Retail & Consumer

Shopping for the future*

Russian Retail Market Survey

*connectedthinking

PricewaterhouseCoopers

Methodology:

Twenty-three online interviews were conducted with representatives of Russian food and non-food retail, supplemented with face-to-face expert interviews with CEOs and CFOs of five retail companies. The quotations anonymously cited in this document are taken directly from the interviews.

Acknowledgements:

We would like to thank the CEOs who filled out the questionnaire and participated in the series of interviews for taking the time to share their viewpoints with our team.

About PricewaterhouseCoopers:

PricewaterhouseCoopers (www.pwc.ru) provides industry-focused assurance, tax, legal and advisory services to build public trust and enhance value for its clients and their stakeholders. More than 146,000 people in 150 countries across our network share their thinking, experience and solutions to develop fresh perspectives and practical advice.

PricewaterhouseCoopers is the world's leading provider of business advice to the retail and consumer sector. Globally, there are over 10,000 partners and professional staff in our Retail & Consumer practice who are dedicated to serving clients. Leading companies recognise the value we bring to the business equation. Our knowledge and global experience with public and private companies, governments and industry associations is second to none. We cover all business sectors, including food, beverages, tobacco, various retail formats, wholesale and more.

The global leader in servicing retail and consumer companies, PricewaterhouseCoopers helps 91% of Financial Times Global 500 (2007) companies in the industry manage their multinational and local operations to develop a competitive advantage across the value chain.

PricewaterhouseCoopers first appeared in Russia in 1913 and re-established its presence here in 1989. Since then PricewaterhouseCoopers has grown to become the largest professional services provider in Russia. According to the annual rating prepared by independent rating agency Expert RA, published in Expert magazine, PricewaterhouseCoopers is the largest auditor and tax and legal advisor in Russia (see Expert, 2000-2007).

Table of contents

Introduction

Globally, the retail sector's strategic focus is moving toward the emerging economies and expanding consumer markets of Asia, Central & Eastern Europe, Russia and other CIS countries. The development of modern retailing in these markets and growing local disposable income offer new opportunities for growth as well as the possibility of global sourcing and offshoring. The Russian retail sector has experienced enormous growth in recent years, driven by the growing purchasing power of Russian consumers, a trend that is expected to continue in the near term. According to PricewaterhouseCoopers' report "The World in 2050", Russia will lead in projected relative income per capita among the seven largest countries with fast developing economies.

In Russia, growth has been experienced in every segment from discount to luxury. Consumers' increasing maturity and sophistication has stimulated the luxury sector in particular; Russia is currently the fastest growing market for luxury goods. While there is still room for further penetration through modern retail formats and brands and huge potential for growth, companies in Russia face a number of challenges. The retail sector is very dynamic, and companies need effective strategies to deal with developing private labels, changing consumer shopping habits, developing products and services to attract and retain increasingly discerning customers, regional (and potentially overseas) expansion, and expanding consumer credit. Challenges include attaining operational effectiveness and cost reduction, shortage of good retail space, warehousing, logistics and supply chain management (and availability of specialists), as well as potential accession to the WTO. With a largely unconsolidated retail market, further M&A activity is inevitable. This will lead to fewer retail players with greater competition for market share and downward pressure on margins (which will affect both the retailer and the producer). The trend for IPOs is also likely to continue. Thus, a clearly defined strategy for further growth in this promising sector has now become crucial for success. Retail companies' ongoing competitiveness can be ensured only via cost and operational effectiveness, access to capital and other growth resources and, last but not least, effective mobilisation of human capital.

The Russian retail market demonstrated solid growth rates over the last several years, making the sector one of the most actively developing markets in the economy. This has been fuelled by growth in the overall economy, growing consumption and an increasingly organised marketplace.

Organised retail is booming due to improving living standards and Russians' desire for more convenient stores with better prices and service. This boom has led to dramatically increased competition in the retail sector and introduced new issues for retail chains to address.

The main objective of this report is to provide a business perspective on significant issues and challenges faced by retail market players.

Chris Skirrow
Retail & Consumer Leader

Market overview

Macroeconomic situation

Over the last eight years, Russia has been one of the fastest growing markets in the world. According to official statistics, the GDP increased from US$196 billion in 1999 to around US$1,231 billion in 2007, representing an average annual growth rate of 30% (in nominal dollar terms).

The main factors driving the economy include an increase in the price of natural resources, an increasing inflow of capital into the economy, an increase in the population's income and spending, diversification of the industrial base and a reduction in personal and corporate tax rates.

During the last five years, the economy's growth rate has been increasing; in 2007, GDP increased by 7.5% in real terms.

The Russian consumer is one of the main beneficiaries of economic growth, with real disposable income growing faster than the GDP at an average of 11% annually over the last five years.

Russian main macroeconomic indicators, 2002-2007

	2002	2003	2004	2005	2006	2007
Nominal GDP, US$ Billion	345	431	589	764	985	1,231 (E)[1]
Growth of Real GDP, % y-o-y	4.7	7.3	7.2	6.4	6.7	7.5 (A)[2]
Population, Million	145.7	145	144.2	143.5	142.8	142.2 (A)
Investment, %, y-o-y	2.8	12.8	10.9	60.2	60.2	21.1 (A)
FDI, US$ Billion	3.5	8.0	15.4	12.9	30.5	55.0 (E)
Gross International Reserves, US$ Billion, end of period	47.8	76.9	124.5	174.9	303.7	476.4 (A)
Exchange rate, RUR/US$, year-end	31.8	29.5	27.8	28.5	26.3	24.6 (A)
Inflation, %	15.0	12.0	11.7	11.1	9.0	11.9 (A)
Real disposable income, %, y-o-y	11.1	13.7	8.4	11.1	9.7	11.8 (E)
Retail trade turnover, %, y-o-y	9.3	8.8	12.5	12.8	13.9	15.2 (A)

Source: Rosstat, Central Bank of Russia, Renaissance Capital, Economic Expert Group, Economic Intelligence Unit

[1] E – estimated value
[2] A – actual value

Consumption and retail trade

Retail trade has also demonstrated very solid growth rates. Over the last five years, its real growth has significantly surpassed the real growth of the GDP. In 2006 the total retail trade turnover was estimated at US$317 billion by the Russian State Statistics Committee.

Russian retail trade turnover and GDP, real growth, 2002-2007

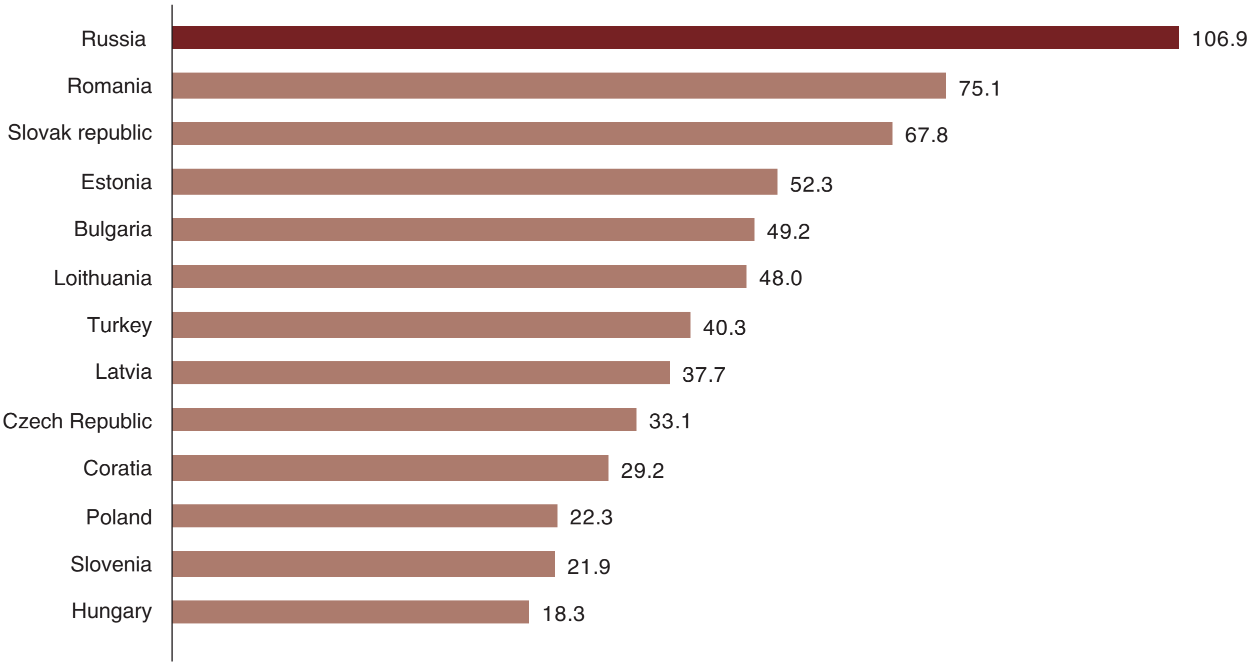
	2002	2003	2004	2005	2006	2007
Total retail trade turnover, US$ Billion	120	148	196	249	317	404 (E)
Retail Turnover, % y-o-y, real growth	9.3	8.8	12.5	12.8	13.9	15.2 (A)
GDP, %, y-o-y, real growth	4.7	7.3	7.2	6.4	6.7	7.5 (A)

