

### Introduction

This report is devoted to the description of top emerging companies of the Russian consumer market. Into this broad definition we include manufacturers of consumer goods, wholesale and retail traders, producers of packaging materials and consumer service providers - businesses that aim not just at satisfying the various and voracious consumer needs of the Russian population but also the supplier companies of the directly consumer-related companies.

The purpose of this report is to identify real success stories that can be of most interest to the wide range of foreign investors and marketers considering the Russian market and searching for potential investment or sales opportunities.

Why have we chosen to research companies within the consumer market when Russia is known all over the world for its exports especially oil and gas? The following main reasons explain why we consider the consumer sector as the most attractive:

- The Russian consumer market was estimated to be worth USD 260-275 million in 2002<sup>1</sup> and is the largest and fastest growing segment of the economy. Unlike domestic exports its growth is not restricted by external demand and not so dependent on the fluctuations of world prices for natural commodities; oil and gas.
- The concentration rate in most segments of the Russian consumer market is still very low which gives leading companies enormous potential for further growth. Currently major consumer companies have just begun regional expansion and are only developing national distribution systems and strong brands.
- Success in the consumer market is usually based on real effectiveness and fair competition. The leading consumer market companies have effective strategic and financial management, production and investment strategies and distribution and marketing policies.

Practically all companies from our list have very aggressive long-term development plans aimed at

- increasing their turnover, profits and market share
- modernizing production facilities
- expanding the assortment of goods and services
- developing distribution system and advertising their brands.

These activities that are critical for success will require huge investment funds, which companies will need to attract from both Russian and foreign financial markets using different approaches like IPO, direct investments, corporate bonds and bank loans.

It is important to understand that the consumer market is vital part of the social structure in Russia, which provides Russians with needed or demanded goods and services but also provides many jobs and incomes. The government must pay more attention to the consumer market since it has an important influence on people's everyday life. There are many problems in the sector that need to be addressed by effective and urgent reforms such as taxation issues and administrative barriers.

We believe that in the domestic consumer market the government could source funds that will assist in accelerating the long-term economic development of Russia and allow significant increases in current growth rates thus lower Russia's dependence on oil exports.

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<sup>1</sup> IRG estimate; see Economic Forecast September 2002

### Originality of the project

There are no similar research projects that study consumer related domestic companies exclusively and all existing ratings of companies usually appear to be in groups with one of two extremes.

The first group of such ratings seems to have no criteria at all. They name 'the best company of the year' without clearly saying why it is the best. So most readers and experts think that these results are *sponsored* by the winning companies.

The second group uses quantitative criteria only. However, in Russia it's very hard to obtain full and adequate company information, which reduces the usefulness of such ratings.

IRG composed a comprehensive and independent non-rated list of successful consumer related companies based on a wide range of criteria including financial information. While we cannot guarantee that all good companies will be taken into account we believe that our approach is the most fruitful and its subjectivity will be low due to the large input of research work.

### Selection of companies

The selection of really successful domestic consumer related companies is the largest task of the project and was conducted very carefully. To ensure best results we used all available public information, opinions of market experts and knowledge from our previous experience within the consumer market.

IRG believes that quantitative criteria like sales volume, gross and net incomes, and their dynamics are very important indicators of company performance. However, used alone they are not enough to identify companies for our Top 100 project.

Some companies achieve good results due to non-market factors. For example, Sberbank retains its leading position in retail banking despite having very low service levels and being very slow and conservative; its success is based on the fact that the government guarantees the safety of individual deposits in this bank.

We also try to avoid companies with scandalous reputations, e.g. the pharmaceutical company, Bryntsalov A, has a strong position in the market, however, it was accused of making counterfeit drugs and violating copyrights. It should be noted that in different segments of the consumer market different factors influence enterprise efficiency.

