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The Impact of Consumer Trends on Business in Russia

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In Soviet times the Politburo and Gosplan decided what to produce and who got what. The Soviet economy was a machine which turned valuable raw materials and labor into tanks, rockets – and pollution.



The Machine Building ministries (arms factories) got the best resources. The Ministry of Light Industry – consumer goods – got the least. It was definitely Guns, Not Butter.



Those days are over as this contrasting photo at GUM in Red Square demonstrates. Decades of consumer frustration during the Soviet era have created huge business opportunities for new Russian companies, many of them totally unknown in the West.



My firm, The PBN Company, helped sponsor research conducted this year by Moscow-based Interactive Research Group (IRG), which identified the Top 100 emerging companies of the Russian consumer market.

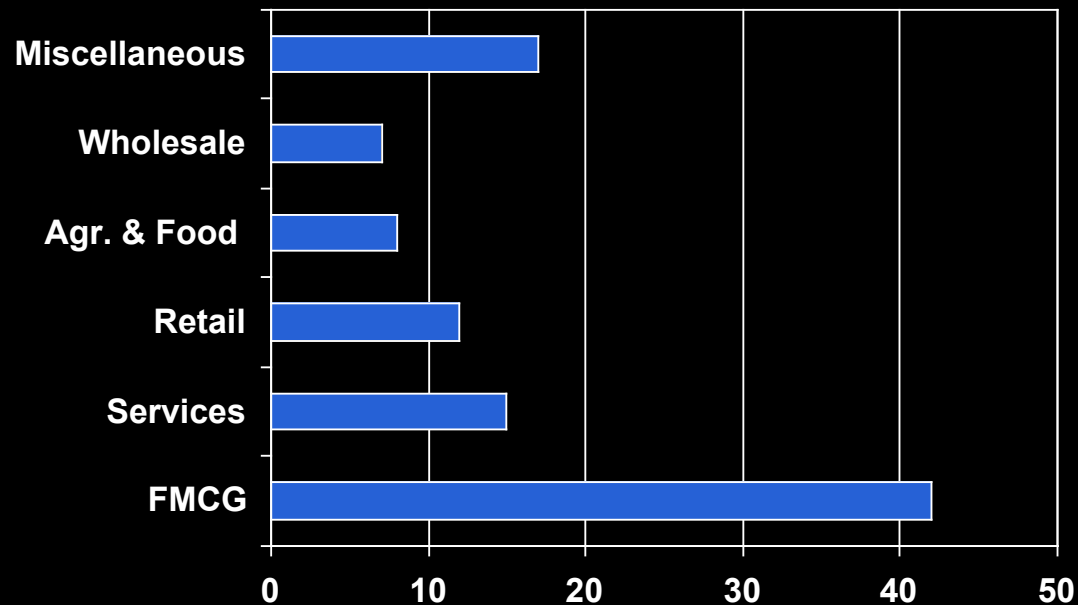
Where are the TOP 100



Most are based in Moscow or St. Petersburg. But over 40 per cent operate mainly in the regions.

Greg Thaine, the chairman of IRG advises, “If you are looking for dynamic Russian companies to invest in, lend to, acquire, merge with or market to – you need look no further.”

TOP 100 by Sector

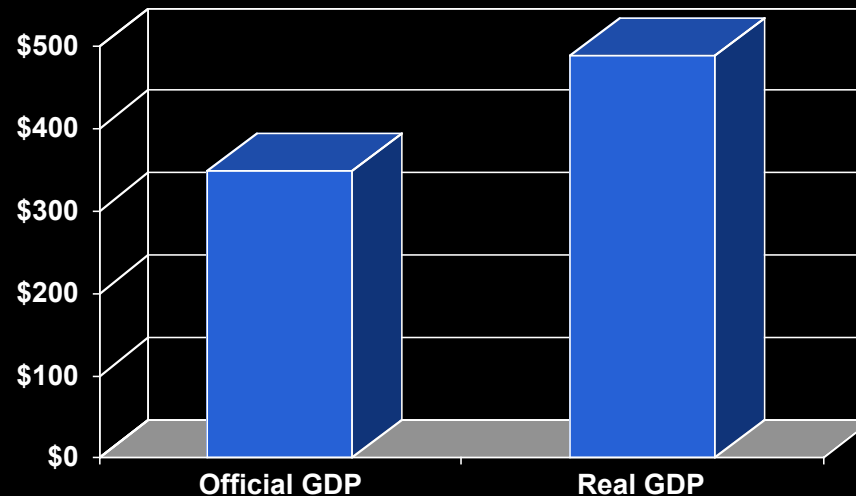


A breakdown by sector shows that 42 of the Top 100 Russian consumer companies produce or sell fast-moving consumer goods, often in competition with big international companies such as Unilever, Procter and Gamble or Danone.

