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FMCG RETAIL CHAINS IN RUSSIA 2011

Leading Retail Food Chains:
General Business Characteristics
Lines of Activity
Company Profiles

Analytical Review

Ninth Edition

Demonstration version



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Moscow, 2011

ABSTRACT

The ninth edition of the market survey "FMCG Retail Chains in Russia" is dedicated to analysis of the development of Russian retail food chains in the post-crisis environment. The survey describes the current market situation, analyzes key mid-term trends in retail development, assesses the market volume and provides possible scenarios and forecasts for its development in 2011-2014, considering macroeconomic forecasts and trends in consumer demand.

This survey includes an analysis of changes in retail chain formats (supermarkets, hypermarkets, discounters, convenient stores) and key characteristics of Russian chains (average check, average selling space, assortment size, sales per square meter of selling area, etc). In addition, the survey analyzes current strategies employed by Russian and foreign food retailers, their advantages and disadvantages. The Federal Trade Law, which began to operate in full swing in 2010, has produced a notable impact on business conducted by retail chains. The survey contains an analysis of a number of key provisions of the Law and its application practice.

An analytical review of the market includes a description of basic parameters of, and trends in, Russia's food retail sector, strategies and business models adopted by major companies, as well as development forecasts for retail chains and the market as a whole to 2014.

Methods

The survey was conducted using the following approaches and methods:

A questionnaire survey among retail chains

A desk study

The desk study was based on the following sources:

Data from printed and electronic media

Materials of conferences

Investment reports by banks

Financial reports of companies

The survey was conducted during April - June 2011. The Report consists of 90 pages.

The Report includes 37 tables and 35 charts and diagrams.

Report language: Russian. The report is provided as a PDF file.

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SUMMARY

According to Rosstat data, Russia's retail turnover totaled 16,435.8 billion rubles in 2010, recording an increase of 4.4% in comparable prices over 2009. Following a decline in August-September 2010, consumption resumed its growth. However, the growth which occurred in 2010 did not compensate for a 5.5% fall in 2009. The main problem faced by retail chains was reduced consumer demand due to increases in real income lagging behind the rate of growth in prices of goods and services.

Consumer inflation stood at 8.8%, the same as in the previous year, having exceeded forecasts by 2.5 percentage points. Unlike in 2009, when consumer prices rapidly decelerated due to depressed consumer demand and low global food prices, inflation rose again in the second half of 2010 after reaching its lowest level in July 2010 (5.5% year-on-year) since the start of price liberalization.

However, Russia's retail sector began to recover in 2010, having overcome the worst difficulties of the crisis period. In the previous year, sales of many retailers reached their pre-crisis levels; yet, it is too early to speak about a complete recovery of the market, as its growth was largely due to a substantial increase in retail prices.

It should be noted that LFL sales of major Russian chains are still growing up to 10% per year. This means that revenue growth comes from new store openings and takeovers of other retailers, while performance indicators of operating chains are not that high. Besides, this confirms the fact that the development of chains is still extensive in nature. However, the development in the post-crisis environment requires changes in operating strategies as the quantitative growth will inevitably slow down.

According to estimates by RBC.research, the turnover in the retail food chain sector in dollars terms grew by 21.7% in 2010 over the previous year. However, the turnover growth rate in ruble terms was lower due to ruble appreciation and amounted to slightly above 16%, which is 8 percentage points lower than the 2009 figure.

The share of retail food chains in 2010 was 27.2%, or 0.7 points higher than in 2009. Organized retail penetration proved to be lower than forecast (28-29%). RBC.research analysts believe that this was attributable to small regional companies whose performance indicators were below market average. A number of companies are still in a crisis condition, which impacts the performance of the retail food chain sector as a whole. In addition, the continuing advance in retail prices and increase in commodity imports prevent retailers from keeping prices at a low level, thereby depressing consumer activity.

It should be noted that the slowdown in market consolidation might have been caused by the introduction of the Trade Law, which limited the dominance threshold for chains within a particular region to 25%. Major retailers were forced to suspend their development in some regions, which affected their revenue growth. According to estimates by RBC.research, the rate of growth in the aggregate revenue of the top ten retailers was 22.3% (in US dollars), or slightly higher than market average. In ruble equivalent, the growth in sales of the top ten companies was 17.1%, which is 0.7 percentage points above the total market growth rate.

As for retail formats, in 2010, amid the continued increase in the number of discounters, other formats such as supermarkets, minimarkets and small wholesale stores, too, began to pick up momentum. Discounter formats were developing most successfully: in 2010, discounters contributed 38% to the total turnover in the retail food chain sector. The share of larger formats like hypermarkets and cash&carry stores contracted to 36% in 2010.

