Growing under pressure in Russia

How consumer products companies are managing the new reality in Russia

January 2013
Economic snapshot¹

The Russian economy is slowing, but not as much as other markets.

Global trends finally brought down Russian exports, which were negative in four of the last six months as recent as January 2013.

In the medium and long term, shale gas could be a threat to the Russian economy.

The rate of inflation slowed in October and November, and year-end inflation finished at 6.6%.

Unemployment has stabilized at a low rate (5.3%), and many towns report labor shortages.

The ruble outlook is stable with moderate risks on both the up- and downsides.

The 2012 harvest disappointed at about 71 million tons, down from the bumper crop of 2011.

Ukraine experienced very poor third and fourth quarters economically, and more western companies report deteriorating business.

The drop in estimates for GDP growth in Ukraine for this year has been very sharp, and 2013 will continue to be challenging.

¹ All facts in this section of the report are sourced from DT Global Business Consulting GmbH

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For Russia, the global economic downturn provided a reality check. Before the crisis, double-digit growth meant large profits despite some inefficiencies. Today, as Russia emerges from the downturn and is becoming a more mature market in better shape than many, consumer products companies are dealing with the pressures facing most businesses in most places: pressure on margins, distribution and trade policies, as well as pressure from consumers, government and head offices.

Lack of clarity during the downturn about the environment and in particular about changes in consumer and customer behavior is giving way to a growing sense of clarity as companies recognize that the shifts that took place in the downturn are now hardwired. Faced with shrinking spending power, consumers are demanding more value for money from both premium and value-end brands. And more companies, both local and global, are trying to deliver it, which is increasing competition and squeezing margins. But while consumer products companies in Russia still face enormous challenges, hard-earned experience means they are much more certain about what it takes to meet those challenges and to succeed in this complex marketplace.

In December 2012, Ernst & Young hosted an industry roundtable with Dr. Danny Thorniley, a leading authority on Russia and Eastern Europe, for country leaders of some of the world’s largest consumer products companies operating in Russia. A number of key themes emerged:

- Most executives reported a good performance in 2012 in Russia; both the premium and value-ends of the market are doing particularly well. Ukraine is difficult for some.
- Managing global HQ expectations remains challenging; as one executive explained, “the top-line expectations have tempered, but the bottom-line expectations have strengthened.” However, some executives felt that there was a sense of shared responsibility for results with global HQ as Russia becomes more significant.
- Executives suggested that focusing on their corporate brand, work environment and flexibility was increasingly important to attract and retain talent. The sector expectation is that base salaries will track beneath inflation with the opportunity for companies to compete through bonus realization.
- Russia has one of the most complex routes to market. It is creating pressure on resources and increasing costs and risks. One executive said, “We need to rethink routes to market in Russia.”
- Traditional media remains important, but spending in some categories is declining as companies face profit pressures and shift spend to digital. One executive highlighted “bottom-line pressure could compromise category growth if brand-building investment declines as a result.” Regardless of medium, creating an “emotional bond” with the consumer is paramount.
- Executives all agreed that the pace of accelerating sustainability initiatives will be slow due to relatively poor infrastructure and perceived benefit from consumers.

Despite the challenges, it’s clear that Russia still has a starring role in most companies’ revenue streams. There is still money to be made here, but businesses have to work harder, innovate and accept that the era of big margins with little effort is over.

At the meeting we sensed cautious optimism in terms of future performance, but also a nervousness that global HQ threatens to harm continuing profits by failing to appreciate the depth of the challenges in Russia. At meetings like this and in our day-to-day client work, two key questions remain:

- How can we increase margins in this increasingly costly and complex market?
- How can we reset unrealistic bottom-line expectations from global HQ?

Finding the answers will be critical to long-term success.
Russia has changed during the economic crisis. Consumer products companies are finding that it is more challenging to turn a profit than it was before the crisis but that there is room for more growth, which is encouraging investment.

Perhaps the biggest difference, however, is the pressure companies are facing on margins from all fronts, including consumers, distributors, people and global HQs. Yet they are far more confident than they were even one year ago because, despite the pressure, they are clearer about what lies ahead, and their experience has equipped them to negotiate the fast-changing market dynamics, unpredictable regulation and similar challenges that make up Russia’s ever-changing commercial landscape.

