





Riding Russia's Consumer Boom

Russia is poised to become the largest consumer market in Europe. From retail and grocery to financials and pharmaceuticals, the market is rebounding. What must consumer companies do to operate profitably in Russia? What changes must Russia make to realize its potential? The answers depend on what the companies do next. For whether they know it or not, consumer companies are both directly and indirectly shaping Russia's next wave of economic growth.

THE FINANCIAL CRISIS HIT RUSSIA HARD.

In the 10 years leading up to the 2008-2009 recession, the Russian economy was booming, expanding at an average of 7 percent GDP per year (in constant rubles), while growth over this same period translated into a staggering average annual increase of 27 percent, fueled by the energy sector and rising oil prices.¹

The crash was as dramatic as the boom: GDP fell nearly 8 percent, the stock market plunged, destroying more than \$1 trillion of Russian companies' value, and the ruble lost one-third of its value versus the dollar. Falling oil prices and rising unemployment took their toll.

Ironically, however, the financial crisis has had a positive impact on Russia's economic thinking. The nation has weathered the crisis and proven its resilience and ability to rebound. More fundamentally, there is a growing recognition that its growth, driven mostly by escalating oil prices and energy exports, is not

sustainable. In the same way the financial crash of 1998 halted the liberal period of President Boris Yeltsin, so too, the latest global financial crisis may mark the end of the Vladimir Putin era of dependence on energy rents.

Russia's new focus must be to balance its traditional government-run industries with a new breed of future-oriented industries, including pharmaceuticals, financial services, high-tech and consumer packaged goods (CPG).

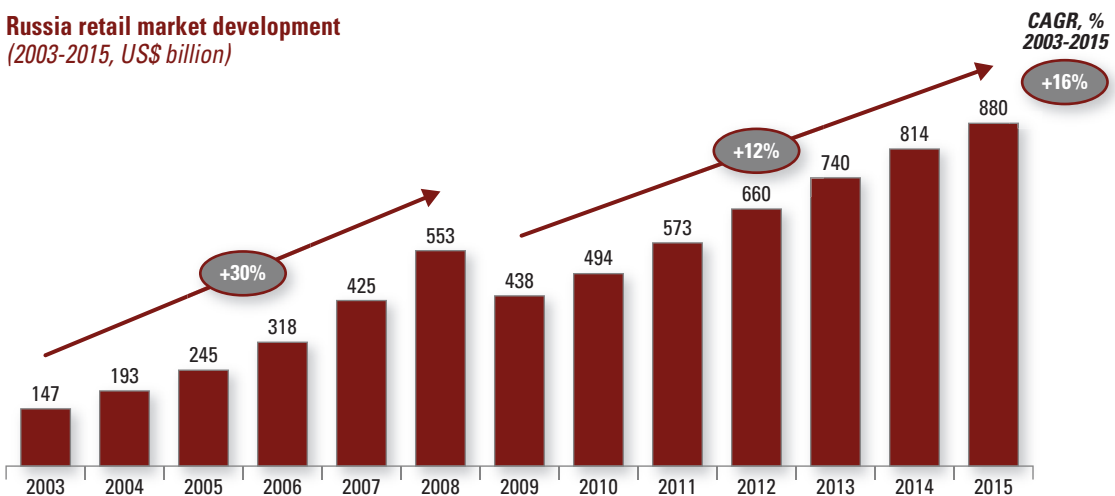
In fact, our analysis shows that the development of the consumer sector in particular is core to Russia's longer-term economic growth and position in the global economy. In the next 10 years, the country is poised to become the largest consumer market in Europe.

Already, many of the CPG companies that were making inroads in Russia years ago, but curtailed investments during the economic crisis, are re-investing. Last December, PepsiCo spent \$3.8 billion to purchase a 66 percent share in

FIGURE 1

Anticipated retail market growth: Russia tops the agendas of most consumer-focused companies

Russia retail market development (2003-2015, US\$ billion)



Note: CAGR is compound annual growth rate.

Sources: Renaissance Capital; Rosstat; A.T. Kearney estimates

¹ This growth rate considers the appreciation of the ruble relative to other currencies in U.S. dollars.

