Strategic Choice Advisory

Strategy and Transactions

Russia Macro Foresight

B2B Demand Slips, but B2C Activity Picks Up in H1/2019. Banking, Monetary, External Sector Indices Worsen as Investments Slump – Efficiency Improvement and New Technologies to the Rescue!

August 2019

Sector growth dynamics mixed in H1/2019, as key B2B-oriented sectors slow, but many B2C-oriented sectors start feeling more upbeat

- The economy stayed in a state of slumber in H1/2019, as growth cooled slightly, yet major financial distress was avoided. Our key observations for this period center on two diverging trends, which are starting to reshape the market landscape. Confirming our conclusion in the previous report (Feb 21, 2019), **demand in B2B-oriented sectors continued to wane** after the upsurge driven by import substitution. Meanwhile, **many B2C-oriented sectors are now becoming more vibrant**, even though consumer demand is only starting to recover from the latest crisis
- **Industrial production (IP) growth made up a comely 2.6% y/y in H1, easing just a bit** after reaching 2.9% in full-2018. **Among the out-performers are a lot of B2C-oriented sectors**, including food (3.8%), especially meat (9.2%) and ready-to-cook meat products (10.1%), cheese (7.2%), and sunflower oil (12.1%); pharmaceuticals (16.7%!); computers and electronics (4.6%, albeit slowing from last year); building materials (7.1%; after a slump), and wallpaper (16.3%)
- Wood products (8.2%), including fuel briquettes (40.1%); and metal products (6%), including pre-fabricated metal structures (5.8%, after a significant decline last year) are also seeing solid growth. Altogether, this reflects the **starting recovery in housing construction, also a B2C-oriented sector** *(for details, please see the next slide)*
- **Total pre-tax corporate profit growth picked up further to 36.5% y/y in Jan-May,** as profit in manufacturing jumped 50.1%

- The brisk growth in foods came alongside **an encouraging uptick in agriculture - 1.2% growth after a sudden 0.8% decline** in full-2018 (which we attributed mainly to market saturation). Growth in livestock resumed, while horticulture was supported by good weather (at least, through end-June in key regions; the weather has deteriorated since), as vegetable sowing rose 5.7% y/y. **Fertilizer production shot through the roof** (sadly, killing off large populations of bees across the country, now being reviewed by authorities), and **agricultural equipment soared well into the double-digits**. This proves agriculture still has a lot of potential. That said, the well-saturated **dairy segment does not appear to be feeling well**, as milk dropped 1.5%, and butter - 5.8%. Nevertheless, **sector profit skyrocketed 55.3% y/y** in H1
- Surprising negatively were textiles and apparel (-3.3% and -4.5%, respectively); key B2B sector machinery and equipment (-3.7%; after robust growth); and fish (-3.3%, also after several years of strong growth). **Overall, growth in a number of B2B-oriented sectors slowed in H1**, compared to previous years

