

# Cracking Russia

Finding the right approaches in a tough  
consumer products environment

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# Cracking Russia

**2011 might be turning into a better year than 2010 for many consumer products companies, but very few feel that they have really “cracked” Russia. While most have seen reasonable results in the first half, companies operating in Russia still trail market growth estimates and lag uncomfortably behind the expectations of global headquarters.**

At a meeting hosted by Ernst & Young and Dr. Danny Thorniley of DT Global Consulting for country leaders of some of the world’s largest consumer products companies operating in Russia, attendees agreed that growth should have been stronger and more consistent than it has been. The challenge facing many local leaders is communicating to headquarters how much growth Russia is capable of generating and over what timescale. While leaders no longer expect Russia to return to pre-recession levels of growth and profitability, mixed economic indicators are causing real concern about what level of growth can safely be forecast and when companies can expect that growth to be achieved.

Performance has been mixed with some subsectors doing well, in part thanks to government public health programs, and others hit hard by a rise in excise duties. Sales value has continued to rise for most companies, but volume growth has been less strong – an important concern in a market where costs continue to rise and there is a big question mark over how much longer consumers will be able to take price increases.

Against this difficult backdrop, companies are getting back to basics – redefining what the consumer wants, how the value proposition should play and how businesses need to adapt to operate more efficiently in these unique market circumstances. Many are reviewing how they operate, experimenting with changes to the operating model and recalibrating the balance between global and local. They are also taking a very close look at social media. In a market where understanding consumer behavior has been consistently challenging, social media is seen by many as a way to reconnect with consumers and boost understanding.

As executives turn toward the second half of 2011, they will need to address some key questions. For example, will Russia remain a premium market? To what extent should companies attempt to extend the appeal of premium down from the very top tier of the consumer pyramid into what some companies are calling the “upper mainstream” in order to drive growth? Extending this idea further, should companies be thinking of introducing a “top-end” offering for consumers at every level of the pyramid so that all income bands have the opportunity to make significant, aspirational product purchases tailored to their spending power? Whether Russia is a market in transition or just a difficult market remains to be seen. However, there is little doubt that leaders will be focusing on activating consumers through different channels and striving to understand the shifts in the consumer basket in a bid to stimulate volume, boost performance and lock in the growth that global consumer products businesses need to generate from markets such as this.



**Emmanuelle Roman**  
Global Consumer Products  
Markets Leader

eroman@uk.ey.com  
+44 (0)20 7951 1651



**Dmitry Khalilov**  
Commonwealth of Independent States  
Retail & Consumer Products Leader

dmitry.khalilov@ru.ey.com  
+7 495 755 9757



## Key takeaways

- ▶ **For all companies, 2011 is looking better than 2010.** Over the last few months, they have seen good or very good growth in value, but volume is still a challenge. For some, the first half has not delivered to expectations, but they are seeing positive signs for the second half of the year. Most executives are still feeling the pressure to perform from global HQ.
- ▶ **Most executives agree that there is still a market for premium.** However, some are seeing a shift of investment to “upper mainstream” products aimed at the “squeezed” middle class. There is also growing evidence of shifts in consumer behavior influenced both by government initiatives (against excessive alcohol and encouragement of sports) and by technology.
- ▶ **All executives are experimenting with social media.** While some are not sure how best to experiment and are struggling to identify the “right” model, they all recognize the huge opportunity social media represents for their businesses, particularly in terms of engaging with the consumer, and some have already carried out very successful projects. With traditional media cost inflation expected next year, social media is an even more compelling channel.
- ▶ **Human resources and talent management are still on the top of everyone's agenda.** Executives have different views on their ability to find the right talent at the management level and how best to motivate their people. One common challenge expressed by all is getting collaboration and teaming to work. One executive explained, “If there is a burning platform, people do regroup and focus.”
- ▶ **Getting the “right” operating model is critical to success.** This is particularly true in markets such as Russia with high operating costs and a fast-changing environment. All the executives agree that “one needs a hybrid model.” On one hand, it is imperative to give more autonomy and authority to local teams so that they can be more relevant and respond quicker to the evolving market needs; on the other hand, leveraging global resources, leading practices and scale is a must to allow local teams to focus on execution and be more effective.

