

Russian  
food and beverage  
industry survey  
2009



# Introduction

At the beginning of 2009, Ernst & Young prepared its latest regular survey of the Russian food and beverage industry in order to collect and summarize the opinions of Russian and foreign companies regarding key changes in business development strategies, as well as possible directions of further growth in the new economic environment.

This is the third survey of the food and beverage industry, following the first two conducted in 2004 and 2006.

Ernst & Young thanks all the respondents, especially those who contribute to our survey on a regular basis. We will continue issuing our survey and keep you informed on recent findings.

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# Key findings

**The findings of the survey indicate that in 2009 most sectors in the food and beverage industry will see negative growth as a result of the economic meltdown.**

Among the most resilient sectors, our respondents name those involved in manufacturing essential goods and subsidized by the government, including crop production/grain processing, flour and bread production, production of dairy products, baby and diet food.

Compared to Russian producers, foreign market participants largely stick to conservative projections of growth and demand dynamics for products they manufacture. Conservative forecasts, however, do not make the Russian food and beverage industry less attractive for foreign players planning to continue investing in production development and promoting products under their own trademarks in 2009. Major Russian players have demonstrated the same active approach to investing and promoting proprietary brands.

The pressure of retail chains remains one of the major negative factors affecting the operations of food and beverage companies. Amidst the economic turmoil, however, industry participants have ample chances to revise established relationships and make them more lucrative.

Reduction of the tax burden was cited by the respondents as a priority crisis management measure anticipated by market participants from the government.

In spite of unfavorable development forecasts by sectors, 90% of our interviewees view the crunch as an opportunity to broaden market share in their sector, enhance working capital management practices and improve internal processes.



# Brief economic overview

The global economic downturn has adversely affected the Russian economy. According to the finalized forecast provided by the Russian Ministry for Economic Development (MED) in March 2009, Russia's key economic indicators this year will fall, while inflation will remain at its 2008 level.

To facilitate the development of the Russian economy, the government plans to earmark RUB 1.1 trillion to support the banking sector, RUB 417 billion in tax incentives, RUB 202 billion to promote popular income growth and ensure social security, RUB 189 billion for direct enterprise support, and RUB 82 billion to maintain demand, as part of its stimulus package.

**Table 1**

Indicator	2007	2008	2009F
GDP produced (RUB bln)	33,114	41,540	40,420
Growth rate (%)	108.1	105.6	97.8
Inflation index over the period (%)	111.9	113.3	113
US\$ rate (RUB per US\$)	25.5	24.9	35.1
Industrial production index (%)	106.3	102.1	92.6
Investment growth (%)	122.7	109.8	86.2
Growth in real salary (%)	117.2	110.3	95.9
Growth in real disposable popular income (%)	112.1	102.7	91.7
Export (US\$ bln)	354.4	471.8	259.7
Import (US\$ bln)	223.5	292.0	233.0

Source: MED

F - forecast

**Table 2**

Indicator	2008	2009	
		Forecast	Effect of government measures
GDP produced (RUB bln)	41,540	40,420	711
Growth rate (%)	105.6	97.8	1.8-2
Capital investments (RUB bln)	8,765	7,555	315
Growth rate in basic prices (%)	109.8	86.2	3.6
Growth in loans to non-financial organizations and the population (%)	36.4	8.9	6.5
Growth in real salary (%)	110.3	95.9	1.3
Growth in real disposable popular income (%)	102.7	91.7	1.1

Source: MED



Global Insight expects that the total amount of foreign investment in the Russian economy will decline in 2009 as compared to 2008, reaching US\$29.4 billion. At the same time, starting from 2010, the forecast envisions growth in direct foreign investment, with an annual growth rate of 5%.

**Table 3**

Indicator	2007	2008	2009F	2010F	2011F	2012F
Direct foreign investment (US\$ bln)	52.2	58.7	29.4	30.8	32.4	34

Source: Global Insight  
F - forecast

Along with other Russian economic segments, the ongoing crisis will impede development of the food and beverage industry. However, due to the strategic importance of this sector and the entire agro-industrial complex for the economy, 34 out of the 295 backbone enterprises eligible for direct government support operate in the food and beverage industry.

According to MED estimates, the growth of prices for essential food products, such as bread, baked goods and sunflower oil, will significantly slow in 2009 against 2008, which cannot be said of sugar, cheese and horticultural products, which are expected to grow by 13% as in 2008.

**Table 4**

Food products (%)	2007	2008	2009F		
			H1	H2	FY
<b>Essential products</b>	21.3	16.2	6-6.5	7.5-8.5	14.5-15.5
Bread and baked goods	22.4	25.9	2	5-6	6-8
Sunflower oil	52.3	22.1	-7-9	11-12	2-4
Milk and dairy products	30.4	12.2	4-5	7-8	11-13
Cheese	56.3	-6.7	8-9	6-8	15-16
Meat and poultry	8.3	22.2	9-10	9-10	20-22
Sugar	-4.3	7.0	25-30	-10-12	10-13
<b>Horticultural products</b>	22.2	7.7	30-35	-15-20	8-10
<b>Other products</b>	11.1	18.2	8-9	2.5-4	11-11.5

Source: MED  
F - forecast

# Key changes in legislation

In 2008, virtually all chapters of the RF Tax Code were subject to amendments, most of which became effective 1 January 2009. Below is a list of changes which may have a significant impact on food producers' operations:

## **Profits tax rate reduced to 20%**

Effective 1 January 2009, the profits tax rate fell from 24% to 20%, with 2% out of 20% to be paid to the federal budget and 18% to the budget of a constituent entity.

## **VAT deduction in the case of prepayment**

A buyer who effected prepayment will be able to deduct VAT from such prepayment before the goods are shipped.

The deduction may be taken against a factura invoice, documents confirming the receipt of prepayment, and the agreement with a prepayment clause.

This regulation generally aims to expedite the process of confirming a tax deduction.

## **No need for cash VAT payments in non-cash settlements**

The requirement to pay VAT to a seller by a separate payment order in offsetting, barter transactions, or settlements involving securities is no longer in effect.

Also canceled is the requirement to use a separate payment order to remit tax in settlements involving private property for purposes of a tax deduction. From now on, tax may be deducted subject to general regulations, i.e. after the recognition of goods (work, services) and against a factura invoice. This regulation will simplify the tax administration procedure.

## **New amount of interest on loans expensed**

In the period from 1 September 2008 to 31 December 2009, the cap on interest for debt included in expenses will be as follows:

- ▶ For debt denominated in rubles: the refinancing rate of the CBR multiplied by 1.5 (previously 1.1)
- ▶ For debt denominated in foreign currency: 22% (previously 15%).

An enterprise determines the cap on interest charged at the moment it is recognized, i.e. at the end of the reporting period; therefore a new marginal amount applies to interest recorded as expenses for the specified period, irrespective of the time the debt was settled.

