RCIS RUSSIA-CIS Business Group

DT - Global Business Consulting

Business and Economic Numbers for the 2019 Budget

The 4th report in a budget series of 4

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IN ASSOCIATION WITH:

Contents

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Curriculum Vitae of Dr Daniel Thorniley

Danny Thorniley is President of DT-Global Business Consulting GmbH (a LLC company), Danny's own consultancy company based in Vienna through which he works with some 330 key clients on business strategy in global and emerging markets in 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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Some key assumptions behind the 2019 budget

- We take the view that any new US sanctions in November 2018 and later in 2019 will prove moderate, mild and limited. Our forecast is based on this scenario. BUT there is no guarantee that this will be the case.
- We also share the consensus view that the average price of a barrel of oil in 2019 will average above $70 and maybe as high as $75 in 2019.
- This means that Russian GDP will be 1.8% in 2018 with some slight possible upside and that level will be repeated in 2019 at 1.7%.
- This also means the rouble in 2019 will average 65 to 70 to the dollar and 75 to 80 to the Euro presuming the Euro-dollar rate is about 1.15.
- Inflation will average 4.5% in 2019 and end 2019 at 4.8% with some marginal risk to either side.
- Real wages will moderate in 2019 at 3.0% growth as inflation rises and after a surge +8.5% average in 2018.
- The rise in VAT to 20% and the announcements regarding changes in pensions will weigh down on consumer confidence a bit in 2019 and confidence actually worsened again in Q3 of 2018. This means that in 2019 consumer spending (+2.6%) and retail spending (+2.5%) will be steady at best and a bit down on 2018 trends.
- On a middle scenario for sanctions and oil, economic indicators in 2019 will be moderate or slightly soft but will not damage business too much but equally will not provide any foreseeable boost.
- If consumption moderates in 2019, then there may be some soft boost from government spending. This has been very tight in 2015-16-17 and in 2018. But President Putin announced in the spring general spending plans and since then the ministries have been working on how to achieve this.
- Rather than cut into the budget surplus, the government looks to finance some of the new spending from the VAT increase and the future pension reform but this in turn is hurting confidence, spending and GDP growth.
- The Central Bank raised the key interest rate to 7.5% in September and one more rise of 0.25% could happen before the end of the year if inflation continues to crawl up and the rouble comes under any sustained pressure from sanctions impact.

What are companies planning and budgeting?

Sales and profit results 2018-19:

- Believe it or not, business results out of Russia still rank among some of the best in the world!
- Rouble trends and the various sanctions crisis since April this year have hurt business at the margins and taken some of the shine off.
- Corporate experience is increasingly mixed in Russia depending on business sector and scale of operations.
- 60% of companies forecast rouble sales in 2018 in a range of 5-15% with a big cluster around 7-13%.
- But some of the largest companies tend to be growing in lower single digits rather than 7-13% range.
- 2018 results denominated in FX went backwards this year.
- For example, those companies reporting negative sales in FX has fluctuated like this in recent years: 66% in 2015, 25% in 2016 as the rouble recovered, only 6% in 2017 the year of a very stable rouble, while this deteriorated this year (2018) to 30% as the rouble wobbled again but then executives forecast an improvement in 2019 with just 13% predicting negative FX sales.
- Despite this most executives are budgeting for a mild, sensible recovery in 2019.
- Several companies reported that they entered the April “crisis” 2018 in very good shape.

