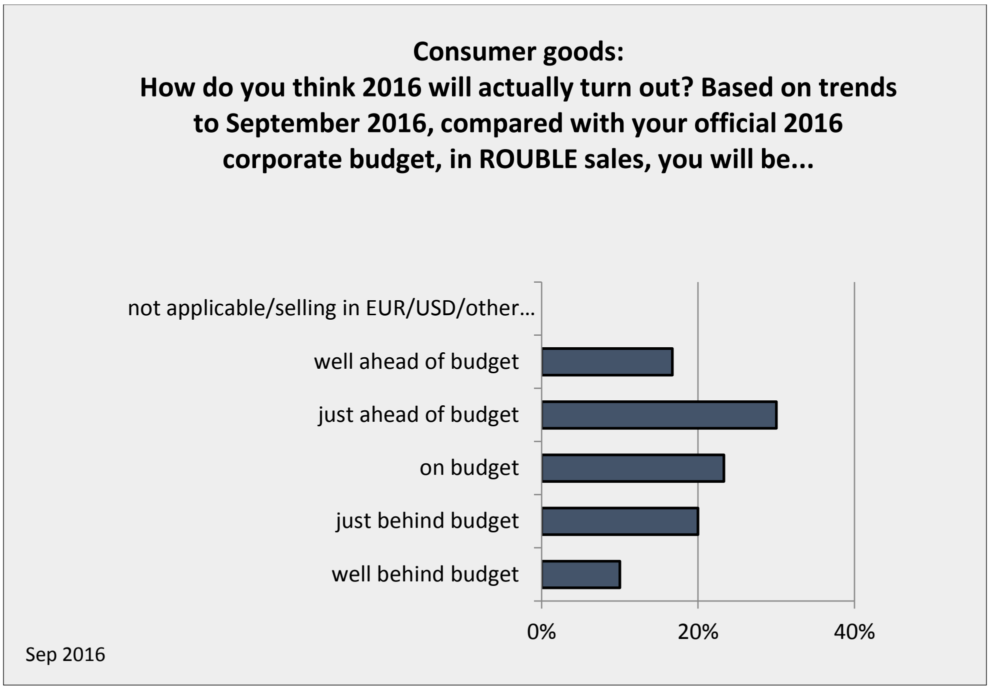


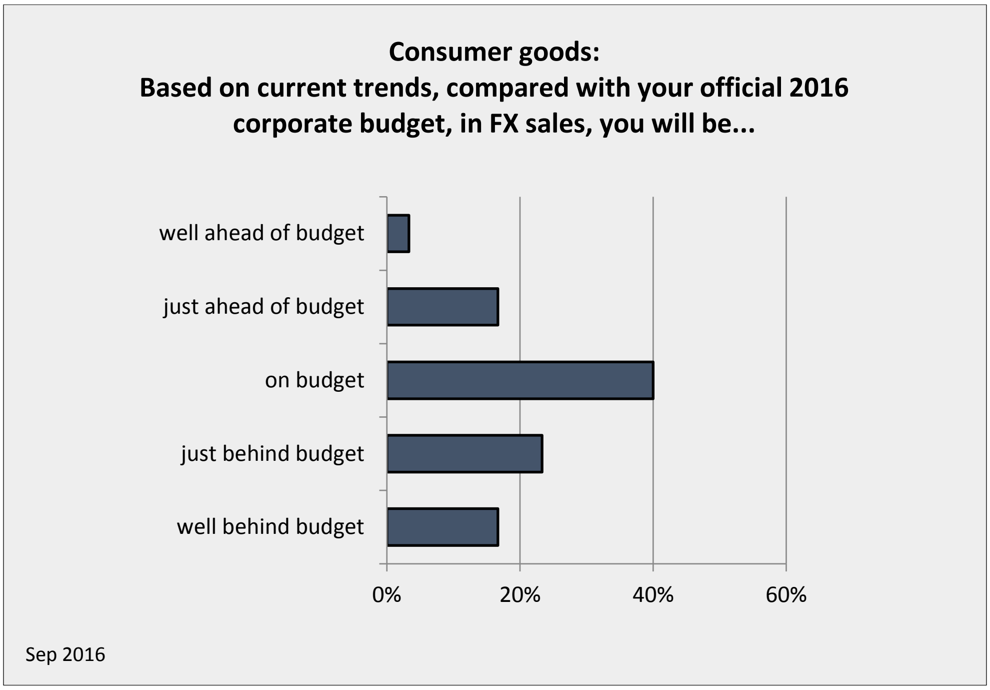


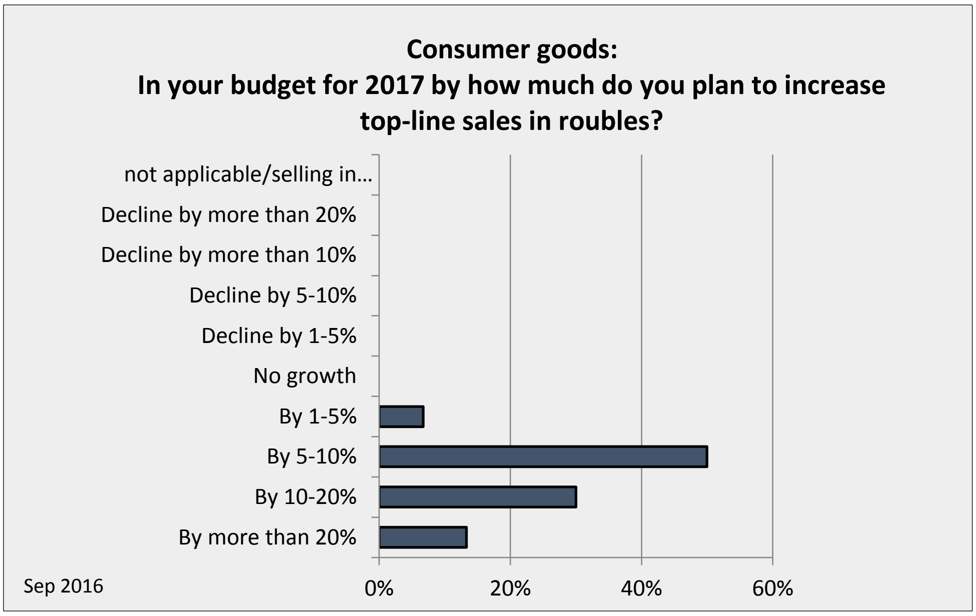

In 2016 by how much did you increase top-line sales in roubles?
not applicable/selling in EUR/USD/other…
Decline by more than 20%
Decline by more than 10%
Decline by 5-10%
Decline by 1-5%
No growth