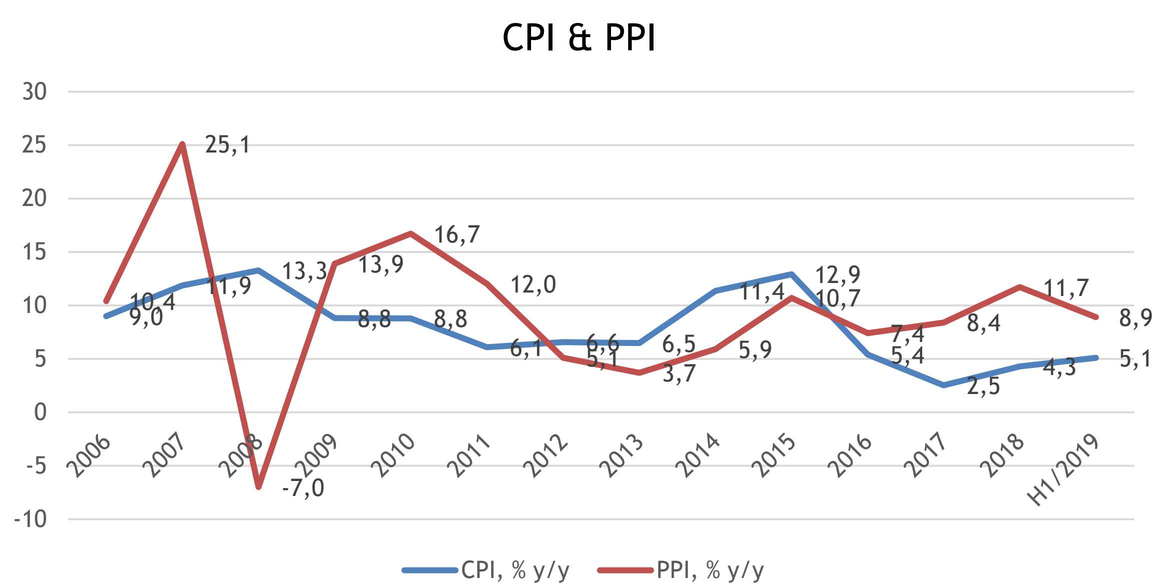
Indicator, % y/y	2016	2017	2018	H1/2019
Industrial production	1.3	2.1	2.9	2.6
Cargo transport turnover, o/w:	1.8	5.5	2.9	1.7
Railway	1.6	6.4	2.3	2.0
Automobile	0.4	2.3	2.2	7.2
Agriculture	4.8	3.1	-0.8	1.2
Retail trade	-4.6	1.3	2.8	1.7
Construction, o/w:	-4.3	-1.2	5.3	0.1
Housing	-6.0	-1.3	-4.5	3.7
Fixed capital investment	-0.6	4.4	4.1	0.5*

** - Q1/2018, % y/y*

B2B vs. B2C demand dichotomy seen also in construction, transport, and inflation data. Profit still grows strongly in key sectors, but rising CPI inflation can affect consumer demand, going forward

- Further highlighting the B2B vs. B2C dichotomy, growth in construction slowed to 0.1% y/y vs. 5.3% in full-2018 (owed to methodology revisions in industrial construction, which we believe may be justified). Looking closer, we can see **housing construction finally got out of the red**, growing 3.7%. This means industrial construction contracted now, as evidenced also by the **slump in fixed capital investment** (0.5% in Q1/2019, per latest available data, vs. 4.1% in full-2018). **Still, construction sector profit soared 5-fold in H1**
- Retail trade grew 1.7%, positive in itself, but lower than 2.9% in full-2018. This shows consumer demand still has not recovered to a point where it can sustain output growth across the board. Encouragingly, **wholesale & retail trade profit soared** 73% y/y in Jan-May
- Also proving the divergence in B2B vs. B2C demand, **cargo transport turnover slowed further to 1.7%, as growth in railways (mainly B2B) slid to 2%, but automobile transport (mainly B2C, last mile) surged 7.2% vs. 2.2% in full-2018.** Profit in transportation and storage overall leapt 68.7% in H1, but rose just 33.4% in railways (still managing to fuel double-digit growth in rolling stock output)
- Positively, **solid output growth continued in chemicals** (2.8% overall), especially in ethylene (3.8%); abovementioned fertilizers (watch out, bees…); and plastics (3.1%), most notably, PVC, and PP and other PO
- Mirroring the boom in pharmaceuticals**, medical equipment gained another 16.7% y/y**, driven by import substitution. Also related to the **trend of people investing more in their health**, bottled water production surged 19.4%, whereas soft drinks rose a mere 1.2%

- Yet another sign of weaker B2B demand can be found in **PPI inflation slowing to 8.9% y/y in H1/2019**, after hitting a dangerously high level of 11.7% in full-2018. Strongest price growth in H1/2019 was seen in extraction, chemicals, automobiles, furniture, and railway transport
- Meanwhile, as we predicted several reports ago, **CPI inflation picked up further to 5.1% y/y in H1/2019** after reaching a record low of 2.4% y/y during H1/2018
- Actually, **we feel official data understates actual CPI inflation.** We have seen food prices hiked about 10% m/m in June alone in various stores, after notable growth from year-start (way beyond the marginal 2pp VAT increase). Official data shows food prices up only 6% ytd
- Going forward, **higher CPI inflation can nip the consumer demand recovery in the bud…**



