Strategic Choice Advisory

Strategy and Transactions

Russia Macro Foresight

Overall Growth Cautious, but Import Substitution Entrenched, Consumer Demand Picking Up – Time for Consolidation?

August 2018

Economic growth rates have stabilized, but manufacturing still upbeat. Now what are the winning investment ideas and business models?

- Economic growth rates stayed positive, but lackluster over the last two years after a steep decline in 2014-2015, caused by Western sanctions and low oil prices. In our previous reports, we dwelled on the robust growth in sectors driven by import substitution, and the much-welcome overall economic stabilization
- Having reviewed data for H1/2018, we can conclude that **growth has indeed stabilized at a rather low overall level.** GDP growth stayed roughly flat in H1. The dynamics and drivers are difficult to judge this time around, due to substantial methodology changes and data revisions. We will have to wait for further data sets to make more sense out of the industry timeseries
- What is evident so far is that **manufacturing is doing fairly well, boosted by import substitution.** We suspect **the high base effect may have affected growth numbers in some sectors** after the recent upsurge
- This effect may also be seen in transportation and fixed capital investment, although we would have to watch these indicators to make sure they do not signal a slowdown in business activity. Meanwhile, agriculture received a boost from much warmer weather, compared to H1/2017 (when growth was only 0.5% y/y)

Indicator, % y/y	2016	2017	H1/ 2018
Real GDP	-0.2	1.5	1.6
Industrial production	1.3	2.1	3.0
Cargo transport turnover	1.8	5.5	2.7
Agriculture	4.8	2.4	2.2
Fixed capital investment	-0.6	4.4	3.6

- Still, processing numerous incoming investment projects from a vast array of industry sectors, we cannot shrug off the feeling that **the economy has become somewhat stuck. It's as if most entrepreneurs have run out of new ideas**, excitement, some grand vision for their activities
- Yes, **Russian businesses have become a lot more prudent**, focusing on cost optimization, **and better skilled in product placement and sales**. But it feels like companies are just launching particular products (especially for import substitution), and… joining the daily grind. If you manage to turn a profit, you consider yourself lucky, and just continue with the same thing – on, and on, and on…

But is there more to it?! More exciting, ground-breaking things to pursue, new lands to conquer?

What are the business models and investment ideas that can really blow the roof and shatter that glass ceiling?

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Before we get to some "more exciting notions", import substitution and products for efficiency improvement remain good investment ideas, despite slowdowns in certain segments. Russian-made manufactured goods are being exported more actively and are starting to squeeze out imports

Import substitution remains a key growth driver

Segment, % y/y	2017	H1/ 2018	Segment, % y/y	2017	H1/ 2018
Agriculture and food manufacturing			**Clothing & footwear**		
Meat	7.3	10.3	Textile	2.8	4.6
Meat products	7.1	6.2	Apparel	8.5	6.6
Vegetable preserves	30.3	9.7	**Chemical manufacturing**		
Confectionery	3.5	9.3	Detergents	6.3	9.3
Bottled water	5.7	13.6	Synthetic fibers	5.2	17.2
Soft drinks	11.2	12.3	Pharmaceuticals	12.7	7.3
Machines & equipment					
Automobile engines	2.2	19.5	Electrical equipment	4.7	3.0
Cargo railcars	59.8	23.7	Electrical conductors	11.2	17.9
Train engines	-11.8	33.6	Metal-working equipment	0.0	11.1
Industrial refrigerators	70.7	16.8	Medical equipment	N/D	14.0
Miscellaneous other					
Wood products	3.9	6.4	Paper & related products	6.9	9.7

Efficiency improvement also spurs growth in various segments

Propane & butane	0.3	6.3	Polymer-reinforced fabrics	17.8	16.9
Plastics & resins	3.8	4.0	Fodder feed	7.8	5.1
Power cables	9.7	17.4	Fertilizers	8.2	3.5

Exports of local higher value-added goods start outpacing imports, also serving as an investment idea

Exports, H1/2018, % y/y				Imports, H1/2018, % y/y	
Metals & metal products	15.3**	Food products	43.0**	Textile & apparel	1.7**
Electrical equipment	39.1*	Inorganic chemicals	25.9**	Chemicals	4.3**
Trucks	4.3**	Soap & detergents	19.3**	Trucks	-8.6**