## **New procedure for using amortization accrual methods**

Property may be amortized using either the straight-line method alone, or the declining balance method alone (applying a ratio stipulated in the Tax Code to the aggregate cost of assets within a group).



The guidelines for accrual of amortization using the declining balance method have changed dramatically. Amortization is currently accrued not for a standalone fixed asset but for the entire amortization group.

This does not apply to buildings, structures, transmission devices and intangible assets in amortization groups 8-10 (with useful life exceeding 20 years). These are amortized on a straight-line basis alone.

There is also a restriction permitting conversion from the declining balance method to the straight-line method only once in five years.

#### **New amount of one-time expense write-off when accruing amortization benefit**

Effective in 2009, the maximum amount of expenses an enterprise may simultaneously recognize as amortization benefit when purchasing or creating fixed assets pertaining to amortization groups 3-7 (with a useful life of more than 3 but less than 20 years) is 30% instead of 10%.

However, if an asset is sold within a five-year period after being put into operation, the enterprise shall recover amortization benefit and include it in revenue. This applies to fixed assets put into operation after 1 January 2008 and scheduled for sale after 1 January 2009.

#### **Deductions related to the amortization of assets under lease**

Effective in 2009, the guidelines for using an accelerated amortization ratio for fixed assets under lease shall not be applied to assets with a useful life of under five years.

Any amortization method uses a special ratio (no more than 3) solely for leased property in amortization groups 4-10.

#### **Mandatory pre-judicial procedure for challenging decisions of the tax authorities**

Pursuant to the Tax Code of the RF, tax authorities' claims and actions (omissions) of their officers may be appealed to a superior tax authority or the courts. Along with filing a complaint with a superior authority, one may simultaneously or consecutively file a similar complaint with the courts. Starting from 2009, in some cases legal recourse shall be preceded by challenging decisions of tax authorities with a superior authority.

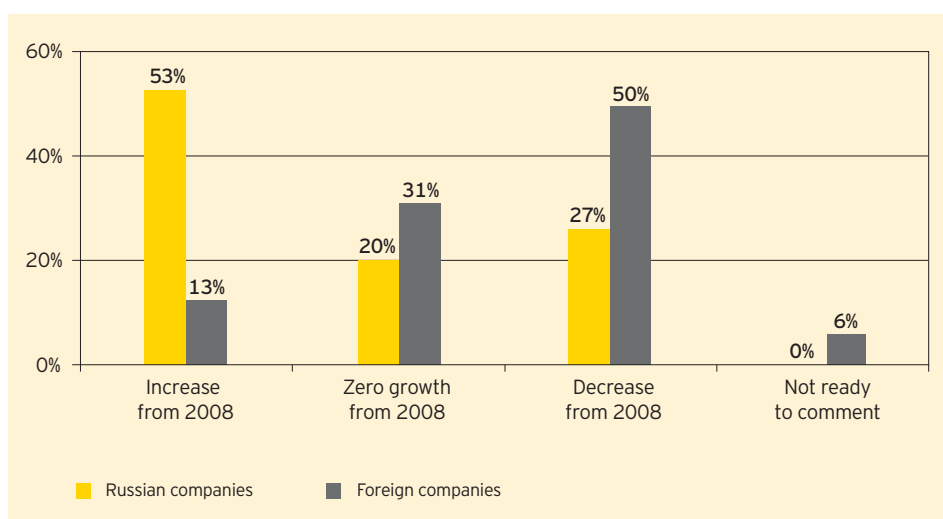
Pre-judicial appeal is provided only for decisions to hold a taxpayer liable for a tax offense based on the results of a tax audit review. A denial of a tax offset or refund or a claim for payment of tax, penalties or interest may be challenged in court without preliminary review by a superior authority.

# Expected industry development trends

One of the key issues of the survey dealt with expectations regarding the development of the Russian food and beverage industry amidst the economic crunch. Respondents' opinions are split.

Foreign companies turned out to be more conservative than domestic respondents regarding the development outlook for their sectors. Thus, 39% of all respondents, largely represented by foreign companies, expect a contraction in the food and beverage sectors they operate in; 32% of respondents, mostly Russian companies, forecast insignificant market growth. The rest of the respondents project zero growth in 2009 from 2008 or find it difficult to estimate.

**Table 5. Development of the food and beverage industry in 2009**



Alcoholic beverage producers expect a 10-15% contraction of the market due to the shift of consumer demand to cheaper alcohol brands and a growing volume of illegal products. In addition, producers indicate a consumer switch to smaller packages (e.g., 0.5 liter instead of 0.75 liter). Soft drink producers expect the market to shrink on average by 10%.

Production of dressings and sauces, snacks and croutons will contract due to the switch of consumer focus to essential products (pasta products, cereals, bread).

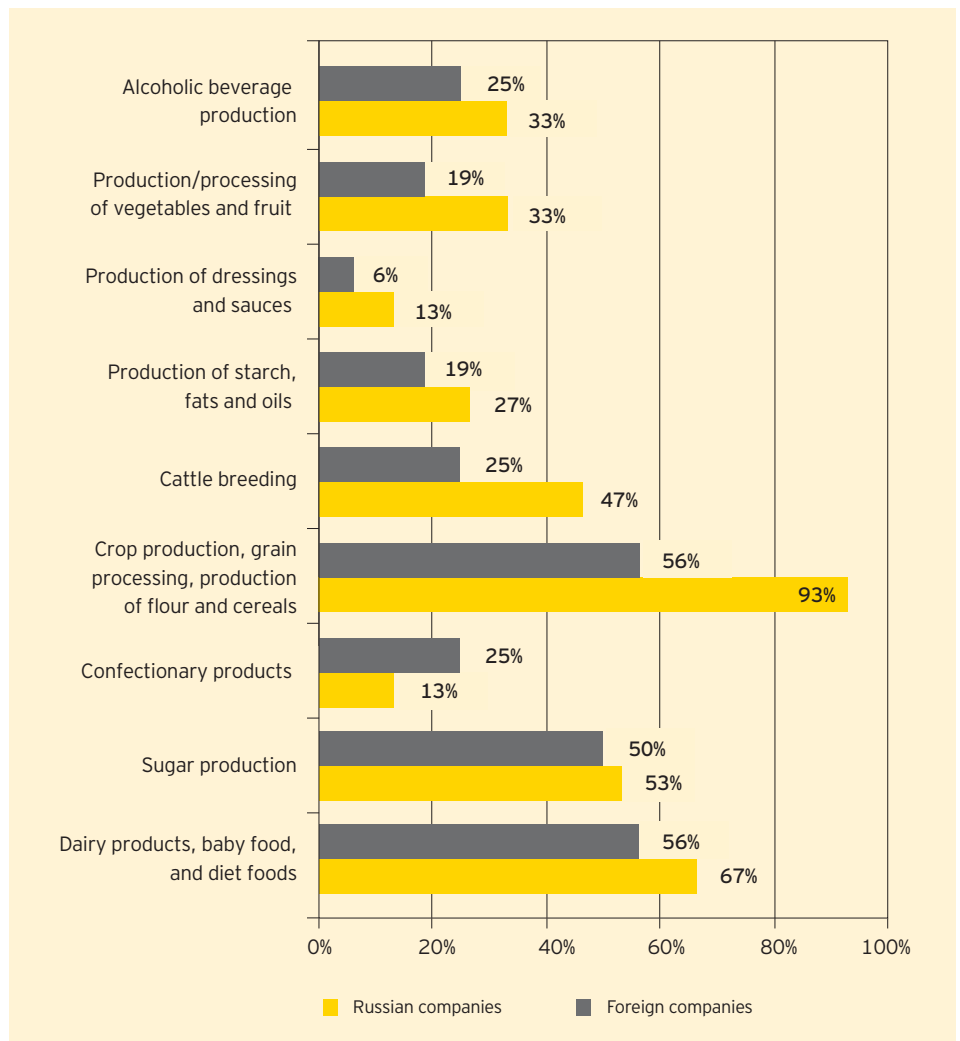
According to various estimates, the dairy products sector will see zero growth or contract by 5-20% depending on the segment. Confectionary producers gave much the same answer: some expecting zero growth and others expecting growth of 5-10%.