## Interesting facts

- ▶ Sluggish economic growth in the first quarter – GDP grew at 4.1% year-on-year compared with 4.5% in the previous quarter – may slow down sales trends in the second half of the year.
- ▶ Inflation has risen to 9.6% but should fall to 8.2% or even less by the end of the year and the Russian Government is expected to boost social spending with the upcoming elections. With an oil price above US\$100 per barrel, all these factors point to reasonable consumer spending levels.
- ▶ Real disposable incomes have been battered this year, falling 5.5% in January, in part due to the huge rise in January 2010. But this was also followed by weak figures in February and March of -0.6% and 0.7%, respectively.
- ▶ Real wages (after inflation) have seen a similar pattern at 0.6%, 0.7% and -0.4% in the first three months of this year.
- ▶ Curiously, the figures for retail sales are comparatively solid: rising 4.2% in the final quarter of 2010, growing only 0.5% in January but then rising again by 5.8% in February and 4.8% in March. This may be explained by Russians eating a bit more into their savings, as well as by the fact that retail sales were very slow in the first months of last year, so some of this year's number is mathematical bounce-back.
- ▶ Furthermore, disposable income trends remain strong: a middle manager in Texas earns gross annual income of US\$60,000 and is left with US\$7,500 disposable income after mortgage, pension payments and other necessary expenditures. His Moscow counterpart earns US\$24,000 but has disposable income of US\$10,000.
- ▶ Recent reports have also shown that retail spend per capita in Moscow is €7,600 while across Germany the figure is €5,600, the same number as in the United Kingdom.

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## Focusing on critical success factors

**Pulling together some of the key themes of the meeting and drawing on our experience of working with consumer products companies in-country, we believe there are some things companies have to get right in order to “crack” Russia:**

### Determining the right value proposition

Local consumers were undoubtedly hit hard by the recession – although they have come back, they are not the same. While they still value the quality and image of Western brands, they are much more demanding, challenging and sophisticated – in many ways more like their European neighbors. Some companies are exploring how premium can be adapted for different market segments, such as the upper mainstream or squeezed middle class. Many are wondering whether shifts in the consumer basket are fundamental (reflecting a behavioral reset in the aftermath of the financial crisis) or temporary (influenced by government intervention). We believe that understanding these shifts is fundamental to establishing and building the right value proposition.

### Adopting a successful pricing strategy

In terms of pricing, we have found that companies are more successful if they adopt three strategies:

1. When introducing a new product, establish the product price (and consumer price perceptions) at a sufficiently premium level early on to maximize financial returns over the life cycle of the product. The volume gains from a low starting price are often short lived as other established players in the market adjust their pricing to remain competitive, creating downward pricing pressure within the category.
2. Develop or reposition brands to fill “white space” within the category price ladder. This action can facilitate long-term category price leadership and capitalize on gaps in the category price structure.
3. Position a brand at the lowest price point in the mid-tier category – just above the value brand price points. We have seen a growing trend of consumers “trading up” the price ladder, and this price position for a brand can capture a significant amount of this upward movement.

## Managing talent effectively

Our view is that it will be easier to win the war for talent in Russia if organizations get the following four things right:

1. Create attractive propositions to target the Russian talent in senior leadership positions across the globe in the medium to long term and focus on “cultural and market” sensitivity interventions to enhance the effectiveness of expatriates in the short term.
2. Think beyond salary by looking at how to make the “total package” more attractive – incorporating benefits that play to the Russian psyche and tailoring the talent management processes appropriately.
3. Strengthen the talent pipeline by working with universities early on, leveraging global mobility programs and getting more women into the workforce.
4. Adapt working practices to the Russian culture by focusing on how to hire and develop managers who can work collaboratively, motivate their peers and teams, communicate effectively and build a sense of common purpose that will help create an operating environment that is more tolerant of change and can adapt more quickly.

## Choosing the right operating model

There is consensus that having the “right” operating model is critical to success because operating costs are high and the environment changes fast. The challenge is to get the balance right between local autonomy and global scale and efficiency. A hybrid model seems to be emerging as the best solution in which companies find their own balance. Strong, empowered local leadership ensures a relevant and rapid response to evolving market needs while drawing on global resources for areas such as innovation, as long as it is relevant.



## Businesses are optimistic about the second half

Over the first few months of 2011, the majority of local consumer products leaders have seen good or very good growth in value, but with many companies somewhat disappointed by sales trends, volume is still a challenge. For most executives, the first quarter of this calendar year was below expectations. Inflation has taken a toll on disposable income and real wages, both of which are growing just above flat or even negative year on year.

"2010 proved to be a tough year, but in 2011, the top line is good, value is better than volume and our market share is pretty good, too," said one executive at the dinner.

A major drinks company commented in a similar vein: "We have grown at 25% in value and 17% in volume; we have managed to pass on price rises and also increased premiumization."