** - monetary terms ** - volume terms*

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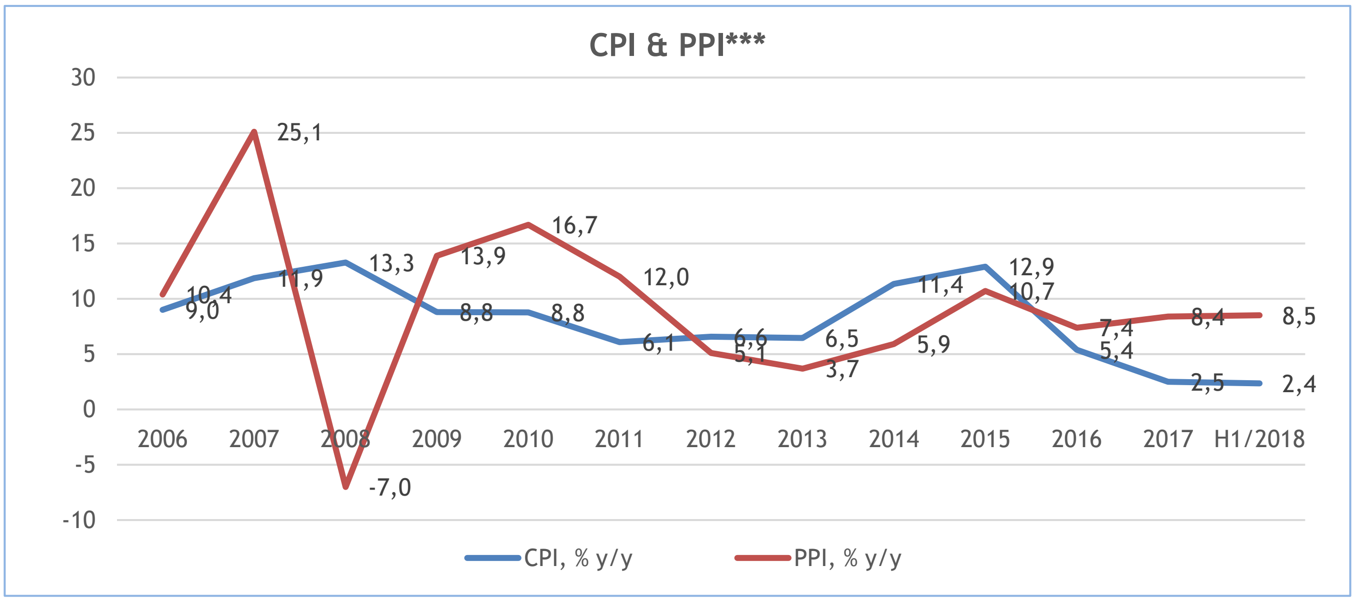
Consumer sector indices start heading up, CPI inflation stays low - retail trade attractiveness should start improving

While investment and other industrial goods have been enjoying a growth spurt for some time, we are **very excited to finally see retail trade and real disposable income indicators going up. A resurgence is also seen in consumer goods,** beyond the recently buoyant foods and other FMCG products**. **As for whether retail can again be a good investment opportunity, we are ready to say: rather yes, than no, both in offline and online.** This stage in the growth curve may be a good entry point!

Indicator, % y/y	2016	2017	H1/2018
Retail trade	-4.6	1.3	2.6
Real disposable income	-5.8	-1.7	1.6
Real wages	0.8	2.9	8.7
Nominal wages	7.9	6.7	11.2
Total unemployment	-0.5	-6.5	-8.5

Indicator, % y/y*	2016	2017	H1/2018
Soft drinks	N/D	11.2	13.6
Bedding	-2.6	-3.4	7.3
Kitchen and other glassware	N/D	N/D	6.2
Ceramic floor tiles	-1.7	-0.6	6.0
Cars	-7.4	21.0	18.9
Car tires	7.1	8.7	9.3

- **CPI inflation inched down to just 2.4% y/y** in H1/2018, helping spending recover
- Meanwhile, **PPI stays much higher**, now at 8.5% y/y
- Historically, one indicator was much higher than the other for a few years, and then vice versa
- Now industrial goods makers are able to set higher prices (in part due to the weak RUB), while many end-product makers and retailers are suffering from low margins. **But this can change soon, especially with improved spending power!**



* - N/D - previously grouped differently by RosStat
** - Please also refer to consumer goods on previous slide

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*** - PPI from 2017 - per new RosStat methodology

Overall liquidity and banking sector indices continue improving, but corporates lending still weak, needs new solutions. Banking sector profit and own capital growth in the red, causing concern. Construction, building materials still struggling; home refurbishment growth prospects unclear

BANKING SECTOR

- **Banking sector activity is gradually picking up**, driven by retail lending, investment in securities, and cash
- **Corporate lending is finally growing again**, but slowly. Overdue debt growth lags behind, as banks remain cautious
- Retail deposit growth is accelerating. Slower corporate deposit growth shows businesses are spending more
- **Still, bank profit and own capital growth are in the red**, as the sector may be walking on thin ice. **Smart Money solutions are much needed!**