Pressure from consumers
In Russia, the financial crisis has fundamentally altered consumer behavior. Following a period of lavish spending on brand names without any serious questions about pricing and whether a product actually delivered, consumers have matured. Even with improving conditions providing more disposable income, “consumers are not trading up as the economy improves,” summarized one executive.

There is also a strong focus on value-extends to the premium end of the spectrum. Affluent Russians will still pay for luxury, and products here are still yielding high margins, but they must deliver value by delivering on their brand promise.

Against this challenging backdrop, attendees find the keys to category growth are premiumization and innovation. Both require a commitment to introducing, developing and growing brands, which in Russia is often frustratingly difficult and always very costly, especially when starting from scratch – a point that can sometimes be lost on global HQs.

Examples of innovation success from the roundtable include Avon. The global cosmetics giant shared how it was able to act quickly to develop its “smart value” line when it became apparent that the change in consumer buying patterns was a permanent evolution, not just a short-lived phase of the economic downturn.

The need to innovate serves as a pressure point between headquarters and local operations, as Russian consumers demand product innovation tailored to their needs: “global HQ is used to a ‘one-size-fits-all’ in Russia, but that has to change.”

Some highlighted how critical it is to create a consumer experience and the importance of the personal touch. As one executive at the meeting commented: “It is really important to create emotional engagement with the consumer. The personal touch and word-of-mouth matter. Those who invested in representatives at the point of sale vs. marketing have seen better results.” However, such a personal approach is costly, as another executive noted: “The cost and infrastructure of managing the point of purchase will be huge, and global HQ do not get that.”

In many companies, marketing functions in Russia still prefer traditional media to digital, though some believe this is due to a lack of “digital competency.”

Pressure from trade
Newcomers to the country-leader role in Russia quickly learn that doing business here cannot be understood until you experience it firsthand. One relatively new executive to the role admitted: “I’ve been here two years, and I’m still trying to understand the complexity of the trade.”

It’s true to say that Russia has one of the most complex routes to market in the world, which requires consumer products businesses to spend a lot of time and money trying to negotiate the highly fragmented trade. Particularly frustrating to those attending the roundtable is the trade’s “win/lose” attitude vs. a win/win attitude to problem solving and negotiation: “The win/lose attitude to trade is distracting and costly.”
Smart innovation

Angela Cretu, Avon Group Vice-President Russia & Eastern Europe, lifts the lid on Avon’s thinking.

How is the Russian cosmetics market evolving?

Avon is a mass-market brand, which is both an opportunity and a challenge in the latest market environment. Over the last two years in Russia, the consumer profile has changed dramatically. Everything – from shopping preferences, lifestyle, the way consumers access and purchase products – is different. In addition, the market has polarized, with consumers migrating up toward premium goods for some products and dipping down into value ranges for others.

How has the consumer products sector reacted to changing consumer behavior?

This changing behavior has led to significant changes in how companies build their offering. Some have gone in for discounting on a massive and unprecedented scale. In Q4 2012, companies discounted more aggressively – many ran TV advertising promoting 50% product discounts.

How does Avon’s “smart value” differ?

Our view is that you can’t discount across the board; it’s unsustainable. You need a tactical response that enables you to maintain brand perception for when the market comes back. This means not discounting too heavily, but creating “door openers” that draw consumers in.

Door openers are consumers’ most-loved products that sell in the highest volumes. Once you identify these products, you give them special treatment. You create a specific offer identity, moving them onto their own page, giving them different positioning and communicating differently. The shock price is delivered as part of a smart package that might include other services like beauty advice. This is not just about merchandising or price. It’s a smart approach that enables Avon to create an emotional bond with consumers in which their specially chosen products are discounted and repackaged to support the choices they’re making as part of their new “smart” lifestyle.

How do you decide which products get the smart value treatment?

As a direct-to-consumer business, we know our consumers’ preferences. We know if innovation is working in real time.