In the opinion of RBC.research analysts, the key trends in Russia's retail food chain market that will determine its development in the short term are as follows:

- emergence of new formats in Russian and foreign chains;
- dominance of the cost-saving model of consumer behavior due to increase in prices and decline in incomes, and growth of sales of medium-price products;
- low demand for non-food products;
- reduction of interest rates on corporate loans to major companies, entry in the public borrowing market;
- expansion of federal and global chains into medium-sized and small towns of Russia;
- unsatisfactory logistics and shortage of warehouse facilities;
- growth of the share of imports;
- bureaucratization and complication of business processes brought about by the Trade Law;
- activation of M&A transactions in the food retail sector.

The post-crisis development will require more flexible strategies to be applied by the retailers. Advances in prices, high inflation, and low incomes have actually determined the vector of chain retail development in the mid-term. The trend towards growth of economy formats, which emerged in 2009, continued into 2010. Yet there are positive trends, too, as consumers have again started to pay closer attention to product quality, buying fewer, but better quality and more expensive goods.

Notwithstanding these temporary obstacles, the Russian market will continue to grow as consumer demand recovers and the middle class which was practically wiped out by the 2008 crisis is revived. In the future, the Russian market is to become the largest consumer market in Europe.

TRENDS IN RUSSIA'S ECONOMIC DEVELOPMENT IN 2010 AND FIRST QUARTER 2011. FORECAST FOR 2011-2014

Russia's economy in 2010 and in January – April 2011: emergence from the crisis and growth slowdown

In 2009, Russia's economy entered into deep recession. A sharp deterioration in foreign economic conditions caused a decline in exports and capital flight, which resulted in a significant fall in production, trade, and investment. The first quarter of 2009 proved to be the most difficult time; however, by the beginning of summer the revival of global raw material markets led to some improvement in the situation in certain export-oriented industries (metallurgy, chemistry, petroleum products manufacture). According to data of the RF Ministry of Economic Development and Trade (RF MEDT), a recovery growth which started in the second half of 2009 continued into 2010, with GDP rising by 4.0% over the year.

The positive dynamics of Russia's economy were mostly facilitated by the improved global economic situation, rallying external demand and rising prices for raw materials exported by Russia. Recovery of internal demand, both investment and consumer, stimulated by anti-recession measures, and restoration of reserves, have also played a certain role in the emergence of Russia's economy from the crisis.

Table 1. Key indicators of Russia's economic development in 2008-2010 as percent of the corresponding period in the previous year

	2008	2009	2010
GDP	105.6	92.2	104.0
Consumer price index (period on period)	113.3	108.8	108.8
Industrial production index	102.1	90.7	108.2
Manufacturing activity index	103.2	84.8	111.8
Agricultural production index	110.8	101.4	88.1
Fixed capital investment	109.8	83.8	106.0
Construction works	112.8	86.8	99.4
Commissioning of residential housing	104.6	93.5	97.0
Household real disposable money income	101.9	102.1	104.3
Real wages	111.5	96.5	104.2
Retail turnover	113.5	95.1	104.4
Paid public services	104.8	97.5	101.4
Commodity exports, \$ billion	467.8	303.4	398.0
Commodity imports, \$ billion	267.1	191.8	248.8
Average Urals oil price, \$/barrel	94.4	61.1	78.2

Source: Rosstat, RF MEDT, FTS

In 2010, industrial production grew by 8.2%, including the manufacturing activity growth of 11.8%. The highest production growth rates were recorded in the manufacture of transport vehicles and equipment, electronic and optical equipment, other non-metal mineral products, metallurgical and finished metal products, chemicals, and rubber and plastic products.

Fixed capital investments grew by 6.0% compared to 2009. However, the decline in construction works which occurred in the first quarter of 2010 was not compensated by the growth in investments in the fourth quarter. As a result, the decline by the end

of the year totaled 0.6%. In residential housing construction, the amount of housing commissioned in 2010 was 3.0% lower than in 2009.

According to 2010 results, retail turnover grew by 4.4%, and the volume of paid public services rose by 1.4%.

Positive changes in the economy enabled household real income to retain positive dynamics and the situation in the labor market to improve. Household real disposable money income grew by 4.3% in 2010; real wages rose by 4.2%. The number of unemployed people decreased by 0.7 million, averaging 5.6 million people for the year, or 7.5% of economically active population.

