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Russia Business Gossip and the Economic Outlook

Contradictions: good news and bad news

by Dr. Daniel Thorniley
President, DT-Global Business Consulting
danielthorniley@dt-gbc.com

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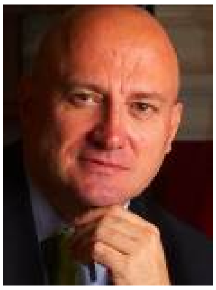
Contact: Dr Daniel Thorniley, President, DT Global Business Consulting GmbH
E: danielthorniley@dt-gbc.com / www.ceemeabusinessgroup.com

About the author



Dr Daniel Thorniley

danielthorniley@dt-gbc.com

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

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

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

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

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

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

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

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

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

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

Executive summary - business

See our appendix below of 25 key business issues but some most recent comments and thoughts include:

- Clearly, most companies are pleasantly satisfied that the rouble had strengthened and that the worst aspects of crisis seem to be behind us… for now.
- But no one is being naïve and few companies are yet wiling to ratchet up forecasts and budgets for this year. Better result will need to prove more sustainable before companies take the route of upward reforecasting.
- Also in recent days in Moscow it became more clear to me that some companies and sectors are still struggling badly and will need 6-15 months to recover.
- The automotive sector and suppliers into it remain extremely strained and car registrations are slumping further this year; some truck producers are down -70%.
- The IT sector is also very tough with sales especially to federal government and major private-state companies being cut back by 25-65%.
- Some specific western companies seem to be suffering from de facto “black-listing”.
- Several western FMCG companies reported a reasonably good first quarter but with some softening in April and May.
- This summer softening was expected by some senior managers but more recently the expectation is that any deterioration this summer will now be less deep than anticipated at the start of the year i.e. the summer will be disappointing but not that bad; views differ on this and see below.
- As we have long known, the pharmaceutical and health sectors perform relatively best while consumer product companies report more mixed results with downtrading and major shifts required in marketing, pricing and route to market.
- But it is the B2B sector which has generally suffered most from a long cyclical decline in industrial output, export and investment spending which has bene exacerbated by a general overall collapse in government spending and cuts in budgets by the major economic players such as Gazprom; tight financing and the indirect impact of sanctions have added to the pain.
- One managing director of a European engineering company is “trying to hide my Russian results among all my European markets”. Trying to hide Russia is not the same has concealing Slovenia!
- A noticeable handful of companies report that they were close to total collapse and closure in February and several have since recovered; but several others remain extremely stressed especially in the heavy equipment sector and construction as well as in automotive and IT.
- Executives report that some US/European suppliers have been formally/informally black-listed by government agencies who have also advised major Russian companies to cut spending with these designated suppliers.
- Such “black listed” companies report sales to the Russian government and to major Russian customers down by -70 to -80%.

Executive summary - economic

- The rouble is better than the economy and the currency feels slightly overvalued; “a fair value” would probably be around 55 to the US dollar with the oil price at $58-64 per barrel.
- First quarter economic results were not good and April came in weak as well (see below).
- But on the positive side we are tweaking our 2015 GDP estimate for this year slightly to the better at -3.8% (from -4.1%) while the consensus in the last three months has improved from -4.3% to -3.6%.
- The Russian Central bank predicts GDP growth at -3.5% to -4% while the government is more upbeat at -2.8%.
- This contradiction of poor results and a GDP upgrade is explained by the fact that the first quarter GDP result was actually better than weak expectations and came in at -1.9% compared with the same quarter in 2014.
- Other supportive factors include the stronger rouble, inflation which seems to have peaked in March and is now slowly decelerating, falling interest rates, some better liquidity, better asset prices and falling bond yields.

- The GDP slump will not be as bad as in 1998 or in 2009 as the rouble has acted as a shock absorber but on the downside we do not envisage any solid and quick bounce-back after this crisis has occurred similar to 1998 and 2009. The medium-term GDP growth outlook is sober at an average of 2.5% to 3.0% over the next 5-7 years with lower numbers in 2015-16 of course.
- There is still a lot of bad news out there now and in the short-term.
- Real wages were slumbering in April at -13.2%, the worst number since 1998.
- Consumer confidence at -32 is the third worst figure reported in 20 years.
- Inflation at around 16%+ is still the highest in 16 years.
- Retail sales at -13.2% are the worst in 20 years.
- New car registrations continue to struggle: monthly levels were about 220,000 in 2011 but were down to an average of 180,000 in 2014 and have averaged the first 4 months of his year at 130,000: so minus -30% on a weak 2014.
- It will need some time to recover from these lows but it is difficult to gauge the timing of when the Russian consumer could start to recover on the back of a stronger rouble and declining inflation.
- Soft nominal wages will still mean that consumers are strained even when inflation comes down to "just" 10%.
- There are some contradictory figures for example, industrial output slumped badly in April (-4.5%) while the Purchasing Managers' Index climbed from 48.1 in March to 48.9 in April and business confidence actually ticked up from -6 to -5 in April.
- Industry is probably down this spring as defence spending and procurement may have slowed after a flurry of military expenditure at the start of the year.
- PMI figures do not include defence procurement while figures for industrial output do so.
- We should not forget that any PMI figure below 50 indicates recession and PMI figures in CEE markets such as Poland and Hungary are in comparison surging at very strong levels of 55 to 56.
- Inflation probably reached its peak this year in March at 16.9%. We expect inflation in December to be around 11% and thus to average about 13% for 2015; average inflation next year will be about 9% on a declining trend and by December 2016 inflation ought to be 7.5%.
- The rouble is the strongest currency in the world in 2015 after being the second weakest in the world in 2014! We have published a report with 10-12 reasons why this is so and see appendix below.
- But the rouble looks a bit over-appreciated at the moment and "a fair price" is probably about 55 to the US dollar rather than the current 50. Please note that the Russian Central Bank has been selling roubles in recent weeks to stop the rouble strengthening much below 50 to the dollar. Quite a crazy world!
- We presume relative rouble stability in the next 12-15 months with some possible softening to 55 to the dollar and 58-60 to the Euro; in the medium-term continued shale energy production ought to prevent any sustained rise in oil prices and thus we see the rouble less volatile but always under some soft downward pressure in the medium term.