No less than 15 provide services such as banking, transport, tourism and media. Twelve are retailers, 8 are in agriculture and food production and 7 are wholesalers. Others include pharmaceuticals, restaurants, telecommunications, furniture, construction and electronics. Roughly one quarter already have *minority* foreign shareholders, but Russia's biggest financial and industrial groups - the oligarch structures - only have stakes in 14.

Real GDP is 40% Higher than Official Statistics

USD Billions



All of the Top 100 businesses are growing fast – from 20 to 70 per cent annually – by satisfying decades of consumer frustration and an explosion in new consumer demand. And, many — I mean millions of Russians — have a lot more cash than you may think.

The leading analysts calculate that real GDP in 2002 was probably between \$450bn to \$500bn, around 40 per cent higher than the official statistics. Why?

Why is Real GDP Under-Reported?

- 40 to 45% Gray Market
- Tax Avoidance
- Subsidized Utilities, Transport & Health Care
- Low Personal Debt

Tax avoidance is still widespread — although personal income tax has been cut to a flat 13 per cent. But the grey economy is around 40-45 per cent of the total — which is why official statistics have to be taken with a pinch of salt. Millions of Russians are richer than they appear statistically.

Even quite poorly paid people are relatively cash-flush because many essentials — such as power, heat, municipal housing and public transport are still heavily subsidized, although subsidies will be phased out over time.

Russians Have Low Debt

- 60% own their own flat and/or dacha
- Only 5,000 Muscovites took out car loans in 2002
- \$4.5 billion in household loans in 2002 — \$31 per person

And remember, the majority, about 6 in 10 Russians, own their apartments and dachas and therefore do not have the burden of monthly mortgages. In the US, buying a house and paying for the car are the biggest components in personal debt. (Believe me, my wife and I know this is true!) The consumer society is fuelled by credit. Russia is only at the beginning of this process. Last year, in a city of 8 million people, only 5,000 Muscovites took out a car loan.

Russian and foreign banks – like Alfa, Citibank, Raiffeisen, Rusky Standard and even Sberbank – are zeroing in and developing personal loans, mortgages, credit cards and other easy credit. The potential is staggering. A housing survey by IRG showed that 44 per cent of middle class Muscovites planned to buy a flat over the next five years and that 57 per cent of those expected to take out a bank mortgage. According to recent research by fellow panellist Stephen Jennings' Renaissance Capital, Russian consumers only took out a total of \$4.5bn in household loans last year or \$31 a head – a figure expected to rise at least ten-fold by 2010.

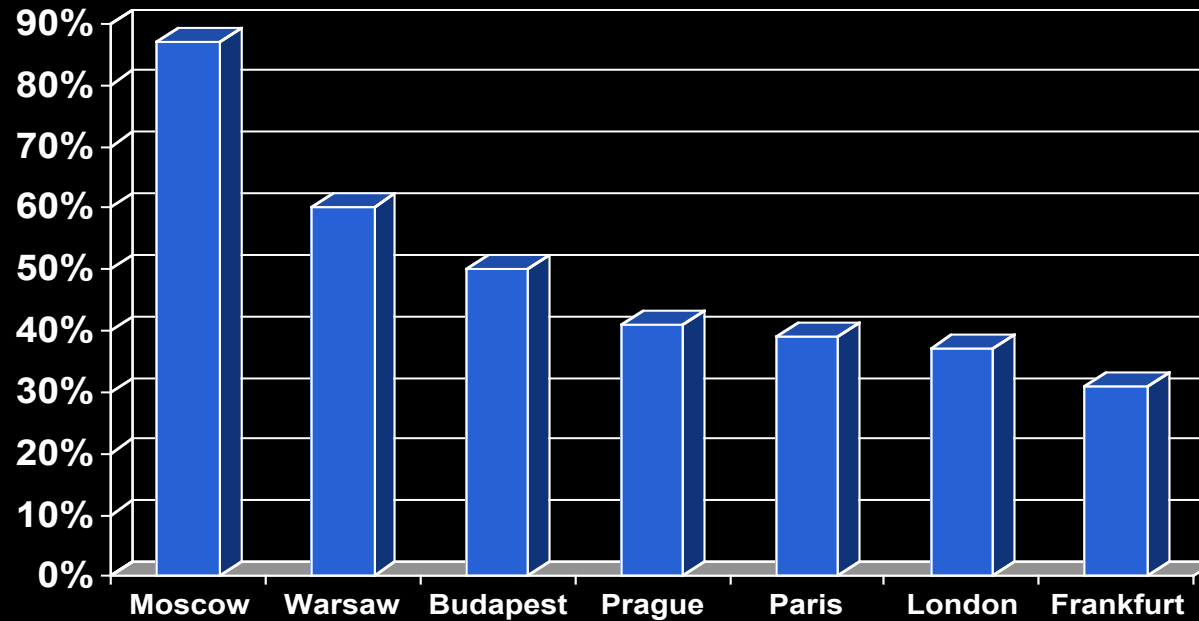
Russia Has Highest Disposable Income of All Emerging Markets