During the crisis period, from 2009 up to the middle of 2010, agriculture demonstrated the most stable and sustained growth of all. However, due to the abnormally hot weather in the summer of 2010, agricultural production experienced a substantial decline in the second and third quarters of 2010, which affected the results of the year, with agricultural production posting an 11.9% fall in 2010.

Exports grew by 31.2% in 2010 compared to 2009, to \$398.0 billion. The growth in export value in 2010 against 2009 was associated not only with the rise in prices for key items of Russian exports, but also with an 11.9% increase in physical supply volumes.

In 2010, imports grew by 29.7% to reach \$248.8 billion. The growth in imports was attributable to a consistent recovery of physical import volumes (by 28.1%) with a moderate growth of contractual prices. The growth in import of investment goods was especially conspicuous.

Trade surplus in 2010 amounted to \$149.2 billion, which is \$37.6 billion higher than in 2009.

Net capital outflow from the private sector in 2010 was \$38.3 billion, with its rate accelerating dramatically by the end of the year. Net capital outflow was mostly due to decreased interest in Russian assets from foreign investors. The accelerated capital outflow in the fourth quarter of 2010 was also due to an increase in foreign assets in the banking sector.

In 2010, inflation in the consumer market was 8.8%. Starting with August, inflation accelerated due to the drought and a poor harvest, which triggered a growth in prices of agricultural and food products both in the domestic and global markets.

According to RF MEDT data, January-April 2011 saw a slowdown in Russia's economic growth compared with the same period of 2010. Fixed capital investments and consumer demand have been showing slack growth amid falling household real disposable income. From the beginning of the year, GDP grew by 3.9% (versus 4.0% in January-April 2010); fixed capital investments rose by 0.1% compared to the similar period of the previous year (in January-April 2010, they fell by 2.9%).

Manufacturing industries, as in previous periods, continue to be the main growth drivers. The industrial production index stood at 105.5%, including 102.8% in the primary sector and 109.2% in the manufacturing sector. The production index for transport vehicles and equipment in January-April of 2011 was 149.1% on the same period of 2010.

According to RF MEDT estimates, industrial production is expected to be steadily growing up to the end of the year and post a year-on-year growth of 5%.

In the construction market, the situation remains complicated: from the beginning of 2011, the volume of construction works has expanded by 0.5%, with 12.4 million square meters of residential housing space commissioned over the first 4 months of 2011, which is 6.7% lower than the corresponding figure in the previous year.

The growth rate in agriculture has declined to 1.6% against the similar period of the previous year, which is mostly associated with a decline in cattle and milk production.

Over the January-April 2011 period, basic indicators of Russia's foreign trade significantly improved, with the foreign trade value exceeding the pre-crisis 2008 level. External turnover as estimated by RF MEDT grew in comparison with January-April 2010 by 31.6% to \$250.9 billion, with exports rising by 26.9% and imports by 40.7%.

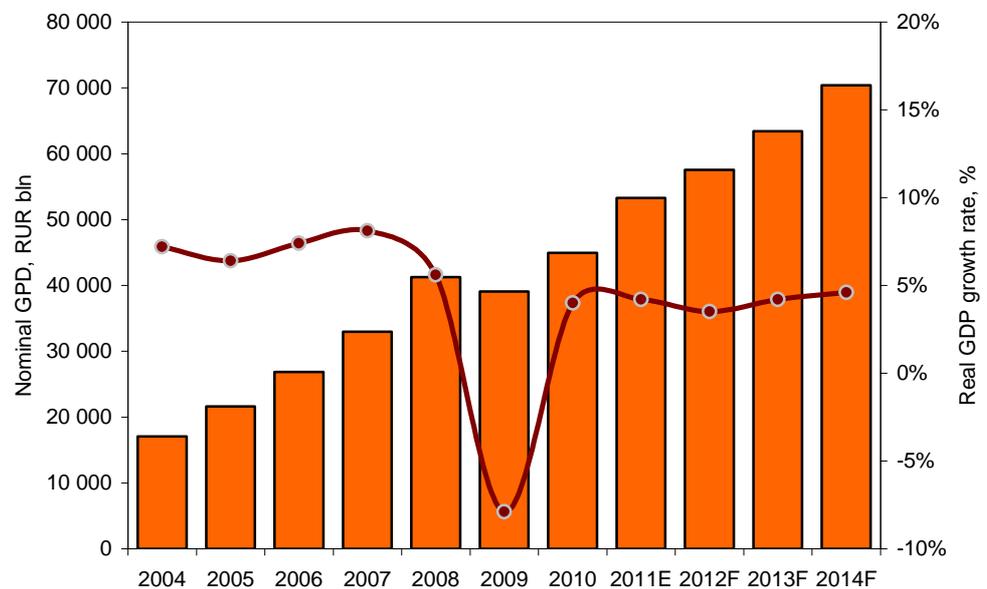
The increase in Russia's foreign trade value in January-April 2011 was due to a growth in export deliveries driven by rising prices, while physical export volumes were contracting, with growth of imports primarily coming from increased physical import volumes. The world price of Urals oil stood at \$119.4 per barrel in April 2011, which is 44.7% higher than in April 2010. On average, in January-April 2011 the world price for Urals oil was \$106.3 per barrel, which is 38.1% higher than the average level in the same period of 2010.