Introduction

1. There are contradictory movements going on with key economic indicators. This is confusing but there are explanations. The first quarter GDP result was better than expected but the March-April figures were generally disappointing: industry slumped badly in April and many consumer sector indicators were bleak again such as disposable income, real wages and retail sales. Industry and investment numbers remain very poor and have been on a downward trend since January 2013 (preceding the Crimean crisis by 14 months). On the other hand inflation seems to have peaked at 16.9% in March and dipped to 16.4% in April.

2. These contradictory figures are reflected in western business results and western executive expectations for the coming 3-4 months through to the autumn. Anecdotally it seems that 30-40% of executives are anticipating some improvement in business over the next 3-4 months but equally 40-60% of mangers are less upbeat and believe the next few months will remain tough and perhaps even worse than the first quarter.

The BIG question is: how will the Russian consumer behave over the next few months? There are at least two possible scenarios:

a) She/he will decide that with the rouble strengthening she/he is feeling much better; there is light at the end of the tunnel with inflation having reached its peak in March and with interest rates coming down; government announcements that "the crisis is over" are taken at face value and consumers dig even deeper into savings and continue spending reasonably well.

Rouble and inflation trends makes consumer reassured and willing to spend.

b) The Russian consumer takes an alternative and more negative approach: disposable income and real wages have collapsed and will take several months to be restored; consumer credit, even if it is wanted, is not available and while unemployment is not leaping up, consumers remain worried about the job outlook as some big Russian organisations take an axe to headcount. As a result the Russian consumer cuts back sharply from current spending levels.

Real wages, incomes, business trends and confidence makes the consumer hold back.

And what is most likely to happen? Well, perhaps to some extent the above factors will cancel each other out but consumer-related economic numbers are bad and the Russian consumer would have to show her/his extreme resilience to come out spending through the summer this year. We anticipate a muddle through scenario for the summer with neither a sustained recovery nor a deep crash.

3. Business results so far this year range wildly across sectors. Just last week in Moscow one executive form a US industrial conglomerate reported that sales were up so far by -25% in US dollars while another executive in the automotive sector reported that sales were down minus -50% in dollars. Even within the industrial B2B sector there are wide shifts and divergent trends: automotive and several parts of the IT industry are suffering badly from tight financing, weak government spending and falling confidence and investment and the indirect consequences of sanctions.

Key, basic factors

It goes without saying, and every executive knows this, that the BIG-3 factors on which much else depends for the current stabilisation to stay in place are:

1) The oil price needs to stay in a range of $53 to 63 per barrel over the next 9-15 months and the current consensus is for about $60-62 which would assist the Russian outlook.
2) The situation in eastern Ukraine must continue to be "perceived" as stable by the western media and western authorities. This seems possible and is probably 60-40 on the positive side. We stress that perceptions are what count and not actually the reality on the ground.
3) Western sanctions must not be intensified and this looks 80-20 probability at the moment.

And those sanctions?

However, regarding sanctions, we now expect that European ones may be reduced or rescinded in early 2016 (50-50 chance) but US ones will remain in place for the long-term (2-4 years or longer) as any future Republican Congress will not vote to rescind them and the next US President, whoever she may be (☺), will not take on a Republican Congress to assist Russia. Any democratic president would have 50 other priorities over which to battle with Congress and any republican president wouldn't even contemplate sanctions removal. So, we need to get accustomed to this new normal.

And a possible central scenario

I apologise for repetition but I underline again one possible central/best-case scenario for business:

Our monthly Survey shows that many companies across many sectors are aiming to increase sales in roubles this year by 6-8-12% so let's say an average of 10% (excluding the tough sectors we refer to in this paper). If the rouble were to collapse 40% this year, then such rouble sales figure would be very poor when reported in FX. But if the rouble remains stable this year and retains its current elevated levels or even returns to 55 to the dollar, then almost automatically 10% sales growth in roubles translates to 10% sales growth in FX. Even if we tweak this down to 7-8%, such top-line sales results compare well with any market in the world today. And when we add reasonable profitability in the market plus the relative volume of sales, this means the Russian market has the potential to be a moderately decent one this year. We repeat: we are neither naïve or overly-optimistic about this scenario and appreciate all the business challenges faced by all companies and the strained environment for many companies in certain sectors.