Source: State Statistics Committee, Economist Intelligence Unit

The Russian consumer market is very dynamic, driven by growing earnings and the rapid development of the domestic retail sector.

Compared to other European emerging markets, Russia demonstrated the highest cumulative growth rate for consumer spending in 2002-2006.

Growth in consumer spending in EUR, %, 2002-2006



Source: Mintel

In line with the overall growth of the consumer market, the structure of the Russian consumer basket is changing and moving toward western consumption standards. The share of foods and durable goods is decreasing, while consumer services and non-durable goods are on the rise. The share of non-food purchases in the average consumer basket increased from 35% in 2002 to 39% in 2006, while the share of food and beverages declined accordingly from 45% to 36%.

Structure of domestic consumption, %, 2002-2007

	2002	2003	2004	2005	2006	2007
Foods and beverages	45	43	42	38	36	35 (E)
Non-foods	35	37	37	38	39	39 (E)
Services	18	20	21	24	25	26 (E)

Source: State Statistics Committee, Interactive Research Group

Social indicators such as number of passenger cars, mobile phone subscribers and personal computers are also demonstrating improvement and are forecasted to reach the level of other Eastern European countries by 2010.

Social indicator and living standards

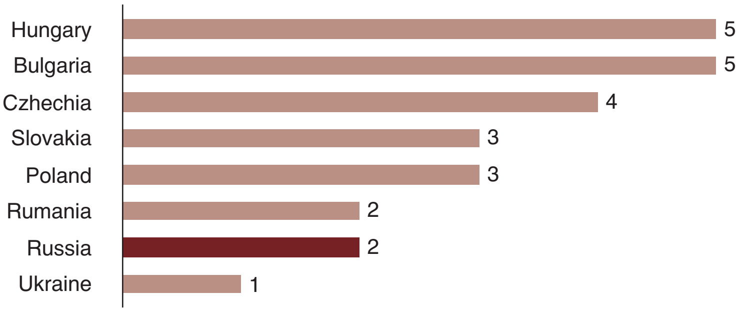
	2005		2010F[3]	
	Russia	Eastern Europe (average)	Russia	Eastern Europe (average)
Consumer goods in use (per 1,000 people)				
Passenger cars	162	288	202	259
Mobile phone subscribers	877	667	1,085	944
Personal computers	130	156	213	228

Source: Economist Intelligence Unit

[3] F – forecast value

In terms of retail space availability, the country has high potential, as in 2006 it was next-to-last by number of stores per 1,000 people in Eastern Europe.

Number of stores per 1,000 people, 2006

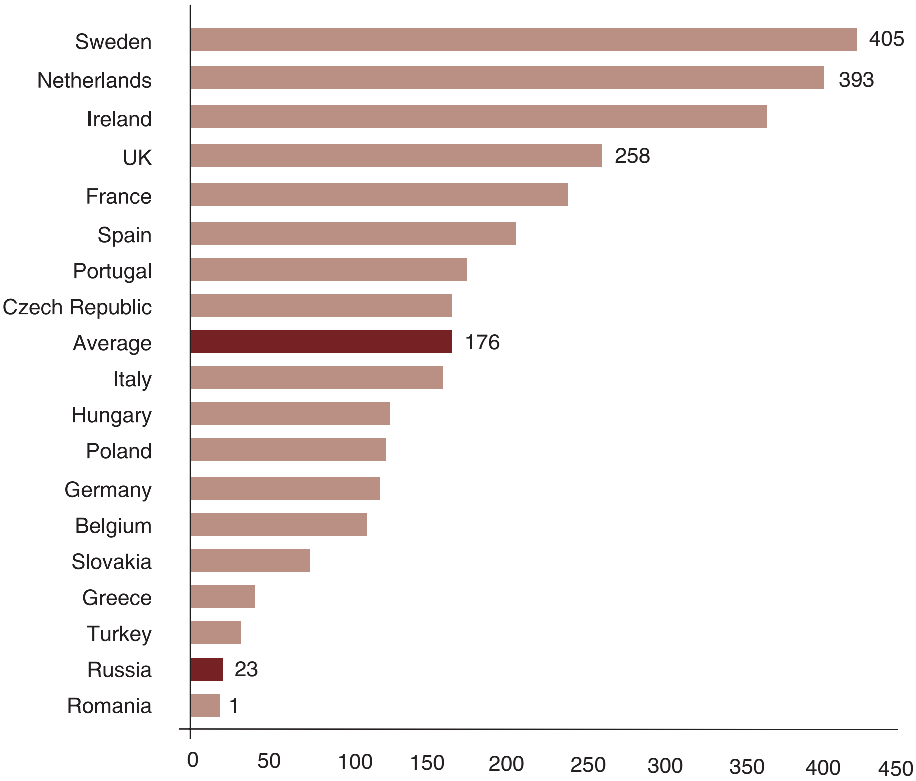


Source: Euromonitor

The total existing shopping centre space in Russia in 2006 was estimated at 3.3 million sq m, and it is forecast to reach 7.3 million sq m in 2008. This is quite impressive compared to the average European value of about 5 million sq m.

But the relative ratio (per 1,000 people) is estimated at 52 sq m, bringing Russia just above the level in Greece.

Existing shopping center space per 1,000 people, sq m, 2006

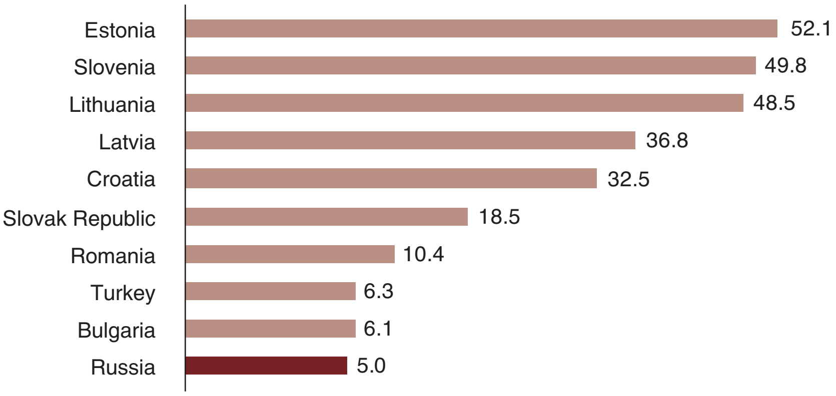


Source: Jones Lang LaSalle

Business development strategy

Significant regional expansion and growing market consolidation marked 2007. Consolidation will be a major factor over the next three to five years since the market share of the top national retailers was about 5% in 2006.

Top five retailers' share of national retail sales, %, 2006



Source: Mintel

These rates can be compared to the UK and Germany, where the top four retailers account for 85% and 80% of the market, respectively (according to Datamonitor).

Retail formats

The first recognisable self-service supermarket chain opened in 1994. Subsequently hypermarkets, discounters and cash&carry formats were introduced in quick succession. The 1998 economic crisis was a major influence in the birth and rise of discount chains.