Wimm-Bill-Dann, Russia's leading dairy, juice and water company—Russia is now PepsiCo's number two market globally. Danone owns 20 percent of the dairy market and is the country's largest dairy producer following its \$2.8 billion acquisition of Unimilk. L'Oréal recently opened the doors of its first in-market factory, and Nestlé is refurbishing two factories and building the company's 14th facility in Russia.

Before the crisis, the Russian business environment was detached; executives knew they would eventually *need* to become more open, but they didn't *have* to. Now, they are slowly coming around, understanding that investments by consumer-driven companies can and will provide the impetus for Russia's integration onto the world stage (see figure 1).

Russia: What CPG Executives Think

A.T. Kearney recently completed a series of interviews with 47 general managers and CEOs of leading Russian and multinational companies to discuss the development of Russia's CPG sector.² These conversations provide unique insights into the issues, challenges and trends driving business investments in Russia and the reasons why Russia remains high on CPG growth agendas.

From these discussions, along with our experience and research, we identified five priority “themes” that represent not only key challenges for CPG companies doing business in Russia, but also where their investments and presence are either directly or indirectly *influencing* market reforms.

² The survey took place between December 2010 and February 2011.

1. Capturing the next Russian consumer wave
2. Improving the “ease of doing business”
3. Strengthening the investment environment and operations
4. Winning the “war for talent”
5. Investing to capture emerging trends

Within these themes are various market challenges and opportunities. Indeed, we are struck by the similarities to the proverbial

Which came first—Russia's desire to become more attractive to Western investors, or investors' quest for global growth opportunities providing the impetus for Russia to address its many challenges?

chicken and egg question: Which came first—Russia's desire to become more attractive to Western investors and its consequent push for change, or investors' quest for global growth opportunities providing the impetus for Russia to address its many challenges?

The following discusses each theme in more detail:

1. Capturing the Next Russian Consumer Wave

While still below pre-crisis levels, the consumer market is on the rise. The percentage of households with an annual disposable income of \$100,000 or more will nearly triple from

1.1 percent in 2009 to 3.1 percent in 2020.³ In our conversations with executive leaders, companies are adjusting their strategies to attract post-crisis Russian consumers who have a far different outlook from their pre-crisis days. The new Russian consumer focuses on value, desires to buy Russian products and demands a more modern retail channel.

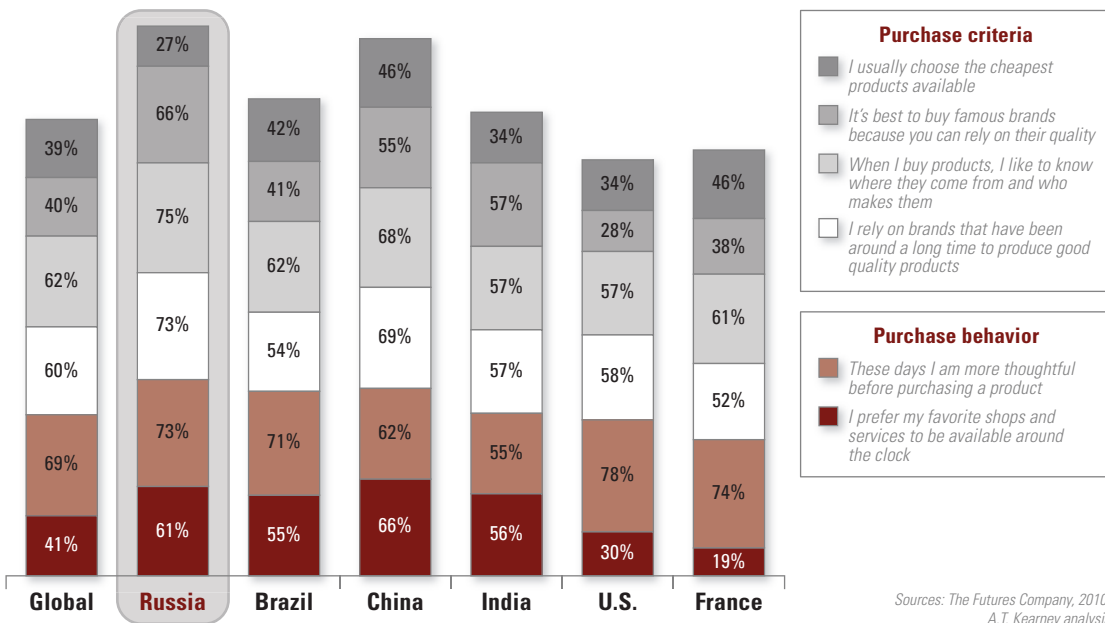
Focus on value. Before the crisis, Russian consumers were less brand and price sensitive—willing to purchase premium items regardless of price. Today they consider value and product quality to be of far greater importance. According to The Futures Company Global Monitor 2010, 73 percent of Russian consumers now put more thought into their purchases, and half look for the best prices (see figure 2).

