Russia’s current economic downturn: a 360° view
How to adapt today to succeed tomorrow

June 2015
When written in Chinese, the word ‘crisis’ is composed of two characters. One represents danger and the other represents opportunity.

John F. Kennedy
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Introduction

The purpose of the survey
The economic crisis in Russia is having a significant impact on the business environment. As such, it has recently been the subject of numerous research studies and analyses. However, it is our view that most of these analyses are too narrowly focused on isolated aspects of the crisis. Moreover, we believe that this crisis is fundamentally different from previous ones, and that it may have a lasting impact on the business environment and, correspondingly, on the success of our clients. Thus, we have set ourselves the goal of conducting a research study with a broader scope, one that is dedicated to covering a more diverse range of factors and players – from end consumers to procurement managers (representing business customers), sales managers and senior executives. Our objective is to connect all of these diverse pieces of the puzzle to publicly available data so as gain greater insight into the mutual dependencies among various market players while forecasting further developments and their implications for business.

Key questions covered
The key questions that we have sought to answer in this survey are:

• How are people and companies feeling the crisis?
• What are their expectations in terms of the duration and severity of the crisis?
• In what ways are consumers changing their behaviour as a result of the crisis?
• How can we expect this trend to evolve once the crisis is over?
• How are companies changing their value propositions?
• Are such changes aligned with the expectations of their customers?
• What are companies doing to adjust their business models?
• What kind of business environment can companies expect after the crisis ends?
• How will this change their criteria for success?
• What should they be doing to prepare for this new post-crisis environment?

About the survey
In order to better understand the various aspects of the current economic crisis, we conducted a thorough research study, consisting of:

• a survey of 3,000 Russian citizens, constituting a representative cross-sample of Russia’s urban population
• 20 in-depth interviews, conducted while we personally accompanied people on their shopping trips, about the changes in each interview subject’s consumer behaviour and the reasons for them
• a survey of 120 middle managers at Russian and international companies with a presence in the Russian market about the impact of the crisis on their businesses
• over 40 interviews with top managers of companies active in Russia about the strategic challenges they face as well as the crisis-driven opportunities they see for their businesses and how they are responding to them
• research in publicly available data sources on economic indicators and consumer confidence
• benchmarking comparison to foreign markets
Summary of key findings

There is a consensus view among both the general population and the business community about the likely duration of the crisis, but members of the latter group are more optimistic about the speed of recovery.

The current economic crisis is affecting a majority of Russia’s population, as shown by the decline in purchasing power for more than 90% of the population and with fully 53% of the population unable to accumulate any savings. Most Russians associate the crisis with rising prices and an unstable national currency. They will consider the crisis to be over only when their purchasing power improves and the Russian rouble (RUB) stabilises versus the US dollar (USD) and the euro (EUR).

While both average citizens and businesses expect the crisis to last about two more years, members of the latter group are generally more upbeat regarding the speed of recovery and already expect to see some improvement within the next six months.

Shopping habits are changing, in part permanently, which will radically alter demand patterns.

In an effort to stretch their household budgets, many people are displaying thriftier behaviour and adopting various money-saving strategies, such as buying fewer items, choosing cheaper products, or buying only items on promotion, etc. Based on our interviews and international experience, we believe that consumers will continue to exhibit most of these behaviours after the crisis as well. This factor will permanently change the nature of consumer demand. And, given how business customers are also changing their behaviour in a similar way, B2B-focused companies are also feeling the effects.

A significant number of people no longer qualify as middle class due to the drop-off in their real incomes. But even those who still meet the income criteria are changing their buying habits by limiting spending on everyday goods, delaying purchases of “big ticket” items due to a general feeling of financial insecurity, and spending less on leisure activities, among other behaviours. What this means is that the traditional role of the middle class as a driver of economic growth may be diminishing.

Companies are feeling the impact in the form of shrinking profits and diminished ability to finance new projects.

The majority of companies report falling demand and rising input costs as the main effects of the crisis. These factors, in turn, are putting pressure on profit margins. Additionally, they report the inability to finance new projects as a critical issue. This weak point, given its close connection to depressed margins and the frequently short-term horizon of many shareholders, may well jeopardise the development of the very capabilities that are critically needed for longer-term growth. Some companies, however, especially consumer goods producers with operations in Russia, are reporting a positive impact in the form of better relative price positions compared to their competitors with a larger share of imports.

In response, companies are tending to utilise tactical measures, such as cutting direct spending and marketing budgets.

The majority of companies have moved to cut spending on input materials and marketing costs as their first response to the crisis; however, some of these cost reductions are unsustainable. Many companies have also introduced a range of optimisation measures in logistics and production, but mostly within their current configurations without making any fundamental changes.

Some of the crisis-driven changes in the business environment will likely be long term; thus, companies need to make fundamental changes in how their businesses operate.

Based on the general mood of our survey participants, as well as our own analysis and external forecasts, we believe it is highly likely that Russia will experience a period of low growth after the crisis. Essentially, this will be the “new normal”, similar to what was seen in Europe following the 2009 crisis. Partially, demographic factors will contribute to this. As one example, we can cite the shrinking of the working age population, which is expected to accelerate dramatically over the next several years, mainly due to Russia’s very low birth rate in the 1990s. Among other things, the “new normal” will be characterised by:

- permanent changes in consumer behaviour with a much greater emphasis on value; and
- a surplus of supply due to falling demand, putting even more pressure on prices.

This means that companies, on the one hand, will need to adjust their value propositions to cater to changing consumer behaviour. On the other hand, they will need to rethink the ways in which they create value (i.e. their operating models) so as to remain profitable. This requires making thorough changes in business processes and systems.

Just doing this will prepare them to adequately respond to structural changes in the economy and adjust the way they operate accordingly: from managing growth to competing for profit and market share.
Impact of the crisis

Consumers and companies are expecting gradual improvement in the economy, with companies showing a more positive view.

Both believe that the economic crisis will be over in two years’ time.

Around 90% of the population has seen their purchasing power decrease in the last 12 months.

The majority of all consumers are not saving at all.

A higher proportion of lower-income consumers have started to limit expenses on everyday goods.

The majority of all consumers are not saving at all.

Even the large share of people who should be able to save (with monthly household income over 50,000 RUB), are not saving.

Purchasing behavior

Food products are a good example of how consumer purchasing has changed.

Some new habits will persist even after the crisis ends, thereby permanently changing the consumer landscape.

- 32% are now buying less
- 31% are now buying low-budget brands
- 24% are now buying more on promotion
- 19% are now buying at cheaper retailers

- lower quality of products
- buying less

Even after the crisis, I will continue focusing on...

I will switch back from...
The majority of businesses have been negatively affected by the crisis.