Self-service format development (chain retailers only)

Source: Interactive Research Group

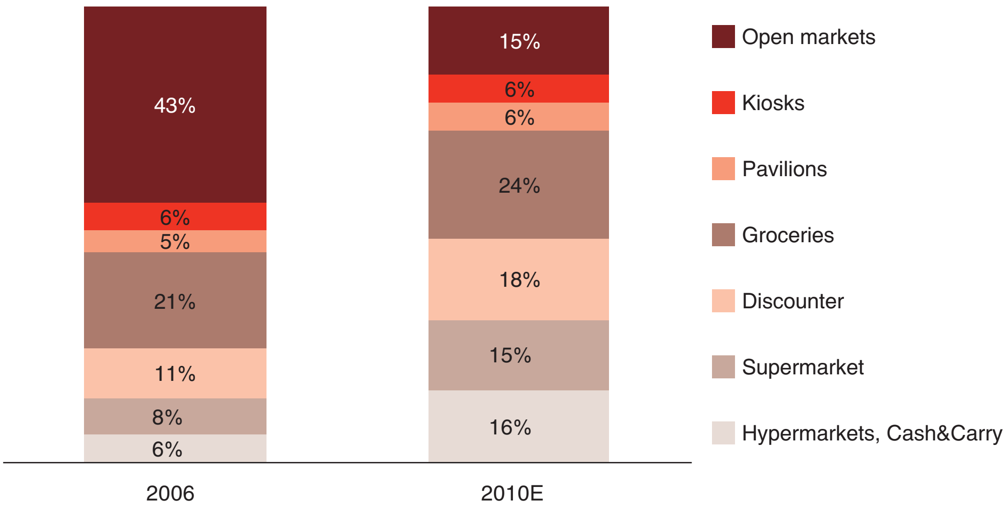
Main modern self-service formats in Russia

	Assortment of products	Typical gross margins	Location	Examples
Hypermarkets	15,000-40,000 SKU	15-24%	Along main roads, outside city limits	Auchan, Ramstore, Metro, Mosmart, Karousel, Lenta, Magnit, Perekrestok, Seventh Continent
Supermarkets	Up to 20,000 SKU	25-32%	City centres, along main roads, in residential areas	Magnit, Billa, Perekrestok, Seventh Continent, Grossmart
Discounters	Up to 4,500 SKU	18-26%	Residential areas	Pyaterochka, Dixy, Kopeyka, Magnit

Source: Deutsche UFG

According to estimates, the share of modern self-service formats in Russia is about 25% in 2006. It is expected that by 2010, this will reach around 50%, with most of the additional market share being taken from open markets.

Food retail sales by format



Source: Business Analytika, Renaissance Capital

Survey results

Part 1 — External factors

The following external factors were identified by survey participants as affecting Russian retail market operations (see figure 1).

The first three factors are considered to have the greatest effect on the retail market in Russia.

1. Administrative barriers;
2. Growing competition;
3. Infrastructure barriers.

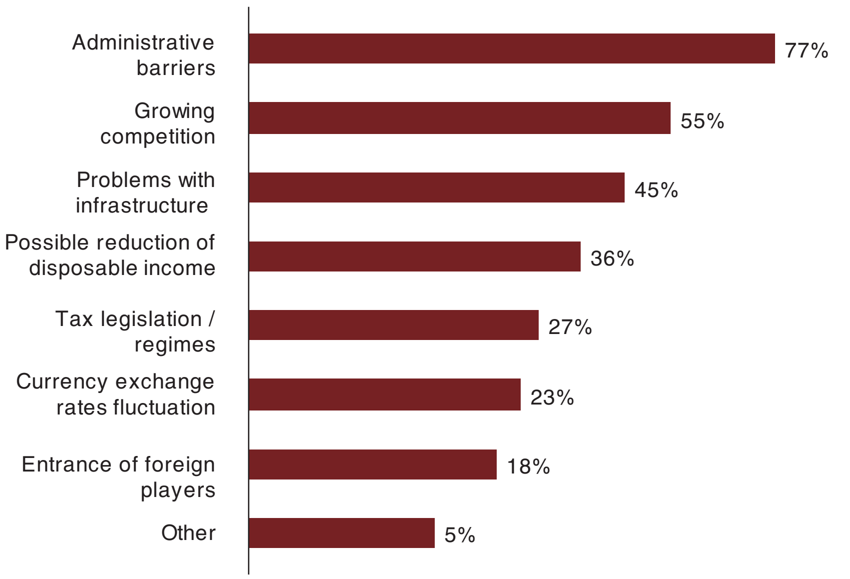
1.1. Administrative barriers

The below stated administrative barriers are marked for having a negative effect on the market's future:

- Bureaucracy, which implies excessive amounts of paperwork and obstacles in importing goods and obtaining space.
- Regional differentiation of public administration: Regional authorities are able to establish different rules and recommendations that result in additional barriers which force retailers to develop different policies in different regions. Participants point out that one of the most widespread barriers for fast regional development is the recommendation to purchase from local producers, who are often not able to provide products of sufficient quality regularly. This system conflicts with the logistic system established by retailers and reduces cost effectiveness.

Figure 1

Which external factors do you consider to most influence your business?



'We need to work legally and prepare a lot of documents, like approval for working as a store or approval for having a meat department in the supermarket.'

'Instead of one single Russian market, we are moving to create 89 markets with 89 different regulations. This is the biggest risk to our business.'

‘The main struggle is for the client. The main question is customer loyalty… There are different regions with different income levels, and loyalty-generating actions to be undertaken are different for different regions.’

‘The competition for locations is very high. The competition for customers is beginning. And we are seeing that some businesses are being sold because they can’t compete.’

1.2. Growing competition

Although the retail sector has been one of the fastest growing sectors in the Russia economy since 2000 and has enjoyed relatively high margins, growing competition, while mentioned by only one-half of participants, is considered to have one of the greatest negative impacts on retail business (see figure 2).

Most market players estimate the level of competition as high, although it may vary in different regions of the country. The most intense competition is observed in Moscow and Saint Petersburg.

Competition covers the following three main aspects:

- Competition for customers;
- Competition for better locations and retail space resulting from a lack of space coupled with growing rent prices;
- Competition for employees: Lack of qualified staff in regions where labour market growth rates do not meet the retail market’s rapid development.

In the early 1990s, competition was often described as being between local and foreign retailers. This is no longer the case; retailers are now competing without regard to nationality.

Most participants view the future appearance of more foreign players as positive for the market, but less so for their business (see figure 3). In three to five years the competition level in the Russian retail market has been forecast to reach that of European countries.

Figure 2

How would you describe the level of competition in your sector?

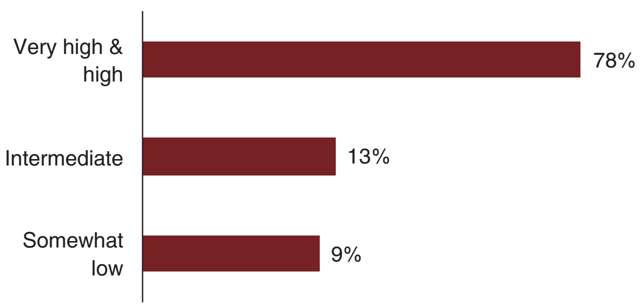
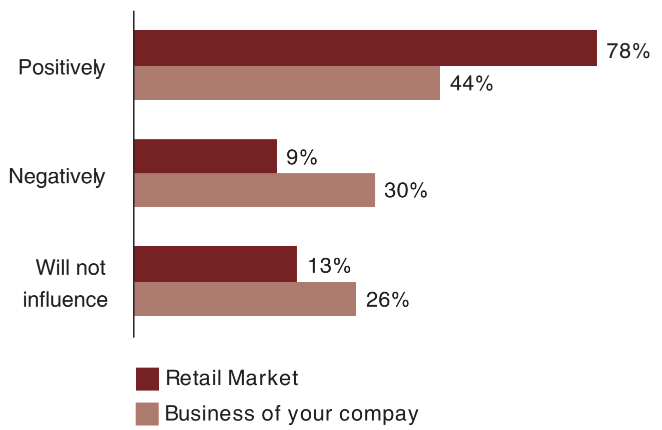


Figure 3

Please assess how the possible entrance of more foreign retail players will influence the Russian retail market / your business in 2008-2010?