Exports accounted for 63.6% and imports for 36.4% of total trade turnover. External trade balance remained positive and grew by 12.2% compared with January-April 2010.

Forecast for Russia's economy in 2011-2014

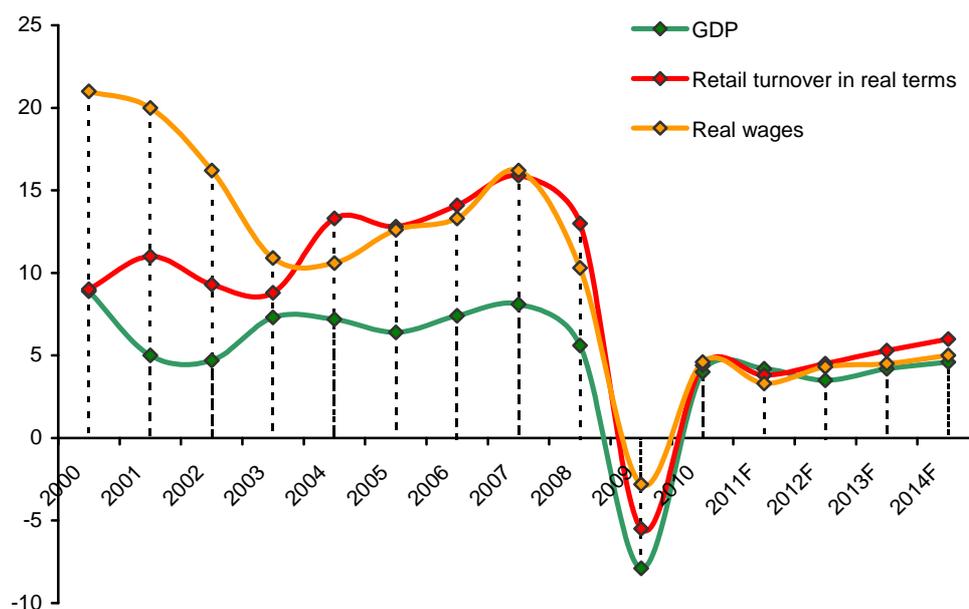
The Russian economy's growth trajectory in the projection period will largely depend on the situation in global raw material and capital markets. As a consequence of the noticeable rise in oil prices at the beginning of this year, the annual average Urals oil price will reach its historical high of USD 105 per barrel in 2011 (according to the baseline forecast scenario by RF MEDT).

Russia's nominal GDP in billion rubles, 2004-2010, and forecast for 2011-2014



Source: RF MEDT

Comparison of real growth rates of key indicators, %, 2000-2010, and forecast for 2011-2014



Source: Rosstat, RF MEDT.

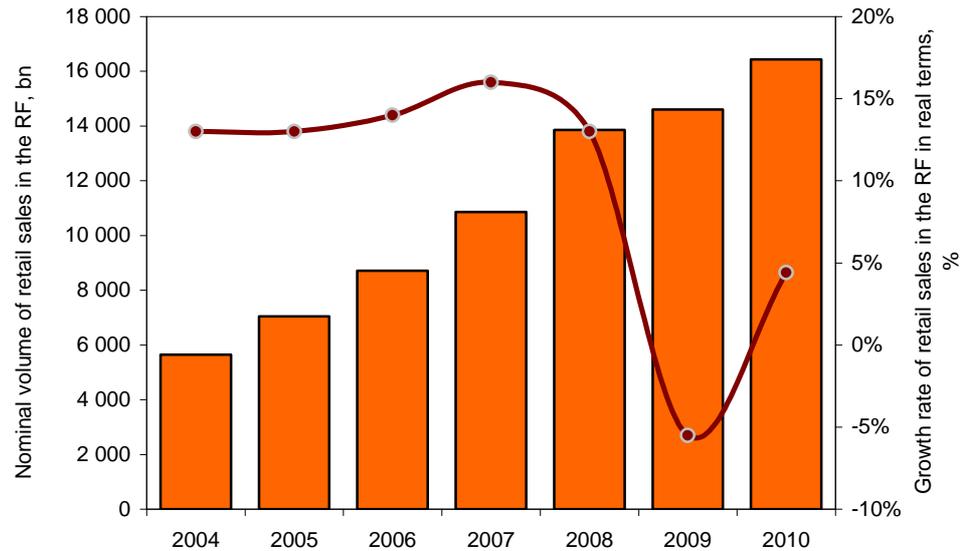
According to estimates by RF MEDT, the growth rate of economy-wide investments in 2012 will be 8.8 percent. The decisive contribution in this growth will be made by the oil and gas sector and infrastructure industries (about 3.6 percent). In 2013-2014, the contribution by these sectors to investment growth will tend to decline. Investments in the transport sector (excluding pipeline transport) in 2011-2013 are expected to grow at 4.9-6.1% per annum, while in 2014, provided that appropriate budgetary provisions are made, investments may increase by more than 10 percent.

