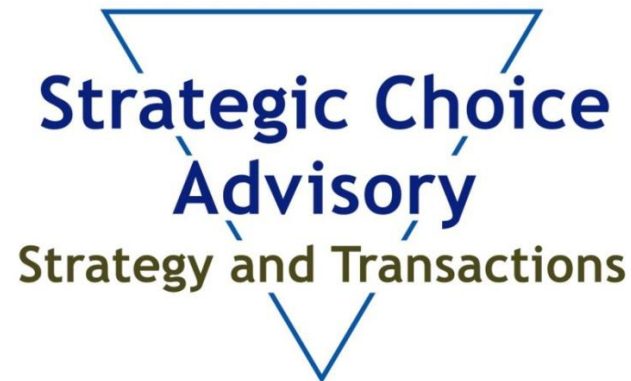


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**Strategic Choice  
Advisory**  
Strategy and Transactions

**Macro Foresight**

**Rebound in Consumer Demand May Start Within One Year,  
Triggering Broad-based Economic Recovery**

**October 2016**

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# Consumer sentiment is starting to improve, driving delayed purchases. Meanwhile, production, profit, financial stability and other leading indicators improve in key economic sectors

## CONSUMER DEMAND

- Consumer sentiment/ confidence surveys (VtsIOM, Higher School of Economics, etc.) are showing visible improvement. Most people believe the economic situation has stabilized, and concerns over high inflation and unemployment are now receding
- According to anecdotal evidence from several major online retailers, the average receipt on per item basis has grown 2-3 times in recent months. Market players tend to attribute this to delayed purchases now being made by customers
- According to GfK Research, sales of consumer electronics and household appliances surged 14.2% y/y in Q2/2016

## LABOR MARKET

- The drop in real wages has been reversed due to slowing inflation and corporates trying to retain key employees. Nominal wages still managed to grow 7.3% y/y in Jan-Aug 2016 amid the economic slump
- Corporate wage arrears declined by 6.6% over May-Sep 2016 after spiking up since the start of the “Ukraine crisis”
- ILO-definition unemployment is down marginally y/y as of end-Aug 2016, despite widespread concerns

## ECONOMIC DEVELOPMENT

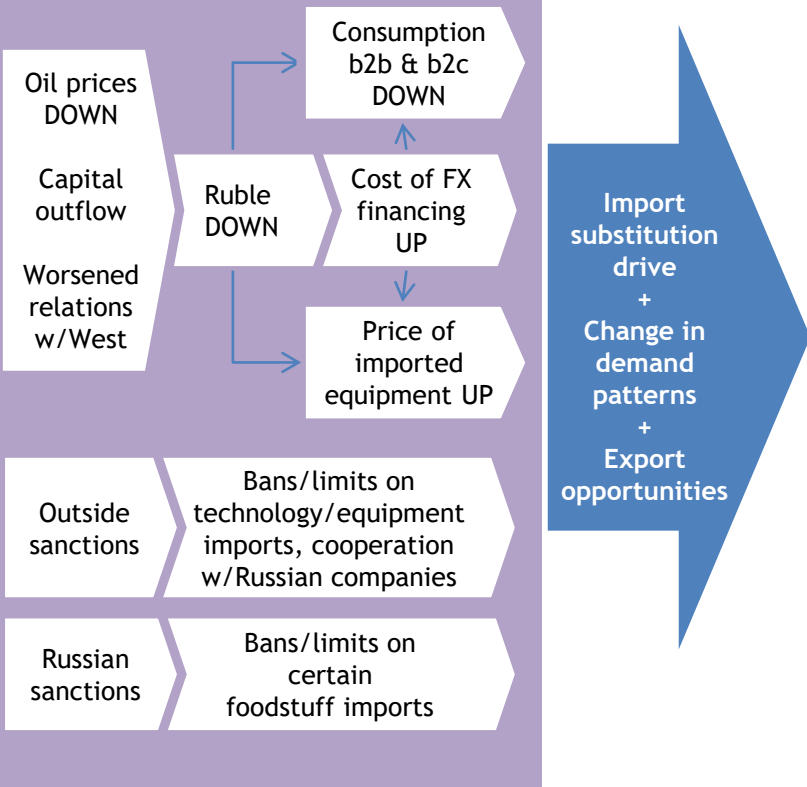
- Import substitution continues fueling growth in a widening range of economic sectors, which cannot be explained away by the low base effect. Production volumes in absolute terms in a number of key industries significantly exceed levels recorded before the start of the “Ukraine crisis” in 2014 (*for details, please refer to sl. 2*)
- Moreover, output price growth is now starting to pick up in a host of sectors enjoying production increases, e.g. fish, agricultural produce (grains & cereals, sunflower oil, etc.), footwear, textiles, and electronics & home appliances. This reflects stronger consumer demand and bodes well for growth of investment in these sectors
- Real sector pre-tax profit rose another 4.7% y/y in Jan-Jul 2016 after growing 50% in 2015 (which included a 3-fold increase in manufacturing). Corresponding indices declined just marginally in 2014, which shows the upsurge is not owed to the low base
- Central Bank data shows vivid improvement in key financial stability indices in retail & wholesale trade, including current liquidity, own funds’ sufficiency, and debt/earnings. The improved financial performance allows retailers & distributors to introduce additional discounts, further supporting consumer demand, and to broaden their sales network