Most of the largest retailers have been announcing their plans to enter the market since 2001, but only a few already have stores in Russia. The biggest are Auchan, Metro C&C, Ramenka and Spar. The most expected market entry in the near future is Wal-Mart. Although the study participants did not mention Carrefour, they have announced plans to open their first supermarket here in 2008 (see figure 4).

The most popular measures for combating competition are investing in advertising and increasing assortment of goods (see figure 5).

Although increased customer loyalty and private labels are a significant boost for profitability, selection and brand recognition are considered key to maintaining a competitive position.

1.3. Infrastructure barriers

- Lack of retail space and rising prices for retail space in large cities. This is especially critical in Moscow, where the retail space market is considered saturated. All large retailers have special departments to cope with these issues;
- Lack of warehouse facilities: This is a common issue faced by retailers in all of Russia's largest regions. Many overcome this problem by constructing their own distribution centres;
- Limited transportation infrastructure: Retailers face the problem of deliveries delay and longer transit periods due to poor roads and heavy traffic. The situation is forecast to worsen in the next two to three years;
- Lack of electricity and poor lines of communications in the regions: Retailers complain of a lack of energy in some regions, and lack of proper communication channels for existing facilities.

'Before, foreign retailers had technology, but had neither experience in the Russian market, nor knowledge of its specifics, while in Russian companies, it was vice versa.'

'All Russian cities were planned at a time when there was very little private transportation and public transportation. And now the number of cars is growing at a rate much higher than the capacity of the cities.'

' …So we are thinking about delivering at night.'

Figure 4

Please indicate which companies are most likely to enter the Russian retail market in 2007-2010.

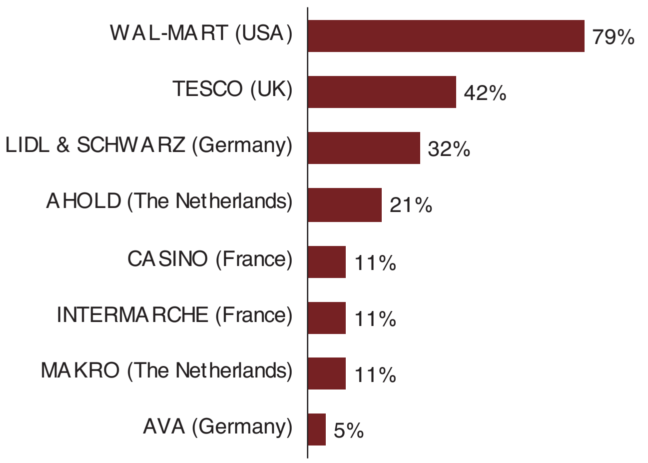
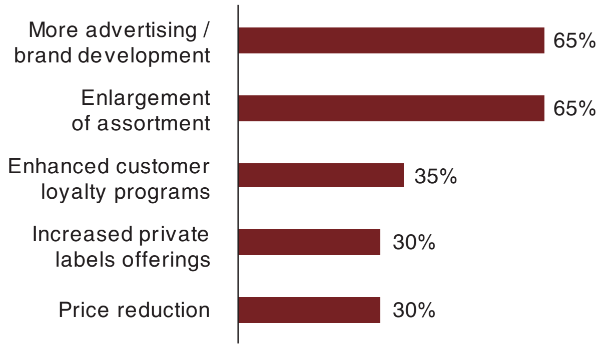


Figure 5

Which measures did your company undertake in 2006-2007 to combat competition?



'It turns out that when you grow and work transparently, you cannot compete with private companies that work non-transparently and do not publish any information. This is why it is important that taxation is equal for all market players.'

1.4. Legislation

Most participants complain about the complexity of legislation, bureaucratic procedures, unclear wording of laws and excessive paperwork in all areas covered by regulations. There are five main directions for legislation improvement based on retail market player needs:

Areas of legislation equiring improvement	Main issues to solve
1. Tax regulations	• Excessive paperwork • Inconsistent application of the law • Proper control • Insufficiently clear rules for VAT reimbursement
2. Licensing	• Non-transparency of document collection procedures and corruption as a result of the necessity for multiple approvals and agreements • Necessity to obtain a license for alcohol sales for every location of a chain, which is regarded a complicated administrative procedure • Alcohol licenses are valid for only one year, requiring retailers' constant work for license renewal
3. Customs control	• Complicated import / export procedures • Frequently changing regulations • Unclear rules for how custom duties are charged • High tariffs
4. Real estate	• Impossibility of purchasing land in Moscow Region
5. Introduction of new laws	• Lack of an appropriate legal and operational framework for proper functioning of new laws and amended old laws

1.5. Other external factors influencing retail business

- The strengthening of the rouble is regarded simultaneously as both a positive and negative factor depending on the company's debt position and how much it imports (see figure 6).

  The positive consequences result from the fact that income is accumulated in roubles, while debt is often at least partially in dollars; the stronger rouble also makes imports cheaper and positively influences the trade of foreign goods.

  Negative consequences relate to increased expenses on real estate and personnel.

- Slowing disposable income growth rate, is not necessarily a purely negative influence (see figure 7). Retailers point out that market trends are favouring modern self-service formats, and the expected decrease in the disposable income growth rate is compensated for by the increase in market share. Slowing income growth is not expected to have a significant negative impact on them in the next five years.
- One positive factor is the availability of consumer loans, which results in increased demand for all types of merchandise.
- Movement towards International Financial Reporting – Many significant improvements, as they are more complicated and time consuming than international standards.

'A lot of people get loans from banks… This has a very positive effect on the retail business because they spend it on entertainment, on retail…'

Figure 6

Please indicate how your operations are influenced by the strengthening of the rouble.

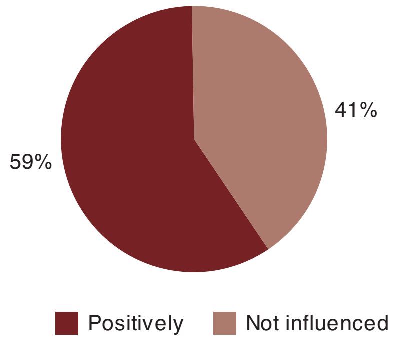
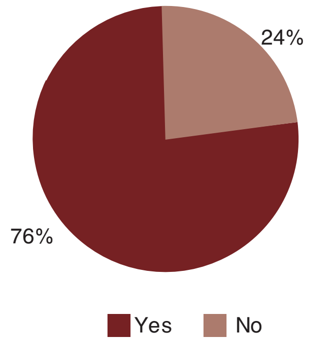


Figure 7

Will a decrease in the disposable income growth rate somehow affect your business?



'The progress is evident. Five years ago there were no specialists in Russia who could work with these standards [IFRS], while now even in an average company there are specialists who know not only Russian Accounting Standards, but also international ones. This means that in five years time we can switch to these standards or change the Russian ones to be combined with the international. Now this is a reality, while five years ago it was not possible.'

Survey results

PART 2 — Internal business factors and issues

'We had the following priorities. First is mergers and acquisitions. Second is organic growth. Third is construction of new stores.'

2.1. Business development strategy

2.1.1. Business expansion models

Russian market players are focused on expanding their businesses and considering implementing a range of expansion strategies through the end of 2010, including: renting, construction, purchasing space, M&As and franchising (see figure 8).

A draft law introduced in 2007, "On Trade", is expected to influence retailers' plans. The law introduces a restriction on the maximum allowed market share that a single retailer can hold (not more than 35% of any regional market). This may reduce the number of M&A deals in regional markets. However, the proposed legislation is unclear about on what basis market share will be calculated.

The most preferable strategy for business expansion is a greenfield model, which implies renting and construction, but retailers continue to employ other strategies as well.

The following factors are mentioned as possible threats to a greenfield model of expansion (see figure 9).

Figure 8

Which business expansion model do you plan to use through the end of 2010?