61% Negatively affected

26% Not affected

13% Positively affected

The negative consequences of the crisis have put pressure on both:

- **Short-term profit margins**
  - In 89% of companies, sales have declined

- **Long-term development opportunities**
  - In 92% of companies, input costs have increased

  - 80% are unable to finance new projects

The main response by companies to the crisis has been the introduction of tactical measures:

- 52% cut spending on materials
- 42% optimise production within existing configuration
- 34% cut marketing spending
- 28% optimise logistics within existing configuration

However, more fundamental measures will be required:

- Long duration of the crisis
- Limited growth after the crisis
- Permanently changed consumer behaviour

Changed competitive and consumer landscape

Need to transform business models

Managing rapid expansion

Optimise for the “new normal”
How companies and consumers are feeling the crisis and their expectations

Businesses are more optimistic than consumers regarding the speed of recovery

A variety of statistical data shows that the Russian economy is in crisis. In the period from January to April 2015, GDP fell by 2.4% year on year, accelerating further in April to a 4.2% decline (versus April 2014). Meanwhile, inflation rose to 16.4% and the consumer confidence index was at anemically low levels. Eighty-three percent of the Russian consumers and 74% of the businesses covered by our survey agreed that the country is now undergoing a crisis. A majority of the population associates the crisis mainly with rising prices and an unstable national currency and, hence, will consider it over only when their purchasing power improves and the rouble stabilizes versus leading foreign currencies.

Companies and the general population are in basic agreement that the crisis will continue for around two more years. The exceptions here are those companies active in industries that cater to large business clients, such as construction and metals and mining. They started feeling the impact of the crisis later than most, but likewise expect the recovery in their industries to come later, i.e. no earlier than three years from now. Compared to the 2009 crisis, there is now a broad consensus that this crisis will be more severe and will last longer. Still, both consumers and companies expect to see some improvement within six months and further improvement in a year from now. Among respondents, business managers are the most optimistic, with fully 68% believing that the state of the economy will be better in a year’s time than it is now, while only 37% of the population shares this sanguine view.

Those who believe we will see an uptick in only six months’ time may be a bit too optimistic, however, as the Russian Ministry of Finance expects the current economic contraction to peak in the third quarter of this year; however, an optimistic view regarding the one-year horizon is in line with current forecasts.

Figure 1: Both the general population and business managers believe that the situation will improve within one year and the crisis will end within two years

Figure 2: Most analysts predict moderate growth for the Russian economy in 2016

Dynamics of the real GDP of Russia

<table>
<thead>
<tr>
<th>Actuals</th>
<th>Forecasts*</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2015</td>
</tr>
<tr>
<td>2014 January – April 2015 (Y-o-Y)</td>
<td></td>
</tr>
<tr>
<td>0.6%</td>
<td>-2.4%</td>
</tr>
<tr>
<td></td>
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<td></td>
<td></td>
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<td></td>
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</table>

*Latest forecasts as of the 1st June 2015.

Sources: Rosstat, The Ministry of Economic Development of the Russian Federation, press releases and reports of mentioned in the table organizations

2 Statement by Russian Minister of Finance Anton Siluanov, 21 May 2015
Residents of Moscow and smaller cities across Russia have been less affected by the crisis

A majority of people feel that they have been personally affected by the crisis, with falling purchasing power cited as the most pressing issue. One-third of survey respondents report a decline even in nominal income (which includes salary and other sources of income); but, if we factor in inflation, we see that purchasing power has declined for fully 91% of the Russian population. This is even worse in the food category, where inflation in April hit 24.4% compared to the same month last year.

The burden of the crisis is not spread evenly across the population, however, with residents of Moscow and smaller cities (below 100,000 inhabitants) reporting a lower-than-average effect from declining income levels. Moscow is an exception as the overall income level in Russia’s capital city is higher and higher-income consumers tend to feel the effects of the crisis less. As for Russia’s smaller cities, a majority of their inhabitants are employed by local businesses, which operate in a less competitive environment and thus have not felt compelled to introduce major layoffs or reduce staff salaries significantly.

Lower-income people tend to feel the impact of the crisis more, with a much larger proportion from these income groups reporting that they now must buy less. While this is not surprising, it should serve as a reminder that these social groups are especially vulnerable and may fall into severe poverty if adequate assistance is not made available to them.
The role of the middle class as a driver of growth is declining

In contrast to the poorest social classes, the middle class does not face an existential challenge. That said, however, our research indicates that its role in driving economic growth could well decline as a result of the crisis. One key criterion for determining middle class status is monthly household income. Given that the real incomes of a great majority of the population have declined, it is clear that over the past 12 months a substantial share of the population has effectively “exited” the middle class (see figure 5). In some EU countries, such as Greece and Portugal, the aftermath of the 2009 crisis brought high unemployment and triggered widespread mortgage defaults, which had the effect of abruptly pushing people who had enjoyed relative middle class affluence into abject poverty. In Russia, while we do not expect such high levels of unemployment and the mortgage issue is less pressing, it’s clear that some degree of downward mobility on the social ladder will continue as long as real incomes keep falling.

Those who can still be categorised as middle class in terms of income, however, are starting to exhibit far fewer typically middle class consumer behaviours, such as car ownership, spending on leisure activities, and discretionary purchases of non-essential items. Younger people, who in economic boom times typically expect to enjoy constant growth in their real incomes, tend to be active spenders in particular. However, judging even by some of those European countries that have not been as badly affected by the crisis, we see that these free-spending patterns have changed since 2009.

People have become more cautious in their spending habits, and now prefer to save more. This has been reflected in the declining, or at best stagnating, number of consumer loans issued and the consequent decline, or very limited growth, of sales in such categories as apparel and consumer electronics that we have seen in several European countries ever since the crisis of 2008-2009. We expect this to happen in Russia as well. This means that the traditional profile of middle class consumer behaviour is changing and, thus, the role of the middle class in fuelling economic growth will inevitably decline.

Figure 5: The role of the middle class as a driver of Russia’s economic growth is diminishing

<table>
<thead>
<tr>
<th>Per capita income per month, RUB</th>
<th>Change in size of income groups among the Russian population during the past 12 months, %</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;4k</td>
<td>1.6</td>
</tr>
<tr>
<td>4-6k</td>
<td>2.4</td>
</tr>
<tr>
<td>6-8k</td>
<td>4.2</td>
</tr>
<tr>
<td>8-10k</td>
<td>3.3</td>
</tr>
<tr>
<td>10-12k</td>
<td>0.8</td>
</tr>
<tr>
<td>12-16k</td>
<td>-0.9</td>
</tr>
<tr>
<td>16-23k</td>
<td>-4.7</td>
</tr>
<tr>
<td>23-36k</td>
<td>-5.1</td>
</tr>
<tr>
<td>36-50k</td>
<td>-0.8</td>
</tr>
<tr>
<td>&gt;50k</td>
<td>-0.9</td>
</tr>
<tr>
<td>Lower middle class</td>
<td></td>
</tr>
<tr>
<td>Middle class</td>
<td></td>
</tr>
<tr>
<td>Upper middle class</td>
<td></td>
</tr>
</tbody>
</table>
Consumers’ responses to the crisis

Even higher-income people are cutting spending on necessities ...