We used the following set of criteria for identifying effective companies, to be included in the IRG Top 100 a company had to have specific characteristics:

- High turnover, profitability and productivity rate.
- Effective strategic management: market segments, mergers and acquisitions, aggressive plans for the future.
- Positive corporate image and reputation: transparency.
- Effective production policy: high-level investment into new equipment and technology, quality control, international quality standards.
- Effective financial management/investment strategy: bank loans, foreign investment, corporate bonds, high credit rating, Western accounting standards.
- Effective marketing and distribution policy: large market share and brand awareness/loyalty. Active advertising and sales promotion, regional network/sales representatives.
- Aggressive development and growth plans.

IRG and their partners on this project also decided to exclude from the list the most well-known Russian companies listed in the stock exchange; such as Baltika, Wimm-Bill-Dann, and MTS as they are today's success stories not 'tomorrow's companies identified today'. We also excluded domestic companies already acquired by foreign multinational corporations.

The process of selection of top 100 emerging companies was as follows:

- Firstly within each segment of the consumer market several successful companies were identified based on IRG research experience in each segment, statistical information on companies' performance and information from desk research about each company. The initial pool consisted of some 150 companies from various segments
- On the second stage we excluded some companies, which didn't meet some of the main criteria, e.g. turnover or transparency. Then we made basic cross-comparisons of the companies from different consumer related segments to ensure the list of Top 100 is balanced.
- To reduce the subjectivity of our choice we discussed the list of selected companies with several leading journalists and experts who specialize in the Russian consumer market, who provided their comments and suggestions relating to the whole list and particular segments of the market. Using these comments we finalized the list of top 100.

The journalists who participated in the discussion of the list of Top 100 include Sergey Rybak, "Vedomosti", Ivan Prosvetov, "Kompaniya", Torrey Clark, "Moscow Times", Alexander Pypin, Retail.ru, Ben Aris, "Daily Telegraph", RusBizList

### Profiles of selected companies

The final report contains information profiles of all selected companies. IRG researchers collected the information from public sources including media publications, free databases and corporate websites of selected companies.

To ensure the quality and reliability of the information all selected companies were asked to check the information profiles composed by IRG and provide additional information.

### Sponsors and partners

The sponsors of the project include Deloitte & Touche, Bank Societe Generale and Altium Capital.

Information partner: The Moscow Times.

Organization partner: The PBN Company.

### The Russian consumer market

**Soviet period:  
more guns, less  
butter**

In the Soviet period consumer industries were not a priority for the centralized planned economy, which mostly focused on developing heavy industries. In general domestic enterprises produced high volumes of low-quality unbranded commodities, Rare imported and good quality domestic consumer products were in high demand among consumers which caused long queues in shops selling them.

**1991-1997: the  
consumer boom  
saturated with  
imports**

In the beginning of the market transition the situation changed radically. In a very short time the Russian market became saturated with huge amounts of consumer products mostly of foreign origin; that in turn badly affected domestic production, which experienced a catastrophic slump.

Half the country was engaged in 'shuttle trade' with China, Turkey & Poland - delivering gigantic bags with fake brands. Many of today's Russian tycoons started their business careers in this period illegally importing or distributing computers, alcohol, sportswear and other commodities.

**Crisis of 1998:  
the chance for  
domestic  
companies**

The infamous financial crisis of August 1998 brought everything back to reality; population incomes fell sharply and the banking system was almost ruined.

However, the crisis also stimulated the renaissance of domestic companies as they got an excellent chance to revive due to the overnight cessation of imports. Many of them took advantage of the situation increasing production & sales volumes significantly.

One of the main drivers for such growth was the rouble devaluation, owing to which the prices of imports significantly increased and Russian consumers shifted their purchasing habits dramatically to domestically produced consumer goods.

Large rouble emissions by the Central Bank provided the economy with real money; in addition the role of barter and non-payments were significantly decreased and almost eliminated. For many companies from our list the period of 1999-2000 was a decisive time for achieving success in the consumer market.

**Today: the  
critical moment  
for the Russian  
consumer  
companies**

The devaluation effects have by now almost disappeared; since 2000 consumer incomes has been rapidly recovering and now exceed pre-crisis levels. Increasing incomes causes changes in consumer habits when the price factor becomes less important while the influence levels from product quality, advertising and brand awareness is strengthening.