Some of the larger consumer products companies grew organic top-line sales in 2010 at about 8% to 10% and were budgeting for 12% to 14% this year. Executives are still reasonably optimistic that the second half of the year will prove stronger – some noted that May had seen a pickup in sales – but it will be hard work to achieve the budget numbers that many expected at the start of the year.

As the general manager for an international beauty products company explained, "Euromonitor forecasts 12% growth in the beauty market in Russia this year. We have seen mid-single-digit growth in the first half of the year but are seeing positive signs for the rest of 2011."

## Relying on price increases, but for how long?

One major concern is that operational and input costs are rising sharply (as they are elsewhere in the world), and Western companies are obliged to pass on noticeable price increases. So far, Russian consumers have broadly accepted these price increases, but the key question is how long this can continue. Executives recognize that they cannot rely on price increases indefinitely.

"If consumers do not accept future price rises, companies will need to resort to cheaper portfolio or some type of affordable innovation or be obliged to accept a squeeze on profits," according to DT Global Consulting's Dr. Danny Thorniley.

However, some companies take a different view and believe that "premium" is the place to be, one that is not as challenged where pricing is concerned. One executive explained: "During the recession, we focused on premium and resisted going into the 'value' sector; for our company this was the right approach."

## Focusing on the squeezed middle, in addition to premium

While Russia is still a premium market, since the recession, consumers are putting more emphasis on value for money and turning toward affordable alternatives. "Our investment is shifting away from premium to upper mainstream, which sits below premium, toward the 'squeezed' middle class," said one executive. He added, however, that "there is still a good market for premium."

As mentioned at our last consumer products CEO dinner in Moscow (8 December 2010), most executives agreed that they were increasingly seeing "a blurring of the Russian and European consumer."

Executives also recognized that Russian consumers who are coming back to premium or "sub-premium" are now much more demanding, challenging and sophisticated. They do value the brand, quality and lifestyle of Western products. However, there is a need to justify the value at every level – consumers want to understand the value proposition and are demanding information. "They want detailed explanations from sales and marketing why they should be buying an expensive Western brand," Thorniley said.



## Feeling the pressure

Against this backdrop, the retail environment remains tough – with private label in some categories becoming a real threat – and logistics costs are high. “The costs of logistics are crazy, and I expect very high media inflation next year,” said another executive. “We need higher than mid-single-digit growth coupled with further efficiencies to compensate for these cost increases.”

Executives largely agreed that, although the outlook is optimistic, Russian operations of multinational consumer products companies remain under considerable pressure. As Western markets stagnate, they are increasingly looking to emerging markets for bumper growth that simply may not be sustainable.

Russia is the smallest but most prosperous of the BRIC markets, with the highest GDP per capita and a tangible “upper middle class” today – and with 82% of all households expected to be part of the middle class by 2015.

Although Russia is unlikely to generate the level of growth and profits experienced pre-recession, companies can still deliver a strong performance if they can adapt to the changing environment. One executive commented: “We have pushed profits and gained market share. I believe this is because we have the right strategy, with our value proposition and our distribution.”

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## Social media – watch this space

**Russians are the most engaged users of social media. As one executive noted, “Russians are so intellectual and smart buyers. They enjoy getting more information through the internet, particularly when they are first-time buyers.”**

The rise in social media is providing opportunities for companies to gain greater consumer understanding, engage further with their consumers and create new direct-to-consumer channels.

With traditional media costs expected to rise dramatically next year, social media is an even more compelling channel.

### Collaborating and engaging with consumers

“With social media, there is a huge opportunity for co-creation and collaboration in innovation,” observed one executive. “Increasingly, creativity does not just come from our marketing function.”

Social media is also a great way to engage with consumers. “We have found that women are less responsive to traditional forms of advertising, such as television, and are more sensitive to personal recommendations and intangibles such as the emotional bond with the product,” explained one executive in the beauty sector.

Because accurate data is an issue in this market, exploiting social media may be a good way to bridge the gap by obtaining information and insights straight from the consumer through a direct dialogue. However, this comes with the caveat that although social media is effective with niche or known groups, it is definitely not a mass media tool. “We do 95% of our advertising online,” said another executive. “It is a great way to reach your specific target groups if well-defined, but it is more problematic to go broader.”



## Experimenting to find the right model

All executives are experimenting with social media. Some are unsure how best to proceed – they have not found the “right” model yet – but all recognize the huge opportunity that social media represents for their businesses. Some have already carried out very successful projects, but no one claims to have found the right model.