Some consumer companies are addressing this change in attitude by changing the size of their products. Red Bull, for example, whose drinks were available only in a 250-milliliter can, recently introduced a 450-milliliter container. While the price is higher, it is a better value on a per-milliliter basis.

Desire to buy Russian products. Russians have always held a firm belief in tradition and heritage—a quality that CPG companies must understand in their pursuit of customers. Russians still rely on home-grown brands over products from the West, and this is particularly true of older consumers: Sixty-six percent of people 45 years of age or older prefer to continue buying the same familiar, tried and trusted products.⁴ Western companies have spent years tapping into this desire. Nestlé, for example,

FIGURE 2

Purchasing criteria and consumer behavior in developed versus emerging markets



³ Source: Euromonitor International; based on constant 2009 prices
⁴ The Futures Company Global Monitor survey, 2010

Sources: The Futures Company, 2010; A.T. Kearney analysis

offers a range of distinctly Russian coffees, yogurts and candies, packaged and advertised with these consumers top of mind. Kraft introduced a Russian-branded candy bar, and Unilever launched a Russian line of single-serving soups. Younger consumers are more willing to try new products, as are residents of Moscow and St. Petersburg, regardless of age. These shopping behaviors continue to evolve as both young and older Russians become wealthier and worldlier and their definitions of quality and brand change.

Enjoy the retail experience. While still lagging behind Western levels of retail penetration—approximately 45 percent of today’s retail revenues in Russia still come from shoppers in traditional retail channels, such as open-air markets, fairs, bazaars and mom-and-pop stores—the retail channel is quickly evolving to offer a broader range of retail options to the many young, affluent singles and families who seek more sophisticated, convenient and novel shopping experiences. We believe the recent consolidation trend among Russia retailers, such as X5’s acquisition of Kopeika and Dixy’s purchase of Victoria, is just the beginning. Larger investments by CPG companies naturally will spur more demand for products, increase reliability in the supply chain, and drive further consolidation of today’s fragmented retail landscape. More critically, CPG companies’ ability to work openly and transparently with Russian retail partners will be imperative to meeting their growth goals.

2. Improving the “Ease of Doing Business”

Beyond language and cultural norms, doing business in Russia is fraught with problems associated with government bureaucracy, complex regulatory requirements, corruption and

a systemic lack of transparency. The difficulties have increased despite the government’s efforts to curtail them. In the late 1990s, Vladimir Putin began cracking down on lawlessness and corruption. For the most part, however, his attempts to add controls only created more layers of bureaucracy and hidden levels of unmanageable corruption.

While some improvements are noticeable, Russia today is neither open nor transparent. According to the World Bank’s “Ease of Doing Business” index, Russia currently ranks 123rd out of 183 countries, just behind Uganda.⁵ The data indicate that doing business in Russia has grown steadily more difficult over the past few years: In 2005, it ranked 97th; last year, it was 116th. Meanwhile, neighboring former Soviet Republics are advancing faster—their business markets are demonstrably more open and transparent. Georgia now ranks 12th in ease of doing business, Lithuania ranks 23rd, and Kazakhstan ranks 59th.

A recent report by the Economist Intelligence Unit criticized Russian import procedures, citing only two countries—Azerbaijan and the Central African Republic—that require more paperwork to support cross-border trade. One executive in the course of our conversations described the difficulty in obtaining approval to build a commercial warehouse and connect it to basic services. “It required 53 different procedures over nearly 18 months,” she said. “Getting an electricity connection required nine procedures, including multiple inspections by various agencies and a permit from the Transport Ministry.” The entire process takes, on average, nearly 300 days and costs 47 times the average per capita income in Russia.

The problems are compounded by the many agencies involved—with names such as the Federation of Antimonopoly and the

⁵ The “Ease of Doing Business” index is created by the World Bank and rates different countries across nine areas in the life cycle of a business.