In this situation many domestic companies face problems as they need to change their marketing strategy and become more operationally effective to retain their position in the market. We suggest that the trial period since 1998 has been very beneficial

for the Russian consumer-related companies and now we are seeing the beginning of their real emergence.

### **Tomorrow: the real growth is beginning!**

Successful domestic companies have huge potential for further growth by provided by Russia's 146 million inhabitants. Expansion will come from consolidation and replacing of small and ineffective companies and moving into the Russian regions and to CIS countries.

In this report you will find the companies that we think will play the most important role in the growth and development of the Russian consumer market in the next three to five years.

In the beginning of this report we describe major characteristics of the consumer market including its size, growth rates, structure etc. This would help our readers in better understanding of the sector and the prospective of the selected companies.

### **In 2002 the Russian consumer market was worth USD 260-275 Billion**

Identifying the real size of the Russian consumer market is crucial to understanding the scope and structure of the domestic GDP on the whole. IRG's main theory states that the Russian official statistics completely underreport the real volume of consumer spending and the incomes of the Russian population.

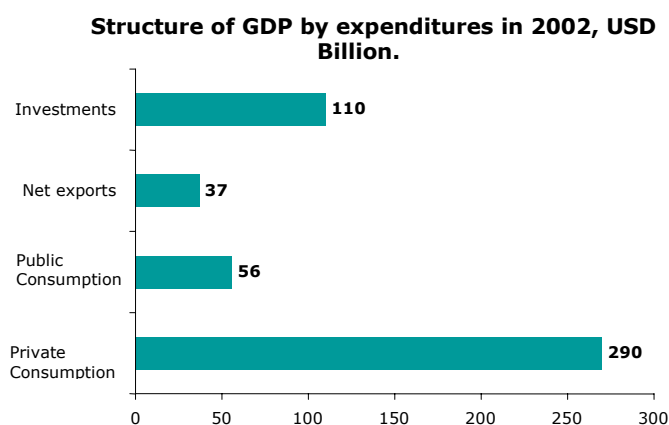
We estimate the aggregate value of the Russian consumer market was USD 260-275 Billion in 2002. That is 70-80% more than the official figure. To make this statement we conducted our own assessments of several key segments of the market (tobacco, alcohol, personal care, home appliances, motorcars and various consumer services) and compared them with the official estimates. The detailed description of the estimate and its methodology was published in our September and December 2002 Economic Overview Reports; it was also broadly discussed in the domestic business press.

While we don't aim to continue this discussion in this report it is would adding that working on these assessments provided us with many additional arguments supporting our main thesis about the real value of the Russian consumer market.

### **Russia is not so dependent on the export sectors**

Having accepted the IRG estimate there are several quite interesting conclusions. First of all, it means that the consumer market is 2.5 times larger than the amount of Russian exports. Now we can clearly see that Russia in reality is less dependent than we thought on the export sectors of the economy and on world prices for oil and gas!

Based on our estimate of the Russian consumer market we state that the real value of the Russian nominal GDP is in reality 40-45% more. We estimate the nominal GDP at some USD 430 – 440 Billion in 2001 and USD 480-500 Billion in 2002. Share of the grey economy comprises approximately 45% of GDP vs. 23% of the official estimate.



Source: Consumption and Investments – IRG estimates; Net exports – Central Bank; Government spend – Goscomstat

### **Consumption takes 60% in the Russian GDP**

The share of Private Consumption in GDP comprises almost 60%, which is more similar to western countries than the official 49.6%. Thus the Russian consumer market plays a very important role in the economy, which is not totally realized by most economists.

### **Imports account for not more than 20-25% of the Russian consumer market's value**

One of the main stereotypes about the Russian consumer market is that domestic production can't successfully compete with imports hence imports absorb all the growth in consumer incomes and spending.

While in some market segments the position of imports is very strong, their share in the total consumer market is comparatively low. Domestic enterprises have proved to be efficient in food production, while suffering a lot from foreign competition in the markets for clothes, home appliances and electronics, motorcars, pharmaceuticals.

Moreover, the domestic providers of consumer services don't compete directly with foreign companies; neither do intermediaries such as wholesale and retail companies, which sell both domestic and imported consumer goods.

