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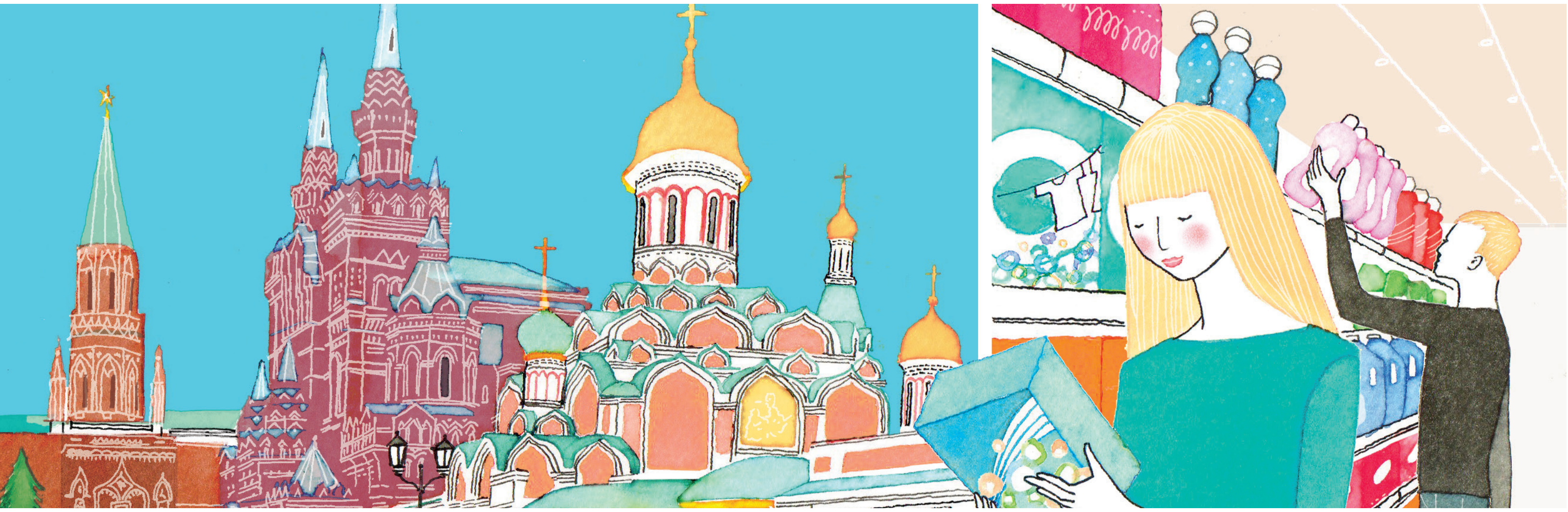

CONSUMER PACKAGED GOODS/RETAIL

A new reality for the Russian consumer industry

The country's economy is showing signs of recovery, but many consumers are still hesitant to spend. Here's how companies can win in this evolving market.

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In the past three years, declining oil prices and international sanctions have taken their toll on the Russian economy, plunging the country into financial crisis. Between 2014 and 2016, GDP fell by 1.5 percent per year on average, and private consumption by 7.1 percent. Recently, there have been glimmers of recovery—driven in part by a modest rebound in oil prices, a growing agricultural sector, and increased trade with China—and growth is expected to be as high as 1.5 percent in 2017. Still, consumer spending remains substantially below precrisis levels, and purchasing power has weakened due to the devaluation of the ruble.

Russian consumers have been adjusting to this new economic reality. They've become more selective and discerning in their purchases. In a recent consumer survey, a majority of respondents—57 percent—said they more often shop around to get the best deals. But they still buy their preferred brands, albeit in smaller quantities; only about 17 percent of Russian consumers said they have traded down to cheaper options. More than one-third said they have changed where they shop in order to buy their preferred brands at lower prices.[1]

Russia's changing retail and consumer landscape brings new challenges but also new opportunities. The most successful companies will be those that can best make data-driven decisions, manage their customer relationships, and keep costs under control.

Changes and challenges

The financial crisis in Russia has been tough on consumer-goods companies' margins, for a number of reasons. For one, a weaker ruble buys fewer raw materials, causing the cost of goods sold to rise. Retailers have substantially stepped up their promotional activity. Companies have been unable to pass on higher costs to consumers, and any price increases are outpaced by inflation.

For manufacturers, profitability has been further squeezed by the growth of modern trade, a lower-margin business for them. Modern retail now constitutes 68 percent of the Russian grocery market and is poised for more growth. Consolidation among modern grocers continues, with the top five grocery retailers accounting for a combined market share of about 27 percent, gaining approximately 6 percent between 2014 and 2016. The soft-discounter format, which already has a 22 percent share of modern trade, is the fastest-growing and most profitable modern format in the country: Russia has 112 soft-discount stores for every one million people—the third-highest density among European countries. "Alcomarkets," modern convenience stores that specialize in selling alcohol and tobacco products, grew 50 percent in 2015 alone. The online channel is also gaining popularity, growing by 19 percent a year in Russia, compared with only 7 percent a year across Europe, since 2013.

Further complicating matters for manufacturers, a newly introduced trade law puts restrictions on the producer-retailer commercial relationship. The law places a 5 percent cap on the volume discounts that manufacturers can give retailers, thus limiting manufacturers' flexibility in offering pay-for-performance trade terms.

In addition, international sanctions have negatively affected certain parts of the Russian economy. That said, the Russian government's countermeasures have provided a stimulus for local suppliers: across multiple categories, particularly those affected by sanctions, local sourcing is becoming more pervasive. From coffee to furniture, companies are finding Russian suppliers to meet local demand. The Russian agricultural sector has stepped up production, and in many categories, locally grown food has completely substituted for imports. In poultry and pork, for instance, Russia is expected to become almost entirely self-sufficient by 2019.