- 2017 was not bad at all with 67% of respondents reporting very good or decent results and this continued into Q1 of 2018.
- High-single digit rouble sales growth or low double-digit sales growth has been the “name of the game” in Russia for 2017-18 and will be so for 2019.
- 2018 will turn out not so badly with 31% of companies anticipating double-digit rouble sales growth and 27% expecting high single-digits.
- The double-digit number in 2018 of 31% is down on that of 2017 at 40% but is still a good proportion.
- In 2019 some 23% expect double-digit rouble growth, down from 31% in 2018.
- But 63% of companies look to high singles and low double-digit sales growth in 2019 which will be actually UP on the 2018 figure of 58%.
- Yes, 27% of executives predict flat/negative sales growth in roubles in 2018 and this is the worse figure since 2015 but executives expect this to improve and decrease to 16% in 2019.
- Remember that even in the super-good CEE markets, some 10-20% if companies report flat-negative sales.
- Back to Russia, some 68% of companies are on or ahead of their 2018 budget.
- Profits remain comparatively good or better: in 2019 some 5% of companies budget for a strong rise in profits, 42% forecast a steady increase, with 33% expecting stable-good profits, while just 20% forecast a mild decline to reasonable levels and only 1% of companies forecast a profit collapse!
- Consumer products forecast a steady recovery in 2018 with 33% of firms looking to double-digit sales increases and another 30% predicting high singles; for 2019 these figures are 25% and 39% respectively.
- Pharma & medical also look to high-single digit sales in 2018 (27% of respondents) while 28% expect double-digit sales in 2018 (this figure is down from 54% of respondents in spring this year). We thought the spring proportion seemed high/ambitious unless companies were diversified. Still 54% are clustered this year in high singles and low double-digit increases. Executives in this sector expect this cluster to be bigger with 27% looking at double digit growth and a large 40% forecasting high singles digit growth.
- B2B firms are moderating away from double-digit growth expectations: 32% of firms in 2018 and 21% in 2019. But a solid 41% predict high-single digit sales in 2019.

FX rates and FX results:

- Regarding FX rates, the Survey was taken at the tail-end of the August rouble crisis/devaluation.
- Almost two-thirds of executives are using a mid-case range for the rouble in their 2019 budgets which means 65-70 to the dollar and 75-80 to the Euro.
- About 20% of executives budget a weaker range than this while 10% forecast a stronger rouble.
- This “feels” about right for now.
- We have pointed out in other reports and executives are well aware that much depends on the next round of US sanctions scheduled for mid-November. Depending on their severity, the rouble could go either way.
- We presume “rationally” that such US sanctions will not be brutal or comprehensive and that the rouble will remain stable or fall by 3-5% and the counter-balance here could be a strong oil price above $80 depending on sanctions impact on Iran oil exports.
- We noted above how the weaker rouble in 2018 has damaged FX sales: 30% will report such negative sales in 2018, up from a low of 7% in 2017. But the good news is that executives take a mid-case scenario for 2019 and therefore those looking at negative FX sales falls to 13% in 2019.

A special separate point:

- Companies in Russia (and globally) in 2018-19 are coming under more cost pressures from global HQs.

- Global cost cutting measures are being intrigued regardless of Russian business trends.

New investment seems to hold up, surprisingly or not:

- The proportion of companies which plan new investments in manufacturing, logistics and warehousing in 2019, surprisingly or not, sticks at the historical average of 25%: this is a very strong number given the circumstances. This may decline at the margins as a follow through consequence of sanctions and the rouble.
- It may prove harder to make acquisitions in Russian or to build large-scale greenfield sites.

HR, staff and talent issues:

- After some roller-coaster years, there is a sense of some normalisation in Russian HR trends: behaviour, attitudes and money.
- Average salary increases for average white-collar staff were stuck at 7% (in fact a range of 6-9%) in 2015-17.
- As we expected, with average inflation trending at about 3.6% in 2018 (lower at the start of the year), companies offered increases around inflation in 2018 (26% at inflation and 51% just above inflation and 15% a bit below inflation or no increases at all).
- This trend will be maintained in 2019 with 39% at inflation and 48% just a little above inflation and 5% a bit below. Few companies plan well above inflation (7%) or well below inflation (2%).
- Few companies plan any extensive staff cuts: 72% plan none at all in 2019 and the rest will be cuts below 5-7% of total staff.
- **To stay closer to inflation, companies will need to tweak up absolute amounts of pay increases in 2019 but only by a small amount.**