An executive's company launched a new hair product in two different markets, using traditional media in one and social media in the other, and the return on the latter was seven times better than on the former. However, the same executive admitted that the company had not “cracked” it yet.

## Top tips for social media success in Russia

### 1. Forget Facebook

Facebook hasn't taken off in Russia, but its local equivalents – Vkontakte.ru, Odnoklassniki.ru and Mail.ru – keep users excited. Vkontakte.ru, or “VK” as Russians call it, is the number-one social network in the country and currently has more than 98 million members – out of a total population of 142 million. Reckitt Benckiser used Vkontakte to engage Russian teens and encourage them to use the face-cleansing product Clearasil on a regular basis.

### 2. Focus on blogger outreach

Blogging is big in Russia. There are 7.4 million Russian-speaking blogs with a readership of approximately 23 million, according to the Russian Association of Electronic Communications. Livejournal, the most popular blogging service, has almost 5 million registered accounts. Because 60% of bloggers are urban women, outreach programs offer an invaluable opportunity for luxury brands targeting a female audience. Yves Rocher generated online buzz for its Serum Vegetal product line in Russia by inviting key beauty bloggers to a lavish launch party. The brand offered bloggers makeup and product training and generous gift packs. Not surprisingly, they fueled the internet with raving product reviews afterward.

### 3. Only use mobile if you market a luxury product

Although the number of smartphone and tablet users is likely to reach 18 million by the end of 2011, the mobile market offers access to only 10% of the population so it is best-suited for targeting the top end of the market. Automaker Volvo launched its XC60 by directing Russian luxury car lovers to a mobile website featuring the 3D game *City Rally*. It offered users the chance to test the Volvo XC60 and see for themselves why it's called “the safest in Volvo's history.”

### 4. Offer exclusivity

There's only one thing Russians love more than luxury, and that's exclusivity. And it's no different when it comes to online communities. Forum.awd.ru is a social network of elite Russians who enjoy traveling to exotic locations. Due to the social status and high net worth of the members, car manufacturers and banks are eager to offer exclusive value-added services to the privileged group.

Source: “Social media scene in Russia with case studies,” wearemba.com  
<http://wearemba.com/2011/05/12/russia-the-dreamland-of-social-brands/>, accessed 7 July 2011



## Operating model – striking the right balance

**Getting the right operating model is critical to success in markets such as Russia where companies face high operating costs and the challenges of a fast-changing environment. There is often no perfect structure. All the executives agreed on the importance of having a hybrid operating model that strikes the right balance.**

On one hand, one needs to give autonomy and authority to local teams so that they can respond quickly to the evolving needs of the market; on the other hand, leveraging global resources, leading practices and scale is vital to allow local teams to focus effectively on execution.

### Executives have different perspectives

There is no one-size-fits-all solution to this conundrum. Companies have to respond in the right way for their organization, so models will invariably change over time and according to the history, size and type of the business. With this in mind, it is no surprise to see the executives at different points on the scale – some prioritizing global emphasis, others local. But they certainly are all heading toward a hybrid model.

One senior executive explained: “We have completely switched our model, from global to local. It happened within six weeks with a lot of resources being moved around. We are now using global and regional resources as support. Ultimately, we will need a hybrid approach where we can leverage R&D and other resources, share best practices and understand competitor moves around the world so that we can act before them.”

This was in direct contrast to another executive, who said: “We are the other way ‘round; we need to be more coordinated globally. You cannot demand each zone to do everything; you need to learn from global. One thing that has not changed is that we are clear about who has the P&L.”

Everyone agreed that global and regional teams need to move from controlling to adding value to local markets.

### Execution is everything

The theme was continued by the general manager of a fast-moving consumer goods (FMCG) company: “I want to focus on execution. I want my R&D to come on a plate, and as long as it is relevant to my market, that’s fine. I need to focus on making it work here.”

As one executive said, “Russia is a market that changes at a faster pace than any,” so a clear theme of this discussion was that whatever you do, speed of execution is essential.

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## Making talent work

Human resources and talent management still top the agenda for many executives. The demand for talent is extremely high, with voluntary turnover levels back at pre-crisis levels of 14% to 17%. Demands for higher salaries are intense, and companies have to work harder to sell themselves to applicants and attract the best talent.

“The key issue is how we can attract and develop the right managers – people of quality with sound business knowledge,” said one executive. “The pipeline of talent coming through is weak,” said another.