We have conversations on social media where consumers can vote which products they love the best. For us, digital is the environment to reach out to our consumers and representatives in real time.

What is the shelf life of smart value, and how will it evolve?

We know the beauty market is growing slower than anticipated, and consumers are remaining very cautious. So we’re looking at how to add more attributes – like convenience, access and service – alongside best price to ensure that our product remains a compelling choice.

We believe that smart value will transition into smart emotional value. Consumers want Avon to make it personal and show them that it understands them as individuals and not as CRM segment.

What lessons have you learned through the implementation of “smart value”?

› Overdoing it dilutes its impact – very few concepts are selected for “smart value” offers.
› It doesn’t work for products that are already in value categories.
› You have to differentiate it creatively.
› Use social media to promote the door openers with direct link to shopping page.
› Connect the door openers with the rest of the goods in your store to build up the order.

What has the impact of “smart value” been for Avon?

“Smart value” has become a great platform that enables us to adapt and innovate in a way that is more subtle than just discounting. It gives us choices. It’s also delivered unprecedented unit growth and reignited our consumer relationships, helping us reconnect with the consumer. We have more consumer interactions with existing consumers, and we’ve established connections with new ones, so we’ve also increased market penetration.

We think the future is in creating emotional value. It’s obvious that traditional purchase drivers are no longer enough. Women look for an emotional connection with the brand, instant gratification, convenience and highly personalized service, and we aim to do just that.
There are few distributors, and they work with all the manufacturers. The result is that there are no exclusive agreements, and no one company accounts for more than 20% of a distributor’s business. “We have no power and no control over our destiny,” said one major player. However, many believe distributors are in trouble: “They are expanding their business by taking on more clients. They are facing the heat, and business is shrinking.” More bluntly, another predicts, “They are an endangered species.”

“The win/lose attitude to trade is distracting and costly.”

Retailers also threaten to make life difficult for brands. Retailers in Russia experienced exponential growth in recent years, but having run out of room to expand, they are now competing heavily with each other as the growing pains associated with market consolidation start to bite.

As a result, many are pushing manufacturers to do more in-store promotion, while others are going down the private-label route without fully understanding the implications. “Retailers are going to reduce the category and their profitability if they go the route of private label. They lack experience; they should test and learn instead of steaming full-scale ahead with private labels.”

Faced with pressure from the trade, almost all consumer products businesses in Russia admit to rethinking their routes to market, with those who find innovative solutions likely to create real competitive advantage.

Pressure on bottom-lines from global HQ

Global companies grew accustomed to Russia as the land of high margins and healthy profits. Those days are over, so the pressure on margins has many scrambling to boost profitability in order to meet often-unrealistic expectations from the head office. Slowly, those expectations are being reset, although expectations remain high:

“The top line expectations have tempered but the bottom line expectations have strengthened.”

Continued pressure to deliver has seen many companies cutting their marketing spend dramatically in order to increase profitability. “The risk is that bottom-line pressures will compromise category growth if brand building investment declines,” explained one attendee.

Rethinking routes to market

Routes to market in Russia are becoming increasingly challenging for consumer products companies, but innovative solutions aimed at establishing more collaborative relationships are helping to drive shared value. Examples include sharing warehouse facilities and transportation resources.

While this approach has been effective in some subsectors, challenges remain particularly acute for food producers, which have limited opportunities to gain control over distributors through acquisitions, granting of exclusive rights or different pricing strategies, such as omni-channel vs. multi-channel. Because food producers are more dependent on distributors and retailers, they have been forced to come up with innovative solutions to stay on a shelf. Changes in brand positioning and reformatting of products are tactics that have worked well. However, such initiatives need to be managed with care as they can drive up cost for producers and the outcome is uncertain.

We believe that rethinking routes to market by developing more collaborative relationships that deliver mutual advantages for producers, distributors and retailers is a critical success factor in Russia.

It is already difficult and expensive to build a brand in Russia, yet it appears many are cutting back and running the risk of losing hard-won ground. “In 2012, media spend was reduced some 20% to 30% in some categories, which is not right,” admitted one attendee. Another said, “we predict media cost plus inflation.” When one executive admitted they were under pressure to “reduce media spend and do more in-store promotions,” they were warned, “if you allow retailers to go with promotional activities, it takes you decades to recover.”