By 1-5%
By 5-10%
By 10-20%
By more than 20%
Sep 2016
0%
10%
20%
30%

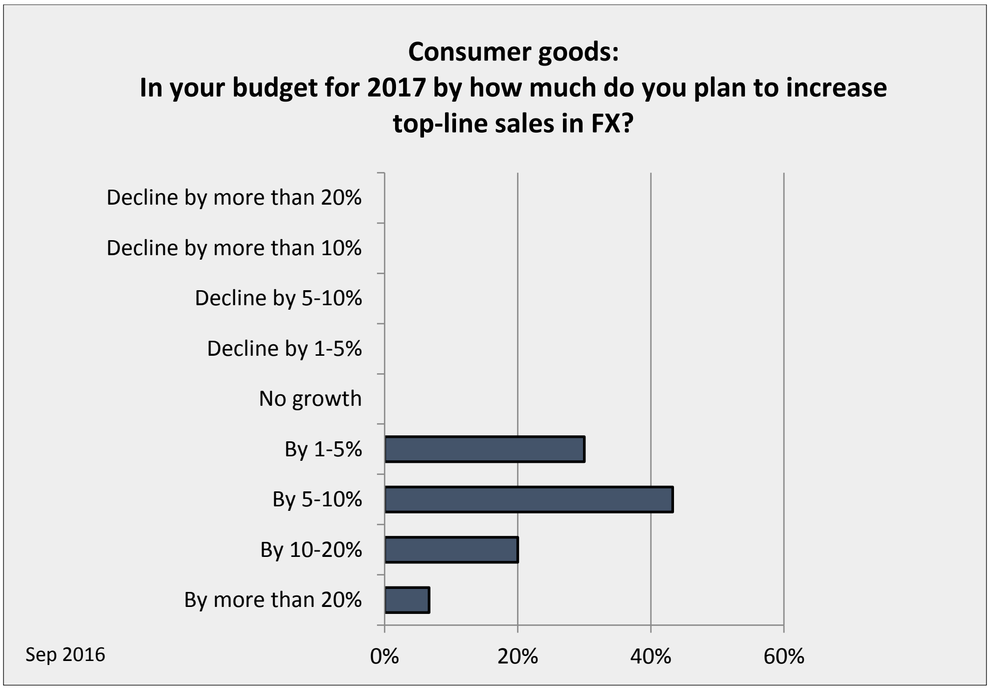

In 2016 by how much did you increase top-line sales in FX?
Decline by more than 20%
Decline by more than 10%
Decline by 5-10%
Decline by 1-5%
No growth
By 1-5%
By 5-10%
By 10-20%
By more than 20%
Sep 2016
0%
10%
20%
30%