Recruitment remains challenging; the difficult operating environment has meant that the tough salary conditions seen in 2010 have continued into this year, and companies are responding with a mix of salary and an additional focus on benefits. “We have managed to secure people by ensuring a good working environment – we have just moved to flashy premises – as well as providing incentives and other non-cash benefits,” noted one executive. But while recruitment is hard, retention is harder, making it all the more important to look at the whole package.

The most effective way to manage talent is also a concern, with executives expressing different views. One common challenge expressed by all is getting collaboration and teaming to work. One executive explained, “If there is a burning platform, people do regroup and focus.”

“We have to learn to adapt to the Russian culture,” said another. “They are great in silos but weak in collaboration. It is a daily effort to think about how best to motivate them.” Another believes that there is huge commitment from people in Russia, but the main issue is getting feedback. “There is a ‘silent resistance,’” he said. “We have to find the key to managing Russians. We are struggling to find people who are good at coaching others to get to managers. It takes ages to make changes.”

None of the international consumer products companies operating in Russia appear to have yet solved the management conundrum, and in the meantime expatriates continue to dominate, especially at the higher levels of foreign companies. “I do not see our Board becoming Russian within the next three years,” said one executive. “Among the top six people in our business, none are Russian,” commented another.

## Reassessing retailer relationships

More consumer products companies in Russia, as in other emerging markets, are paying extremely close attention to route to market, evaluating their supply chains and reassessing their relationships with retailers.

Russian retail is getting more powerful and aggressive, although there still is some way to go with market consolidation. Retailers feel they have grown out of the crisis and can force discount promotions on the manufacturers. Massive rises in the value of retailers’ real estate holdings has also helped to consolidate their power in the market, giving them the upper hand in negotiations with manufacturers.

One executive said, “The retail environment is tough. They demand your pound of flesh, and you give it to them.”

This is not say that relations with retail are entirely brutal; there is still space for win-wins, especially on the premium side, but the relationship between retail and the manufacturers has changed and is continuing to evolve.

However, it comes as no surprise that the executives spoke about getting more direct routes to market in an effort to exert greater control over their brands, reduce costs and reach a wider audience through more pan-national approaches that most Russian distributors cannot offer.

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## Government intervention

**Government intervention is a fact of life in the Russian market, and executives are used to dealing with government moves and adapting to government influence, both positive and negative.**

In 2011, executives in some subsectors have felt the power of government intervention. A huge public health campaign has been introduced by the Government with the objective of getting 3 million people into sports every year – good news for sporting goods companies. The general manager for a brand apparel company noted, “We are seeing the benefits of this ‘sport participation’ program, and our main competitor is also growing fast as the market is expanding. It would seem that these government initiatives are creating a shift in consumer spending habits as we seem to be growing faster than other consumer products categories.”

While similar government intervention has not had the same positive impact on sales of alcohol, it could be anticipated that public pressure will help to create the conditions in which there could be greater interest in sports performance drinks, juices and flavored waters – as we have seen in other countries.

The alcoholic drinks sector is also coming under increasing pressure as the Government targets excess drinking as a key priority. In 2010, ministers tripled the tax on beer and introduced a minimum price on vodka of RUB89 (US\$3) per half-liter. The Russian beer market shrank by around 9% in the first six months of 2010 as a result. In Moscow, restrictions on selling alcoholic beverages with greater than 15% alcohol have been introduced.

Commenting on these developments, the managing director of one major investor in the beer sector said, “Volumes have declined over the last three years, and retail sales have been flat in the first quarter of this year. The cost of sharp spikes in excise duties could only be partly passed on to consumers, and while the industry had soared in the years prior to the crisis, it is likely to grow at more subdued/normal levels in the future.”

## Questions executives are asking

As executives turn their attention to the second half of 2011, a number of questions are now top of mind:

- ▶ Is there real growth in Russia?
- ▶ What is the optimal operating model for Russia?
- ▶ What are the shifts in the consumer basket?
- ▶ Should we be extending our premium range to appeal to the “upper mainstream”?
- ▶ Is the time right to create a “top-end” product offering to appeal to income bands towards the middle and bottom of the Russian consumer pyramid as well as to those at the premium and upper mainstream levels?
- ▶ Do consumers want deals, quality or both?
- ▶ To what extent will consumers accept further price increases?
- ▶ What are the best ways to engage with consumers?
- ▶ How can we best activate consumers through multiple channels, and how can we adapt the supply chain accordingly?
- ▶ What is the best distribution model?
- ▶ How do global companies manage Russian talent effectively?
- ▶ What are the leading practices in social media?
- ▶ Is social media contributing to awareness, loyalty and sales?

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