Wage growth slows, real disposable income declines again, holding down consumption. Banking sector situation deteriorates sharply: loans and deposits slump, overdue debt soars

- **No sooner did real disposable income (RDI) finally grow in 2018, albeit just slightly, the indicator declined again by 1.3% y/y in H1/2019.** Worth noting, a massive methodology revision is underway at RosStat, so the figures may still be updated. But so far, contrary to some critics, who expected the numbers to be artificially inflated, they were actually revised downward
- The latest RDI decline was caused by a **notable slowdown in nominal wage growth** to 7% from 11.6% in full-2018. Coupled with higher CPI inflation, this led to **a drastic slowdown in real wage growth** from 8.5% in full-2018 to just 1.8% in H1/2019
- As we noted earlier, besides wages, this indicator also accounts for mandatory payments, including bank loans. This is why **the population's rapidly growing debt burden is cause for concern.** Weak growth of savings shows people often borrow mostly to repay previously taken out loans *(for details, see below)*

Indicator, % y/y	2016	2017	2018	H1/2019
Real disposable income*	-4.5	-0.5	0.1	-1.3
Real wages	0.8	2.9	8.5	1.8
Nominal wages	7.9	6.7	11.6	7.0

** - Methodology still under review by RosStat; further adjustments may be possible*

- In another highly negative, related development, **banking sector figures worsened notably in H1, overturning last year's positive trends.** Total assets still rose 6.8% y/y, but dipped 1.7% ytd
- **Corporate loans slid 0.2% ytd** after a recovery in 2018. **Retail loan growth stayed alarmingly high** at 22.8% y/y. **Corporate deposits rose 13% y/y (vs. 21% in full-2018), declining 2.4% ytd**
- **Individual deposit growth also slowed** by 2.1pps, as deposits rose just 1.8% ytd. **Interestingly, long-term retail deposits rose 4.5% ytd,** and 10.1% since 2018-start. **This is positive for forming long-term assets, but also shows people's reluctance to spend**
- **A highly worrying turnaround took place in overdue debt, which rose 18.4% y/y.** Corporate past due debt surged 25.6% ytd, retail past due debt - 5.5% ytd after dropping 10.4% last year
- At least, **banking sector profit growth stayed strong, easing just slightly to 58.5% y/y** in H1. Our main concern is that **bank profits are not finding their way into the broader economy**

Indicator, % y/y	2016	2017	2018	H1/2019
Banking sector profit	**4.8-fold**	**-15.1**	**70.3**	**58.5**
Banking sector assets	**-3.5**	**6.4**	**10.4**	**6.8**
Loans to individuals	1.1	12.7	22.4	22.8
Loans to corporates	-3.6	1.8	10.8	6.5
Total overdue debt, o/w:	-5.1	3.5	0.2	18.4
Individuals	-0.7	-1.0	-10.4	-1.4
Corporates	-8.9	2.7	7.8	24.5
Individual deposits	4.2	7.4	9.5	7.4
Corporate deposits	-13.8	9.2	21.0	13.0

Money supply contracts suddenly, FDI inflows collapse, while foreign debt resurges. Trade surplus stays strong, while government debates whether to provide extra stimuli or focus on stability

MONETARY AGGREGATES

- **Echoing the deterioration in banking sector indices, key monetary aggregates also did an about face after steady growth.** Broad-definition monetary base dropped and 5.7% y/y and 3.3% ytd in H1, while broad money rose 7.5% y/y, but shrank 0.7% ytd. **It is not as if a liquidity crisis is underway, given strong corporate and bank profit growth**, but credit and cash have indeed become less readily available for both corporates and the population. **The uncertain economic climate seriously hinders investment and spending**
- **The latest banking and monetary sector data has sparked a fierce debate within the Russian government,** as EconMin, FinMin and CBR have been sparring over whether additional stimuli (first of all, credit) is needed to rev up economic growth, or the debt burden is already too high, especially for the population. EconMin and FinMin say support measures need to be developed for the general public, whose creditworthiness and purchasing power can collapse around 2021-2022. **Many an economist now argue whether growth or stability (read: fiscal prudence) are the top priority for the local economy**