The only respondents projecting market growth are meat (by 15%) and baked goods (by 2-5%) producers.



Thus, the most crisis-resistant sectors are those producing essential food products (crop production/grain processing, cattle breeding, sugar production) and subsidized by the government. This finding is confirmed by respondents' estimates of sector attractiveness in 2009, regardless of their actual presence in these sectors.

**Table 6. Most crisis-resistant sectors**



# Adverse factors

As before the crisis, the strengthening pressure of retail chains remains the major issue for food producers, as indicated by 60% of Russian and 63% of foreign respondents.

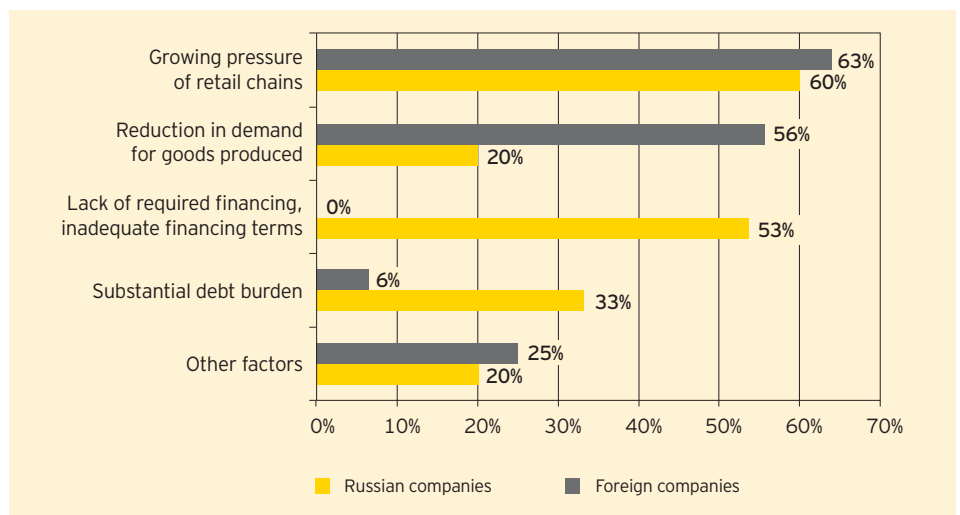
In terms of the effect that the economic downturn has on companies' operations, the respondents, primarily foreign companies, noted a reduction of demand for manufactured products, particularly in the premium price segment, or a switch of focus to cheaper brands due to declining disposable popular income and growing prices for imported products as compared to domestic ones as a result of ruble devaluation.

A heavy debt burden, lack of required financing and inadequate financing terms are significant issues for Russian producers that responded to our survey, 87% of which use bank loan facilities.

No foreign company participating in our survey named limited access to financial resources among the issues, since 75% of them receive funding from parent companies.

Other adverse factors indicated by the respondents included collection of payment from regional distributors, volatile and strengthening state regulation, and growth of prices for raw materials (primarily foreign ingredients of raw materials).

**Table 7. Adverse factors affecting operations of companies**

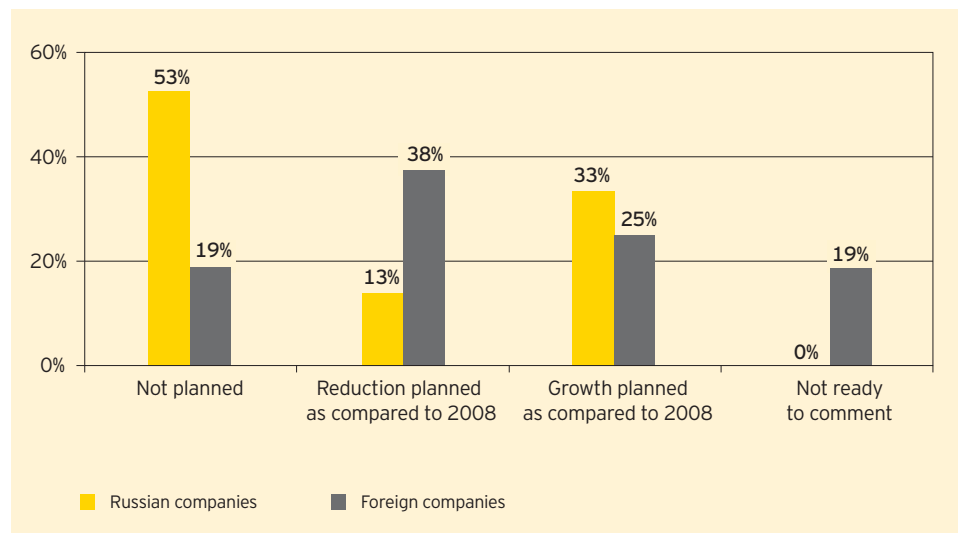




As mentioned above, the foreign respondents gave more conservative estimates for their sectors' development outlook than domestic producers. The same trend was noted in 2009 sales budget adjustment strategies.

In view of the conservative estimates in respect of 2009 production demand, 57% of foreign respondents have plans to curb their sales budget by 5-10% or leave it flat, intending to shift part of the problems related to devaluation onto buyers' shoulders. The number of Russian respondents who plan to cut their budget is three times lower (13% in all), while 53% of domestic respondents are not adjusting their sales budget.