Key business factors include

(These are worth repeating here even though we have analysed them frequently before).

- Localisation is key for many companies: FMCG, retailers, food & beverages are often aiming to expand on the ground; pharmaceutical companies are accelerating plans due to legal changes in January 2016.
- Sourcing patterns have and are changing: companies are trying to source less from their regular western/US suppliers and looking more at “non-sanctioning states” to improve their image with the Russian government and simply to get cheaper inputs.
- Diversification, when possible, is proving beneficial to many so-called conglomerates. But all companies are judging what their best products are: currently some companies are diversifying away from juices and focussing more on chips/crisps which seem to be the current comfort food for stressed Russian consumers!
- Key business debates revolve round brand or value. A growing number of senior managers feel that they now need to focus on affordable innovation and that most future growth will come from the value range, cheaper/discounted products and services; companies are also spending more time reviewing the mid-price and mid-brand sector which in Russia, and many other markets, has often been ignored or down-played.
- Perhaps the other big business debate is: volume or price and how to drive growth.
- Finally all knowledgeable managers appreciate that the name of the game is market share.

Business Gossip: what are senior executives thinking and doing?

Many of the following comments emanate from a working dinner held last week in Moscow for senior managers from the B2B sector as well as many one to one conversations in Moscow in the last two weeks. While many of these remarks were made in public, as a professional courtesy I will continue my practice of never naming companies or individual executives.

I knew very well indeed that parts of the B2B sector were struggling badly but comments and feedback last week were nonetheless sober and thought-provoking. While several factors are improving and many executives do see signs of first improvement, there are notably sectors which are under extreme strain which will not evaporate for another 6-15 months.

First, some good stories

Business results even within the B2B sector are swinging between extremes: last week the MD of one US conglomerate reported that thanks to supplying into 4-6 industrial/consumer sectors “our business is able to continue its strong growth from last October and we are currently up by +25% in dollars and in volume”. Interestingly to continue this business momentum, this executive needs more headcount but commented that:

> I want to hire 25-30 people at the moment but we are facing real challenges and cannot find the people we want. We are aiming to expand more in the regions and are finding real headaches to get people there.

This comment fits in with overall perceptions that at least getting top-talent is not so easy at the moment and the current crisis has not entailed “a flood of Russians on the job market willing to take anything at any wages”: far from it.

The managing director of a European engineering company supplying the electricity/energy sector echoed this:

> We are also growing 15-20% and financing is possible but by no means easy. I think our business is becoming much more complex and differentiated and we have to spend much more time on operational business and liaison with customers. It takes more time to make the money now! We are also hiring a lot of people.

And a senior director operating in the real estate sector also spoke of a “steady business improvement”. He did caution that of course there is no room for naïve optimism but that:

> Financing was extremely tight or impossible at the turn of the year but with interest rates coming down (but still high) we are starting to see projects being revived and clients approach us asking about business. This was certainly not the case 3-4 months ago.

But some companies were/are close to the edge

Conversely the regional managing director of one German equipment company commented that:

> Our business started to turn downwards last autumn and it has gotten much worse since then and we are down in dollars -30%. Staying close to the supply-chain is proving harder and we are getting hit on profitability and margins as we adjust our invoicing, currency usage and terms.

This executive did go on to say that perhaps some of the problem lay within his own company which had perhaps failed to supply enough liquidity to distributors and he was reviewing different options.

> Other companies are also facing tough challenges. The MD of one western truck supplier said that his company is reflecting the market: “We are down -70% and that is par for the course at the moment”. Car and truck registrations overall are currently at their weakest level for years and consumers are downtrading which invariably hurts the better brand western cars and trucks.

Business was quite recently very bleak: two executives, one from industrial-durables and one from the automation sector both alluded last week in Moscow that:

> In February we were close to the brink. We had experienced several months of deep cuts in the business and the FX rate was killing us. In mid-February I could readily envisage a scenario of our business collapsing totally with us closing the country operation or essentially freezing it for 12-18 months.

The MD for an industrial durables noted:

> Since mid-February we have seen a good rebound. Now we are surviving but it will still remain very hard this year. Some sub-sectors are down -35% to -50% but given the spread of our sales, I think if the current trend continues, then we will grow this year by about 4-5%. Being so close to a total implosion shocked me and I have been working in Russia for more than 20 years. It sent a cold chill down my spine and that was only 12 weeks ago!

The strains and volatility of the market are well reflected in these above comments: from a possible closure of the business in February to perhaps 8% growth for the year with everything “still to play for”.

But not all companies are “out of the woods” yet. One German heavy equipment company reports sales down by -70%+. The MD notes:

> We are almost dead. Our momentum is keeping us alive and it means we can probably hold on for another 6-9 months. But if fundamental improvements do not take place in that time-frame, then we die and will have to close most of the business and leave a plaque on the wall.