Reference charts: consumer products, pharmaceuticals/healthcare and B2B






Consumer goods:
In your budget for 2017 by how much do you plan to increase top-line sales in roubles?
not applicable/selling in...
Decline by more than 20%
Decline by more than 10%
Decline by 5-10%
Decline by 1-5%
No growth
By 1-5%
By 5-10%
By 10-20%
By more than 20%
Sep 2016
0%
20%
40%
60%


Consumer goods:
In your budget for 2017 by how much do you plan to increase top-line sales in FX?
Decline by more than 20%
Decline by more than 10%
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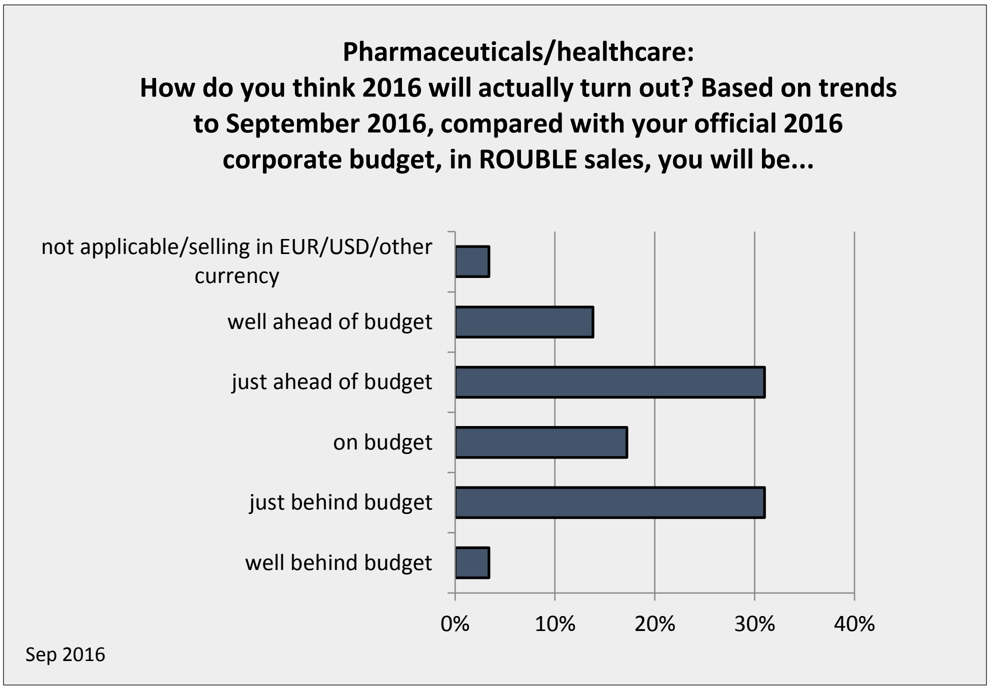
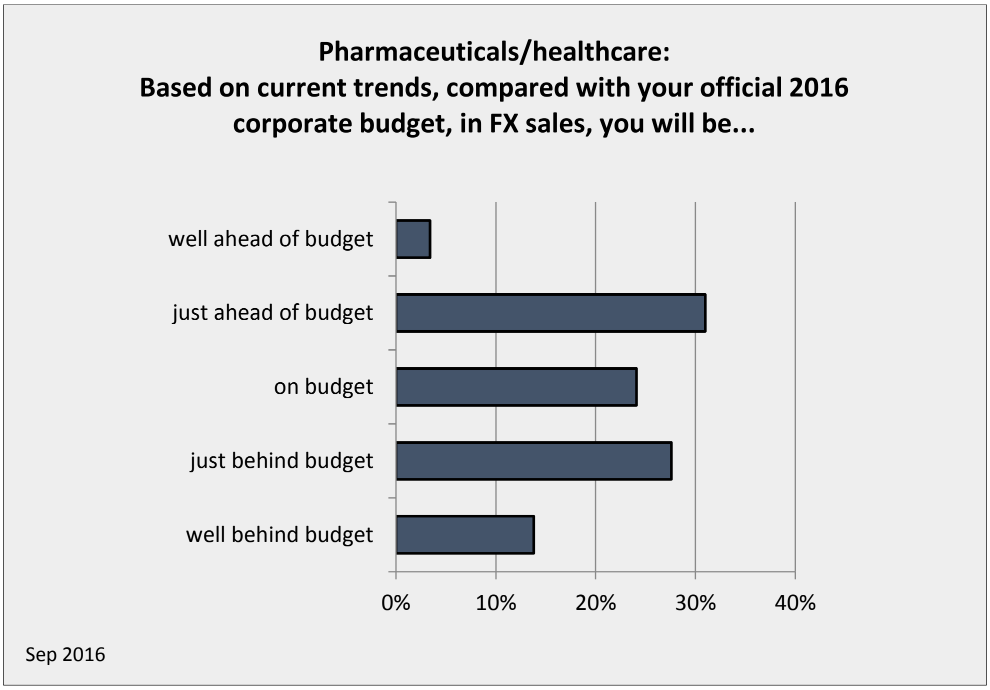
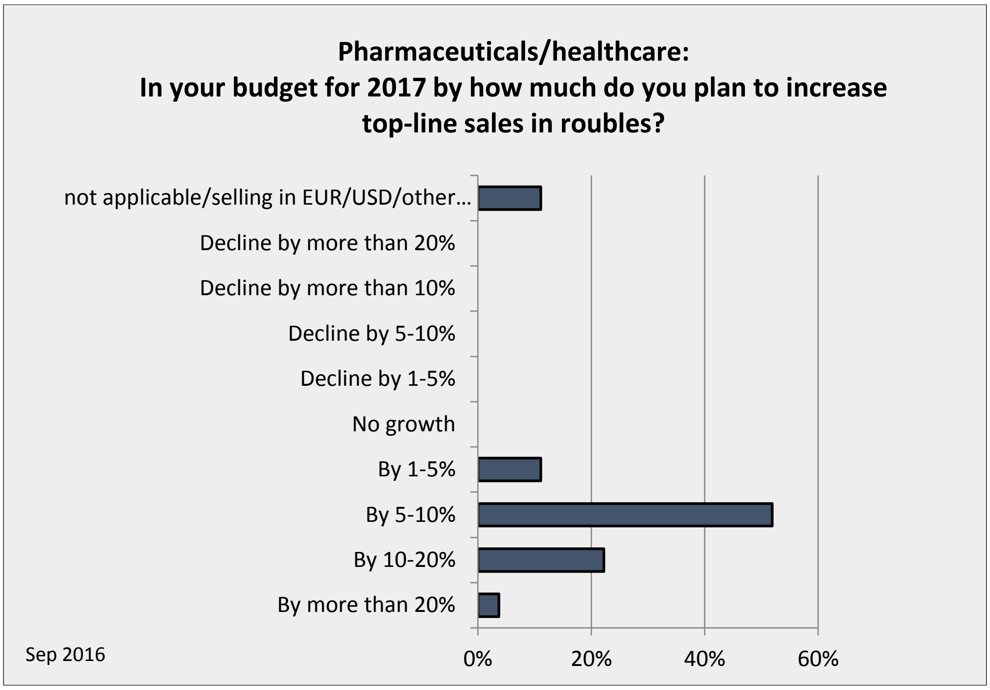
By 1-5%
By 5-10%
By 10-20%
By more than 20%
Sep 2016
0%
20%
40%
60%


Pharmaceuticals/healthcare:
How do you think 2016 will actually turn out? Based on trends to September 2016, compared with your official 2016 corporate budget, in ROUBLE sales, you will be...
not applicable/selling in EUR/USD/other currency
well ahead of budget
just ahead of budget
on budget
just behind budget
well behind budget
0%
10%
20%
30%
40%
Sep 2016


Pharmaceuticals/healthcare:
Based on current trends, compared with your official 2016 corporate budget, in FX sales, you will be...
well ahead of budget
just ahead of budget
on budget
just behind budget
well behind budget
0%
10%
20%
30%
40%
Sep 2016