**Table 8. Adjustment to sales forecasts for 2009**



# Crisis management measures

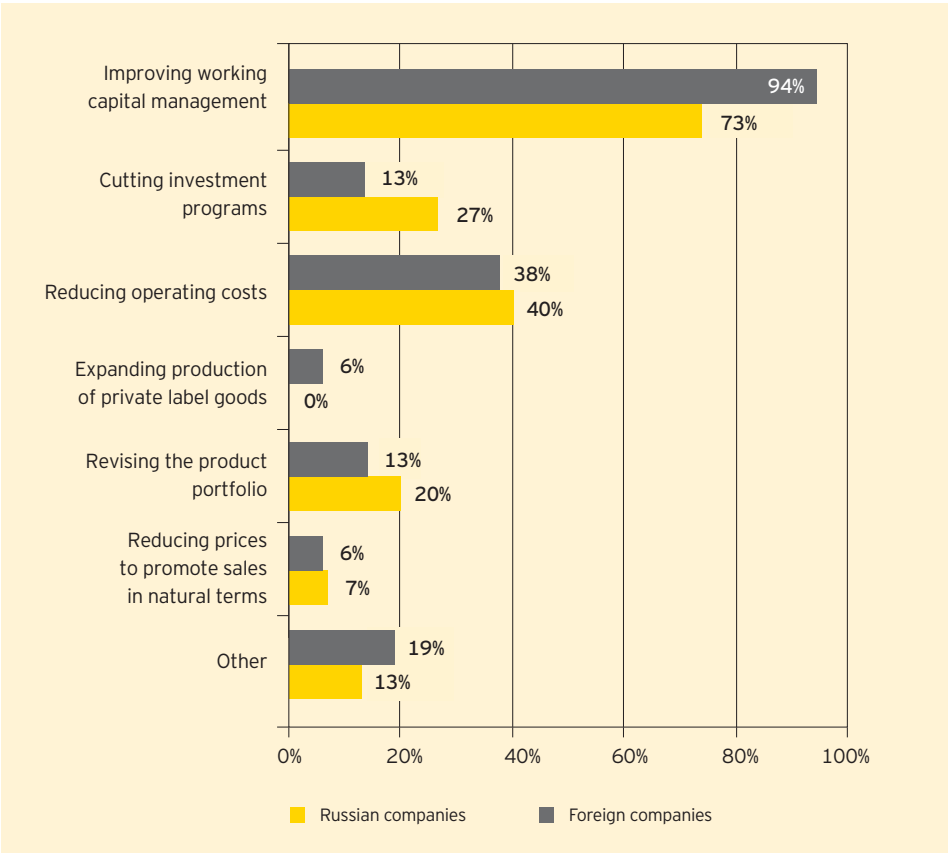
Having experienced almost identical sets of problems, companies have developed fairly similar measures for their resolution.

## Market participants' strategy in the crisis environment

In the context of the crisis, most companies are encountering the following issues:

- ▶ Decline in demand for products
- ▶ Overdue receivables by retailers and distributors due to prolonged payment terms
- ▶ Limited access to financing.

**Table 9. Measures undertaken by companies to overcome crisis effects**





In light of the above, domestic and foreign respondents have made improvement in working capital management a priority measure to combat the crisis.

The reduction of operating expenses was named a second priority in crisis management: 40% of Russian and 38% of foreign companies are planning to cut costs, although in different ways. Domestic producers intend to trim marketing and advertising budgets and slash personnel costs.

Foreign respondents are planning to scale back personnel costs primarily at the expense of training and professional development programs, as well as by leaving agreed vacancies open. Just 19% of our survey's foreign participants intend to reduce marketing budgets, while the rest will not change the budget or will actually direct additional funds toward promoting in-house products during the crisis.

27% of Russian respondents will have to scale back their investment programs due to the lack of required financing and inadequate financing terms. The overwhelming majority of foreign companies plan to continue investing in the development of their Russian operations in the face of the economic turmoil.

20% of Russian and 13% of foreign companies are considering revising their product portfolio due to the new consumer focus on cheaper products.

Only a modest proportion of our respondents said they would combat the crisis by expanding manufacture of private label goods or the trademarks of their sector's producers to load production capacity, as well as lowering prices to bolster sales in natural terms.

## Personnel downsizing

Personnel costs are a considerable cost item for food producers. For this reason, the reduction of costs in this particular area brings companies material results in the short term.

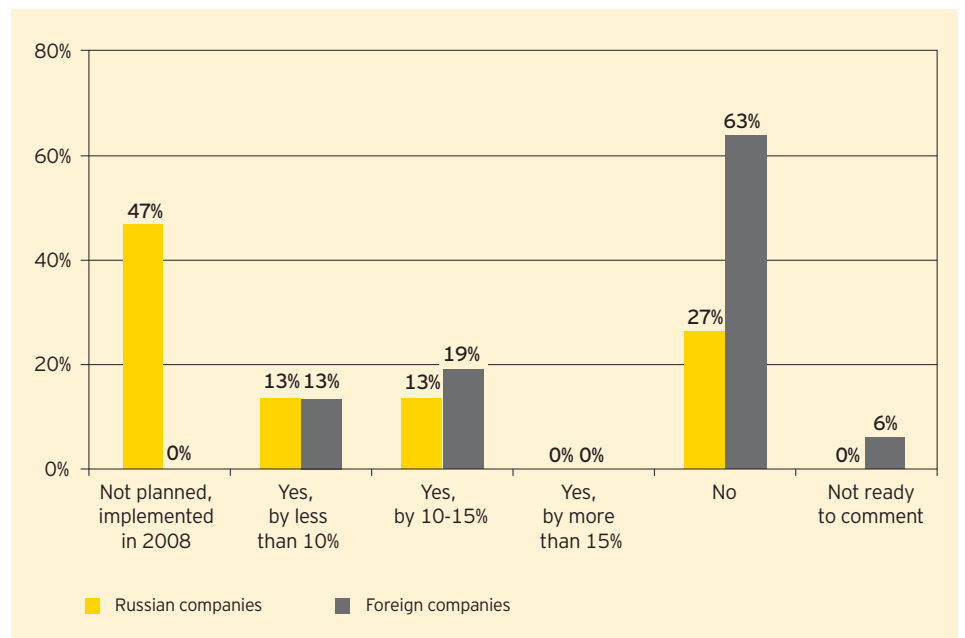
In the challenging financial situation, companies are curbing training costs, social security payments and benefits, and payroll costs. The harshest measure aimed at optimizing personnel costs is downsizing.

As the survey findings demonstrate, no foreign company laid off staff in 2008, having largely stopped at trimming training costs, while 47% of Russian companies had to downsize their personnel by 10-30% as early as last year due to financial problems, limited access to financing and sizable debt burdens.



In 2009, 63% of foreign and 27% of Russian interviewees have no plans to reduce the number of their employees. 13% of domestic and foreign respondents will cut their staff by less than 10%; 13% of Russian and 19% of foreign respondents intend a 10-15% personnel cutback to curtail operating costs. No company is scheduling a staff reduction exceeding 15%.