As noted, different social classes have been feeling the impact of the crisis differently, and to some degree they are responding to it differently. Some lower-income people report being on the very edge of survival, unable to afford anything but the most basic food items. So, they tend to cut expenses on everyday goods at a higher proportion than higher-income people. For example, while 83% of people with monthly household incomes under RUB 12,000 report changing their food purchasing behaviour, for those with monthly household incomes above RUB 50,000 this figure is 53%. A similar picture can be seen regarding apparel and other basic goods.

... in order to keep up their accustomed lifestyle of “conspicuous consumption”

However, we have also observed some unexpected behaviour among higher-income consumers. For example, while many in this group are cutting back on food expenditures, at the same time they are trying to maintain their pre-crisis levels of spending on certain non-essential goods and services, such as travelling abroad or eating out.

Based on our interviews, we believe that this trend is driven by the desire to preserve their accustomed lifestyle of “conspicuous consumption”, namely in those areas where their spending power is clearly visible to others. As one of our interviewees said: “It is easier for me to cut spending on food, as nobody sees this, but it’s important to keep going abroad for the holidays, as common conversation topic with our friends.” Still, this trend has its limits and more than half of those people who used to travel abroad before the crisis have started to report doing this less, or even curtailing their foreign travel completely. A similar picture can be seen as concerns eating out.

There are also generational differences in how people are responding to the crisis. A higher proportion of younger people are seeking to work more in order to be able to retain their accustomed lifestyles. In contrast, older people predominantly rely on cutting their expenses.

The crisis is affecting people’s longer-term plans as well. A significant portion of respondents report putting off doing home renovations or buying a car, while buying one’s own property seems like a very distant ambition for most of our interviewees.

Residents of smaller cities are reacting to the crisis even as their incomes have been less affected

From a regional perspective, given the fact that Moscow residents report a lower decline in purchasing power, they also report reacting to the crisis less, with 38% stating that they have not taken any measures in response to the crisis (versus a Russia-wide average of 25%). Interestingly, though, the same logic does not apply to Russia’s smaller cities (under 100,000 inhabitants).

Although residents of such cities report the lowest impact on income from the crisis (along with Moscow), they still have a much greater proportion of interviewees reporting having taken “anti-crisis” measures (only 19% say they have not taken any measures). This is probably related to the generally lower levels of income in such cities, where people spend a higher share of what they earn on food. Given the high level of inflation in food prices, this has resulted in a materially significant decline in purchasing power, which has inevitably had a severe impact on many people’s lives. But, it may also be a function of the proverbially more frugal, fiscally conservative behaviour of small town denizens.

Figure 6: A higher proportion of lower-income consumers have started to limit expenses on everyday goods

Share of respondents who have made any changes since the crisis and more than half of those people who used to travel abroad before the crisis have started to report doing this less, or even curtailing their foreign travel completely. A similar picture can be seen as concerns eating out.

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Figure 7: Higher-income consumers have cut spending on eating out and travel

Share of people with monthly household income of over RUB 50,000 who have cut spending on eating out and travel
Consumer behaviour is changing across categories

Cutting spending, either by buying less or buying cheaper items, is by far the most widespread response to the crisis. People are spending less across all categories, with even those categories considered absolute necessities being affected. For example, about one-third of people surveyed who buy medicines, report some change in their purchasing behaviour and two-thirds report making changes in their food purchases, which is greater than in either apparel, for example, or the aforementioned foreign travel category. This may come as a surprise, but it is attributable to two factors. First, food is by far the biggest expense in family budgets and the lower the income level, the more this is true. So, by curbing their spending on food, a family impacts its finances the most. The other factor that can explain this, which is mostly relevant for high-income households, is the previously noted visibility of categories.

In order to cut spending, people are deploying various strategies. The greatest variety of such strategies can be seen in the food category, which is connected to its previously noted relevance for family budgets. The most commonly mentioned strategies are buying less, buying cheaper brands or products, changing retailers, and buying more items on promotion (see figure 10).

Some changes are likely to be permanent

While some of these behaviours are likely to be temporary, as most people find them unpleasant (i.e. buying less) and even unhealthy (i.e. downgrading to lower-quality products), international experience and interviews with consumers strongly indicate that the majority of these behaviours will remain even after the crisis. The crisis has forced people to become savvier about getting more value for their money and once they get used to behaving more frugally, they will see no reason to revert back to their previous behaviour, even if their material status would allow them to do so. This is especially true if they expect economic growth rates to remain depressed for a longer period of time, as was seen in most European countries after the last crisis.

A typical example of this are goods sold under retailers’ own in-house brand labels. Several respondents admitted that they wouldn’t even think of buying such products before the crisis as they assumed they were of inferior quality, but now after trying them they have realised that they represent good value for money. “For some of these goods, I see no reason to switch back to branded products”, as one of our interviewees said, for example. Similarly, people who started shopping in more value-oriented stores have seen that they provide good value for money and are now unlikely to switch back to more expensive stores after the crisis. This is also connected to an additional change in behaviour that some people have reported: They tend to make fewer trips to big shopping centres for large bulk purchases and

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**Figure 8:** Moscow residents report having taken fewer actions in response to the crisis than in other cities

<table>
<thead>
<tr>
<th>City</th>
<th>Changes in Medicines</th>
<th>Changes in Food</th>
<th>Changes in Apparel</th>
<th>Changes in Foreign Travel</th>
</tr>
</thead>
<tbody>
<tr>
<td>Moscow</td>
<td>23%</td>
<td>54%</td>
<td>17%</td>
<td>7%</td>
</tr>
<tr>
<td>St Petersburg</td>
<td>73%</td>
<td>49%</td>
<td>20%</td>
<td>5%</td>
</tr>
<tr>
<td>1m+ cities</td>
<td>74%</td>
<td>42%</td>
<td>23%</td>
<td>7%</td>
</tr>
<tr>
<td>500k-1m cities</td>
<td>73%</td>
<td>51%</td>
<td>17%</td>
<td>5%</td>
</tr>
<tr>
<td>100-500k cities</td>
<td>81%</td>
<td>51%</td>
<td>17%</td>
<td>5%</td>
</tr>
<tr>
<td>&lt;100k cities</td>
<td>77%</td>
<td>58%</td>
<td>5%</td>
<td>5%</td>
</tr>
</tbody>
</table>

**Figure 9:** Younger people are trying to survive the crisis by working more, while older people are cutting expenses

<table>
<thead>
<tr>
<th>Age Group</th>
<th>Work More</th>
<th>Cut Expenses on Everyday Purchases</th>
</tr>
</thead>
<tbody>
<tr>
<td>18-30 y.o.</td>
<td>23%</td>
<td>42%</td>
</tr>
<tr>
<td>31-45 y.o.</td>
<td>20%</td>
<td>49%</td>
</tr>
<tr>
<td>46-60 y.o.</td>
<td>17%</td>
<td>51%</td>
</tr>
<tr>
<td>&gt;60 y.o.</td>
<td>5%</td>
<td>5%</td>
</tr>
</tbody>
</table>

**Share of respondents who have made any changes since the crisis began in terms of consumption, shopping habits and borrowing, %**

- Moscow: 62%
- St Petersburg: 71%
- 1m+ cities: 74%
- 500k-1m cities: 73%
- 100-500k cities: 81%
- <100k cities: 77%
are increasingly patronising smaller, nearby stores to which there is no need to travel and in which the likelihood of spending money on non-essential, “impulse” purchases is lower. As well, because convenience stores in Russia are usually focused on price, similar to discount stores in the West, consumers will have even less incentive to abandon them for more upscale stores.