Pharmaceuticals/healthcare:
In your budget for 2017 by how much do you plan to increase top-line sales in roubles?
not applicable/selling in EUR/USD/other…
Decline by more than 20%
Decline by more than 10%
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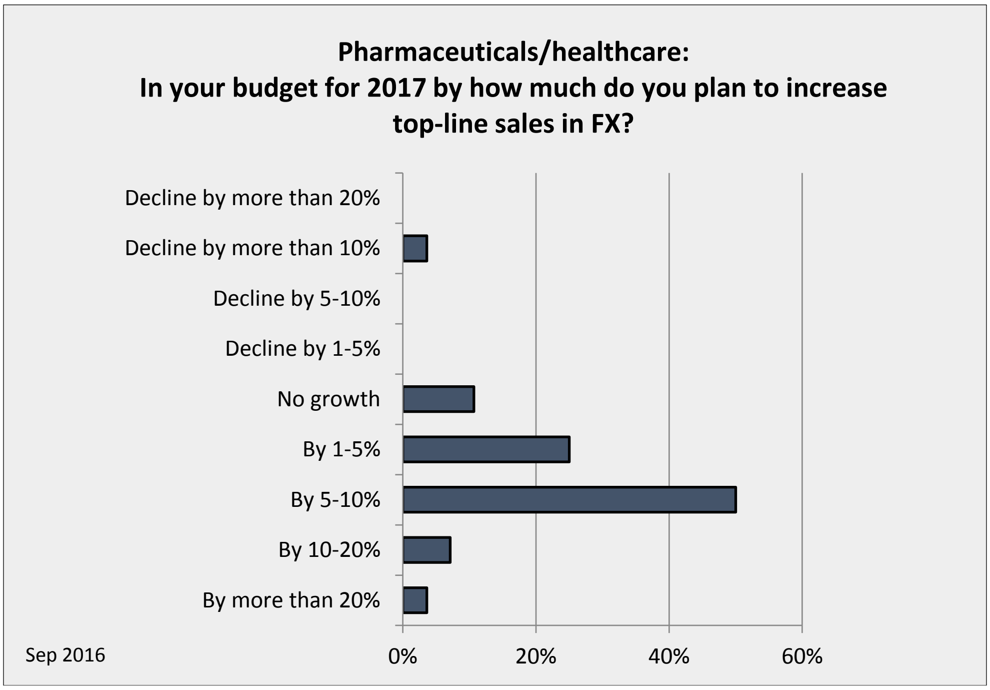
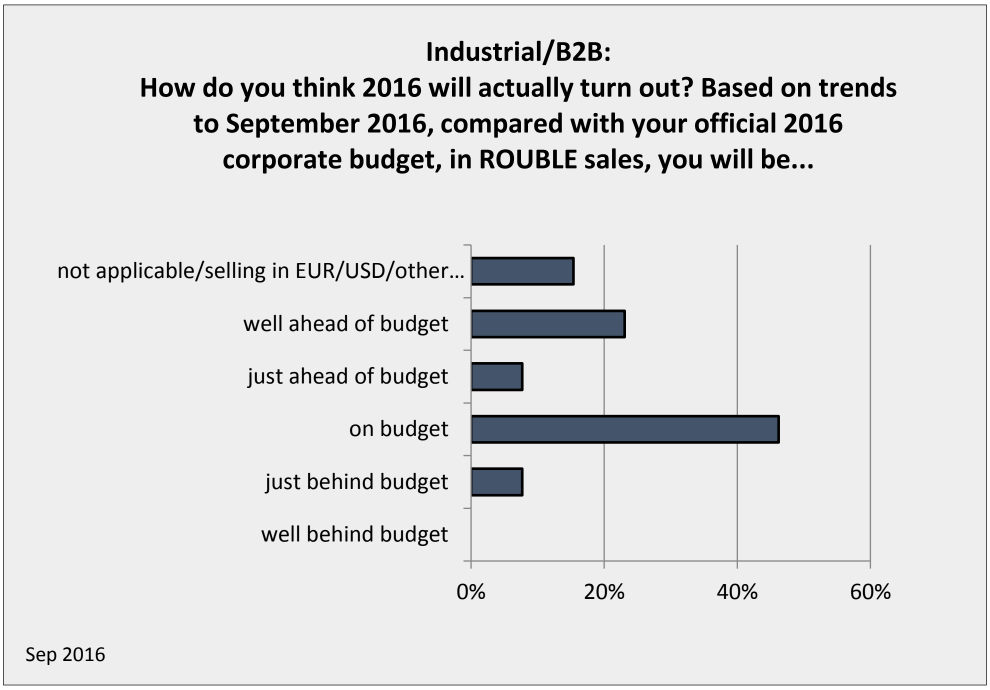
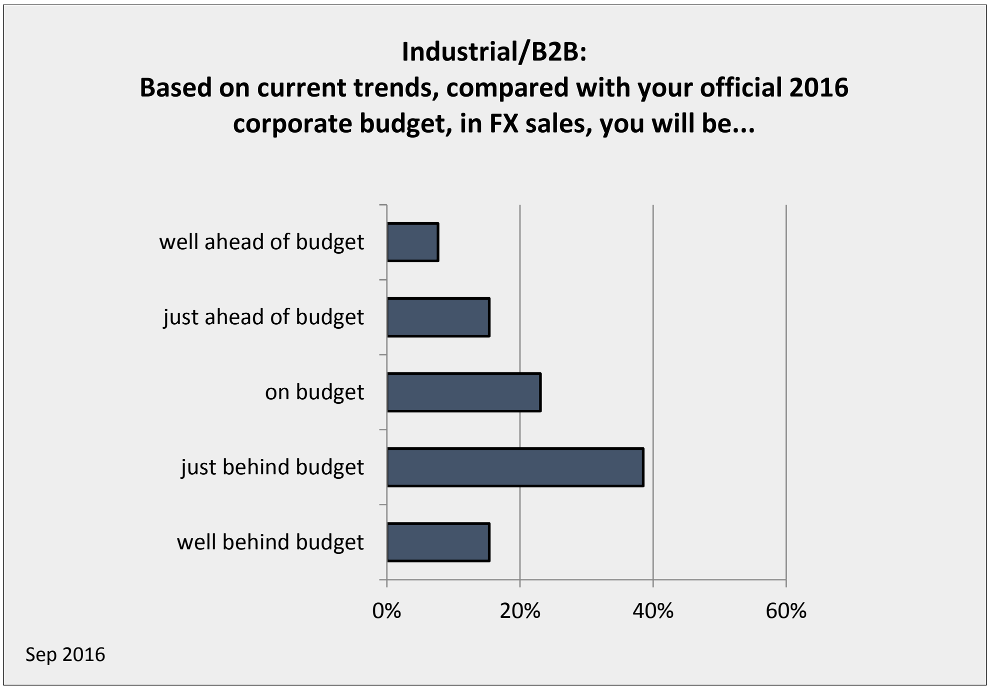
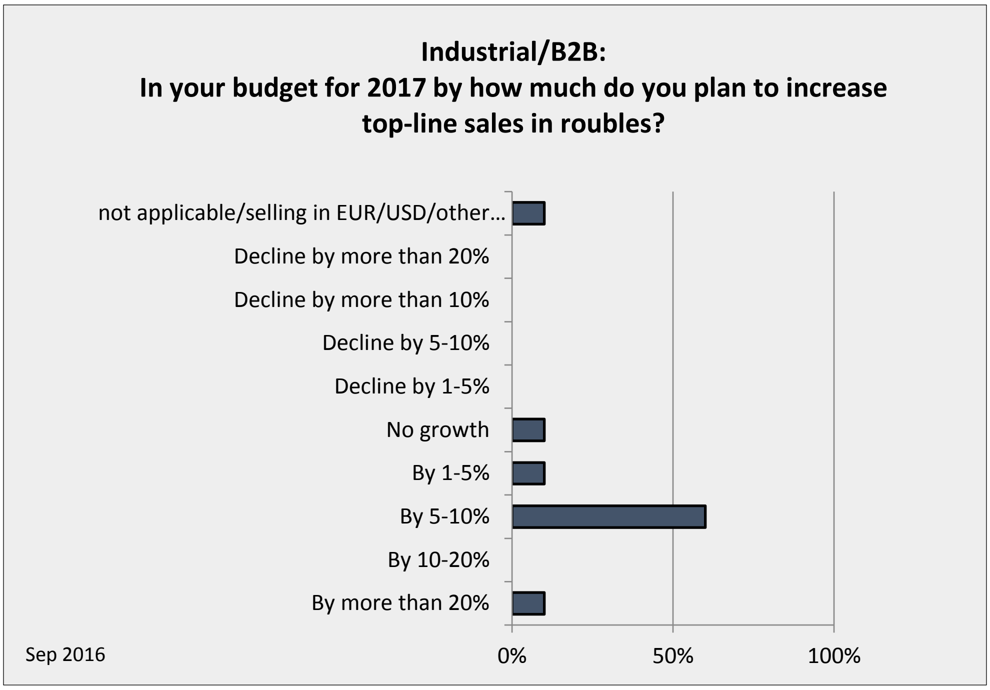
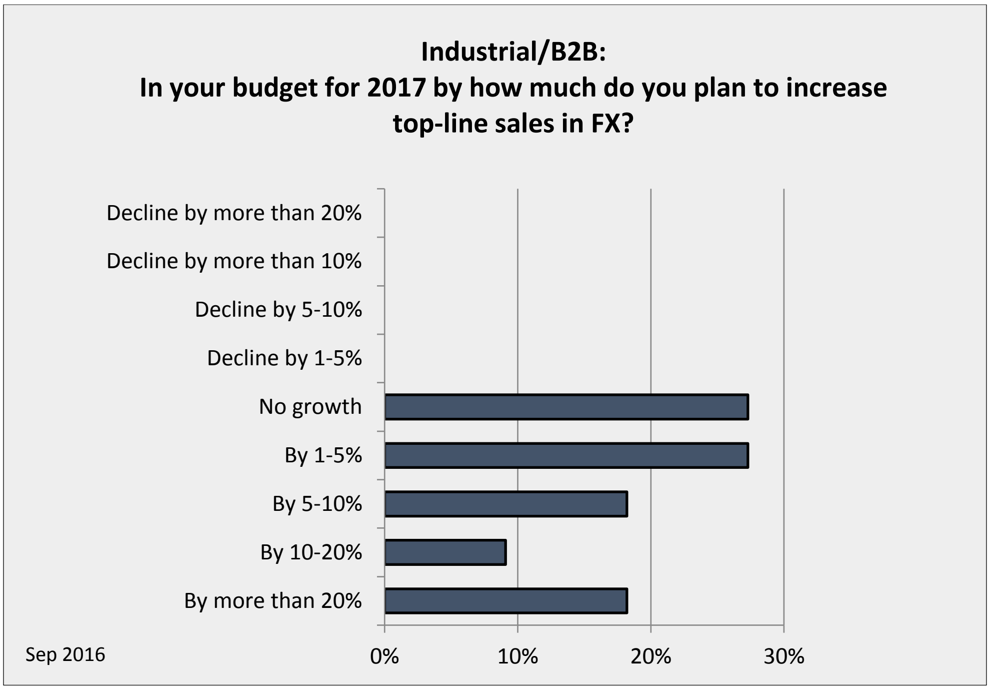
60%