Imports of consumer products and services account for approximately half of the total imports, i.e. about USD 40 million in 2002 (according to Central Bank statistics). Allowing for some grey supplies the real amount of imports of consumer goods and services can be estimated at USD 50-60 million. Thus imports take no more than 20-25% of the Russian consumer market's value (in final consumer prices).

It's also important to note that that the growth of imports doesn't exceed the growth rates of the Russian consumer market on the whole.

### **The Russian consumer market is growing by 13-15% in dollar terms a year**

According to Central Bank, the growth of total imports was 13% (in dollar terms) in 2002. We estimate that the Russian consumer market's value was increasing by 13-15% (in dollar terms) during 2001 and 2002. Moreover, we forecast that the growth rates of the consumer market will not be slowing in the mid-term assuming that the oil prices don't fall too low.

Our optimism about the dynamics of the domestic consumer market is supported by independent indicators illustrating the growth of incomes, consumer spend, and confidence of the Russian businesses and population:

- Savings and retail deposits in Russian banks increased by 43.8% in 2001 and 38.1% in 2002 (in dollar terms), according to Central Bank.
- The number of mobile users exceeded 20 million people at the end of February 2002 while in the beginning of 2001 there were only 4 million mobile users in Russia (*Source: J'Son & Partners, Sotovik*).
- The Russian advertising market grew by 51% to USD 2.68 billion in 2002 (*Source: RARA, Gallup Media*).
- Over 85% of Russian households have no problems with buying enough food; over half can easily afford new clothes and other needed goods and services. 96% of households own a refrigerator, 89%; a colour TV set, 82%; a washing machine, 43%; a video recorder, 30%; a car. (*Source: IRG, Inside Russia II*).
- In the next 6 months over 35% of households will purchase at least one durable product like a new color TV set, washing machine or motorcar (*Source: IRG, Inside Russia II*).
- 42% of Russians claim that the economic situation became better during the last year. 40% are optimistic about the economic situation this year. (*Source: IRG, Inside Russia II*).
- Major multinational companies working in Russia reported a 15-30% growth of sales in dollar terms in 2002.

Other IRG research projects show very strong and healthy development of such sectors of the consumer market as retail trade and catering, production of packaging materials, telecommunications, various food industries including beer, edible oil and fats, ketchups, instant foods and semimanufactures, juices, meat, dairy, confectionery production, agricultural sector, and financial services for retail clients. All these sectors are represented by several companies in this report.

**Individual incomes are growing by 8-9% a year**

One of the major drivers of the consumer market growth is obviously increasing incomes of the Russian population and the 'emerging middle class'.

According to official sources; individual incomes increased by 8.5% in 2001 and 8.8% in 2002 (in real terms) IRG agrees with them on this point based on various independent indicators.

**Comparison of consumer spending in Russia, Portugal and Czech Republic, 2001.**

	Russia	Portugal	Czech Republic
Standard Consumer Spend, USD Billion	\$240.0	\$75.6	\$29.1
Population, Million	144.0	10.08	10.25
Per capita consumer spend, USD	\$1,660	\$7,500	\$2,840
% of total consumer spend on obligatory payments; communal services / rent etc	10-12%	40%	36.5%
Per capita discretionary consumer spend, USD	\$1,470	\$4,500	\$1,800
Per capita discretionary consumer spend (based on BigMac index), USD	\$2,980	\$4,720	\$2,700

**Source: Russia** – IRG estimates; **Portugal** – Banco de Portugal/2001 Annual Report; **Czech Republic** – Czech Statistical Office; **BigMac Index** – the Economist, April 2002.

**Russia surpasses Czechs in per capita discretionary consumer spend based on the BigMac Index**

It also should be mentioned that the per capita incomes of Russians are not so catastrophically behind the levels of East Europe and even such countries as Portugal especially in terms of real purchasing power.

At the top of the page is a table with comparisons of consumer spending in 3 countries (Russia, Portugal and Czech Republic) in 2001. Figures in the Russian section are based on IRG estimates of the domestic consumer market.