How to win

The strategies that consumer-packaged-goods (CPG) companies can employ to win in Russia are similar to those in other emerging markets: active management of pricing and promotions, cultivation of the traditional trade, and careful attention to costs. But the specific tactics they should use are somewhat different due to the particular context of the Russian economy.

Differentiate pricing and promotions across regions and channels

Many Russian companies (and Russian subsidiaries of multinationals) have traditionally charged the same prices in every region of the country. Of course, pricing is a tricky matter, particularly in a market where consumer sentiment has yet to recover—but companies operating in Russia must acknowledge and capitalize on the heterogeneity of the country's regions. Income levels, macroeconomic indicators, consumer preferences, competitive dynamics, and price sensitivities vary widely from one region to the next.

Data-driven differentiation of pricing, at both the SKU and region/area level, could lead to 2 to 3 percent growth in revenue and profit. Some executives might believe there's not enough data in the Russian market to enable active pricing management, but we've found the opposite to be true: companies can in fact access vast amounts of data—including data on consumer price sensitivity and product-switching behavior—to inform the development of advanced pricing mechanics. The data are available from retailers and market-data aggregators; there are also official government statistics. Some gasoline stations already adjust prices based on factors such as traffic and weather conditions.

Active management of promotions can be a powerful lever as well. Because discounts and promotions tend to be quite effective in enticing Russian consumers to make purchases, retailers engage in promotion wars and squeeze their suppliers for additional funding—typically resulting in margin losses for both parties. Companies should use advanced analytics and big data to understand the historical performance of their promotions and estimate the impact of future promotions. When companies make data-driven choices as to which items to promote, the mechanics and timing of promotions, and the depth of discounts, they can realize margin improvements of 1 to 3 percent.

With analytics, companies can model the net effect of promotions (incremental net sales and incremental margin). They can also make fact-based estimates with regard to a variety of critical factors, such as pull-forward effects (when shoppers stock up on a promoted product, "pulling forward" purchases that they would otherwise have made at a later date); cannibalization (when customers opt for a promoted product instead of a full-priced product, resulting in lost margin for the retailer); and the halo effect (when shoppers buy additional products at the same time as a product on promotion—for instance, shoppers buying ice-cream cones when ice cream is on sale).

Carefully define trade terms and retailer incentives

The buying power of large modern retailers typically allows them to purchase products from CPG manufacturers at prices 3 to 7 percent lower than what traditional retailers pay. In addition, the promotional funding that modern retailers receive from manufacturers is about 20 to 30 percent more than what traditional retailers get. These disparities give large national retailers an incentive to "leak" volumes to traditional trade—that is, they resell products purchased in bulk to smaller independent retailers, thus gaining additional profit for themselves while eroding profitability for CPG manufacturers.

CPG companies can take steps to prevent such leakage. For one, they can craft tighter trade terms that make it unprofitable for retailers to leak products. They can closely monitor sales volumes by benchmarking both regular and promotional sales across key accounts, taking into consideration seasonality and price elasticity. They can track their own sales activity as well as competitors' by acquiring transaction-level data from retailers and by having their merchandisers conduct regular checks of sales in and sales out. They can also strengthen their relationships with the traditional trade—perhaps by offering nonmonetary incentives (such as retail equipment) and loyalty programs—to stimulate direct purchasing.

Traditional trade is still, and will continue to be in the coming years, an important component of Russian retail. Many "B brands" (lower-priced, locally produced goods and services that are not well known globally) become bestsellers in modern trade but aren't available at all at independent retailers, suggesting that there is pent-up consumer demand for these lesser-known brands. Manufacturers of B brands should build a presence in the traditional trade, whether by finding distribution partners, developing their own distribution capabilities, or a combination of the two.

Drive cost efficiency

Best practices for achieving greater cost efficiency include using zero-based budgeting,[2] cutting nonstrategic expenses and funneling the savings into marketing efforts, and driving down third-party costs through improved procurement, using techniques such as design to value.[3]

Many CPG companies also look at their route-to-market model as an area in which they can easily cut costs, whether through outsourcing the sales

force, sharing coverage with exclusive distributors, or migrating to lower-cost service models for lower-priority customers. For example, a large CPG manufacturer in Russia has improved its route-to-market decisions and refined its service model by conducting large-scale surveys among the outlets it serves. Depending on the outlet characteristics, the company tailors every store visit—from the type of representative who visits to the frequency and duration of the visits.

Several companies have gained efficiencies—simultaneously securing their supply chain—through vertical integration. A few of the top retailers in Russia are exploring options for acquiring and integrating manufacturing capabilities into their organizations; one major national retailer has announced a $10 million investment in production development in 2017. Some manufacturers are integrating downstream and opening their own retail chains.

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The Russian market is undergoing tremendous change. Companies that take a disciplined and analytical approach will not only be able to withstand economic volatility—they will also be well positioned to thrive when the market recovers. ■

[1] The McKinsey Russia Consumer Sentiment Survey was conducted online in September 2016 and had 1,000 respondents.

[2] Kyle Hawke, Matt Jochim, Carey Mignerey, and Allison Watson. "The truth about zero-based budgeting: ZBB for consumer-goods players," April 2017, McKinsey.com.

[3] Søren Fritzen, Heiko Nick, and Jan Wüllenweber, "Capturing the full potential of design to value," *Perspectives on retail and consumer goods*, Winter 2013/14, McKinsey.com.

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