<u>Overall, the clear conclusion for now remains as in previous years: companies are trying hard to protect their headcount (but accept churn) but are determined to manage their costs and will keep salary increases closer to inflation.</u>

Operational issues:

- Companies are interested in e-commerce but not quite pouring into it (21% plan a sizeable initiative and 38% prepare for a moderate investment).
- Relations with distributors are stable but companies monitor increasing risk.
- The receivables current status and outlook looks good or very good (only 16% predict a slight deterioration).
- Price increases in 2018 were very limited with low inflation and a strong rouble for the first months.
- But expected increases in 2019 are moderate: 16% plan no price rise at all, 41% will limit this to a 1-5% increase with 31% in a range of 5-10% increases; only 12% of respondents plan price increases above 10%.
- Of course, if the rouble were to fall much more, then price increases would follow.
- But it remains to be seen just how much the Russian consumer can absorb.
- CIS markets have been stable/not bad in 2017 and 2018 and this is expected to continue in 2019 with decent sales growing in a range of 5-15% for 60% of respondent companies.
- Almost 70% of executives except their CIS markets to be neutral on the Russian business but 31% think that the CIS markets will make appositive contribution to the Russian business.
- The Russian market still represents 85-90% of total CIS sales for most manufacturing companies, excluding oil and gas.

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Organic sales growth in roubles, 2018 and 2019

Sales growth in roubles, 2018 and 2019

	All Companies			Consumer Prod.			Pharma/Health			B2B/Industrial		
	2018	2019	Δ	2018	2019	Δ	2018	2019	Δ	2018	2019	Δ
Growth of 20%+	10	3	-8	7	0	-7	0	0	0	15	5	-10
Growth of 10-20%	21	21	0	26	25	-1	27	27	0	17	16	0
Growth of 5-10%	27	40	13	30	39	8	27	40	13	24	41	17
Growth of 1-5%	15	21	6	12	27	16	33	27	-7	12	15	3
Flat-zero	7	11	4	7	7	0	7	0	-7	8	16	9
Decline of 1-5%	6	2	-5	9	2	-7	0	7	7	6	0	-6
Decline of 5-10%	8	3	-6	7	0	-7	0	0	0	11	5	-6
Decline of 10-20%	2	1	-2	0	0	0	7	0	-7	3	2	-1
Decline of 20%+	3	0	-3	2	0	-2	0	0	0	5	0	-5

Source: DT-Global Business Consulting, Russia-CIS Business Group Survey. September 2018. Number of responses, in %.

- Consumer product companies have had a bumpy period with 37% reporting flat or negative rouble sales in 2017. While the beginning of 2018 showed some improvement for most in the industry with only 7% reporting flat or negative sales growth, the numbers have declined over the year and now 26% report flat or negative growth. For the 2019 budget, most companies are optimistic and cluster around the single-digit growth region (66%) and some expect double-digit growth (25%).
- For pharma/healthcare, the very good results from 2017 seem to continue into 2018 and more than 87% of them report growth in sales while only 7% report flat and another 6-7% declining sales growth. For the budget 2019, 40% are in the growth range of 5-10% and a third (27%) expect to do better with 10-20% sales growth.
- B2B companies appear to have had a tougher start into 2018 than some expected and cannot fully meet their sales growth targets. Purely in terms of double-digit growth, 55% reported such in 2017, budgeted more conservatively for 2018 (38%), and now double-digit growth is a little lower than budgeted (32%). But given that expectations for 2018 were already curbed during budget season last year we do not expect big consequences out of this and the majority of the industry is seeing growth.
- For 2019 expectations are curbed and some 16% budget for flat sales growth. Still, 56% for single-digit growth and only 21% for double-digit growth.