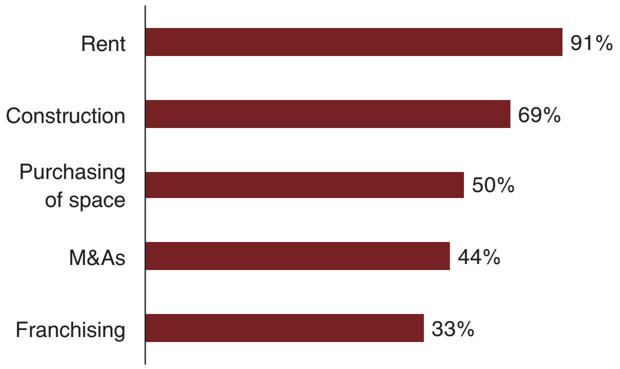
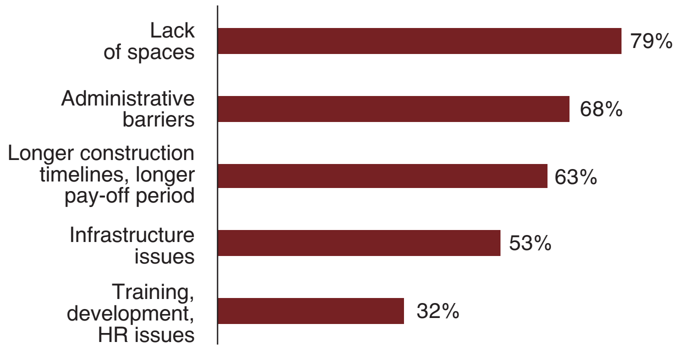


Figure 9

Please rate each of the following factors by their level of threat to a greenfield model of expansion.



Expansion through M&A is not the main focus, despite the possibility for rapid growth and the additional competitive advantages it provides. This is because the following negative factors are associated with M&A in the Russian market (see figure 10).

Apart from the abovementioned factors, retailers have identified other barriers to an M&A strategy:

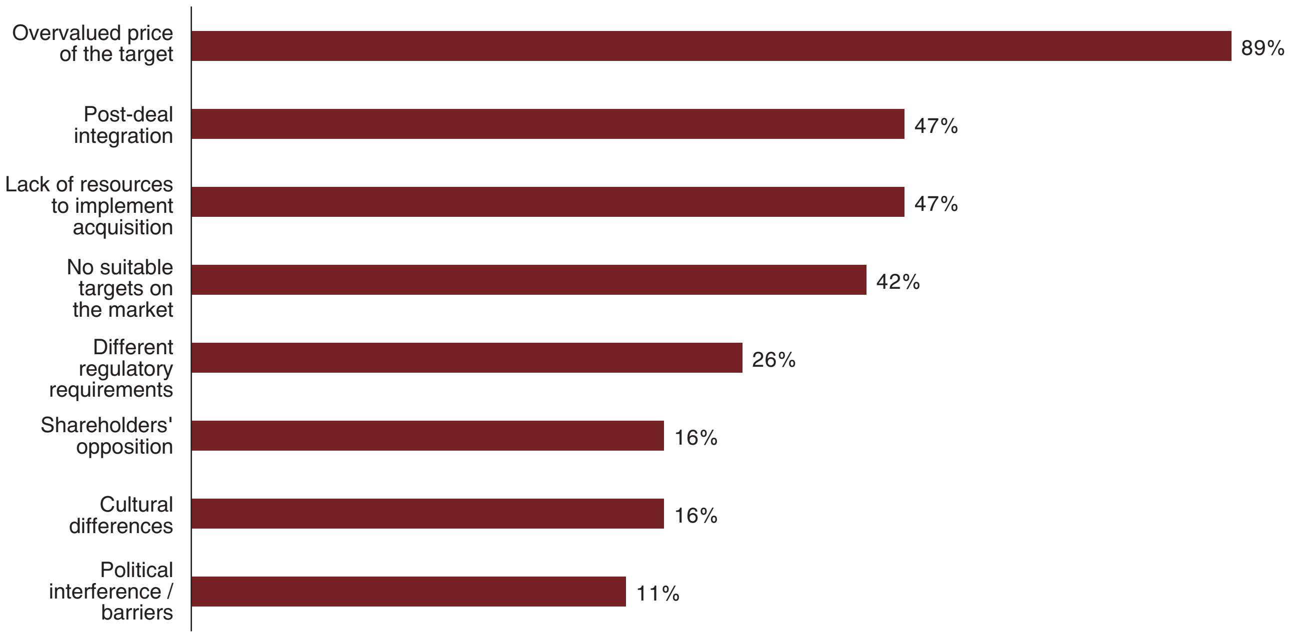
- Potential M&A targets cannot provide proper financial and legal documentation; there can be claims against the documentation supporting the structure of obligations;
- M&A targets may include an excessive number of legal entities;
- Low level of trust in M&A targets' financial reporting;
- Targets may not have clearly differentiated formats, or formats that don't correspond to those of buyers. This is especially relevant for foreign players, who usually develop only one format in the Russian market and expect that M&A targets' format can be easily adapted to fit theirs;
- Significant financial resources for integration processes.

Retailers consider the M&A process to be complicated and lengthy. Consolidation in the market, however, is seen as inevitable, which means that a few large players will be expanding aggressively through acquisitions.

'Many foreign companies have difficulties purchasing our multi-format chains because they develop only one format, and they require that someone else buys the company for them, divides it into pieces and then sells them to different buyers.'

Figure 10

Please rate each of the following factors by their level of threat to M&A expansion.



'…[Russian chains] don't have proper documents. So for us, any acquisition means a huge amount of legalisation.'

2.1.2. Business development financing

The most preferable ways of development financing are debt financing and using company profit. Strategic investing and IPOs are considered by few market players (see figure 11).

Only a few companies plan to go public starting in 2009; most of these are Russian-owned retailers, as most foreign retailers are already part of a public company (see figure 12).

Non-transparency of the business is the main issue faced by retailers in preparing for an IPO (see figure 13).

Figure 11

Which of the following instruments do you plan using to finance the development of your business through 2010?

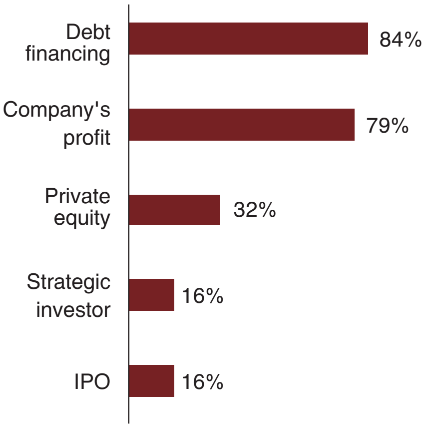


Figure 12

Please indicate when your company intends to go public.

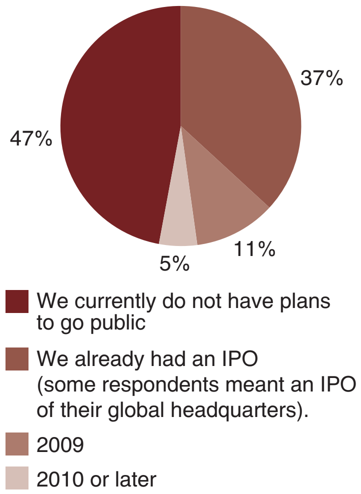
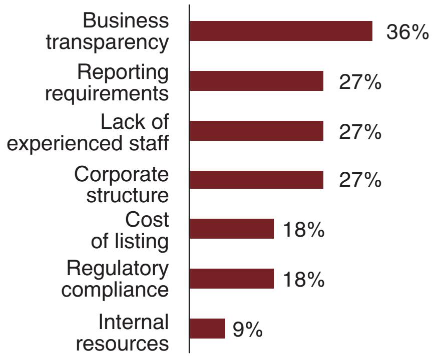


Figure 13

In your opinion, which of the following areas causes the most difficulties in preparing for an IPO?



2.1.3. Retail formats

The retailers surveyed have predominantly supermarket and hypermarket formats in their portfolios, and about half of them do not plan to launch new formats before the end of 2008 (see figure 14).