Another European company supplying to the construction sector is also struggling badly and perhaps doing itself some self-inflicted damage. This company was performing exceedingly well just 18 months ago and perhaps the business in Russia suffered from hugely elevated expectations and global management were unwilling to accept cuts in sales and profits. Comments made to me suggest that the company may have turned too brutal on its distributors and been unwilling to share some of the pain with local partners. The company also engaged in some extreme overall cost cuts to staff, marketing and channels. Overall in addition to everything else, the company has started to lose market share at excessively fast levels and seems caught in a downward spiral of cuts, lost customers leading to more cuts.

We have often underlined how the automotive/truck sector is under severe strain and this was reflected in several remarks last week in Moscow. The MD of one major car producer reported that “We are down -50% this year after -55% last year. We had good years in the past but heavens, we are paying for it now. Those producers who can offer anything affordable are in a better position but it is hard even for them with less demand and cheaper competition.

> The MD of a major truck supplier commented that, “20 months ago we were looking at selling 7,000 units but this year I doubt we will manage even 950 units”. Tough times indeed.

Conversation with a managing director in the engineering sector:

Last week I was lucky enough to have coffee with a managing director with wide experience of the market who shared many genuinely interesting insights. This is a summary of the conversation which is printed with his agreement on the basis on non-attribution.

“We too were struggling very badly in February and things looked bleak and I started to think that our business could implode. But we picked up a large state contract at the start of the year and since then the overall business environment has also improved: confidence, currency and financing. While some of my sectors were and are still down by -50% to -30%, I think if current trends persist and thanks to some big individual contracts and some sectors performing quite well, then for the whole year we could grow sales by about 8%”.

“We, like many other companies in our sector and related ones, are examining localisation: this will help us with the Russian government, with our distributors and with pricing. For this we are researching what is the market for automation, for engines, for control systems, and what market share do we have already?” The executive went on to say that “the government has set up working groups to measure mathematically the levels and degrees of localisation and what is really means: it’s no longer enough to stick on a metal label on the engine in Russia”.

“We are sourcing more form China and Asia now. This means the quality is lower and we have to put that into our business equation and explain this to customers. But of course another advantage to us is the price: we are trying to protect our margins so cheaper inputs suit me fine. This fits in well with trends among customers. For example mining and metallurgy customers are not so much affected by sanctions and they are not particularly anti-western but increasingly and invariably these customers make their purchasing decisions on price. This is certainly the case when it comes to single products, then price is everything. If we are bidding for an overall project, we are able to inject some quality arguments into the price discussion”.

“With us facing stiff competition from Russian and Chinese suppliers, we have to lower our prices and sell more affordable products and this ultimately means lower profits and this has to be explained to global headquarters”.

This executive and several others commented that Gazprom has certainly trimmed its budget but is also looking at replacing western suppliers with others: in descending order they prefer Russian companies, Chinese ones, Asian ones, non-sanctioning countries, sanctioned countries and black-listed companies. Some companies as a result have seen their sales collapse by minus 50% to 85%. Some companies report that sales to

Rosneft are holding up better as this company sometimes chooses quality over price and nationality of provider when it wants good quality inputs for a project.

And finally when it comes to HR issues, this executive finds himself very much in the general ball-park for salary increases currently: "For our sales staff salary increases are now just 6% but we do have a bonus structure and this is the best way to incentivise sales forces at the moment: a large base salary with automatic increases is not feasible. We are paying our overall white-collar staff raises of about 8% but for our engineers we are offering 12-14% as we see these people as the critical positions. We cannot afford to lose good engineers".

Absorbing the price rises/working with distributors

One upcoming challenge could be increased resistance to price rises. We covered this topic extensively in our April report and noted how some western companies now face the "threat" of windfall profits given they jacked up prices noticeably in February since when the rouble has further appreciated. Generally most companies across most sectors feel that the consumer/client has been able to absorb most of the price increases without segments declining or market shares crumbling. But the threat of this happening remains out there. The regional MD of a US conglomerate with decades of experience in the Russian market noted that:

> Our industrial distributors told us that they could absorb the last three price increases but that the current one and any future ones are not bearable. I do think that in our industry of refined chemicals and other products that we have just about reached the limit.

Another industrial company decided to invite all its major distributors (numbering 8-10) into a private hotel conference facility to spend a whole day with them. The managing director of the US engineering company commented:

We had to agree pricing, currency, and payment terms with them. Basically at the start of the event I said to them: "What do we have to do to make sure you survive?" We only have about 8-10 major distributors and so we ought to be able to help most/all of them. We did come up with a number of solutions that helped them without destroying our business. We did take on more risk but I think at sensible and acceptable levels. And at the margins our profits will be tweaked downwards more. But this is the price we have to pay if we want a good business in 2016-2020.

Such remarks were echoed a few weeks ago by the regional head of major European pharmaceutical company:

> I don't want to destroy my distributors and finish up with just one or two of them left in 2016. That does me no good. We have built relationships over 15 years and should not waste that because of some short-term financing problems.