Department of Comprehensive Well-Being—that demand completion of similar documents, but each done in that agency’s specific wording and style. Often these documents have to be completed in sequence; so if one agency withholds approval (for any or no reason), the other agencies will not move forward with their approvals.

Lack of transparency. A lack of regulatory transparency is among the biggest headaches for CPG companies, often with unintended consequences as laws are passed in seeming secrecy. Last year, for example, the amount of customs duties levied on imports changed without public debate or discussion; the government added an additional surcharge to each kilogram

of imported goods weighing more than 50 kilograms. At times, the added cost of just one container rose by thousands of dollars, significantly impacting the cost of doing business in a country where companies ship thousands of containers a month.

So, how are companies managing? Nearly everyone in our discussions cites the importance of developing relationships with top-level local and regional authorities, by directly investing, hiring local managers or joining industry associations. Figure 3 highlights mitigation strategies to confront the many challenges.

Lobbying for change. As individual companies, big players such as Nestlé, P&G or Kraft may have lots of investment power. By acting

FIGURE 3

Many of the challenges in Russia can be mitigated with internal policies and controls

Challenge	Description	Mitigation
Legislation system, bureaucracy and corruption	<ul style="list-style-type: none"> Legislative changes are frequent, including tax policies Constant inspections take place (taxes, health benefits, insurance) Government procedures are lengthy 	<ul style="list-style-type: none"> Build top-level relationships Hire local legal experts or law firms Monitor changes in laws and regulations continually
Government control	<ul style="list-style-type: none"> State- and government-owned companies control 50 percent of the economy Strategic industries are restricted from foreign investment 	<ul style="list-style-type: none"> Build top-level relationships Coordinate investments in operations with regional, state and federal governments
Management style and culture	<ul style="list-style-type: none"> Management approach is Soviet-style Fraud is widespread Workers are passive; they await orders 	<ul style="list-style-type: none"> Put in place experienced international managers Introduce internal controls and security systems Demonstrate growth opportunities
Supply base	<ul style="list-style-type: none"> Standardization in supply base is limited 	<ul style="list-style-type: none"> Focus on supplier development Adapt requirements to the materials supplied
Logistics	<ul style="list-style-type: none"> Logistics are not reliable, and just-in-time delivery is difficult to achieve Import process is lengthy and complicated 	<ul style="list-style-type: none"> Find a reliable local partner Plan thoroughly and account for emergencies Choose locations close to customers and suppliers
Tax code	<ul style="list-style-type: none"> Tax payers and tax inspectors have different understandings of the letter of law Corrections and additions are constantly being made to federal statutes and the tax code 	<ul style="list-style-type: none"> Hire experienced accountants and tax advisors Employ auditors
Accounting	<ul style="list-style-type: none"> Russian accounting standards differ from both IAS and GAAP 	<ul style="list-style-type: none"> Employ an experienced accounting department and chief accountant
National and international standards	<ul style="list-style-type: none"> Russian standards differ from international standards for the same processes and procedures (for example, technological procedures and labeling) 	<ul style="list-style-type: none"> Understand national standards and where they correspond with international ones

Source: A.T. Kearney analysis

together, however, they provide the real influence behind organizations that lobby the government on behalf of CPG companies. The largest and perhaps most influential of these is RusBrand, a nonprofit association of more than 60 branded manufacturing and service companies. This industry-wide voice can inspire radical change. One example: A recent free-trade agreement forged by Russia, Belarus and Kazakhstan opens up borders and allows the free flow of goods among the three countries. RusBrand, by defining the rules and the way companies need to operate within that environment, shaped the government's response to this important issue.

3. Strengthening the Investment Environment and Operations

Beyond the regulatory and management complexities, the overall investment environment

in Russia has major challenges. Two stand out: inflation and operational excellence.