- 87% of per capita income is disposable
- 15% increase in first six months of 2002



Little surprise, therefore, that today Russia has the highest disposable income among emerging markets – around 87 per cent of per capita income. Over the first six months of this year alone, disposable income rose nearly 15 per cent on an annual basis.

Muscovites Spend More Disposable Income on Consumer Goods



More telling than the percentage of disposable income, Muscovites spend a greater portion of their income on consumer goods than residents of any other big city in Europe!

Size of Russian Consumer Market

143 Million Russians Spend \$275 Billion



So how big is the consumer market? Last year 143 million Russians, of whom 12-15 per cent rank as middle class in income terms, spent between \$260-275 billion on consumer goods and services. Over the last two years, official incomes have been rising 8 to 9 per cent annually.

This is partly because of the increasingly strong rouble and the recovery from the 1998 crash. Mostly, however, growing incomes are thanks to high world energy prices and steep rises in productivity as Russian companies invest in western machinery and eliminate Soviet-style management practices.

Average Russian Consumer

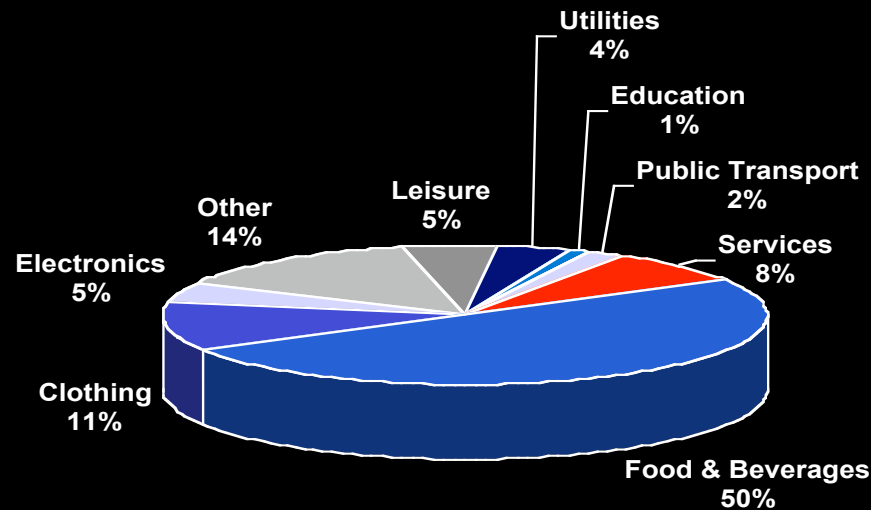


- 35-55 Female
- Single Parent, with One Child & Cat
- \$4,200 Yearly Disposable Income
- 4 Times Higher than Average of \$1,023

The middle class is growing – especially in Moscow where average income is three times the national average, and some people are very rich indeed. Polls show the average Russian consumer to be a 35 to 55-year-old female single parent with one child, a cat (missing from the photograph!), with average net monthly disposal income of \$350 or \$4,200 a year. The official average disposable income is only \$1,023.

As incomes rise, by 2010 the portion spent on food will decline to 35 percent from the current 46 percent. Housing will become the second largest expense, taking 15 per cent of the total. Spending on transport, communications and housing will double.

How Muscovites Spend Their Money



Consumer Goods Spending = 87%

And where and how are Muscovites spending their money today? It's clear...with the Top 100 Russian consumer goods and services companies, and with thousands of other Russian and international producers and retailers of consumer goods.