Russian import-substitution helps western companies

One mid-size European chemical company reports that import-substitution is working in Russia, at least as far as their own sales are concerned. The European MD commented last month in Vienna:

> We are doing quite a lot better than expected. Our chemicals and related products are being bought up by Russian chemical, agro-food and packaging companies for their own operations. We didn't except these sales and financing is being found. Don't get me wrong: business is not booming but going nicely and better than we expected. We're growing about 10-15% in roubles which of course is stable in FX.

Another European equipment supplier echoed this view:

> Many of our Russian clients want to produce their "own stuff" and to upgrade their own output with less dependence on western suppliers; but the irony of course is that they have to buy equipment from us to get into that situation. We are increasing sales with good profitability at about 15%.

This executive is aware that such a spending trend could finish in 12-18 months when such customers have bought all that they need for their own production.

The Economic Outlook

For a further detailed assessment which remains valid, see our 20 April paper. This is a quick summary of key trends and modifications in recent weeks:

Macro-economic data 2009-2018

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
GDP	-7.9	4.3	4.3	3.4	1.3	0.6	-3.8	0.5	2.1	2.7
Retail sales	-5.5	6.3	7.2	5.7	3.9	2.5	-5.2	1.5	2.5	2.8
Household spending	-7.6	5.5	6.8	7.9	4.7	1.8	-4.8	0.9	2.3	2.8
Real wages	-2.8	4.4	4.9	8.2	5.2	1.9	-8.7	1.0	3.1	3.0
Disposable income	1.0	3.7	2.8	3.7	3.3	2.1	-2.0	1.0	2.5	2.9
Inflation (year-end)	8.8	8.7	6.1	6.6	6.5	11.4	11.0	7.7	6.6	6.3
Unemployment rate	7.9	7.6	6.5	5.3	5.5	5.3	6.5	6.0	5.7	5.5
Gross fixed investment	-17.9	5.6	9.8	6.0	-0.3	-4.8	-8.5	0.5	3.2	3.8
Industrial output	-10.8	8.3	4.7	2.6	0.3	1.1	-3.0	0.7	2.4	3.0
FX reserves ($bn) year-end	447	485	510	528	509	385	310	290	270	280
Rouble/$ (year-end)	30.3	30.4	32.1	30.4	32.9	58.0	56.8	60.0	62.5	64.8
Rouble/Euro (year-end)	43.4	40.0	41.5	40.1	45.1	72.0	58.0	62.0	64.5	66.5
Budget balance (% of GDP)	-6.3	-3.5	-0.2	0.0	-0.5	-0.5	-3.0	-1.9	-1.0	-0.5
Current-account balance (% of GDP)	3.8	4.9	4.9	3.6	1.6	2.0	2.6	2.2	1.8	1.8

Consumer-related statistics: by year and monthly

	2012	2013	2014												2015			
	year	year	Jan	Feb	Mar	Apr	May	June	July	Aug	Sept	Oct	Nov	Dec	Jan	Feb	Mar	Apr
Disposable income	3.7	3.3	-1.5	1.0	-6.8	1.9	5.8	-2.9	2.3	3.4	0.6	2.1	-4.7	-7.3	-0.8	-1.6	-1.8	-4.0
Real wages	8.2	5.2	5.2	4.6	3.1	3.2	5.0	2.1	1.4	-1.2	1.5	0.3	0.5	-4.7	-8.0	-7.4	-10.6	-13.2
Real retail sales	5.7	3.9	2.4	4.1	4.0	2.6	2.1	0.9	1.2	1.4	1.7	1.7	1.8	5.3	-4.4	-7.2	-8.7	-9.8
Unemployment	5.3	5.5	5.7	5.6	5.4	5.3	4.9	4.9	4.9	4.8	4.9	5.1	5.2	5.3	5.5	5.8	5.9	5.8
Industrial output	2.6	0.3	-0.2	2.1	1.4	2.4	2.8	0.4	1.5	0.0	2.8	2.9	-0.4	3.9	0.9	-1.6	-0.6	-4.5
Fixed investment	6.0	-0.1	-7.0	-3.5	-4.3	-2.7	-2.6	0.5	-2.0	-2.7	-2.8	-2.9	-4.8	-2.4	-6.3	-6.5	-5.3	na
Consumer prices	6.6	6.5	6.1	6.2	6.9	7.3	7.6	7.8	7.5	7.7	8.0	8.3	9.1	11.4	15.0	16.7	16.9	16.4
Budget deficit (running)	0.0	-0.5	0.4	0.3	1.4	-0.4	-0.1	-0.1	-0.1	-0.2	-0.4	-0.5	-0.6	-0.6	-1.6	-1.8	-1.8	-2.1

GDP and overall economy

The economic outlook has improved generally thanks to the stronger rouble, softening inflation and lower interest rates. There is a sense that this could be the beginning of the end of the crisis. The consensus view for Russian GDP has improved from -4.3% three months ago to -3.6% today. We were quite accurate recently predicting -4.1% and now tweak this to -3.8%. We firmly believe that there will be no big bounce back in 2016-17 and GDP will rise by about 1% next year on a middle scenario.