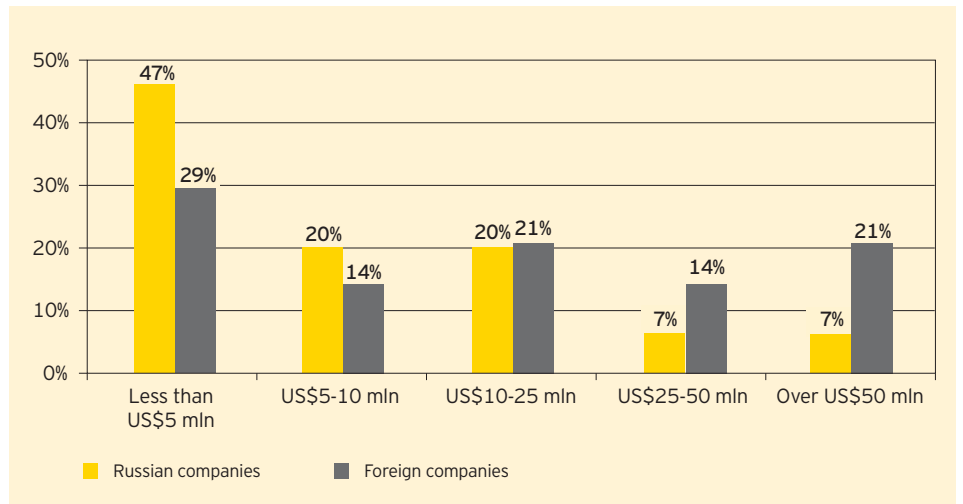
**Table 10. Personnel downsizing**



## Investment budget

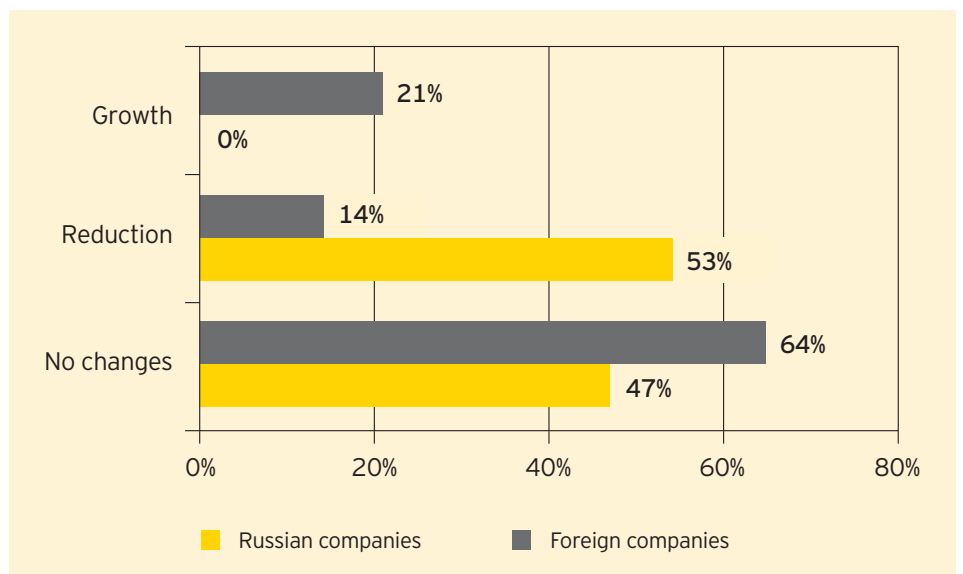
In 2008, foreign companies invested far more money in their production than their Russian peers. Thus, 47% of Russian and 29% of foreign respondents had investment budgets under US\$5 million; 14% and 21% of foreign respondents indicated budgets of US\$25-50 million and over US\$50 million, respectively, for their actual 2008 investment plan.

**Table 11. Budget for the 2008 investment program**



Regarding the possibility of adjusting the 2009 investment budget against that of 2008, the survey findings indicate that foreign and domestic companies do not see eye to eye on the issue.

**Table 12. Adjustments to the 2009 investment budget as compared to the budget for 2008**



Sixty-four percent of foreign interviewees are not planning to cut investment programs in 2009, including the bulk of companies ready to downsize personnel to combat the crisis. Worth noting are three respondents from the dairy products, baby and diet foods sectors which intend to increase their investment budget from 2008.

Fifty-three percent of Russian companies are considering reducing their investment programs by 50% on average. Despite Russian companies' policy of cutting investment in production development, the implementation of investment programs in certain food and beverage industry sectors is under way. In 2009 the government will extend considerable support to Russian producers in cattle breeding through capital injections into uncompleted investment projects for a total of RUB 74 billion, as well as subsidizing the interest on investment and short-term loans for a total of RUB 17 billion.

## Marketing budget

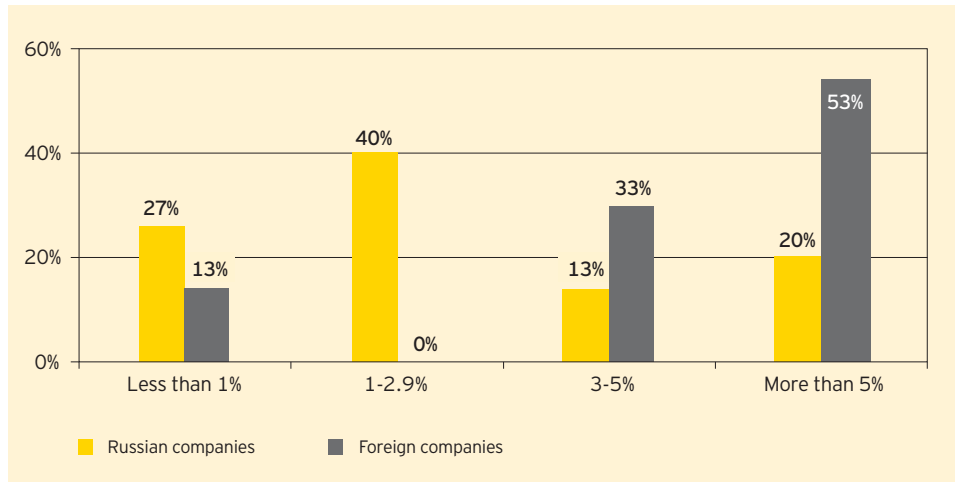
According to the survey results, Russian companies trail far behind foreign ones in the amount of their marketing budgets, both in absolute and in real terms.

In 2008, the majority of foreign companies (53%) had marketing budgets exceeding 5% of gross revenue, while the budgets of most of the Russian companies (67%) generally constituted less than 3% of gross revenue. Marketing budgets over 5% were primarily those of Russian and foreign producers of alcoholic beverages and soft drinks.



If we compare these indicators with our previous (2006) survey, in 2006, 100% of foreign companies had marketing budgets exceeding 3% of gross revenue, while 53% of domestic respondents had budgets under 3% of gross revenue.