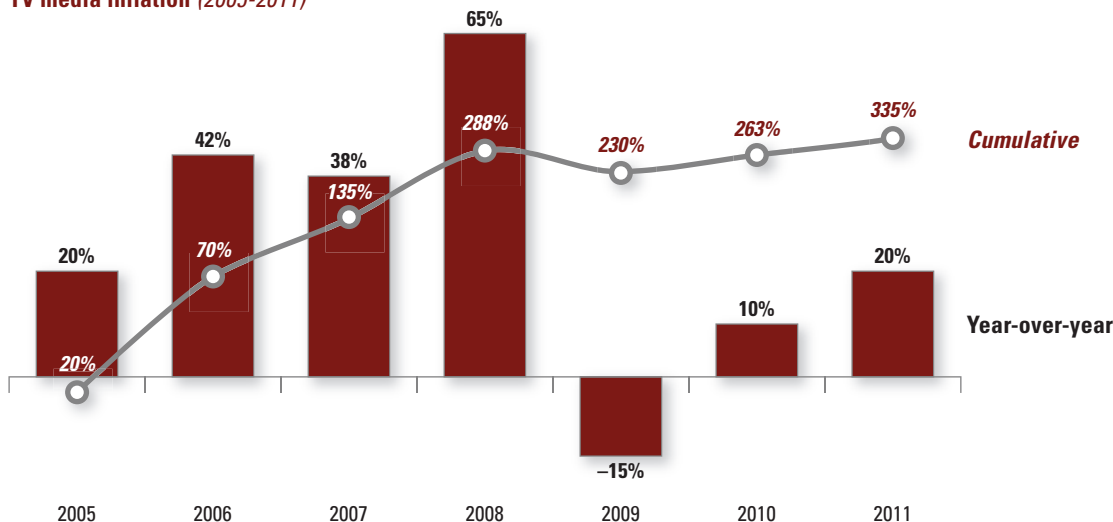
Soaring inflation—the impact on media, commodities and prices. In 2004, the Russian government took control of the primary media outlets and began imposing more stringent regulations on the advertising industry. More recently, following the economic crisis and subsequent loss of competition, the cost of advertising in the national media—primarily television, but also print and billboards—became inflated. As a result, most CPGs face more margin pressure.

And prices continue to soar. Between 2005 and 2008, according to Optimum Media OMD, advertising prices for Russian television rose nearly 300 percent cumulatively (see figure 4). This rate is well above advertising prices in other BRIC and most developed countries. In the United States, for example, advertising costs rose 10 to 15 percent annually during the same three-year period.

FIGURE 4

Television advertising prices continue to rise

TV media inflation (2005-2011)



Sources: Optimum Media, Media First; A.T. Kearney analysis

Yet advertising in Russia is considered the principal means of building a brand and increasing product demand. CPG companies continue to advertise, but many do so only when launching new products. They then cut back as brands become established.

In addition, as in most countries, there is extreme margin pressure on commodities—including raw-material inputs, transportation and oil. But unlike other countries, the rules are defined by government controls and pressure from monopolistic suppliers.

Further, as Russians become more value conscious, companies cannot raise product prices as production costs increase. Without price elasticity, the focus must be on managing costs and profitability—building a world-class procurement practice, maintaining a globally integrated supply chain and managing total operating costs.

Operational excellence, the key to profitability. Nearly all executives in our survey spoke of operational excellence—the overall quality of the end-to-end value chain from supplier to customer—as key to long-term success to combat inflation, preserve margins and drive profitable growth.

Leaders are retooling local manufacturing to operate not at local standards, but at world-class efficiency levels. Local companies must have a reliable global supply chain that ensures on-time, right-price delivery of raw materials to manufacturing plants and finished products to shelves. In the West, having products on the shelves is taken for granted, as everyone knows how to do it. Companies, therefore, compete by differentiating their products through quality and added services and, to a lesser degree, price. In Russia, companies differentiate their products primarily on availability and then on price and quality.

Distribution. Several barriers may prevent a product from arriving on Russian store shelves, most of which are caused by “predictable unpredictability,” where something unexpected—often an obscure action by the government or an unforeseen supply-partner glitch—will upset operations. Take, for example, one CPG executive’s dilemma when the government passed legislation restricting the entry

As Russia begins to make changes, investments by consumer-driven companies will provide the impetus for Russia’s integration onto the world stage.

of fresh ingredients for its products from European suppliers. When the legislation went into effect, almost without notice, the shipments were held at the border until a new, high levy was paid. What’s more, the restrictions associated with the new legislation were so confusing that key retailers mistakenly removed all of the company’s products from their shelves. Today, the company is struggling to re-start its business in Russia.

Interestingly, preparing for the unpredictable is leading to unique relationships. For example, PepsiCo and Anheuser-Busch, two non-competing bottlers, are developing a joint distribution system to reduce the challenges in getting their bottled products onto consumer shelves. Local supply partners are slowly improving their capabilities to capture some of this work.