Ramstore



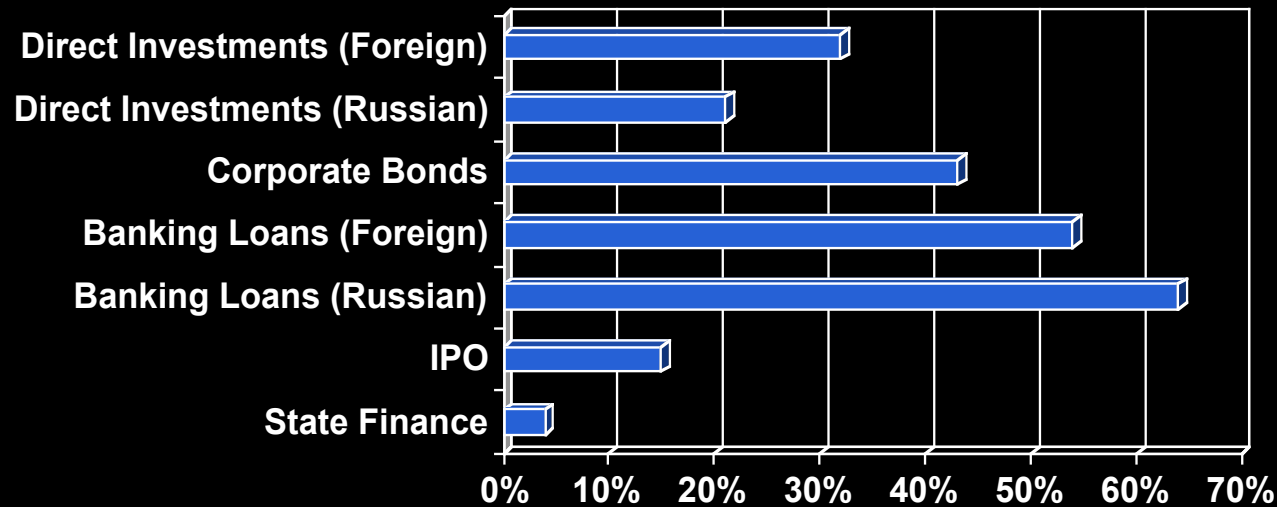
IKEA



MEGA

To illustrate the impact of consumer spending on foreign investment in the sector, Turkey's Ramstore is investing around \$500m in hyper and supermarkets and expanding out from its Moscow base to big provincial cities. Ikea, the Swedish furniture group, attracts more customers to its two new Moscow stores than any of its other outlets in Europe. It is building three more stores in Moscow, two in St. Petersburg, and making furniture locally. Germany's OBI is the latest European supermarket group to pile into the market. The newest hot property investment trend is the construction of modern automated warehouses to serve the new stores.

Financing Plans for TOP 100 Companies



Of course, along with all this good news come limits, challenges and consequences.

Financing growth for Russian consumer goods and services companies is a huge challenge. A handful of these companies are publicly quoted and trading, such as Wimm Bill Dann and the pharmacy chain 36.6. Virtually all others are looking to foreign investors, capital markets and credits for expansion. Most seek traditional bank financing, a third are wooing foreign investors and 15 are considering IPO's. But this where it gets tricky.

Most of the Top 100, and companies like them, have complex holding structures. They lack the transparency and accounting practices investors and banks demand. Many have reputational issues. Attracting capital will require a sea change in management practices. Unfortunately, too few truly comprehend and are prepared to embrace what is required.



Muscovites in particular are also starting to see the flipside of the consumer society. Traffic jams and air pollution are already serious headaches. Expensive road improvements, such as Moscow's third ring road, are swamped as soon as they open, and car sales are rocketing. Some hard decisions will have to be made by citizens, policymakers and the business community.

Red Flags & Watchwords

- Consumer Rights Activism
- Public Interest Lobbyists
- Consumer Protections & Regulations
- Environmentalism
- Corporate Social Responsibility



Looking further ahead, the explosion in consumer credit will inevitably have casualties – and create new openings for debt collection and enforcement agencies. Some consumers have been here already. In the absence of banks many borrowed from loan sharks. There is no shortage of large gentlemen skilled in the un-gentle arts of persuasion. But as credit-fuelled consumerism takes off, the banks will have to improve their credit risk assessment capacity. The Union of Russian Consumers and other NGOs must address the credit protection needs of their constituents.

In fact, consumer protection is in its infancy – there is no Russian Ralph Nader, yet. But political activism and public interest lobbying is just around the corner. Politicians are under increasing pressure to champion consumer rights. Most insurers, banks, factories utilities, pension funds and oil companies have yet to grasp that consumer rights regulations and corporate accountability are inevitable. From international experience, we know that companies, industries and investors which look after customers and the public interest will prosper – those who do not, will not.

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“Russia will not sleep under the warm blanket of oil dollars and will continue down the road of economic reform,” President Putin said several days ago to the World Economic Forum in Moscow. In fact, the consumer economy has overtaken the carbon economy.

If the country continues on the road of economic reform, which I believe it will, and if political forces and powerful interests in government do not upset the apple cart, which I believe is possible, then the Russian consumer economy is undoubtedly where the biggest opportunities are to be found for many years to come.