2.2. Operations

2.2.1. Cost optimisation

Participants mentioned the following ways of cost optimisation techniques for retail companies:

- Standardisation of business processes;
- Strengthening the security department to reduce internal fraud (which may cost up to 4% of retail turnover in some companies);
- Moving towards centralised logistics: building own distribution centres (DC) and organising own transportation systems. At present, the majority of logistics services are outsourced;
- Outsourcing (see figure 15).

'We have several manuals which contain descriptions of all processes in our company… It helps to optimise costs.'

'We are losing millions of dollars every year.'

'We tried to use outsourcing for quite a long time. But this was not the best solution. Everything was very expensive. As a result, we started our own logistics company. Other logistics companies were not always in line with our development.'

Figure 14

Which of the following formats do you currently have in your portfolio?

Which of the following formats do you plan to introduce by the end of 2008?

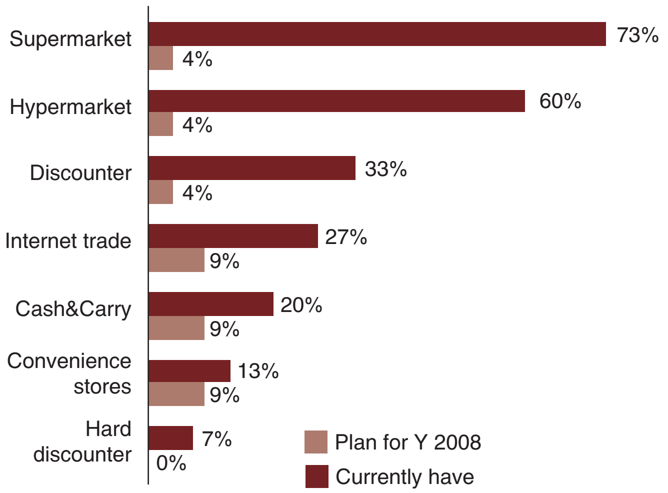
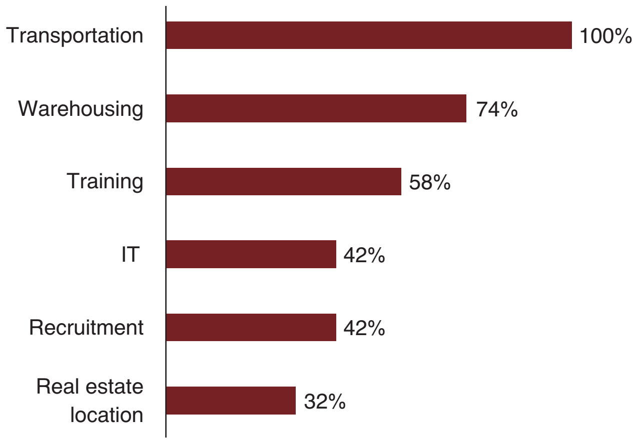


Figure 15

Please specify the areas where your company uses outsourcing.



‘The market has big potential but also demonstrates a great increase in rent costs. And costs are very important.’

‘The prices for rent are still going up dramatically. In the last year, many big chains went to the regions and are no longer investing in Moscow.’

2.2.2. Real estate approach

Despite the fact that the preferred approach to real estate is owning it, most companies combine renting and ownership because of financial limitations, administrative barriers, and the lack of available retail space. Although renting results in faster growth rates, it is also at greater risk for increasing costs, as landlords regularly raise rent prices (see figure 16).

A practice of acquiring or leasing space from existing over-the-counter convenience stores that were built during Soviet era is widespread among supermarket and discounter chains.

2.2.3. Supply chain management

Most of the companies said that the component of the supply chain most urgently requiring optimisation is stock management. Moving towards centralised logistics is one step in this direction (see figure 17).

Figure 16

What is the preferred approach to retail space real estate in your company?

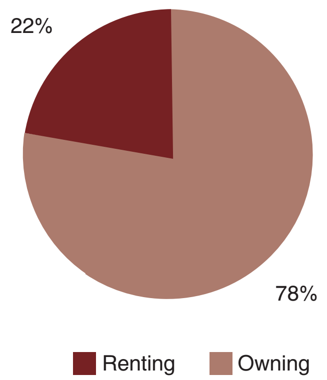
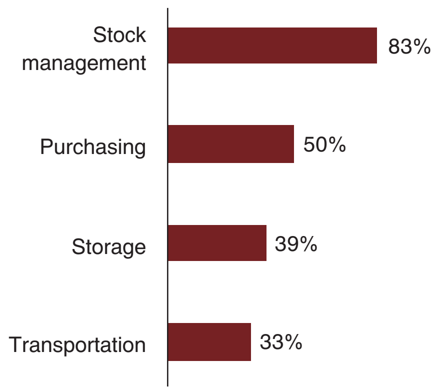


Figure 17

Which supply chain management components in your company most need optimisation?



2.3. Sales & marketing

2.3.1. Measuring brand performance

Most of the companies surveyed have been measuring brand performance since 2006, using their own marketing departments instead of outsourcing to research or consulting companies (see figure 18).

Introducing private labels and increasing their share in the turnover is one of the market's main emerging trends (see figure 19).

In 2007 most top retailers and developed regional chains had private labels in their assortment. Their share in overall turnover usually does not exceed 8%.

'We are actively studying the European experience. Today the main focus is on private label… There are plans to increase the share of private label in the assortment.'

'There are several assortment groups for which we are developing private labels, and we are in search of those groups and regions where private labels will be in the highest demand.'

Figure 18

Have you measured the brand performance of at least one of your brands since the beginning of 2006?

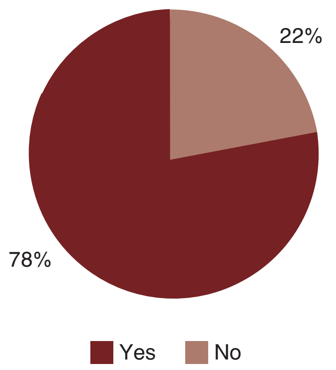
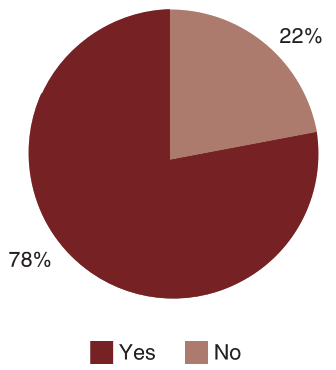


Figure 19

Do you have private label programmes at present?



> 'Currently, we are developing several loyalty programmes. They differ depending on the size and frequency of purchases.'

> 'If they [customers] are happy, they are confident and they are loyal.'

2.3.2. Loyalty programmes

Most of the retailers offer loyalty programmes to their customers (see figures 20-21).

In 2006 the majority of these programmes employed discounts rather than more permanent loyalty-building arrangements. In 2007, retailers were slowly moving towards programmes employing bonuses for purchases, acknowledging that the previous discount programmes were no longer as effective.

It is expected that this trend will continue in the future. However, even market leaders do not make effective use of information gathered from loyalty programmes. CRM systems that monitor customer loyalty and segment customer preferences are not well developed.

Figure 20

Does your company offer loyalty programmes to its customers?

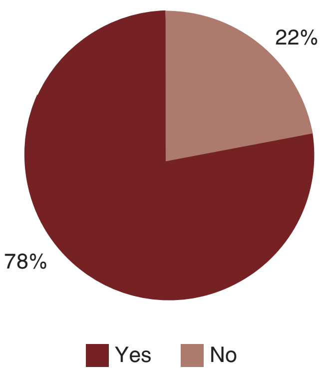
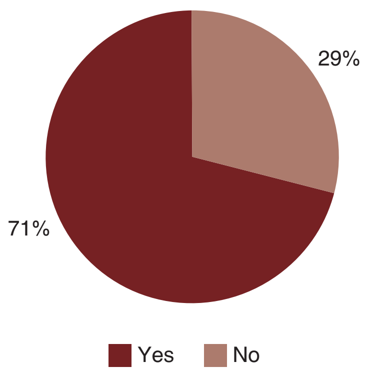


Figure 21

If your company has a customer loyalty programme, do you consider it effective?