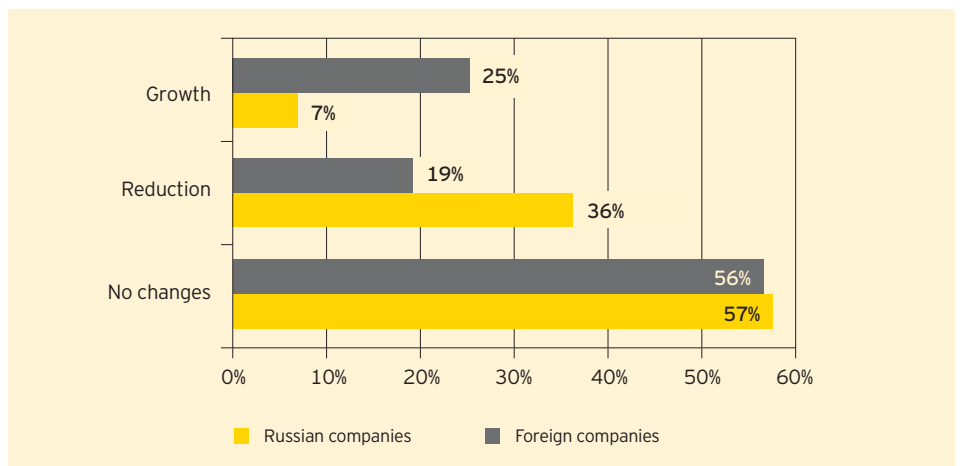
**Table 13. Marketing budget expenditure in 2008 (as % of gross revenue)**



Most Russian (57%) and foreign (56%) companies plan to leave the 2009 marketing budget unchanged from 2008. Twenty-five percent of our foreign interviewees noted a scheduled 2009 increase of this expense item aimed at promoting proprietary trademarks by an average of 20%. Foreign companies are not revising marketing budgets and in some cases are even boosting them in spite of staff reduction.

Russian companies (36%) planning to curtail marketing expenses (by 40% on average) primarily operate in crop production/grain processing, flour and bread production.

**Table 14. Adjustments to the 2009 marketing budget as compared to the budget for 2008**



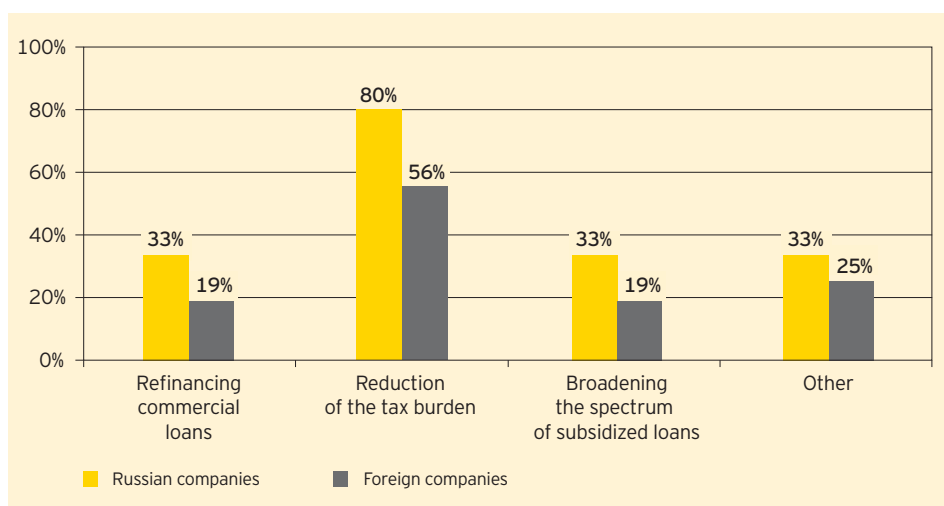
## Government support

Russian (80%) and foreign (56%) companies named tax burden reduction as the most efficient government support measure. The Russian government has already taken a number of steps in this direction. *For instance, the zero profits tax rate was extended to 31 December 2012 for agricultural producers; and companies are exempt from VAT on pedigree animals and produce imported into Russia until 1 January 2012.*

Refinancing commercial liabilities and expanding the range of subsidized expenses are equally important for 33% of Russian and 19% of foreign companies.

Among other government support measures, our respondents named simplification of the procedure for subsidizing interest, enhancing lending to distributors and retailers, steps combating illegal trade turnover, improving lending conditions for real sector companies by banks, issue of loans at reasonable rates of interest and non-involvement of the state in market participants' business activities.

**Table 15. Most efficient government support measures**



# The economic downturn as a source of further growth opportunities

## Development opportunities provided by the crisis

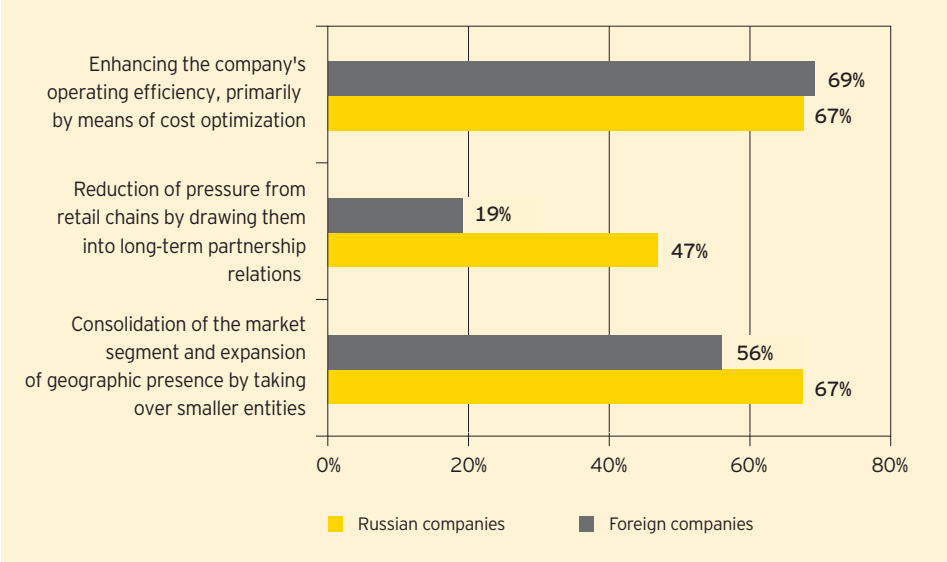
Ninety percent of respondents view the crisis as a source of opportunities for developing business in their sector.

The key opportunities indicated by the respondents included increasing operating performance and expanding market share, both through broadening the geography of operations and acquiring or occupying the niche of "squeezed out" minor producers.