Standard Consumer spend: if considering the amount of per capita spending (at current dollar value) Russia lags behind Portugal by 4.5 times and the Czech Republic by 1.7 times. Given the current rate of consumer spend growth (15% a year in dollar terms) Russia will catch up with Portugal in 10-11 years and Czech republic in 3-4 years.

Per capita discretionary consumer spend: Russians spend a much lower share of their income on obligatory payments such as communal services and rent than their European counterparts. Thus, it's more realistic to compare the amount of spending after eliminating those payments – leaving only real disposable income. Then we see that Russian spending on consumer goods and services is one third of the Portuguese spend and only 20% less than the Czechs in current dollar terms.

On the base of the BigMac Index Russia surpasses the Czech Republic by \$200-300 but is only approximately two thirds of the

Portuguese spend (63%).

The main purpose of these comparisons is to show that the Russian consumer market is worthy of attention from foreign investors. Russians have approximately the same amount of per capita spending as East Europeans (taking into account the very low spending on various obligatory payments and communal services); but more importantly the Russian consumer market is ten times larger in volume than any East European market.

**Russians spend most their incomes on consumer goods and services**

On the other hand, it should be mentioned that the income differentiation level in Russia is enormously high and the main share of consumer spend falls at the richest 20% of population. Also a very low share of the Russian individual income is taxed.

Russian consumers don't have to pay large bills for electricity, gas and water; they also usually own their apartments and have no debts to banks for mortgage or education loans.

Certainly, it implies that the Russian economy remains at the low stage of development compared to western market economies. On the positive side, most individual incomes of Russians comes to the consumer market and thus accelerate its growth.

**Structure of consumer spendings, Russia vs. Czech Republic in 2001, %.**

	Russia	Czech Republic
Total spending (= disposable incomes - savings)	100%	100%
Obligatory payments and non-consumer spending	6%	22.3%
Foods	39%	20.5%
Non-foods	34%	29.9%
Services	21%	9.4%

Source: IRG estimates, Czech statistic office

**Foods accounts for up to 40% of the consumer budget**

Expenditures on food takes the largest share in the total spending of the Russian population, but this share is declining. The share of services and non-food products in the consumer budgets is increasing, driven by the growth of incomes.

People are becoming richer and their purchasing patterns are changing. Now they can afford more expensive and high-quality products. They want to buy brands and taste new goods and services (4-5 years ago only a few purchased mobile phones, yogurts and snacks; now these are the products of mass-market).

Thus, in the last four years the demand has moved from the low-income segment, where low price is a key factor, to the middle-class segment, where there are many competitive factors (quality, advertising, famous brand, price ).

**The Russian middle-class: 40-50% in Moscow, 20-25% in regions**

Now we are seeing the emergence of the Russian middle-class. We define the middle-class as people spending less than 35-40% of their income on “essential commodities”. These people are able to make savings, spend money on durables, education, entertainment and healthcare.

How many people are included in the middle-class? In Moscow our estimate is about 40-50% of all households. In regions the middle-class is smaller – 20-25% of all households.

What also important is that a very large group of the population (up to 30%) can become middle-class in the future. These people work hard to earn more money and aim at increasing their social status. Actually their purchasing habits are already very similar to the middle-class, as they prefer buying well-known brands of leading producers.

These 2 social groups, which together account for up to 50-60% of the Russian population play an increasingly important role in the Russian consumer market.

We believe that only those domestic companies that can satisfy the rising demands of the Russian middle-class will succeed. To be popular among Russian consumers businesses should focus on active advertising and marketing, quality control and innovations, developing of brands and company’s image.

### Top 100 companies: summary

The companies from the list of Top 100 have one main similarity – they are leaders in the Russian consumer market. At the same time they represent different market segments, regions, ownership structures, business models and strategies.

However, looking at them altogether we can identify key factors that enabled these companies to become leaders.