The rouble and softer inflation are very good news BUT these are countered by extremely bleak numbers in the first 4-5 months of this year for the following: investment, industrial output, retail sales, disposable income, real wages and consumer confidence:

- Real wages are slumbering at -13.2%, the worst number since 1998
- Consumer confidence at -32 is the third worst figure reported in 20 years
- Inflation at 16%+ is the highest in 16 years
- Retail sales at -13.2% are the worst in 20 years

As we discussed above, it may need a few more months for the effects of these bad numbers to run through the system.

Industry and fixed investment continue their poor performance which started in January 2013 and combined with sanctions, weak confidence and difficult financing, this all explains why the B2B sector is struggling the most. Industrial output slumped badly in April (-4.5%) while the Purchasing Managers' Index climbed from 48.1 in March to 48.9 in the same month and business confidence actually ticked up from -6 to -5 in April. Fixed investment continues to struggle poorly and declined by -4.8% also in April.

The slowdown in industry is officially attributed to weaker manufacturing and mining but the sector is probably deflated this spring as defence spending and procurement may have slowed after a flurry of military expenditure at the start of the year. Readers should note that PMI figures do not include defence procurement while figures for industrial output do so, which explains why relatively, industry is now softer than PMI (at the start of the year when defence spending was strong the relationship was reversed with relatively better industrial output than PMI).

We should not forget that any PMI figure below 50 indicates recession and so Russia is struggling and PMI figures in CEE markets such as Poland and Hungary are in comparison surging at very strong levels of 55 to 56.

We estimate that industry will decline in 2015 by -3.3% and engage in soft recovery in 2016 by +0.7% with investment down almost -8.5% this year with also soft pick-up next year to +0.5% especially if European sanctions are rescinded next year.

2015 economic outlook

GDP	-3.8%
Inflation (year-end) Inflation (average)	11.5% 12.5%
Consumer spending	-4.80%
Investment	-8.5%
Industrial output	-3.0%
Rouble to US dollar average	52-55
Rouble to the Euro average	56-60

Presumably, the Russian budget deficit will no longer be kept within prescribed limits. The recession will necessitate that the deficit shifts from an initial target of -0.6% for 2015 and in fact dip to -3.0% this year which is now a government estimate (the budget deficit in 2014 came in at -0.5%).

Economic scenarios at different oil prices

Average oil price 2015	GDP	Inflation	Rouble/US$ Average	Rouble/€
$80-85	1.0%	6.5%	40-44	47-49
$70-80	0.0%	7.50%	44-48	49-53
$63-70	-2.0%	9.0%	48-52	53-56
$55-63	-4.0%	11.50%	52-58	56-62
$50-55	-5.5%	14.0%	58-66	62-68

Inflation and interest rates

Inflation appears to have reached a summit in March at 16.9% and slowed to 16.4% in April. We predict that inflation will end December this year at about 11.5% and possibly a little lower. This will mean that average inflation for 2015 will be about 13.5% this year. For 2016 we expect inflation to soften to an average of 9% and then ending in December 2016 at about 7.5%.

Presuming this decline in inflation and some stabilisation of the rouble against the back-drop of weak GDP, we presume that the Central Bank will continue with interest rate cuts: the key central rate was jacked up to 17% last December and since then the Bank has chosen whenever possible to help growth rather than worry about inflation. The Bank rightly presumed that elevated inflation would be a temporary 3-7 month feature. Interest rates are already back down to 12.5% and we expect them to be lowered again this summer and to reach 10% or lower at the end of 2015. This will continue to help an improvement in mood regarding financing but effective market rates for customers will still be high and at double-digit levels for all of 2015.

We also expect overall new bank credits to companies and citizens to remain in negative territory. This follows an increase of 30%+ in 2013 followed by a declining trend through 2014 with new credits also drying up at the end of last year. We presume that overall new bank credits will be in negative territory this year at -5%.

As ever, I hope you have found this paper useful and if you have any comments or queries, do let me know.

danielthorniley@dt-gbc.com
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Appendix 1 - Why is the Russian Rouble so strong in 2015?

Since the start of 2015 (3 January) the rouble has appreciated until 26 May by 22% against the Euro and 9% against the strong US dollar: compared with its low points in December and January it is up 34% against the Euro and 29% up versus the dollar; many emerging market currencies have fallen in recent months against the USD by 8-15%.

The Russia rouble is in 2015 to date the best performing currency in the world after being the second worst in 2014. It's certainly the most volatile one in the world for the time being.

First though, why is the rouble rising now?