In Russia, as in other countries, we advise our clients to do scenario planning in order to have contingency plans in place that can be implemented quickly.

4. Winning the “War for Talent”

The competition is fierce to recruit and retain talented Russians. According to UNESCO, 51 percent of young Russians graduated from higher educational institutions in 2008—placing Russia ninth in the world in graduation levels.⁶ Compare this figure with the United States, where 36 percent of young people completed higher education in the same year. Everywhere, young, ambitious, well-educated and hard-working Russians are determined to succeed.

However, the global recession has caused a systematic “brain drain,” as young people leave the country in droves. Skilled young Russians, in part frustrated by the pace of change and levels of corruption, are leaving for countries with higher growth rates and more opportunities to find work or start businesses. When presented with the opportunity to live or work abroad, many young Russians are eager to accept. A recent survey by *New Region* of the Russian Information Agency finds that 73 percent of young Russians are seeking to live or work in another country—whether just to experience life outside their own country or to emigrate permanently.

What does this mean for companies operating in Russia? When companies enter Russia, they will most likely bring all or most of their top leadership with them. Expatriates lead many of the more successful CPG companies in Russia. However, for longer-term success, many of the executives we spoke with are also putting programs in place to recruit capable Russians

into their management ranks. While reversing this brain drain is a priority for the government, it provides an opportunity for CPG companies to attract talented but disaffected young workers who crave exposure to Western standards and ways of working.

Mars, for example, in contrast to many of its competitors, is led by home-grown executives, and its presence in Russia since 1991 speaks to the company’s long-term commitment and steadfast investment in its people. It has built “Western-standard” facilities, and in an effort to win the competition for talent, offers a generous employee-compensation plan—competitive salaries, bonuses, healthcare, management rotations and training programs abroad that help develop and retain capable local staff.

5. Investing to Capture Emerging Trends

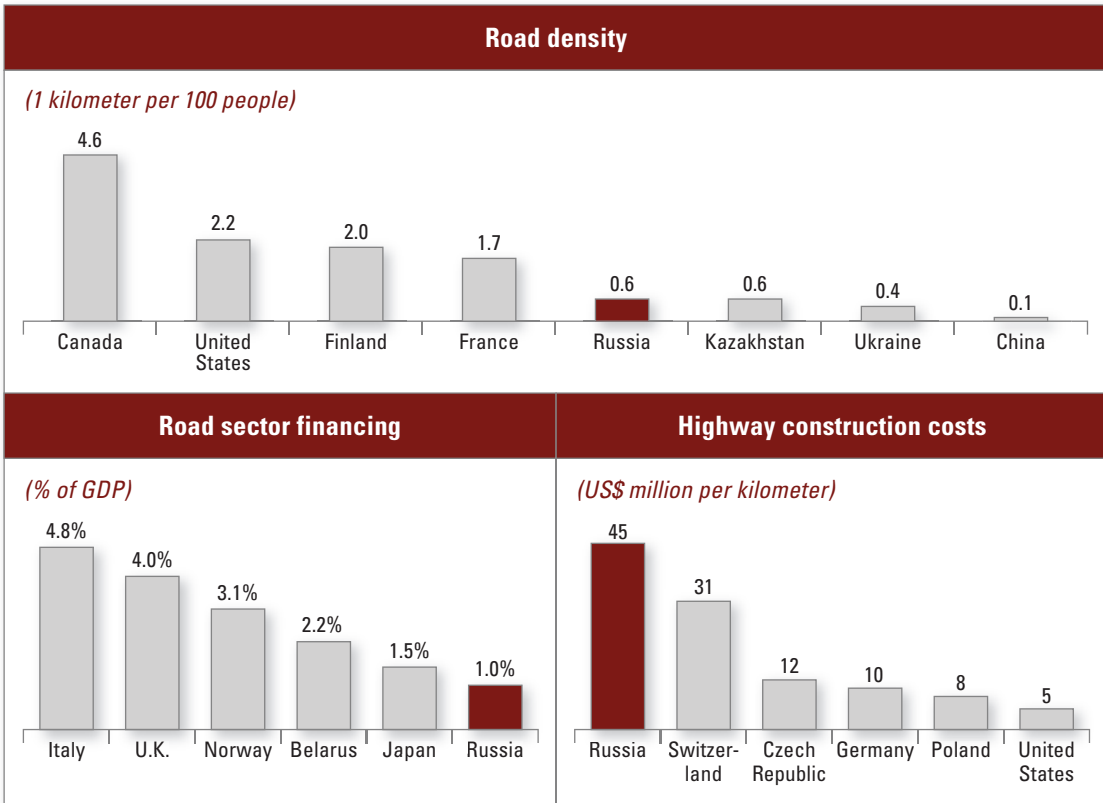
Our analysis shows that the consumer industry is paving the way to shape future development in Russia in two emerging areas that will become of greater importance to the country: infrastructure development and environmental sustainability.