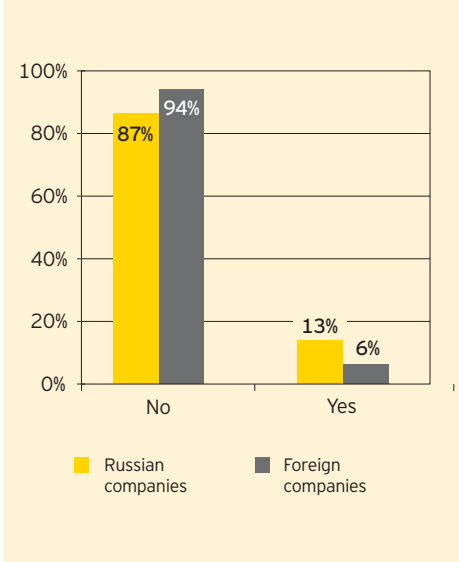
According to 47% of domestic and 19% of foreign respondents, the crunch facilitates long-term partnership relations with retail chains and mitigates one of the major adverse factors for food producers – the increasing pressure of retail chains.

Just a few foreign (6%) and Russian (13%) companies are considering entering other segments of the food market amidst the crisis.

**Table 16. Crisis-driven opportunities**



**Table 17. Penetrating other segments driven by the ongoing crisis**



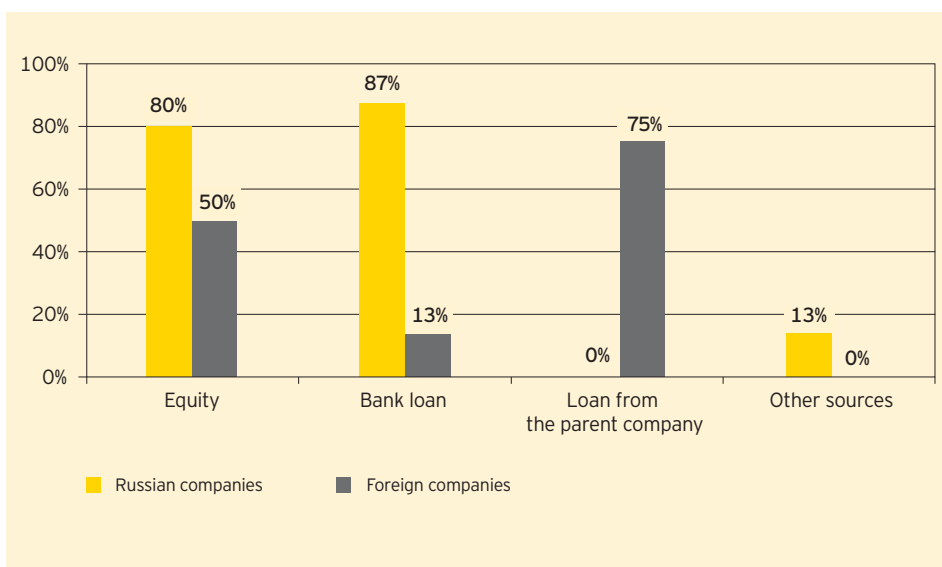


## Sources of financing further development

Russian companies view bank loans and equity as major sources of financing for implementing their strategy of further development. Among other sources of financing, the Russian interviewees named government subsidies to backbone enterprises on the list approved by the Russian government. Another possible source of financing for major Russian players in the most crisis-resistant sectors is strategic investors.

Foreign companies are planning to finance further production growth with loans from parent companies (75%) and equity (50%). Only 13% of foreign producers are considering bank loans.

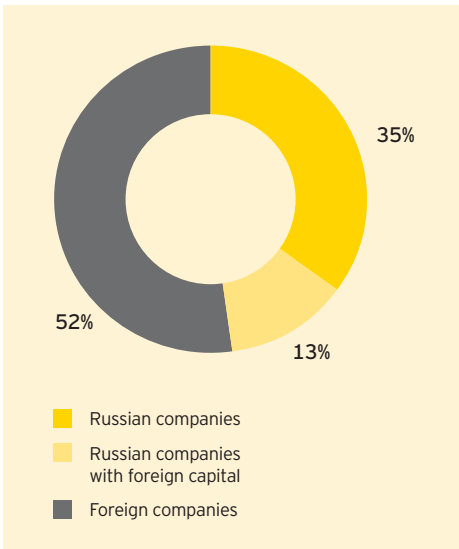
**Table 18. Sources of financing further growth**



# Survey respondents

A total of 31 Russian and foreign companies from various food and beverage industry sectors took part in the survey.

**Table 19. Companies by country of origin**

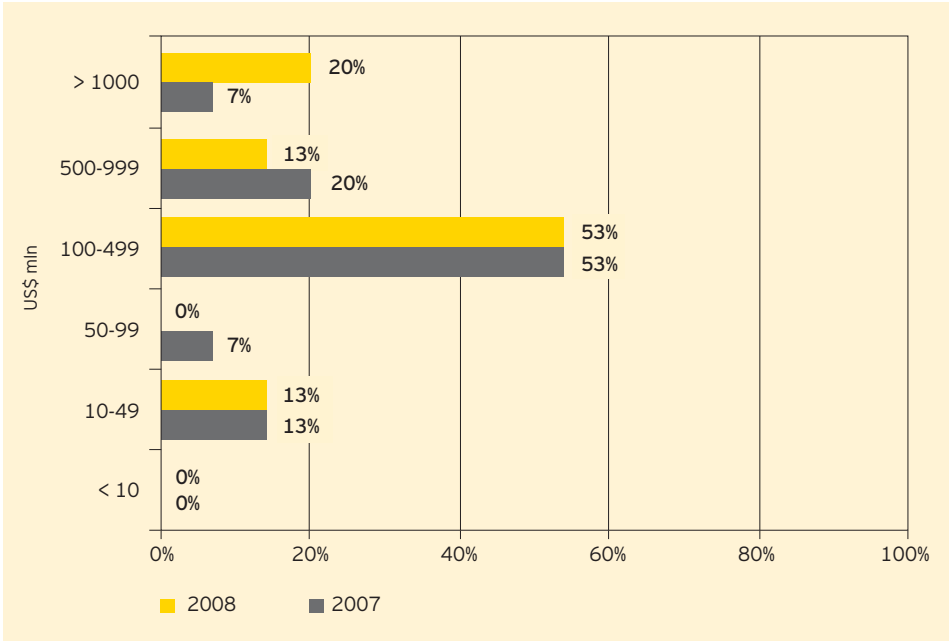


Companies with 2007-2008 gross revenue of US\$100-499 million prevail among the Russian and foreign respondents.

In 2008, all companies (7%) with gross revenues of US\$50-99 million in 2007 moved to the US\$100-499 million category. Half of companies with revenue of US\$500-999 million in 2007 had over US\$1 billion in 2008. The proportion of Russian companies with annual revenue of US\$10-49 million did not change in 2007-2008 and stayed at 13%.