## OTHER LEADING INDICATORS

- Serving as a leading indicator for such a vast country like Russia, growth of transportation is observed in practically all means of transport, including truck and railway. The goods breakdown reveals growth in both consumer and industrial goods

# Import substitution becomes a major economic growth driver, despite political turbulence and consumption weakness. This presents ample production localization and M&A/ JV opportunities for foreign players

## Political and economic conditions



Output growth, Jan-Aug 2016, % y/y	Main growth drivers	Opportunities
<b>Agriculture +3.4%</b> - Grain +2.9% - Meat & poultry +5.2%	<ul style="list-style-type: none"> <li>• Import substitution</li> <li>• Government support</li> <li>• Export opportunities</li> </ul>	<ul style="list-style-type: none"> <li>• Investment in leaders in respective segments</li> <li>• Joint production</li> </ul>
<b>Food manufacturing +2.4%</b> - Meat, meat products +4.0% - Oils & fats +6.7% - Canned vegetables & mushrooms +11.4% - Ice cream +9.8% - Rice +15.5% - Fodder feed +4.4%	<ul style="list-style-type: none"> <li>• Import substitution</li> <li>• Vertical and horizontal integration</li> <li>• Increased competition</li> </ul>	<ul style="list-style-type: none"> <li>• Investment in leaders in respective segments</li> <li>• Joint production</li> <li>• Investment in high value-added products, incl. eco and premium foods</li> </ul>
<b>Marine products +3.6%</b> - Frozen fish fillet +24.9% - Fish preserves +15.0%	<ul style="list-style-type: none"> <li>• Import substitution</li> <li>• Growth of processing</li> <li>• Increased competition</li> </ul>	<ul style="list-style-type: none"> <li>• Investment in processing capacity, joint production</li> </ul>
<b>Textiles &amp; apparel +4.0%</b> - Fabrics +20.4% - Apparel + 4.6%	<ul style="list-style-type: none"> <li>• Import substitution</li> <li>• Increased readiness to buy local products</li> </ul>	<ul style="list-style-type: none"> <li>• Investment in textile manufacturing, JV</li> <li>• Creating design bureaus</li> </ul>
<b>Footwear, leather +9.3%</b>	<ul style="list-style-type: none"> <li>• Import substitution</li> <li>• Horizontal integration</li> </ul>	<ul style="list-style-type: none"> <li>• Production localization</li> <li>• M&amp;A</li> </ul>
<b>Plastics &amp; resins +5.9%</b>	<ul style="list-style-type: none"> <li>• Demand in industries spurred by import substitution</li> </ul>	<ul style="list-style-type: none"> <li>• High-precision plastics - manufacturing &amp; equipment</li> </ul>
<b>Cosmetics +8.7%</b>	<ul style="list-style-type: none"> <li>• Import substitution</li> <li>• Focus on local brands in natural products</li> </ul>	<ul style="list-style-type: none"> <li>• M&amp;A</li> <li>• Licensed production in Russia</li> </ul>
<b>Machines, equipment +3.6%</b> - Agricultural equip. +28.8% - Metal-cutting tools +16.9% - Medical devices +11.6% - Home appliances +11.2%	<ul style="list-style-type: none"> <li>• Import substitution</li> <li>• Production localization by foreign players</li> </ul>	<ul style="list-style-type: none"> <li>• Technology transfer</li> <li>• Production localization</li> </ul>

# Consumer demand expected to start recovering over the coming year, further stimulating investment, in addition to import substitution. Several key sectors may see a new wave of M&A

## Import substitution to remain a key growth driver

- We expect the strong growth momentum to be maintained in sectors outlined above
- The production growth should gradually find its way into B2B-oriented industries, including **machines & tools** as means of production, and more sophisticated equipment, e.g. **medical, electronics components manufacturing equipment** and etc. As a matter of fact, these segments are already starting to enjoy production increases
- A major factor companies will continue watching is consumer demand. As soon as it picks up, further output growth will follow

## Consumer demand to start recovering within one year

- As long as no further external political shocks occur and the labor market remains stable, we expect reviving consumer sentiment to trigger a broad-based economic recovery within the next year
- The recovery is likely to start in the low and medium-price segments and gradually encompass more and more expensive items, driven by delayed purchases (**clothing, DIY products, cars, etc.**)
- The positive dynamics will likely be supported by government authorities, trying to please the population ahead of the 2018 presidential elections

## New investment in sectors seeing both production and output price growth

- Currently, several key sectors are starting to witness both production and output price growth, e.g. **grains & cereals, sunflower oil, textiles & apparel, footwear, marine products, electronics & home appliances, and household chemicals, among others**
- This is always conducive to investment, and we suppose these very sectors are the ones that will see increased investment in the next 1-2 years
- In addition, we expect further investment in **pesticides (59.3% y/y output growth in Jan-Aug), packaging (up to 20% growth), and private healthcare**

## New wave of M&A in traditional manufacturing sectors

- Positively, we are finally seeing production growth in several traditional manufacturing sectors, after several years of fairly dismal performance. Namely, **timber and wood processing (+1.5% y/y in Jan-Aug), glass (+3.3%), paper and cardboard (+5.9%),** and etc.
- The sector structure in these capital-intensive industries is formed by large enterprises, which underwent a period of active M&A in 2000-2007
- We expect M&A to restart in such sectors, as company owners will be able to get more favorable deal multiples, while market leaders may use the opportunity to acquire competitors

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