**This crisis will fundamentally transform the consumer landscape**

We believe that this crisis is permanently changing how and where people shop and what they shop for. Such a transformation in consumer behaviour will undoubtedly lead to permanent changes in how retailers and consumer goods companies do business. Post crisis, people will remain more price sensitive, more sceptical toward brands that do not offer obvious, credible additional value compared to low-budget retailer’s brands, and much more savvy about getting the merchandise they want at discounted, promotional prices. Companies will need to adjust their product offerings to reflect this new reality and, at the same time, revamp their operating models to support such an adjustment.

**Figure 10:** Some habits adopted during the crisis will continue even after it’s over

<table>
<thead>
<tr>
<th>Habit</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Buy less</td>
<td>32%</td>
</tr>
<tr>
<td>Buy cheaper brands</td>
<td>31%</td>
</tr>
<tr>
<td>Buy more on promo</td>
<td>24%</td>
</tr>
<tr>
<td>Buy at cheaper retailers</td>
<td>19%</td>
</tr>
</tbody>
</table>

Once the crisis ends, behaviour is likely to...

- **Continue**
- **Revert back to pre-crisis habits**

When the crisis ends, consumers will tend to buy cheaper goods of comparable quality to items they bought before the crisis, but will switch away from buying cheaper goods of unsatisfactory quality.

**Figure 11:** The highest share of consumers report changing their shopping behaviour in the food category

<table>
<thead>
<tr>
<th>Category</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Food</td>
<td>77%</td>
</tr>
<tr>
<td>Apparel</td>
<td>66%</td>
</tr>
<tr>
<td>Cosmetics, perfume &amp; hygiene items</td>
<td>50%</td>
</tr>
<tr>
<td>Medicine</td>
<td>34%</td>
</tr>
</tbody>
</table>

Share of respondents who changed their consumption patterns and behaviour in each category during the past 12 months, %

**Specifics of the apparel and electronics categories**

We have observed similar behavioural changes in the apparel category with a lot of people reporting buying less apparel and around every tenth respondent saying he or she has completely curtailed buying items in this category during the past year. There are two further noteworthy changes in apparel. First, an item’s brand is clearly more important in this category. If in the food category over 30% of consumers say that they have switched to cheaper brands as a response to the crisis, in apparel only 14% report having done so. So, while people may prefer buying less apparel, they remain loyal to their favourite brands. Another behaviour that is typical in the apparel category is delaying a purchase until the item goes on sale at a discount. As consumers learn that apparel retailers are very likely to hold sales, offering a large number of goods at significantly reduced prices (and in a crisis, under pressure from falling demand, are even more likely to do so), they are increasingly unwilling to pay full price for any item, preferring to wait until the retailer offers the item on sale. Needless to say, this can have very negative consequences for retailers’ margins.

In the consumer electronics and home appliances category, we saw an extreme spike in sales activity in the fourth quarter of 2014, as shoppers desperately tried to convert their rapidly depreciating roubles into tangible goods. Now, however, a lot of consumers are delaying purchases of such items, which is also associated with the widespread postponement of home renovation plans. Those who are buying are becoming much more savvy about finding the best prices, using online aggregators such as Yandex Market to find the best price and then buying the item from that specific vendor, regardless of its reputation or the buyer’s previous experience with the store. Another contributing factor here is that brand loyalty toward gadget and equipment manufacturers tends to be much higher than toward retailers.
People are increasingly concerned about financial security

When asked which values have gained in relevance to them during the crisis, the vast majority of respondents mentioned financial security. They are especially concerned about losing their jobs and being unable to sustain themselves during their retirement years.

As for other values gaining relevance, some worry about their children’s education. As well, physical security has become a primary concern for some people. As a positive consequence, many respondents say they are devoting more time and attention to their families and health. The former response may be related to spending less time on leisure activities and hence having more time for family, while the latter could be one of the benefits of adopting more rational spending habits.

The share of people who are not saving at all is high and expanding

Regarding the widespread need for a feeling of financial security, there is an intriguing connection here with the savings rate. On the one hand, it’s clear that those who cannot save feel financially insecure, as they don’t have any cushion in case of an emergency, e.g. if they lost their job or needed to make a major expenditure. But, it’s noteworthy that even those who could save, don’t. In fact, more than one-third of respondents with a monthly household income above RUB 50,000 save nothing at all, while 30% are saving less than before. This appears to be connected, on the one hand, to the desire to retain their current social status (especially as regards such “conspicuous consumption” items as foreign travel, apparel, etc.) and, on the other hand, to a lack of confidence in the security of their savings due to previous negative experiences with the aftershocks of default and currency devaluation, not to mention a low level of trust in financial institutions.

When asked about their expectations for the future, people do say they intend to save more, although fully 39% of those answering this question believe they still won’t be able to save anything even three years from now.
The share of non-performing loans is at a record high, and this problem is more widespread in smaller cities

Official statistics show that loan performance is deteriorating with the volume share of non-performing loans to individuals having already reached levels last seen during the 2009-2010 crisis (over 9%). As the total volume of loans is much higher now (9% of GDP in 2009 versus 13.2% now), the problem of non-performing loans could become even more acute than in 2009.

Still, the majority of people in our survey report that their families have no loans (69%). The most commonly cited reason is that they do not want to go into debt, although some may also face challenges in being approved for a loan given their financial situation.

Eighteen percent of people surveyed report having taken out a loan during the past 12 months, with a higher proportion of smaller-city residents doing so. Indeed, the smaller the city, the higher the share of residents who report taking out loans in the past year. This means that Russia’s smaller cities, which already had a higher level of indebtedness before the most recent crisis, are becoming even more indebted now.

Interestingly, approximately half of those people who reported taking out a loan over the past year borrowed the funds from family or friends. Such person-to-person loans may be the most risky of all, however, given that the borrower’s poor credit rating was likely one of the main reasons for not borrowing from a bank in the first place. In such cases, there is a high likelihood that the loan will eventually become non-performing, thus hurting all parties involved. So, it’s clear that the situation with non-performing loans is potentially worse than the official statistics show.