FX sales outlook 2018 and 2019 by sectors

Sales growth in FX, 2018 and 2019

	All Companies			Consumer Products			Pharma/Health			B2B/Industrial		
	2018	2019	Δ	2018	2019	Δ	2018	2019	Δ	2018	2019	Δ
Growth of 20%+	4	2	-2	0	0	0	0	0	0	8	3	-5
Growth of 10-20%	7	10	3	7	10	3	7	23	16	6	7	0
Growth of 5-10%	22	26	4	20	18	-2	36	38	3	20	30	9
Growth of 1-5%	26	28	2	34	35	1	7	15	8	25	26	1
Flat-zero	11	21	10	7	25	18	36	8	-28	8	21	14
Decline of 1-5%	8	9	0	15	13	-2	0	15	15	6	5	-1
Decline of 5-10%	16	4	-12	10	0	-10	7	0	-7	22	7	-15
Decline of 10-20%	3	1	-2	5	0	-5	0	0	0	2	2	0
Decline of 20%+	3	0	-3	2	0	-2	7	0	-7	3	0	-3

Source: DT-Global Business Consulting, Russia-CIS Business Group Survey. September 2018. Number of responses, in %.

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- The weaker rouble in 2018 has damaged FX sales: 30% will report such negative sales in 2018, up from a low of 7% in 2017. But the good news is that executives take a mid-case scenario for 2019 and therefore those looking at negative FX sales falls to 13% in 2019.
- For consumer products companies in 2018, 32% had a decline in FX sales. For the 2019 the number went down to 13%; nonetheless, 25% expect flat growth.
- The pharmaceutical industry faced a similar picture with 50% of companies reporting flat or declining FX sales for 2018, while for the 2019 budget only 23% expect this to happen.
- For the B2B companies, 41% were with flat or declining FX growth in 2018 and a third (34%) expect this to continue in 2019.

HR, staff and talent issues 2018-19

- After some roller-coaster years, there is a sense of some normalisation in Russian HR trends: behaviour, attitudes and money.
- Average salary increases for average white-collar staff were stuck at 7% (in fact a range of 6-9%) in 2015-17.
- These numbers reflected very closely what was happening in the overall economy with government salaries and those in Russian corporates.
- As we expected, with average inflation trending at about 3.4% in 2018 (lower at the start of the year), companies offered increases around inflation in 2018 (26% at inflation and 51% just above inflation and 15% a bit below inflation or no increases at all).
- This trend will be maintained in 2019 with 39% at inflation and 48% just a little above inflation and 5% a bit below. Few companies plan well above inflation (7%) or well below inflation (2%).
- Pay increases also vary across jobs and sectors: oil and gas pay the highest rates along with e-commerce, pharma tends to pay higher than the above averages and retail and FMCG are at the lower end; many big Russian companies are also very selective about pay increases now.
- Few companies plan any extensive staff cuts: 72% plan none at all in 2019 and the rest will be cuts below 5-7% of total staff.
- **To stay closer to inflation, companies will need to tweak up absolute amounts of pay increases in 2019 but only by a small amount.**

Economic backdrop to the 2019 budget

Central Scenario - 2019 economic outlook (oil averages USD 68-75)	
GDP	1.7%
Inflation (year-end)	4.8%
Inflation (average)	4.5%
Consumer spending	2.6%
Investment	3.0%
Industrial output	2.0%
Rouble to USD (average)	65-70
Rouble to EUR (average)	75-80

Inflation outlook	2017	2018	2019
Average annual inflation	3.7	3.4	4.5
Year-end inflation	2.5	3.7	4.8