Pharmaceuticals/healthcare:
In your budget for 2017 by how much do you plan to increase top-line sales in FX?
Decline by more than 20%
Decline by more than 10%
Decline by 5-10%
Decline by 1-5%
No growth
By 1-5%
By 5-10%
By 10-20%
By more than 20%
Sep 2016
0%
20%
40%
60%


Industrial/B2B:
How do you think 2016 will actually turn out? Based on trends to September 2016, compared with your official 2016 corporate budget, in ROUBLE sales, you will be...
not applicable/selling in EUR/USD/other...
well ahead of budget
just ahead of budget
on budget
just behind budget
well behind budget
0%
20%
40%
60%
Sep 2016


Industrial/B2B:
Based on current trends, compared with your official 2016 corporate budget, in FX sales, you will be...
well ahead of budget
just ahead of budget
on budget
just behind budget
well behind budget
0%
20%
40%
60%
Sep 2016


Industrial/B2B:
In your budget for 2017 by how much do you plan to increase top-line sales in roubles?
not applicable/selling in EUR/USD/other…
Decline by more than 20%
Decline by more than 10%
Decline by 5-10%
Decline by 1-5%
No growth
By 1-5%
By 5-10%
By 10-20%
By more than 20%
Sep 2016
0%
50%
100%


Industrial/B2B:
In your budget for 2017 by how much do you plan to increase top-line sales in FX?
Decline by more than 20%
Decline by more than 10%
Decline by 5-10%
Decline by 1-5%
No growth
By 1-5%
By 5-10%
By 10-20%
By more than 20%
Sep 2016
0%
10%
20%
30%

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