Figure 15: Russia’s regions had a higher debt load than Moscow even before the crisis hit

Average bank loan load in average monthly salary (2014)

Moscow | St Petersburg | Regions with 1m+ capital | Others
---|---|---|---
1.7 | 2.3 | 2.6 | 2.4

Figure 16: Consumers in Russia’s smaller cities have increased their debt load more than consumers in larger cities

| What actions have you taken during the past 12 months (%)? | Moscow | St Petersburg | 1m+ cities | 500k-1m cities | 100-500k cities | <100k cities |
---|---|---|---|---|---|---|
I have taken a loan from friends or relatives | 2.6 | 3.3 | 3.3 | 4.7 | 3.4 | 0.7 |
I have taken both types of loans: from banks and from friends/relatives | 2.3 | 6.2 | 11.8 | 2.2 | 3.4 | 0.7 |
I have taken out a bank loan | 5.2 | 8.7 | 17.1 | 2.3 | 6.0 | 8.3 |

Figure 17: The share of past-due loans in Russia is increasing and has almost reached peak levels last seen during the previous crisis

Source: The Central Bank of the Russian Federation
Impact of the crisis on business

Companies report a mostly negative impact from the crisis with importers affected the most

The majority of managers that we interviewed agree that Russia is currently experiencing a crisis. Most commonly, they began feeling the effects already in mid-2014. A predominant percentage of managers surveyed report that the crisis is affecting their business negatively, but there is also a fair proportion of managers who report seeing a positive impact from the crisis on their companies. Among negative factors, rising costs for input materials, shrinking demand, and inability to finance new projects are the most frequently cited. Meanwhile, the biggest positive development cited is improved relative price positioning versus competitors with a higher share of imported goods or input materials. Some large Russian companies also report that they have been able to boost exports due to the weak rouble.

Some larger companies are benefiting from the crisis and expect to strengthen their positions

The impact of the crisis is unevenly felt among companies, even to a larger extent than has been observed among the general population. The first factor that impacts the degree to which a company is affected by the crisis is its size. Unsurprisingly, bigger companies tend to feel the negative impacts of the crisis less and some even report gaining market share. This is in line with the experience of European companies in the last crisis, during 2009, when bigger companies strengthened their positions as smaller players either could not afford to develop their business during the crisis or went out of business entirely. We expect to see a similar trend in Russia, with bigger players using their economic heft to gain market share and their own financial resources to invest in their businesses, while smaller players won't be able to follow suit due to high interest rates and the general lower availability of financing. Thus, we expect to see accelerated concentration across most industries in Russia, both due to faster organic growth of bigger players and M&A activity, with bigger players swallowing smaller ones or driving them out of business.
There are significant differences between industries concerning the impact of the crisis

Retailers, especially non-food companies, report feeling the negative impact of the crisis the most. This is very much in line with our findings from the consumer survey, where we have seen that people are cutting spending on everyday items and delaying purchases of larger, non-food items such as electronics and appliances. The burden of the crisis has been felt less in the telecoms industry and among Russian consumer goods companies. The latter benefit from two factors: limitations on imports of certain food products, which limits competition, and the weak rouble, which makes imported goods comparatively more expensive. As a result, consumer goods companies with operations in Russia are winning market share, which is visible from a comparison of the revenue dynamics of FMCG companies and food retailers. Food retailers report a much higher decline, however, meaning that the share of imported goods in their revenue is decreasing, which is also confirmed by official statistics.

The crisis will affect profit margins

When asked about the negative consequences of the crisis, the most widespread answers were rising input prices and declining sales. Most respondents also believe that these trends will continue into next year.

A combination of these factors may prove very negative for companies, both in the short term and over the longer term. In the short term, rising input costs mean that companies would need to raise prices accordingly, in order to keep their gross margins comparable. However, as sales are under pressure, raising prices can be a very risky move, as it may alienate value-seeking consumers, thus decreasing sales even further. What’s more, consumers are not only buying less but, as we have seen, are also becoming savvier about finding better value for money by buying cheaper products or buying on promotion, all of which affects the margins of retailers and, consequently, their suppliers.

The situation is comparable for those companies that predominantly sell to other businesses. Such businesses are curbing spending as well, deploying similar measures as end users. The expected result is that the input prices of most companies will grow faster than their selling prices, decreasing gross margins and affecting profitability.
Longer-term development opportunities may be at risk

The third most frequent answer regarding the negative consequences of the crisis is “inability to finance new projects”. This is a result of both high interest rates and generally less accessible funding, as well as general business uncertainty. Given companies’ need for new projects to boost their ability to compete, this negative consequence may prove to be the most harmful for Russian companies in the longer term.

![Figure 22: The crisis is affecting both short-term profit margins and long-term development opportunities](image)

The negative consequences of the crisis have put pressure on both:

- **Short-term profit margins**
  - In 60% of companies, sales have declined

- **Long-term development opportunities**
  - In 51% of companies, input costs have increased
  - 65% of companies are unable to finance new projects

Business customers are changing as well, which is having an impact on B2B-focused industries

From our interviews with procurement managers, we learned that when trying to optimise spending, companies are deploying some of the same strategies as end consumers. For example, they are buying cheaper products, changing suppliers and attempting to buy less. There are also some strategies that are specific to professional buyers. Many of them are trying to omit the middleman by buying directly from manufacturers as well as renegotiating payment terms in their favour.

As a result, the procured volumes of goods and materials that are used as production inputs are declining, hurting companies in industries that cater to business customers, such as the industrial products sector, in which we have combined the automotive, heavy engineering, extraction and industrial electronics industries. Seventy percent of managers surveyed in this sector report sales declines over the past 12 months. As well, buying of business services, such as marketing, has been affected, impacting providers in these areas as well.

We expect some of these crisis-driven behaviours to dissipate and managers to revert back to accustomed behaviours once the economic situation improves. Overall, 47% of procurement managers are expecting growth in procured volumes within the next year and 65% within three years. However, similar to consumers, we believe that many managers will continue to display some of their crisis-driven behaviours even after the crisis ends. This is also evident from the fact that procurement is a key area where companies are investing in making improvements. All of this should in turn have a long-term impact on suppliers as well, who will likely also retain certain crisis-driven behaviours in how they serve their customers.
Banking
According to senior executives in the Russian banking industry, banks have been engaged mainly on refocusing from pursuing further growth to optimising their portfolios and reducing their risk exposure. To achieve this, they are focusing on their core business operations with particular emphasis on existing large clients and lower-risk projects. Some foreign banks are concentrating on their multinational clientele, offering them a wider range of services. In segment terms, retail is weaker due to falling income levels, so banks are predominantly focused on corporate clients. However, there is currently scant demand for financing of new projects; for the most part clients are seeking to refinance their existing loans. Moreover, as financial institutions are now reluctant to expand lending to the general population given the already high level of indebtedness, some banks are now putting greater emphasis on generating additional revenue from their existing clients in more affluent segments.