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Russia - Macroeconomic Data

Category	Indicator	2012	2013	2014	2015	2016	2017	2018F	2019F	2020F	2021F	2022F
Country	GDP	3.4	1.3	0.6	-2.8	-0.2	1.5	1.8	1.7	1.9	2.0	2.1
	Inflation (year-end)	6.6	6.5	11.4	12.9	5.4	2.5	3.7	4.8	4.3	4.4	4.5
	Budget balance (% of GDP)	0.0	-0.5	-0.5	-3.5	-3.7	-1.5	0.3	0.6	0.0	-0.4	-0.4
	Current-account (% of GDP)	3.6	1.6	2.7	5.0	2.0	2.8	2.8	2.8	2.2	2.0	1.5
FX	FX reserves (USD Bil.)	528	509	385	370	377	431	470	480	495	515	530
	Rouble/USD (year-end)	30.4	32.9	58.0	73.0	61.1	57.8	66.0	67.0	68.5	69.0	70.0
	Rouble/EUR (year-end)	40.1	45.1	72.0	78.0	64.0	67.0	76.0	77.0	78.5	80.0	82.0
Industry/ Consumer	Retail sales	5.7	3.9	2.5	-9.8	-3.5	1.5	2.7	2.5	3.0	2.8	2.9
	Household spending	7.9	4.7	1.8	-8.5	-2.6	3.3	3.3	2.6	3.0	2.8	3.2
	Real wages	8.2	5.2	1.9	-9.5	1.5	3.4	8.5	3.0	3.0	2.9	3.0
	Disposable income	3.7	3.3	2.1	-4.0	-5.2	-1.0	2.2	2.4	2.5	2.4	2.4
	Unemployment rate	5.3	5.5	5.3	5.4	5.8	5.2	4.9	5.0	5.1	5.1	5.1
	Gross fixed investment	6.0	-0.3	-4.8	-7.6	-2.7	4.4	3.4	3.0	3.3	3.2	3.1
	Industrial output	2.6	0.3	1.7	-3.4	1.1	1.3	2.5	2.0	2.4	2.8	2.9

Please note: real annual change in % unless otherwise stated

Key statistics by Year and Monthly

		2017												2018								
Category	Indicator	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep
Country	Inflation (end of period)	5.0	4.6	4.3	4.1	4.1	4.4	3.9	3.3	3.0	2.7	2.5	2.5	2.2	2.2	2.4	2.4	2.4	2.3	3.1	3.1	3.4
	Budget balance (% of GDP)	-3.9	-3.5	-3.1	-2.8	-2.4	-2.3	-2.2	-2.0	-1.9	-1.2	-1.3	-1.4	-1.3	-1.1	-0.9	-1.3	0.3	0.1	0.5	1.1	1.5
Industry/ Consumer	Retail sales	-2.3	-2.6	-0.4	0.0	0.7	1.2	1.0	1.9	3.1	3.0	2.7	3.1	2.8	1.8	2.0	2.4	2.4	3.0	2.5	2.8	2.3
	Real wages	3.1	1.0	1.5	2.5	2.8	3.9	4.6	3.7	2.6	4.3	5.4	4.6	11.3	9.7	8.7	7.8	7.1	7.2	8.0	7.0	7.2
	Disposable income	8.1	-4.1	-2.5	-7.6	-0.1	0.0	-0.9	-0.3	-0.3	-1.3	-0.3	1.8	0.0	4.4	4.1	5.7	0.3	0.2	2.0	-0.9	n/a
	Unemployment	5.6	5.6	5.4	5.3	5.2	5.1	5.1	4.9	5.0	5.1	5.1	5.1	5.2	5.0	5.0	4.9	4.7	4.7	4.7	4.6	4.5
	Gross fixed investment	-0.9	-0.9	-0.9	2.3	2.3	2.3	4.8	4.8	4.8	4.2	3.5	3.5	3.5	3.5	3.5	2.2	3.7	2.8	2.6	2.6	2.6
	Industrial output	2.3	-2.7	0.8	2.3	5.6	3.5	1.1	1.5	0.9	0.0	-3.6	-1.5	2.9	1.5	1.0	1.3	3.7	2.2	3.9	2.7	2.1

Please note: real annual change in % unless otherwise stated

As ever, I hope this report proves helpful for you in creating your budget/business plan for 2019. If you have any comment or queries, do get in touch danielthorniley@dt-gbc.com.

19 October 2018

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