Pressure from people

As one executive expressed it: “Keeping a good team together [in Russia] remains a challenge,” but the market is stabilizing. Salary continues to be an important topic, but employer brand has crept up the agenda.

“Keeping a good team together [in Russia] remains a challenge.”

Multinationals are increasingly attracting top talent through their brand as well as their ability to offer an international career. Softer issues like work/life balance, flexibility, sustainability and
engagement are becoming more important as the workforce matures. “We are experimenting with telecommuting, and we do not need to police it,” said one. Another said: “I am amazed by the huge amount of energy brought by young people; they work hard, so we give them flexibility.”

However, it is often difficult to export Russians because their base salaries are too high, although one company reports: “We offer local contracts, and they take them.” Another finds “swapping talent works because global talent is now attracted to Russia.”

In terms of salary, the sector expectation is that base salaries will track beneath inflation with the opportunity for companies to compete through bonus realization. Russia is still considered the fastest-growing market for salaries in Europe. However, the size and scale of future rewards will no doubt be tied to the skills required to grow brands with more demanding consumers in a more competitive marketplace.

**Russia’s importance will grow**

Despite a tough few years, and with prospects for slower and less profitable growth than the glory years, consumer products businesses are still investing heavily in Russia. The cloud of uncertainty has lifted somewhat, as most believe the mix of an improving economy, maturing brands and hard-earned experience will lead to respectably sustainable growth. “There is always an expectation that there will be a crisis in Russia. Actually today, it is a period of stability,” observed one of the world’s biggest industry players at the meeting.

The difficulty is managing pressure from all sides, not least because the rest of Europe remains mired in economic uncertainty. As one executive said: “The biggest pressure will be if Europe stagnates for years to come.” As Europe languishes, Russia’s importance grows. “If something goes seriously wrong with our Russian business, then our CEE but also our whole European operations are in trouble.”

Russia’s necessity and its complexity will demand a newly forged relationship between the HQs of global consumer products companies and their people on the ground. Russia can deliver strong growth, but not on the same scale as before. Finding the right balance between realistic expectations and unrealistic, risky business will require managers near and far to develop a new understanding of the new Russia.

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**Questions executives are asking**

- How can we develop a win/win relationship with retailers and distributors?
- Do we have the right distribution model for our growing business?
- Do we need to build a unique route to market to overcome market fragmentation?
- What role should digital play in the marketing mix, and how quickly should we adopt it?
- Where can we afford to cut costs without causing long-term damage?
- How can we convince global HQ to have more realistic expectations on our profitability prospects?
- Are the Government’s pro-business sentiments genuine, and will its good intentions deliver the expected outcomes?
- Is there anything we can learn from the recession? Is contingency planning worth the investment in time and money?
Ernst & Young in Russia and CIS

We have dedicated Retail and Consumer Products (RCP) teams in Russia and CIS. We offer an array of services that help drive bottom-line growth, generate the greatest value from acquisitions and enhance operational efficiency. The RCP teams are committed to providing insights on the market and critical success factors that affect companies' commercial agendas. We understand that in today's environment, developing a focused market strategy, delivering operational efficiencies and having reliable procurement and distribution processes are critical to increasing market share. Our understanding and commitment to the RCP industries have made us the leading overall service providers in Russia and CIS.

How Ernst & Young's Global Consumer Products Center can help your business

Consumer products companies are operating in a brand new order, a challenging environment of spiraling complexity and unprecedented change. Demand is shifting to rapid-growth markets, costs are rising, consumer behavior and expectations are evolving, and stakeholders are becoming more demanding. To succeed, companies now need to be leaner and more agile, with a relentless focus on execution. Our Global Consumer Products Center enables our worldwide network of more than 18,000 advisory professionals to share powerful insights and deep sector knowledge with businesses like yours. This intelligence, combined with our technical experience, can assist you in making more informed strategic choices and help you execute better and faster. If you want to compete powerfully in your market, we'll help you achieve your potential today and tomorrow.