1. There is some stabilisation in the oil price at around $55-64 to the barrel. I am pleasantly surprised (for Russia) that the recent framework deal with Iran has not destroyed the oil price (because there remain uncertainties about the deal which will in any case take time to come to fruition) and the oil price has stabilised and strengthened on the news that Saudi Arabia has started to raise prices to China for oil.
2. It is "apparent" to western media that eastern Ukraine has calmed down (whether that is the reality on the ground or not is almost irrelevant as it is perceptions which now count).
3. There is a sense that western sanctions are not going to intensify and there is perhaps a vain hope that some may be rescinded in 2015, although we think, given the criteria in the second Minsk agreement, that sanction reductions will be held back until December 2015 or January 2016, but there is small upside risk.
4. It seems that households may now be re-converting back into roubles some of the $25bn worth they converted in 2014 out of roubles into dollars and Euros; we see some shopping/consumer trends reflecting greater confidence in the currency.
5. The Central Bank has been working hard with repo rates to manage the currency upwards.
6. It's not surprising that the falling Central Bank interest rate is not weakening the rouble because interest rates have never really been the driver of FX rates for the rouble or not a major influencer.
7. The Bank persists with its view (and probably rightly so) that inflation will start to decline during summer this year and publicity about this feeds into the markets.
8. I think there is also just a sense of "the worst of December 2104" is over and the markets say "we have stabilisation now" and so … we have stabilisation! This becomes a self-fulfilling prophesy and the market mood turns positive.
9. The end of 2014 was also impacted by large debt repayments which came due for Russian companies to pay back to western creditors.
10. Since a series of December and March debt repayments have now passed, the debt repayment curve for the rest of 2015 is more evenly spread and there appears to be less risk.
11. Other emerging market currencies are struggling so there is more a sense of it's not just a Russian thing and in fact the rouble now looks like an emerging market winner: if investors want to get yield and speculative gains, then ride the rouble wave!
12. However, the rally could be temporary and due to "mood" and to foreign investors closing long positions on the rouble and when this latter feature terminates, then the current rally could fade.

In closing I am a bit surprised that the rouble has rallied quite so much when the Brent oil price is still below (today) $60-64 per barrel.

Where does the rouble go now? One thing to consider is that the Russian Central bank will soon start worrying about rouble strength (a crazy world!) and if the currency gets close to 50 to the dollar, the Bank could even start selling the rouble as it did in May. The Bank will be reluctant to see a large fall in oil-related tax revenues which bolster the budget deficit.

Just as 72/75 to the dollar and 78/82 to the Euro seemed excessively weak and not matching fundamentals, then today's strong rates seem marginally to be an over-reaction in the other direction.

Appendix 2 - 25 key business issues that executives have to monitor

1. Short-term financial planning is agony.
2. Companies were caught again in a “budget trap” last autumn when original targets were set for Russia in 2015; companies have to readjust and reforecast and manage expectations.
3. Surprisingly or not many western companies survived 2014 reasonably well at least in rouble terms.
4. The managing director of one major western food & beverages firm with $2bn sales in Russia said in January: “2014 was great; now it’s over”.
5. Some companies are concerned that a deeper business recession will kick-in during late spring this year as the full impact of inflation and collapsing real wages finally pulls the consumer down; most executives predict a moderate rally for 2016 but a noticeable minority expect still quite hard times at the start of 2016
6. Localisation: western companies realise that to get deeper into the local markets and to access local tenders, they need to be more localised and this is an on-going trend.
7. Diversification: being a diversified conglomerate is proving good for some firms as this spreads the risk and while some sales to some sectors may have slumped (automotive, IT) , they are compensated by comparatively stronger sales elsewhere (consumer related).
8. Several companies report privately that they are making large investments in logistics and warehousing; some companies with large existing market shares want to protect those or plan to expand this market share.
9. Two-thirds of companies report that they are not postponing investments this year: consumer goods and food & beverage companies plan the fewest postponements while pharmaceuticals are also fairly positive with most delays expected in the B2B sector.
10. Market share is rightly the key focus for companies who engage in best practice.
11. Generally pharmaceuticals and health are the favoured sectors, consumer products are average (good/mixed) and B2B is the weakest business sector with recently the IT and automotive industry sticking out as badly strained sectors.
12. For pharmaceuticals and IT firms, selling to the federal government is the biggest challenge as government spending is cut back.
13. IT and pharmacy sales to consumers have been the more upbeat part of these industries.
14. This supports the view that the Russian consumer has proven remarkably resilient until March 2015.
15. Some companies predict that consumer spending will be hit radically in spring 2015 as the full impact of higher inflation and weaker wages sets in.
16. Brand or value? Executives are having strong debates about whether premium brands will hold up this year against the economic odds. One managing director of a food company with two plants in the country states: “Our premium products are weakening while our mid-brands and discount products are performing strongly. I think 2015 will see a big slow down for the premium end”. Others think they will have to work harder to sell premium brands. Most appreciate that they will need to widen their portfolio to reach more consumer segments.
17. Related to this, the Russian regions remain important as a part of business strategy and have been so for many years now but companies realise they must do more to compensate for a slowing Moscow.
18. Volume or Price? Executives also debate heatedly about whether to put their business focus on growing and protecting volumes or price increases. Generally volumes are going to be harder to achieve.
19. It does seem that much business growth in 2015 will come from price rises; companies raised prices in 2014 by a 10-30% range and many jacked up prices again in February 2015.
20. Financing will remain challenging for B2B sales even though the central interest rate fell back to 14% in March.
21. Manufacturing firms complain about rising input costs.
22. Aniti-westernism? About 35% of companies report some degree of anti-western attitudes in B2B tenders and B2G ones. Regarding anti-western consumer behaviour, some 16% of companies report this feature but this is more difficult to gauge: do consumers simply prefer cheaper non-western brands?
23. More western B2B firms are being asked by Russian officials, “Where do you source from”? Consequently some are turning to suppliers in Asia or non-Western sanctioning countries to avoid Russian reprisals and also to find cheaper inputs.
24. Some managing directors are very wary of cutting too deeply: “We cannot fully fix most of the short-term problems without taking steps that will certainly damage the long-term health of the business”.
25. Generally western companies are not cutting back on staff (63% not at all, not yet) while the rest are so far making small cuts; companies are keeping a tight rein on salaries and paying below inflation (90%).