Generally, banks are reporting falling margins due to increased financing costs and heightened risk. In this regard, state-owned banks are at an advantage because they have access to cheap financing. Most of the top managers interviewed believe that they will use this advantage to gain market share.

Property and construction
Companies in the property and construction industry began feeling the effects of the crisis on their revenues later than their peers in other industries. However, they sensed that a crisis was brewing earlier than most, given their understanding that interest rate hikes and the contraction in long-term lending would inevitably have a severe impact on their business in future. It’s not surprising, then, that top managers in this industry expect that their sector will feel the impact of the crisis longer than others. Currently, such companies are mainly focused on completing projects already under way; new projects, however, are largely being postponed. Or, as one of the managers surveyed put it: “The main focus now is to survive.” One of the main issues currently is how to finance working capital, given that major clients are reluctant to pay in advance and interest rates on loans are too high.

Those active in the residential property business are slightly less worried because Russia enjoys a relatively low unemployment rate, which they do not expect will change dramatically. This should serve as a cushion that prevents mass defaults on mortgages. Still, all managers interviewed report substantial declines in both revenues and margins; this is due both to the postponement of new projects and the trend among customers across the industrial, commercial and residential segments to use their increasing leverage to bring prices down. In commercial property, for example, tenants are increasingly making demands that rental agreements denominated in foreign currencies be changed to roubles, to which developers generally tend to acquiesce because they don’t want to keep space empty. Due to the reduced activity in the sector, numerous assets are being underutilised, which is expected to put further pressure on prices.

In light of these pressures, companies in the sector are mainly seeking to minimise their exposure to foreign currencies on the cost side by using local equipment and service suppliers. While they would prefer to switch to rouble financing, current interest rates are prohibitively high. Some companies are aggressively cutting costs; for example, one top manager told us that his company has laid off 30% of staff and plans to cut overheads by 20%. There is a widespread expectation that many smaller companies will not be able to withstand these developments and will ultimately go out of business, while wider consolidation is not expected, even though it would make sense according to our interviewees. The main obstacle to increased M&A activity is uncertainty – not just as concerns business overall, but also uncertainty regarding the fair value of assets in light of the changing environment.

As new projects are being postponed or abandoned altogether, suppliers to property developers, such as construction equipment and materials manufacturers, are starting to feel the downturn’s bite as well, albeit somewhat later than most. Top managers at such companies see the lack of financing for new projects as a key problem. They think it unlikely that investment activity will pick up anytime soon, even if sanctions are lifted. As a way of balancing out revenue losses, they are focused on aggressive cost-cutting and are also trying to boost exports as much as possible.

Food production
The food production industry has been greatly affected by the “scissors effect” of falling revenues and rising input costs. The exceptions here in terms of revenue are those producers that are benefiting from Russia’s countersanctions, such as meat and cheese producers. As for input costs, top managers at all companies are reporting growth in this item, with those that import burdened by unfavourable exchange rates and even those that buy locally faced with a limited supply of materials at the level of quality they need, which in turn helps drive prices upwards. Subdued demand is forcing food producers to fight for market share; in doing so, the majority are sacrificing part of their gross margins in order to remain price competitive.

Food producers have noticed changes in the purchasing behaviours of consumers, who are increasingly seeking cheaper products, thus reversing a common trend in recent years in which the typical Russian consumer started actively buying upscale products with more sophisticated features (more convenient packaging, easier to prepare, etc.). As a response, some of the more advanced companies we talked to are introducing new product lines that offer cheaper ingredients, thus allowing them to address the changing needs and preferences of their customers.

As for overall strategic direction, for the most part our interviewees have not reported charting a radically different course. For sure, the Russian market has lost some of its appeal for international companies, some of which are adopting a more defensive approach in a bid to hold on to their current market positions. Meanwhile, many local players would like to invest but face challenges in financing their projects given that interest rates are high and foreign investors are wary of Russia’s country risk.
How business has responded to the crisis

As their main reaction to the crisis, companies have started to optimise spending

When asked about the main measures that their companies have taken in response to the crisis, a majority of managers mentioned cutting spending on materials, not just in cash terms but also in terms of volume. This is not very surprising, since they cited sales decline as one of the main problems they are facing.

Importantly, we found that those companies with a more developed procurement function are generally more effective in adjusting their spending. With the crisis making it critical for companies to improve their in-house procurement functions, we expect that the level of maturity of this function will increase across the country, making corporate purchasing behaviour more professional overall. This fully reflects what we have seen in our work with a number of clients, which are increasingly investing in building up their procurement capabilities.

Expectations from suppliers are changing

When we asked sales managers about the main things their customers expect from them during negotiations, the most commonly mentioned items were price reductions, volume discounts and payment deferrals. Procurement managers tell us that, as a trade-off, most companies are willing to accept less additional services and use their own logistics resources to pick up goods from the manufacturer’s premises as opposed to having them delivered.

Responding to these expectations, the majority of our interviewees report that the discounts they give to their customers have increased slightly in the past 12 months and that payment terms have become longer. While these are logical measures that companies take to retain customers, they do eat into short-term financial performance by lowering gross margins and increasing working capital.

There is further potential for optimising indirect spending

As noted, the No. 1 measure that companies are taking is to curb their procurement spending, which means companies as customers are also changing, which in turn affects those businesses that primarily serve business customers. If we take a deeper look at the responses, it is interesting to note that companies report that the biggest spending reductions were in core materials, including those used as inputs for their value creation (raw materials, semi-products, goods for resale, etc.). However, there has been less focus on indirect spending, i.e. materials for own use, internal transport, rents, etc.

This may sound counterintuitive, but it can be easily explained. Once sales volumes start to drop, companies immediately need fewer inputs for their production processes as they also start producing or reselling less. As a result, companies immediately start buying less and their inventories go down, which our survey is confirming.
But, we see a different situation with indirect spending, as the need for this kind of spending does not change overnight. Take the simple example of office material: Even if a company’s revenues decrease by 20%, it does not immediately mean that this company needs less office materials. Only after it adjusts its operating model, reduces its staffing levels, redefines it need for office materials and takes similar actions will it start buying less of it. Therefore, reductions in indirect spending typically lag reductions in direct spending. But, as margins are under pressure, we can certainly expect cutting indirect spending to be a priority for managers in the near future.

In spite of efforts by companies to invest in cost optimisation, the majority still report that procurement spending as a proportion of revenues has increased, meaning that gross margins are decreasing. And, even as most procurement managers report having this particular ratio as a target element of their plans, about half of them expect that the trend toward higher procurement spending will continue. This would mean further pressure on margins, but also on a company’s procurement function to lower costs. Judging by some findings discussed previously in this report as well as our work with clients, there is still ample room for improvement in this area.