#### **Segments of the consumer market**

Companies can have several functions and simultaneously can operate as producer, trader or even service provider. Below we provide a structure of the Top 100 companies divided by the main activity they specialize in:

- Agricultural and food holdings – 8 companies
- FMCG producers – 42 companies
- Durable producers – 3 companies
- Leisure goods – 5 companies
- Packaging and printing producers – 5 companies
- Wholesale distributors – 7 companies
- Retailers – 12 companies
- Media – 3 companies
- Building construction – 1 company
- Consumer service providers – 15 companies

Although the number of successful companies varies from sector to sector we haven't rated our favourites. In our view, all segments of the Russian consumer market are worthy of the attention of investors simply because the growth of Russian incomes has led to increased spending on practically all types of consumer goods and services.

#### **Geography**

Identification of the real geographical origins of selected companies can be difficult since many of them have production assets and representative offices in various cities and regions.

Production companies origins are based on the location of their main production facilities:

- Moscow and Moscow Region - 16
- Saint Petersburg and Leningrad Region – 12,
- Central Russia – 6
- North and Northwestern Russia - 3
- Povolzhye – 4
- Southern Russia - 3
- Urals – 3
- Siberia – 3

Moscow and Saint Petersburg account for over the half of the selected companies operating in the production of consumer goods and packaging. In the wholesale and retail segments the situation is even more indicative with the vast majority of traders focusing on the Moscow market.

This is not a big surprise since Moscow and Saint Petersburg represent up to 30% of the Russian consumer market so companies can be successful concentrating their efforts on one of these markets.

At the same time we see strong regional companies that are now actively approaching the Moscow market, e.g. the largest domestic retailer of consumer electronics and household appliances, Eldorado Company, started activities in the regions and is currently trying to catch up with competitors in Moscow.

The opposite trend is where Moscow and Saint Petersburg companies started regional expansion, because the markets in capitals are often almost saturated while regional markets demonstrate enormous growth potential.

### **Ownership/ Organization structure**

The ownership and organizational structure of even the most successful Russian enterprises remains very intricate and this is one of the main constraints for their development.

Over half of the Top 100 companies are in fact holding structures, which consist of several legal entities performing different functions. Such ownership structure is used for optimizing tax payments and protecting a company from possible takeovers.

However, there is evidence that the situation has started to change and companies are or will be reorganizing their structures to become more transparent and attractive for investors.

On the good side it should be noted that none of the selected companies currently experience problems with minority shareholders. Most of them are controlled by a single group of shareholders that often includes top managers. In some cases some major financial group or foreign investor owns a controlling stake in a company.

Major domestic financial and industrial groups including Interros, Alfa, Rusal and Sibneft have stakes in 14 companies from the Top 100 list. 'Real' foreign shareholders (excluding offshore companies) are represented in at least 25 companies.

Only a few selected companies publish consolidated financial statements; we can obtain less than 45% of the financial information from official sources (Goscomstat).

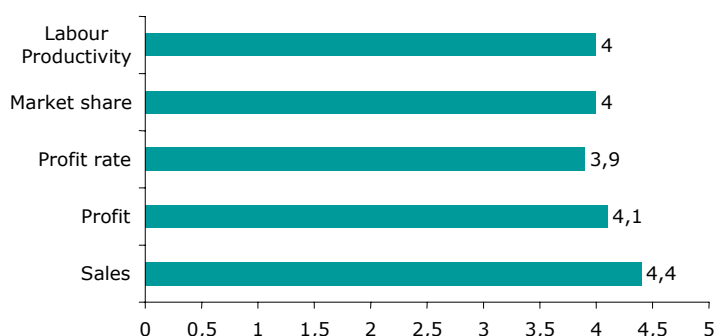
We believe that the selected companies will significantly improve corporate governance practices and transparency in the mid-term and this process could be accelerated by effective government measures in the fields of taxation and investor rights protection

**Current performance and growth potentials**

The overwhelming majority of selected companies report significant growth rates in 2002. The opposite examples are very rare and they are related to problems that the whole Russian economy faces.