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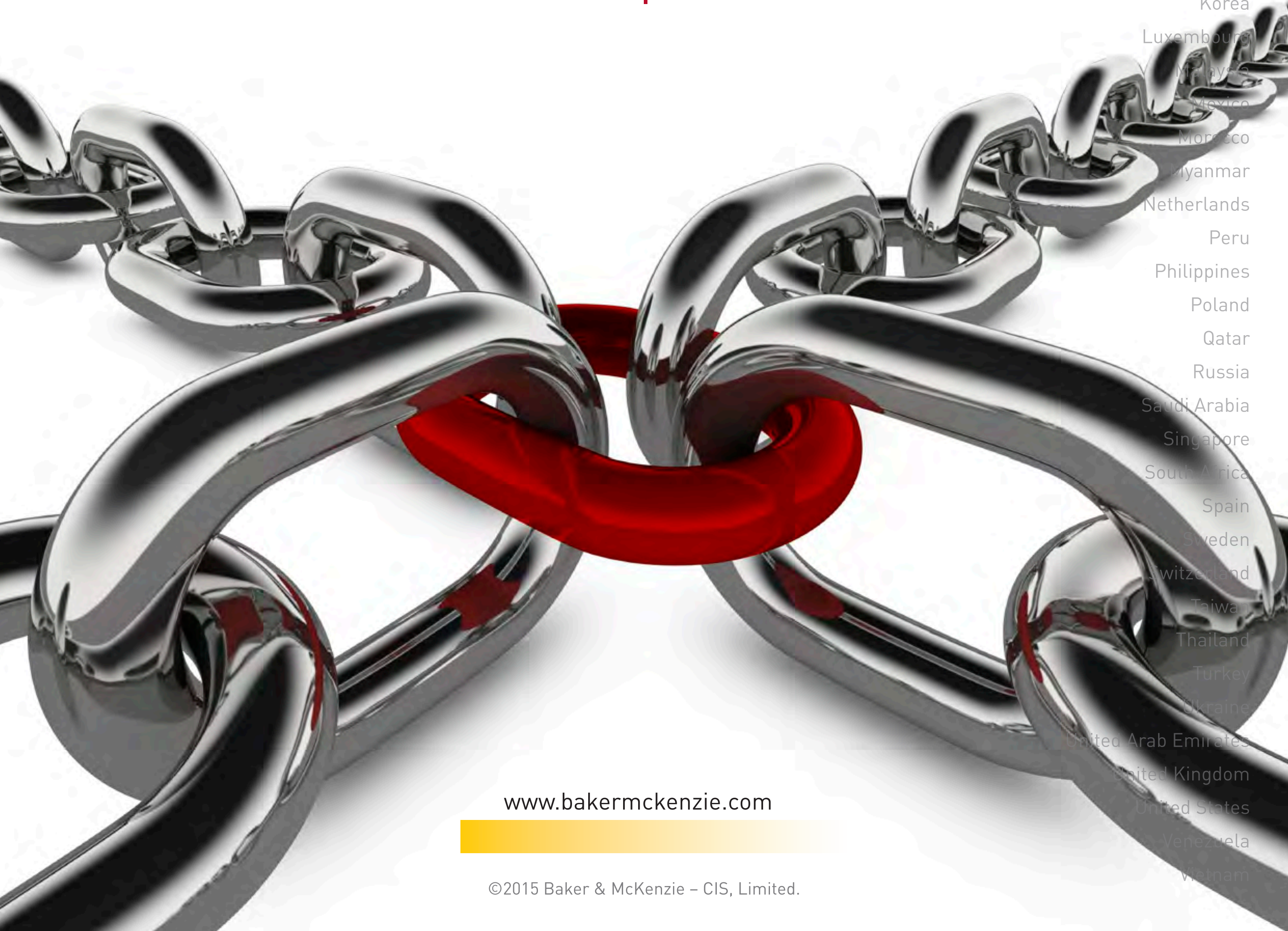
Moscow

White Gardens
9 Lesnaya Street
Moscow 125047 Russia
Tel.: +7 495 787 2700
Fax: +7 495 787 2701
moscow@bakermckenzie.com

St. Petersburg

BolloevCenter
4A Grivtsova Lane
St. Petersburg 190000 Russia
Tel.: +7 812 303 9000
Fax: +7 812 325 6013
st.petersburg@bakermckenzie.com



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