2.3.3. IT

Normally IT expenses do not exceed 1.5% of the turnover. More than half of the retailers surveyed had plans to upgrade their IT system in 2008-2009 (see figures 22-23).

This reflects the fact that while many retailers believe their IT system are acceptable for their current size and stage of development, they see them as unable to support expected future growth.

2.4. Human resources

All market players note the shortage of top management and high turnover of floor personnel as significant factors (see figure 24).

To solve the problem of floor employees, big chains establish their own corporate universities aimed at educating staff.

‘It is connected not only with the fact that top managers may leave. The thing is that due to active growth, we face the necessity of additional top management resources.’

Figure 22

In your opinion, are your current IT systems (including software, equipment, training, consulting and innovative technologies) adequate?

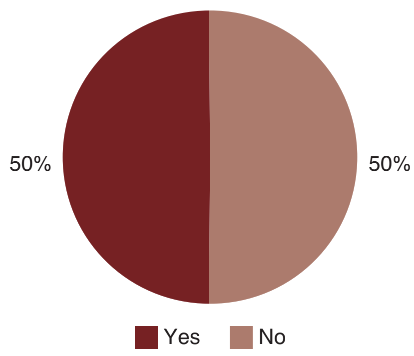


Figure 23

What is the most likely timeframe for your IT systems upgrade?

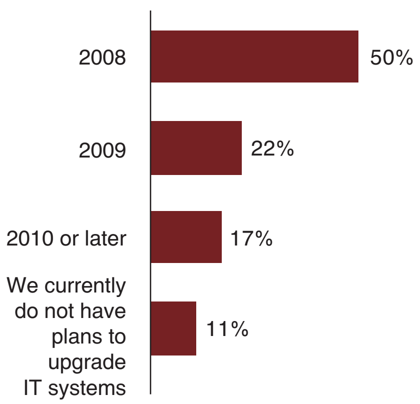
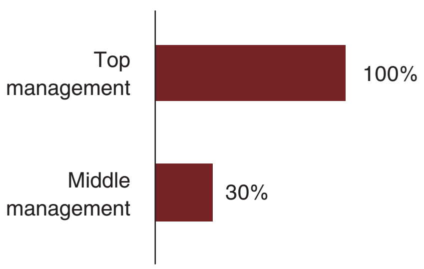


Figure 24

In which of the following personnel levels have you experienced a shortage since the beginning of 2006?



‘We have annual bonuses, for some categories we have quarterly bonuses. … for most of the employees we have bonuses.’

‘Recruitment and training we do on our own. There are some special training programs.’

In general, all retailers are interested in incentive programmes for different levels of staff, and they implement programmes of varying complexities (see figures 25-26).

The popularity of stock options as a long-term incentive for top management in our results is the result of the number of foreign companies operating in Russia who took part in the survey. Stock options have not caught on in Russian companies yet.

Figure 25

Please mark which of the following incentives are included in your company’s total compensation?

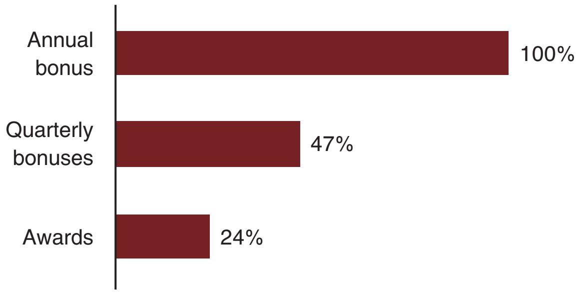
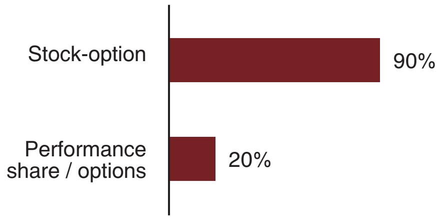


Figure 26

Which long-term incentives does your company offer for top management?



Most of the retailers use KPI systems to assess results and motivate people (see figure 27).

Because of the general staff deficit, compensation packages are reviewed on a regular basis (see figure 28).

Measuring employee satisfaction using external providers is not common practice. The majority of the companies monitoring employee satisfaction do it themselves (see figure 29).

'There are annual bonuses for top managers. They participate in the company's profit. Middle management's bonuses are correlated to qualitative and quantitative work.'

Figure 27

Is your incentive scheme based on KPI?

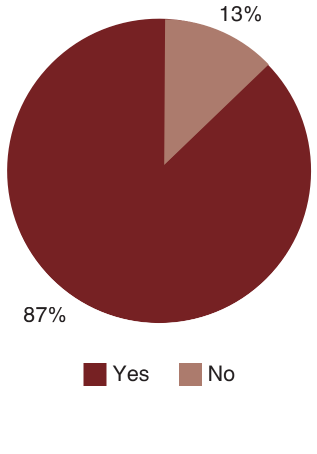


Figure 28

Do you review compensation package & how often?

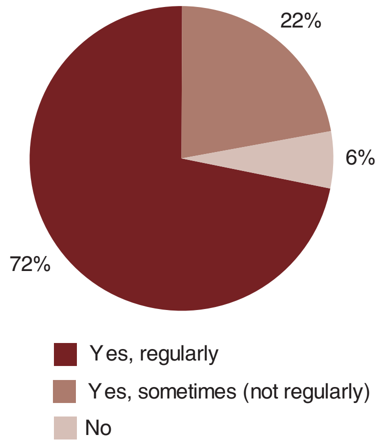
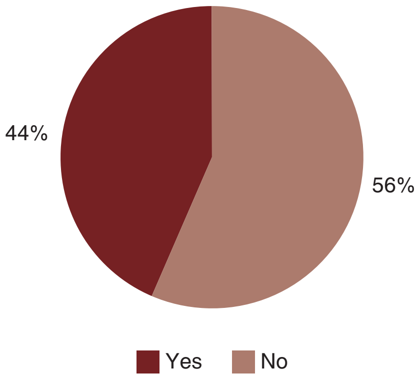


Figure 29

Have you measured employee satisfaction since January 2006?



‘We have 200 pages on how to work with waste and branch impact on the environment. Protecting the environment is very important.’

2.5. Corporate governance

The most widespread corporate governance elements applied in retail companies are internal audit functions, boards of directors and internal control systems (see figure 30).

The fact that 23% of participants indicated an intention to implement a risk management system indicates the continuing need to enhance the effectiveness of the more common governance systems, such as Internal audit, Board of Directors, Internal controls.

2.6. Corporate social responsibility

About half of the companies participating in the survey said that they have an environmental policy (see figure 31).

Figure 30

What elements of corporate governance have already been implemented in your company?
What elements of corporate governance are you looking to enhance in the near future?

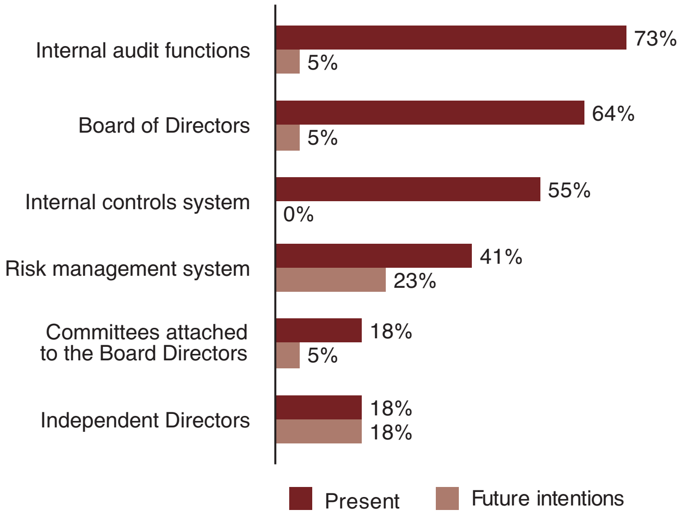
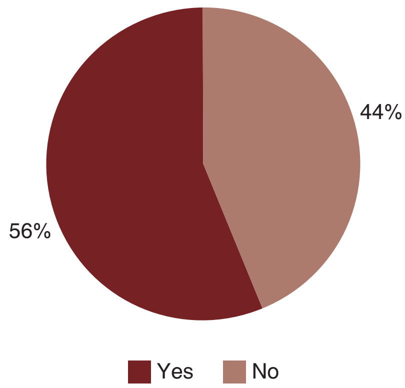


Figure 31

Does your company have an environmental policy?