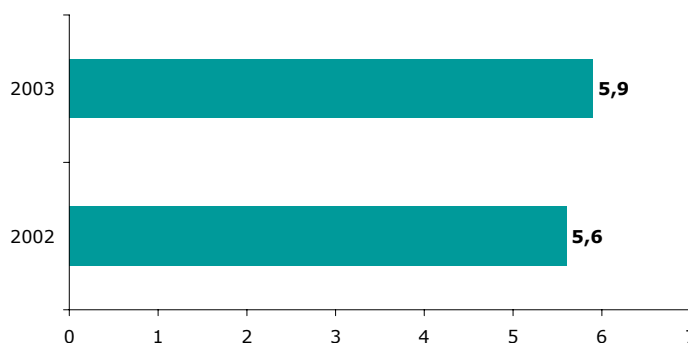
E.g. the Tchaikovsky Textile company, which we consider as one of very few good companies in the Russian textile industry showed a decline in sales in 2002. However this company has significant growth potential and will be of interest for investors and marketers.

**What was the dynamics of main indicators in your company in 2002 (1- very negative; 5 -very positive)?**



Base: companies answered the questionnaire

**What results did your company demonstrate in 2002/plan to achieve in 2003 (1 - very negative; 7 - best than ever)?**



Base: companies answered the questionnaire

From the companies who answered our questions most demonstrated increasing main indicators in 2002. Certainly, the growth of sales is somewhat higher than the other indicators. However, for these companies and for the whole list the growth is quite balanced and is based not just on extensive factors but also on increasing efficiency and productivity.

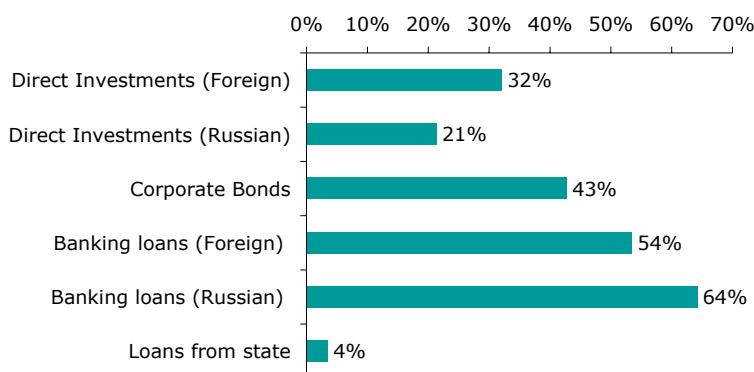
What is also important is that the companies are even more optimistic about their prospects in 2003 compared to 2002. Of course this optimism may not be realized in future due to external factors. But it reflects plans and expectations of successful companies and these plans are supported with investment programs. We think that the Russian consumer market and its major segments are still very far from saturation and in the next two years the growth will continue with an increased pace.

Based on all the information we collected about the companies we forecast the average sales growth of Top 100 at 20-25% in 2003.

### Investments

Again most successful consumer-related companies have realized that their intensive development plans could not be financed with internal sources only. Many of them already have experience in attracting external financing. However, we are sure that the amount of funds borrowed by the Top 100 companies will increase radically in 2003 and 2004.

**Do you plan to attract funds from the external sources in the next 2 years?**



Base: companies answered the questionnaire

Based on the results of the survey and the collected information about the companies investments plans, we estimate the potential annual demand of the Top 100 for external investments at some USD 1.5-2 billion or USD 20 million per company.

The most popular approach for obtaining investors' money will be bank loans. Russian and foreign banks will have almost equal potential to work with successful consumer-related companies.

Corporate bonds are also considered as one of the most attractive means of external financing. Bonds have many competitive advantages to bank loans since the company is not dependant on one investor. We expect up to 30 newcomers to the Russian stock market issuing corporate bonds.

Moreover, about 15 companies from the Top 100 list have announced plans to conduct an Initial Public Offering (IPO) of their shares in the Russian or western stock markets. We forecast that about 10 of them will be able to fulfill these plans in 2003 and 2004. Though it should not be considered as bad news since these companies will be actively drawing loans and direct investments as well as issuing corporate bonds.

Entrance of the successful consumer-related companies to financial markets will be gradual since these companies need to make a lot of improvements their corporate governance, financial accounting, and transparency. However, the Top 100 companies are really interested in becoming more transparent and attractive for investors.

**Agricultural and food holdings**