Infrastructure development. Infrastructure development is crucial to the future growth of CPG companies in Russia. Today, according to the OECD and our own work within the transportation sector, 62 percent of federal highways and 76 percent of regional highways do not meet Russian regulatory standards and requirements. Outside the main commercial centers in Moscow and St. Petersburg, there are few highways and little cohesion—often only one way exists to get from point A to point B. In the past, new road construction was almost nonexistent due to a lack of investment and high construction costs (*see figure 5 on page 14*).

⁶ UNESCO is United Nations Educational, Scientific and Cultural Organization.

FIGURE 5

Infrastructure is a top logistics challenge in Russia



Sources: Ministry of Transport, Rosavtodor, Organisation for Economic Cooperation and Development (OECD), Renaissance Capital; A.T. Kearney analysis

More recently, the government has committed nearly \$1 trillion to road construction over the next 10 years.

Can CPG firms wait for the infrastructure to be built to sell to a country of 142 million people and 20-plus cities with more than 1 million potential customers in each, many of them among the middle class? Leading consumer companies are already locating operations in these cities and identifying (and investing in) reliable, local logistics partners for long-distance transportation.

Over the longer term, as consumer companies expand to capture this market potential, they are investing in roads, bridges and rail systems. In discussions, executives highlighted

plans to develop further their existing factories and build new ones—even farther from the industrial centers of St. Petersburg and Moscow as access to the Internet, computers and wireless increases. As infrastructure improves, more Western companies will move in, completing a virtuous circle of investment, growth, returns and further investment.

Sustainability. Today, environmental sustainability is not high on the list of priorities for most Russian citizens, governments or businesses. Many Russians view environmentalism somewhat skeptically with few businesses recycling or giving much thought to their carbon footprints. The government seldom mentions ecological or environmental issues, except to point out, as

Prime Minister Putin recently did, that preventing man-made disasters is important, a statement followed by little government action.

Most Western companies operating in Russia see sustainability differently. Many demand that the corporate sustainability initiatives and commitments they developed in their home countries be supported in Russia. For example, BAT requires its employees to make sustainability pledges, and Mars, which recently completed construction on one of its most ecologically advanced facilities in Ulyanovsk, operates “green” in all locations.

Furthermore, CPG executives believe that while the Russian government may not be overtly concerned with sustainability today, it has a history of passing legislation quickly and implementing it with little warning. “It’s only a matter of time before someone in the government compares the Russian approach to sustainability with that of the European Union,” explains one executive in our survey. “The government will then push through a law that could result in high penalties for noncompliance and impede our ability to profitably manage our resources.”


This combination of unpredictability and anxiety about what the government might do has opened up a unique opportunity: By helping to enact legislation, CPG executives can both protect Russia’s environment and natural

resources while also becoming part of the solution by shaping standards within which CPG companies can operate profitably.

The Ride of a Lifetime

So what is to come? The political focus is already on the next presidential elections in 2012. Even as Medvedev continues to position himself as independent from Putin (and no one knows if Putin will enter the race), the country will still be run by the elite. As CPG companies invest in Russia, they are operating on pure faith that the country will choose a path toward reform and modernization. Certainly, WTO accession will boost this belief.

For Russia to realize its potential and become the largest consumer market in Europe, and for CPG firms to operate profitably, many changes are still required. And whether they know it or not, CPG companies are both directly and indirectly prompting many of these changes. There will be risks. But we are confident the risks will be worth the rewards for companies that have a clear strategy, plan ahead for unforeseeable scenarios, maintain their flexibility and invest in people—both as employees and consumers.

There is no question that companies that buy into Russia’s consumer boom are in for the ride of a lifetime. 

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