Less than half of the survey participants have a supplier code of conduct or monitor supplier environmental, health & safety and workplace conditions (see figures 32-33). These processes are currently undeveloped in Russia.

'In Europe we of course look at the supplier with this regard. In Russia we don't, but in the future, we probably will. '

Figure 32

Do you have a supplier code of conduct (requiring at least minimum standards of environmental, health & safety and employee wages and conditions)?

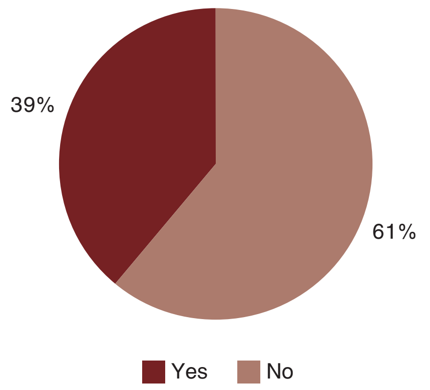
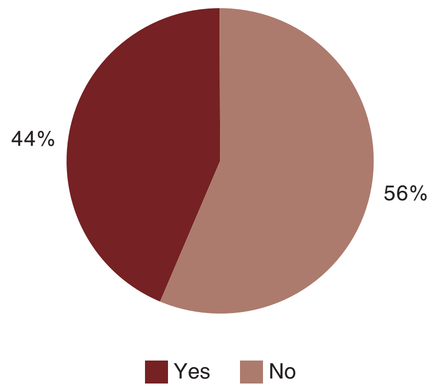


Figure 33

Do you monitor environmental, health & safety and workplace conditions in your supply chain?



‘Of course social responsibility is very important. I know some companies that have developed programmes of social responsibility, and it is also our plan to develop one.’

The majority of companies recognise the importance of a corporate social responsibility (CSR) report and its positive influence on their business. But in many Russian companies, CSR practice is still an area for development (see figures 34-35).

Less than half of participants believe that negative media attention to supplier workplace conditions would affect their business (see figure 36).

Figure 34

Do you issue a corporate social responsibility report?

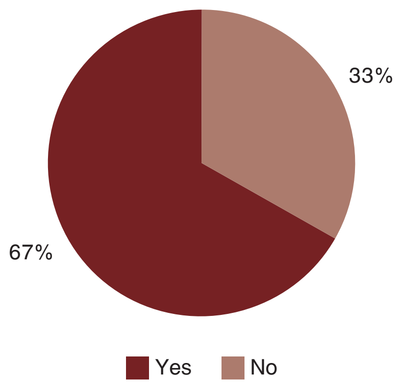


Figure 35

Do you believe the corporate social responsibility report has / would have a positive impact on your business (image / customer loyalty)?

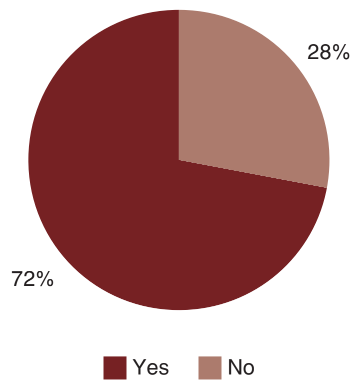
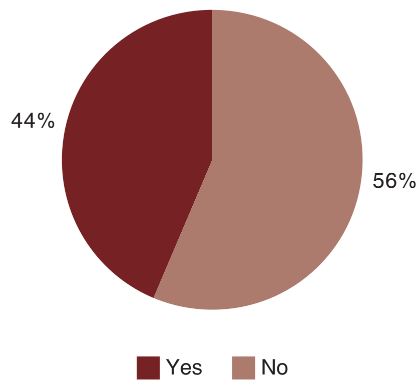


Figure 36

Do you believe that negative media attention on workplace conditions in your supply chain could impact your business?



Closing remarks

Strong economic growth and the rapid expansion of modern trade formats over the last five years have created an extremely face-paced and dynamic market environment for the retail sector. This growth is not without challenges, however, and the responses of our survey participants indicate some common approaches as well as some strategic differences in dealing with these issues. The overall thoughts that can be drawn from this survey can be summarised as follows:

Consolidation – The retail market is currently very fragmented. The top 5 retailers account for only about 5% of the market, compared to the UK where the top four have about 85% of the market. Companies will need specific strategies to deal with market consolidation. Will they grow to be market leaders, occupy niches, be bought or go out of business?

Administrative barriers – These are of greater market concern than competition. Competition is increasing among retail chains as modern formats increasingly replace open markets. There is already strong competition for customers, retail locations and employees, regardless of whether the chain is Russian- or foreign-owned. All survey participants had strategies for dealing with competition, but it is bureaucracy and unclear and inconsistently applied legislation that cause the greatest concern. Increasing red tape and uncertainty create inefficiencies for retailers that are difficult and time-consuming to address.

Development and expansion – Site availability and the increasing costs of development and rent are leading to a much more balanced approach to market development. The capital requirements and slower development associated with construction are being considered against potentially large increases in rent costs and business risks if landlords are too aggressive. Although a limited number of participants cited M&A as a growth strategy, this will clearly be the approach favoured by those few companies with the resources to make acquisitions and the ability to integrate them into existing operations. The biggest problem for M&A is price overvaluation and the non-transparency of targets. Smaller companies are aiming for expansion through debt financing. This remains feasible while the market is growing, but in the medium term, credit shortages and the increasing possibility of declining margins from competition may make loans more expensive and harder to obtain. Although only a small number of companies are looking to IPOs to fund expansion (especially now, when world financial systems are facing a liquidity crisis), this remains an attractive proposition for those who are prepared for the process and for the demands of public ownership.

Customer loyalty – All participants indicate that customer loyalty hinges on brand awareness and will be supporting their brand through advertising, promotional activities and appropriate product assortments. Loyalty programmes are widespread and increasing in sophistication, but customers' expectations of retailers are also increasing, placing considerable importance on innovation and a positive shopping experience.

Internal costs and efficiencies – There is clearly a focus on cost optimisation, inventory management, process efficiency and IT development to enhance profitability and competitive position. While 50% of participants believe that their existing systems are capable of meeting current needs, the rest anticipate upgrades in 2008 and 2009. IT systems' ability to meet growth expectations and provide an integrated response to management's information needs will be a critical success factor for most retailers. Another ongoing issue that affects costs and operational efficiency that respondents cited is a shortage of skilled management. This is not just a retention issue – more managers are needed to cope with the growth that companies are experiencing. Attracting and retaining management will place heavy demands on HR departments to devise longer term and more focused remuneration and incentive packages.

Corporate social responsibility – CSR initiatives in a company and throughout its supply chain is a growing trend in Western Europe. While the benefits of a positive CSR programme are recognised here, the concept is not as developed as in Western Europe. While many participants indicate that CSR and environmental programmes exist internally, a much smaller proportion extend their monitoring of health and safety and workplace conditions throughout their supply chain.

This survey has provided a brief insight into the thoughts and concerns of some of the most significant retailers in Russia. Although there are many challenges highlighted in their responses, we were struck by the high level of optimism and an almost universal belief that the markets will continue to develop positively in the foreseeable future. One CEO compared the situation to the Hans Christian Andersen fairy tale "The Ugly Ducking":

> "Five years ago, retail in Russia was an ugly duck. Now there is a chance that it will become a swan."

Our team

Chris Skirrow
Partner, Audit & Business Advisory services
Retail & Consumer Leader
chris.w.skirrow@ru.pwc.com

Irina Martakova
Partner, Tax services
Retail & Consumer Tax
irina.martakova@ru.pwc.com

Robert Gruman
Partner, Advisory services
robert.gruman@ru.pwc.com

Igor Boldyrev
Partner, Legal services
igor.boldyrev@ru.pwc.com

Tel.: +7 495 967 6000
Fax: +7 495 967 6001

www.pwc.ru