The majority of companies are limiting their marketing budgets, which can be a risky move

The second most frequently mentioned area for optimisation is marketing. Corporate advertising and trade budgets are being affected, as is promotional activity. However, not many companies are reducing the levels of their promotional discounts. Promotion is a sensitive area; on the one hand, it lowers relative margins, but on the other it can drive consumer behaviour in a crisis even more. The majority of consumers in our survey told us they are much more attentive to promotions, which can have more sway over their purchasing behaviour in a crisis, given the need to stretch their budgets. The same can be said for advertising overall. Experience shows that maintaining or even increasing a company’s level of advertising activity in a crisis can result in winning market share. This is why the top managers at companies we spoke to, which are leaders in their segments, for the most part have not reduced the volume of their advertising activities, while some of them have merely renegotiated rates. In general, their plan is to increase their company’s share of voice at the expense of other companies that are seeking to limit their advertising, thus potentially winning more market share based on this approach.

A significant share of companies surveyed are optimising their value propositions, but are generally avoiding making fundamental changes

As a response to changing consumer trends, a significant portion of the companies interviewed mentioned adjusting their value proposition as well as their offering to consumers. For example, retailers are introducing cheaper products and lowering their overall price levels. For several retailers we talked to, private label products are gaining increased relevance, as they offer a way to lower prices on the shelf while still maintaining healthy margins. Consumer goods companies report adjusting the specifications of their products in a bid to reduce costs. They are changing the non-essential components of their products and producing more private label goods. The first two measures mentioned represent a rational response to the consumer’s pursuit of lower prices. Indeed, if a company wants to offer lower prices but maintain its margins, it must change its products. However, while saving on non-essential product elements like packaging (especially transport packaging) is a relatively risk-free measure, tinkering with the specifications of the product itself can potentially backfire on a company as consumers do notice changes to a product and typically disapprove of them.

A more mature procurement function has helped companies respond better to the crisis

Companies are exhibiting various behaviours aimed at optimising their spending, most of which are similar to the behaviours displayed by end consumers (for example, buying less or switching to cheaper products). What is interesting to note, though, is that those companies with a better-developed procurement function (more standardised, centralised, etc.) are more likely to take more decisive measures. For example, they are more likely to switch suppliers, while those companies with a less mature procurement function are more likely to stick with their original supplier, even if it doesn’t offer the best prices. The reasons for this may vary, ranging from a lack of focus on optimisation to a lack of professionalism.
The private label option is a very relevant trade-off that many consumer goods companies are facing. Driven by changing consumer needs, retailers have started placing greater emphasis on this type of product and are searching for suitable manufacturers. On the other hand, however, a growing volume of private label goods amid stagnating levels of overall consumption will inevitably result in reduced sales volumes for branded products. While this effect is currently being overshadowed in Russia by the falling share of imports, it is certain to manifest itself sooner or later. So, producers have a dilemma: either they produce retailers’ private label goods for lower margins but enjoy larger volumes, or they focus on branded products manufacturing and maintain their margins but risk losing market share.

Cost-cutting – yes, changing operating models – no

When asked about operational optimisation, most managers mentioned some initiatives in various areas. In logistics, they tend to optimise warehousing and centralise logistics systems (meaning that they require suppliers to deliver goods to a central warehouse, which they then distribute internally using their own transport). Retailers have been quite quick to adjust staff numbers in stores and sublease surplus floor space in light of reduced traffic. Meanwhile, service companies are reducing spending on maintenance and lowering headcount at their points of sale. There has been little change among manufacturing companies, however, but some production processes are being optimised with the aim of increasing efficiency and material costs are being decreased.
Implications for business

When the crisis ends, will things go back to normal?

When Russia’s current crisis finally ends, which most respondents expect to happen sometime in mid-2017, what will happen then? Will the business environment go back to normal? Probably so, but it will very likely be a “new normal”, characterised by:
- lower growth;
- a fundamentally changed consumer; and
- a changed competitive landscape.

Low growth

Several factors indicate that Russia’s post-crisis economy will enjoy only moderate levels of growth. The recovery scenario will be very different from the 2009 crisis, when post-crisis GDP growth was substantial with the average growth rate for the period 2010-2012 standing at around 4%. First, the 2009 crisis in Russia was part of a global downturn as was the recovery, which Russia benefited from. This time, however, the current crisis is quite Russia-specific in nature and is being driven mostly by external factors, such as the oil price. Second, Russia’s economy is still very dependent on oil and the oil price is unlikely to reach the levels seen in previous years for the next couple of years at least. Third, if Russia succeeded in spurring growth in 2009 by activating existing but underutilised assets, now it would need to invest in new assets while introducing best practice know-how. However, foreign direct investment is low due to the high level of uncertainty and local investors are subdued due their limited access to financing. Adding to all of this, the working age population is shrinking while the share of retired people is growing, causing a potential shortage of skilled labour and increasing the burden on public finances. Most of the top managers we talked to share this view and are expecting low growth over the next several years.

A fundamentally changed consumer

As seen from our consumer surveys and confirmed by several international studies of economic crisis situations, consumers are very likely to change permanently as a result of having lived through a crisis. A number of behaviours that consumers typically adopt temporarily, as they seek to find ways to navigate the crisis, will become permanent, meaning that many consumers will never fully revert back to their pre-crisis behaviour patterns. Judging by developments in Europe after the 2009 crisis, people will remain cautious about spending, placing financial security higher on their personal agendas (e.g. saving to create a financial cushion for retirement or bouts of unemployment, reducing or eliminating debt, etc.).

A similar pattern can be expected among business customers, as the crisis is pushing them to procure more rationally and it is unlikely that they would cease doing so after the crisis is over.

A changed competitive landscape

In most industries, the competitive landscape will change as a result of previously mentioned changes. Some smaller players will lose out and go out of business, while there will be consolidation and increased market share will go to those competitors that can adjust successfully and rapidly to the new reality. In the absence of any significant market growth, the growth of individual companies will depend on taking market share away from competitors, which in turn will increase pressure on prices. Overcapacity in some areas will further exacerbate this development. In short, competing is not going to get any easier.

The business environment is changing fundamentally, requiring a different approach to doing business

The business environment is changing so dramatically that companies must rethink their fundamental strategic goals and their basic approach to doing business. For a good many years after 2000, the environment in Russia was quite positive, as markets in most industries were growing and competition was fragmented. The main strategic goal of the majority of companies was to get big as fast as possible. While doing so, for the most part they could also post healthy profits, something which is not very common in more mature markets, where fast growth and profitability are often seen as mutually exclusive. The focus for most top managers in this period was therefore on top-line growth in order not to miss out on underlying market growth. Simply put, being able to produce enough products of reasonable quality at not too high prices was enough to achieve success.

But, in the environment that Russia will face over the next several years, this previously surefire approach from the 2000s simply won’t do the trick anymore. The focus of business will, of necessity, have to switch from managing rapid expansion to optimising business models so as to protect profitability in a low-growth environment.
Companies need to adjust their business models in order to cater to a changed customer base

While the companies surveyed have described a range of sensible measures that they are already taking in response to the crisis, there is a feeling that they are not doing enough to prepare for a fundamentally different business environment (see figure 25). We believe that more must be done, on the one hand, to revise companies’ value propositions and, on the other hand, to adjust corporate operating models so as to support the delivery of revamped value propositions in a profitable way.