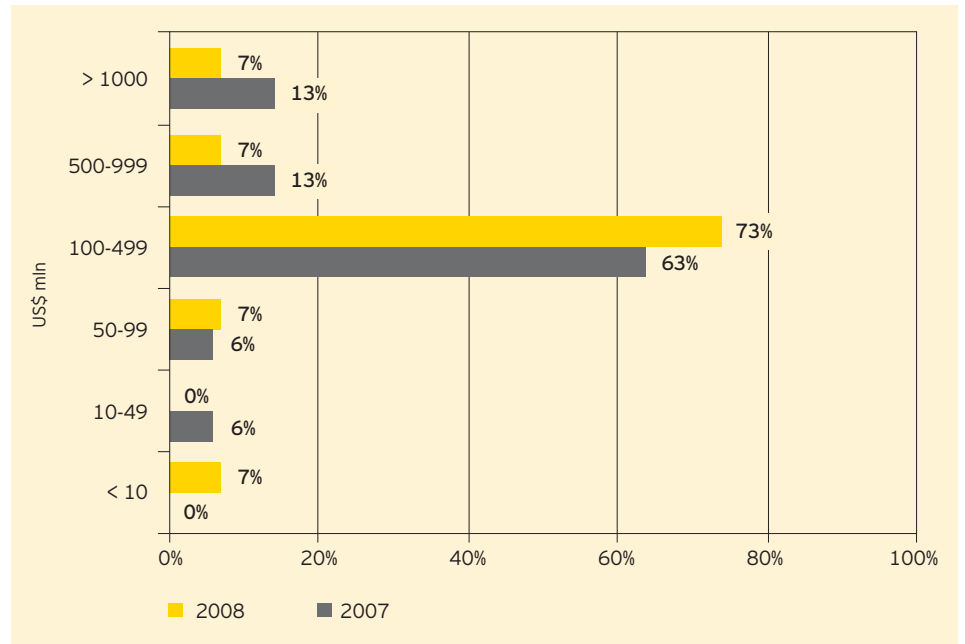
It is noteworthy that the proportion of foreign companies with revenue of US\$100-499 million in 2008 increased by 10%. Some foreign companies with US\$500-999 million in revenue moved to the category of over US\$1 billion (20% in 2007 and 13% in 2008) and from US\$10-49 million to US\$100-499 million (7% in 2007 and 0% in 2008).

**Table 20. Russian companies by the amount of gross revenue**



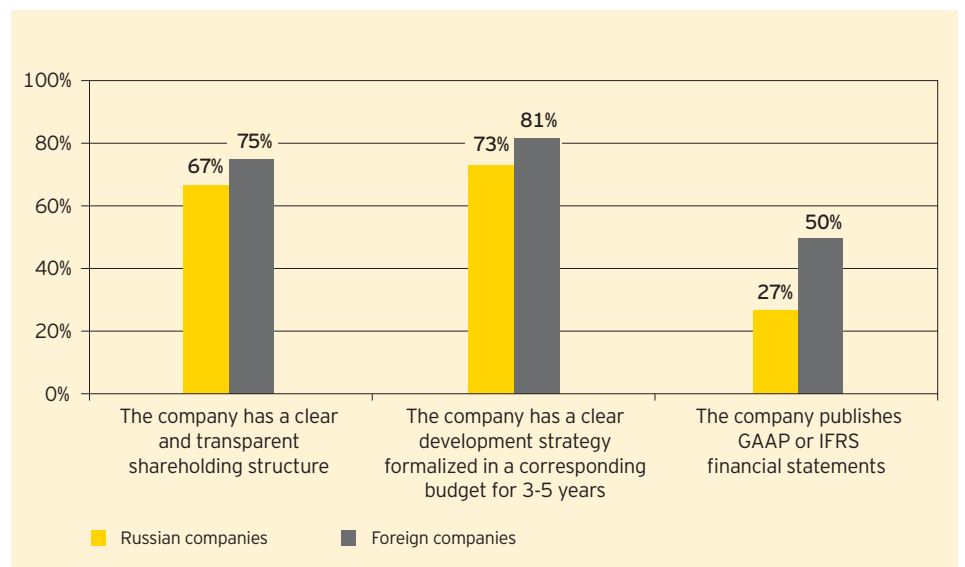


**Table 21. Foreign companies by the amount of gross revenue**



Most Russian and foreign respondents have a clear business development strategy and corresponding three to five year budgets, as well as a clear-cut and transparent shareholding structure.

**Table 22. Transparent operation of a company**

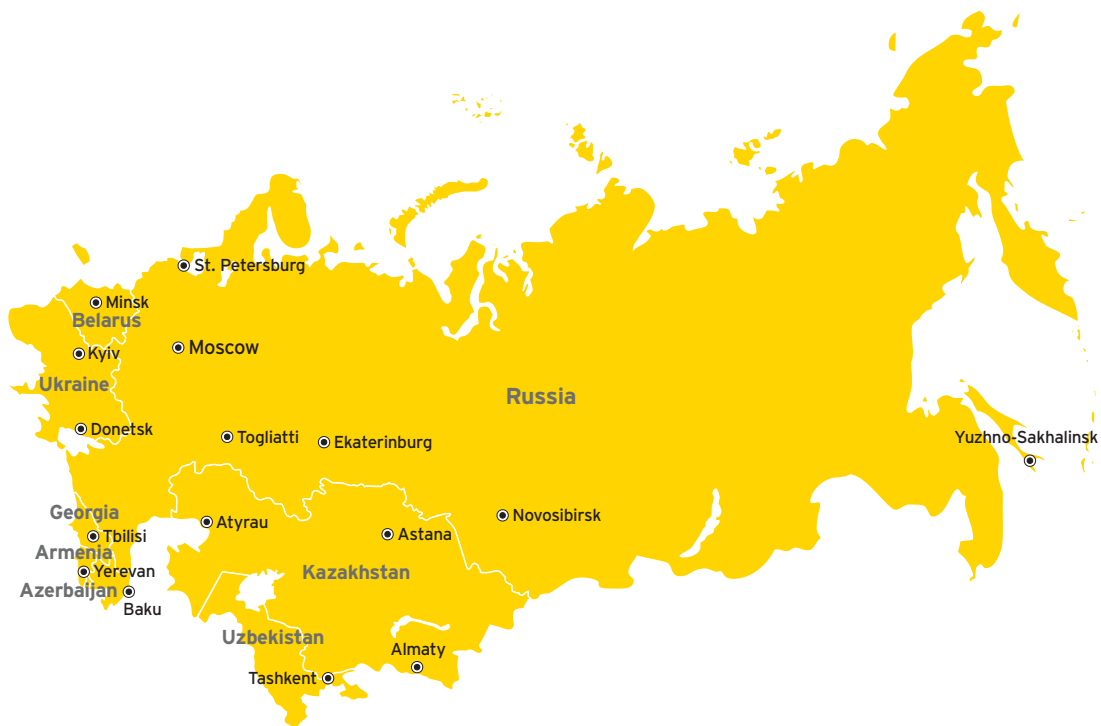


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