Indicator, % y/y	2016	2017	H1/ 2018	Indicator, % y/y	2016	2017	H1/ 2018
Total assets	**-3.5**	**6.4**	**7.2**	**Total liabilities**	**-5.3**	**6.7**	**8.2**
Loans to individuals	1.1	12.7	18.9	Corporate deposits	-13.8	9.2	5.6
Loans to corporates	-9.5	0.2	4.6	Individual deposits	4.2	7.4	8.4
Total overdue debt	-5.1	3.5	1.9	Corporate funds on corresp. accounts	-3.7	6.4	6.7
Investment in securities	-2.6	8.0	9.8	**Own funds**	**4.2**	**0.1**	**-1.1**
Cash & equivalents	-0.3	19.6	46.9	Current year profit	4.8-fold	-15.1	-17.7

MONETARY AGGREGATES, PUBLIC SECTOR, EXTERNAL SECTOR

- National-definition money supply growth accelerated further to 11.4% y/y in H1/2018, while broad money grew 9.7% y/y
- **The federal budget finally turned a surplus in H1/2018**, making up around 10% of budget revenues in the period
- Current account, BoP surplus growth picked up on higher commodity prices and non-oil&gas exports; foreign debt decreased

CONSTRUCTION & BUILDING MATERIALS

- **The construction sector stays weak, with only housing construction starting to recover. Building materials surprised negatively in H1/2018*.** This contrasts the recovery in retail trade, and wage and income growth
- After the sanction and low oil price crisis started in 2014, the population mostly focused on home refurbishment; commercial real estate slumped; as mainly state-driven mortgage programs kept the industry going. **Now home refurbishment enthusiasm is subsiding, dragging down building materials**
- **Still, recovering spending power and retail trade activity should give construction and building materials a new impetus… in 1.5-2 years**

Indicator, % y/y**	2016	2017	H1/ 2018
Total construction, o/w:	-4.3	-1.4	-1.0
Housing construction	-6.5	-1.3	3.8
Ceramic plumbing fixtures	2.3	2.7	0.9
Ready-mixed concrete	N/D	1.8	1.2
Pre-fab. steel structures	0.1	7.9	-1.9

** - This said, partial data and anecdotal evidence show growth in wooden home construction and wooden panels production*

*** - N/D - previously grouped differently by RosStat*

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Many sectors are starting to become over-populated, while players are too cautious for expansion beyond existing niches. Asset consolidation is on the horizon, if M&A appetites recover. Thus, companies opting for value chain integration and product diversification can make breakthroughs!

- Having voiced optimism regarding certain sectors, including retail and many of the manufacturing segments, **there remains a key impediment to growth, which is over-saturation of a rising number of industries and segments.** Signs of it intensifying are evident now in agriculture & food, construction, retail trade, catering, and other service sectors, to name a few (especially in mass market segments)
- In these overcrowded markets, as some businesses fall prey to stiff competition and low margins, others simply take their place, and the cycle continues. In normal times, one would expect M&A activity to pick up, and horizontal or vertical integration to take place. But currently, with overall growth bleak, FX rates highly volatile, and new Western sanctions looming, **businesses are too cautious to dream big and go out and buy or merge with someone**
- Also, a spate of loud corporate conflicts and some personal negative experience is discouraging many entrepreneurs from teaming up with new people and developing the business together. Hopefully, this can change, and players can set bolder goals, going for product range and/or geographic expansion, and value chain integration. **Taking over the commanding heights in an industry (or a few adjacent ones) still has its merits and benefits!**

To sum up:

1. While overall growth may seem lackluster, **import substitution continues driving growth in manufacturing, and now also exports of higher value-added goods. This remains a good bet for investment in Russia**
2. **Construction and building materials stay fairly weak, and a slowdown is seen in transportation.** We would be reluctant to expect strong growth in these sectors in the nearest future
3. **A highly positive trend is the starting recovery in retail trade, and also in wage and income growth.** Production of consumer goods is also rising. Despite currently low margins, we believe a rebound is on its way, and **the consumer industry may be a good investment opportunity for those who can select the right niches and proper business models**
4. Banking sector activity is rising, but banks are underperforming in corporate lending and profits. **If one could develop new solutions for corporate financing, this may be a great investment opportunity.** But with Western sanctions intensifying, this may be just wishful thinking for the time being… Still, it is definitely something to consider
5. **Sector over-saturation is a growing problem, fixable by M&A and business diversification. Those who dare to dream big and go further, may just reap major benefits!** With all due caution and prudence, of course

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