In the section below, we describe a number of potential adjustment options that companies can take to prepare themselves to succeed in the new environment.

Develop cheaper products

A majority of the companies we talked to understand that customers are now much more price conscious. In this light, it is surprising to note that not a lot of consumer and industrial goods companies are developing cheaper products. Yet, this is what our interviewees told us. They are changing the specifications of existing products to lower costs, which can be, as noted above, a risky endeavour. This is because consumers are very likely to notice such changes and generally react poorly to a beloved product being altered. Yet, at the same time, consumers want cheaper products, and so a reasonable way to satisfy consumer preferences without damaging hard-won brand equity is to roll out new, cheaper products. This approach is not limited to FMCG. A senior executive at a real estate development company told us that, in the 2009 crisis, they learned that low-priced residential properties are less affected by broader economic conditions, which is why they have since refocused entirely on this segment. However, as stated, only a very few companies report having taken a similar approach in response to this crisis.

Streamline the product portfolio

One of the most common methods of reducing input prices in times of stagnating volumes is by simplifying the portfolio of products that a company buys. The most straightforward way of achieving this is to streamline the assortment of products that it sells. Doing so while retaining revenue levels should result in the ability to buy greater quantities of individual input materials or products. In addition, it can help reduce complexity in supply chains and manufacturing. While this may sound very basic to most businesspeople, it may come as a surprise that only a small share of the managers in our survey report having streamlined their product portfolios in the past 12 months.

Adjust service levels

Typically, as long as a company attempts to optimise its operations while trying to offer the same service level as before, it will at some point reach a limit (by service level, we mean availability, speed of service, staff support in retail and other service industries; frequency and accuracy of delivery and stock availability in logistics; or sales and customer support in the consumer goods and industrial products industries). Therefore, companies should reconsider the required service levels, especially as crisis prompts customers to shift their preferences, with price becoming a clear priority over service levels.

Forty-seven percent of procurement managers in our survey said that they are willing to accept lower levels of service from their suppliers if they can get a better price. And, a massive shift among shoppers toward discount stores is, in essence, nothing more than a trade-off of convenience and superior service for lower prices. The people we accompanied while they were doing their shopping as a part of our survey were not even particularly annoyed by the poor availability of certain promotional items in some stores. “I’ll come back tomorrow”, they typically said, “as the price is really good”. All these findings indicate that companies should ask such questions as: What services do we need to offer to our customers? Do we need delivery every day or would every other day suffice? Do we need to have our stores open 24 hours a day, or would maybe 12 hours be enough? Do we need all these stores or could we close some of them? Again, not many respondents to our survey mentioned these measures being taken by their companies.

Optimise overheads

As revenues decline, overheads (indirect spending and head office expenses) need to decline as well; otherwise, they will impact margins negatively. However, as noted, not many companies in our sample have reduced indirect spending and only every fifth company reports having optimised their head office. There are several reasons for this, the dominant one being that companies have not yet adjusted their processes and organisation to the new reality and, hence, they find it difficult to cut overheads. This requires a bottom-up reconsideration of what activities a company must be engaged in to create value, how they can be performed in the most efficient way, and what materials and equipment are required to support these processes so to be able to optimise both the number of people employed and the cost of materials and services, which are not direct inputs to the core process (indirect spending).
Reorganise procurement
Even as almost every company in our survey reports having the goal of curbing spending, and even as the answers of our respondents clearly show that those companies with a more mature procurement function have been more effective in responding to the crisis, the procurement function at many companies still remains at a very low level of maturity. A very small percentage of our respondents report that they have changed their procurement organisation (by introducing more standardised processes, centralising decision-making, defining roles and responsibilities, etc.) or policies (for example, differentiated category strategy, supplier classification, etc.). Another surprising insight regarding procurement is that only a very small share of respondents report that they have localised procurement within their companies. Given the limitations on imports and the relative price advantage enjoyed by domestic suppliers, we expected more positive answers in this area and, thus, see this as an opportunity.

To conclude, we believe that companies will need to brace themselves for structural change in the economy and adjust the way they operate accordingly: from managing growth to competing for profit and market share.

Figure 25: The main response by companies to the crisis has been the introduction of tactical measures

Companies are focusing on short-term measures … … but are avoiding

- Cut spending on materials 52%
- Optimise production within existing configuration 42%
- Cut marketing spending 34%
- Optimise logistics within existing configuration 28%

bigger, more fundamental changes (such as adjusting operating models)
tough calls or trade-offs (such as adjusting service levels or streamlining product assortments)
Additional macroeconomic data

Figure 26: Consumer confidence is falling amid shrinking GDP and rising inflation

| Leading macro indicators: Y-o-Y dynamics (vs the same period of the last year) |
|---------------------------------|--------------------------|
| GDP (January – April 2015)      | 2.4%                     |
| GDP (April 2015)                | 4.2%                     |
| Inflation (all goods and services) in April 2015 | 16.4% |
| Inflation (food) in April 2015  | 24.4%                    |

<table>
<thead>
<tr>
<th>April 2014</th>
<th>April 2015</th>
<th>Y-o-Y dynamics</th>
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</thead>
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<td>Consumer confidence</td>
<td>84</td>
<td>70</td>
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</table>

Sources: Rosstat, Levada-Center, Ministry of Economic Development of the Russian Federation

Figure 27: Real incomes of Russian consumers are steadily declining

<table>
<thead>
<tr>
<th>Period</th>
<th>Real incomes: Y-o-Y dynamics (to the same month of the previous year)</th>
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<tr>
<td>November 2014</td>
<td>-3.8%</td>
</tr>
<tr>
<td>December 2014</td>
<td>-6.2%</td>
</tr>
<tr>
<td>January 2015</td>
<td>-0.9%</td>
</tr>
<tr>
<td>February 2015</td>
<td>-1.7%</td>
</tr>
<tr>
<td>March 2015</td>
<td>-2.1%</td>
</tr>
<tr>
<td>April 2015</td>
<td>-4.0%</td>
</tr>
<tr>
<td>Average for the period November 2014 – April 2015</td>
<td>-3.1%</td>
</tr>
</tbody>
</table>

Source: Rosstat

Figure 28: Production volumes are declining in Russia

<table>
<thead>
<tr>
<th>Period</th>
<th>Production index: Y-o-Y dynamics (to the same month of the previous year)</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 2015</td>
<td>100.9%</td>
</tr>
<tr>
<td>February 2015</td>
<td>98.4%</td>
</tr>
<tr>
<td>March 2015</td>
<td>99.4%</td>
</tr>
<tr>
<td>April 2015</td>
<td>95.5%</td>
</tr>
<tr>
<td>January – April 2015</td>
<td>98.5%</td>
</tr>
</tbody>
</table>

Source: Rosstat
Special thanks

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