EXTERNAL SECTOR

- **FX & gold reserves increased by another USD 50bn over H1, reaching USD 518.4bn.** This and other safety cushions keep growing
- According to revised data, FDI inflows hit the lowest level on record, making up a meagre USD 7.4bn in 2018 vs. USD 24.4bn in 2017 and USD 33.9bn in 2016. By the same token, FDI outflows made up USD 31.9bn in 2018 vs. USD 36.8bn in 2017 and USD 22.3bn in 2016. Thus, **net capital outflows have intensified dramatically, as it is more lucrative and safer to invest in and keep money abroad**
- **Total foreign debt grew USD 27.7bn (6%) ytd in H1** to USD 482.4bn. It is still down USD 8.4bn y/y, but the latest increase, driven by government debt (up 46.4% ytd to USD 64.3bn) and corporate debt (up USD 11.8bn ytd to USD 326.1bn) is worth watching. Reassuringly, **corporate short-term external debt receded after the recent pent-up, while new debt mainly came from existing foreign owners.** But the fact government short-term debt keeps surging is a sign **longer-term borrowing remain problematic amid Western sanctions**
- **The trade surplus remained strong, but declined 2.6% y/y USD 72.3bn in H1, as both exports and imports dropped 2.5% y/y.** As we noted last time, the share of value-added goods continues rising, even if masked somewhat by growing exports of oil products and LNG (which keep the total share of oil&gas at around 60% of exports). However, **exports of other key manufactured goods, including chemicals, foods, and metals, were, indeed, weaker in volume terms in H1**, after robust growth. **In imports, machines & equipment slumped, reflecting (yet again) weaker B2B demand**
- Worth noting, **the share of Asia Pacific countries in foreign trade rose to 31.6% in Jan-May 2019 vs. 29.3% a year ago, while that of the EU fell to 42.6% vs. 44.2%.** Strongest growth was seen in trade with the Republic of Korea (23.4%)

PUBLIC SECTOR

- **The federal budget surplus stayed at a solid 2.1% of GDP in H1 vs. 2.7% in full-2018,** supporting long-term economic stability

To sum up:

Pitching in to the current debate on stimuli vs. stability, we can say that **if economic growth stays low, as is the case now, and inflationary pressures remain in place, debt levels are still bound to increase, threatening long-term stability.** The government is trying to spur investments via what are called national projects, targeting infrastructure and technology development, but these **efforts remain rather vague** for the broad investment community. Plus, **such projects need to be better structured and benefit not only the chosen few, the major players who are close to government procurement,** which now fosters widespread corruption. So far, the impact of these initiatives remains doubtful.

So, while government authorities are figuring out the overall course of economic development, **what is an investor to focus on, for the time being?**

1. **B2C sectors, including foods and, to an increasing extent, building materials and home décor** (minding the risk of saturation, especially in foods). The eCommerce option for home décor/ DIY, together with relevant services, may also be a good bet
2. **Russians' newfound desire to invest in one's health continues fueling medical services, medical equipment,** "healthy foods and beverages (albeit market saturation and scale factors have to be weighed up here), and biotechnologies (going forward). Various eHealth and diet/ cook-it-yourself (healthier eating) solutions are also finding interest from consumers
3. **Electronics, including component-based end product solutions, have significant upside**, despite already stepped up import substitution, and are under-saturated so far. The economy of scale is an important factor to consider here
4. **Logistics remain quite attractive, as businesses fight to improve efficiency amid tougher competition.** There is still a lot to optimize and integrate in this area, given Russia's vast geography. Services and electronic solutions for logistics and transportation are now seeing robust growth
5. Overall, given the saturation of a rising number of sectors, and feeble prospects for extensive development (business/revenue growth) for many players therein, **we believe businesses will be putting more emphasis on products and services that allow intensive development**, i.e. boosting profit margins or gaining a competitive edge via new technologies. A good example is chemicals, now spurred by import substitution (cutting costs) and the ability to get required specifications for end products via customization by existing manufacturers, boosting/modernizing capacities
6. Altogether, **new technologies (read: new market segments) can provide the spark**, the light at the end of the tunnel for both businesses and individuals, wary of their low profit/income predicament. A new hope, a "force awakening", and the means to achieve a better life are what is needed for the rise of individuals in this society (politics aside)

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