Retail trade development in 2010 and forecast for 2011-2014

Retail trade is one of the most vigorously developing sectors of Russia's economy, outperforming other sectors in terms of growth rates. However, due to the economic crisis which brought about a fall in industrial production, decline in investments in the economy, growth of unemployment and fall in household income, the growth in retail turnover in 2009 was indicative of negative development.

In 2010, the situation stabilized, household real disposal income rose by 4.4%, revitalizing consumer demand. However, a poor harvest caused by the drought provoked price rises for different product groups, which depressed buying activity. Besides, the rise in housing and utilities tariffs also adversely affected consumer demand dynamics.

Nominal retail sales volume in Russia, billion rubles, 2004-2010



Source: RF MEDT, RF Ministry of Industry and Commerce

According to Rosstat data, retail turnover in 2010 amounted 16,435.8 billion rubles, recording an increase of 4.4% in comparable prices over 2009. Between January and July, monthly retail turnover (adjusted for seasonal effects) tended to increase gradually. Following a fall in August-September 2010, consumption resumed its growth. However, the growth in 2010 did not compensate for the 5.5% fall experienced in 2009.

According to Rosstat, in 2010 trading organizations and individual entrepreneurs operating off-market contributed 87.3% to total retail turnover, with retail markets and fairs accounting for a 12.7% share (versus 86.5% and 13.5% in 2009, respectively). The share of markets contracted, indicating that the situation in the retail sector has stabilized and the role of organized retail in the sector as a whole has increased.

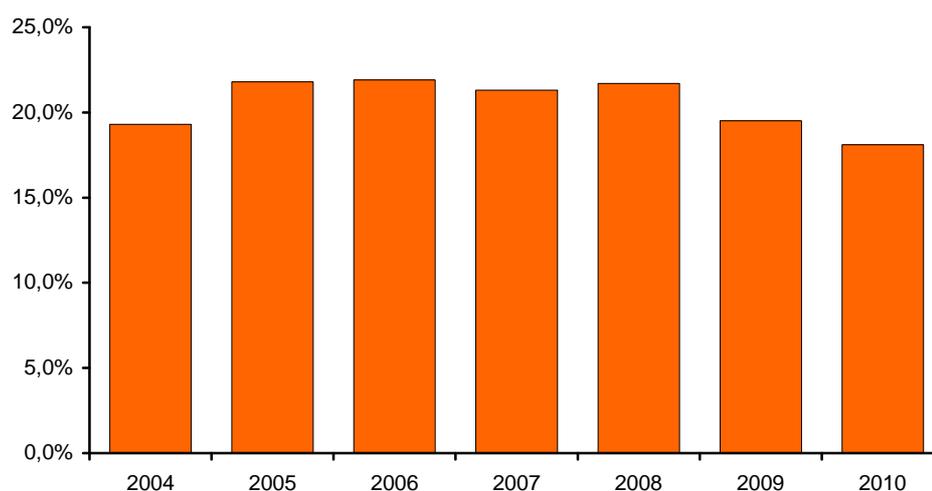
RUSSIA'S FOOD CHAIN RETAIL MARKET: POST-CRISIS DEVELOPMENT

Russia's retail trade started to recover in 2010, having overcome the worst difficulties of the crisis period. In the past year, the revenue of many retailers reached the pre-crisis figures; however, it is yet too early to speak about a complete recovery of the market, as its growth was largely due to a rise in retail prices provoked by a poor harvest in 2010.

Having overcome initial difficulties of the crisis period, Russian retailers came across problems associated with the development in the post-crisis environment. At present, the key obstacle for the development of retail chains is a change in the consumer behavior model of Russian people brought about by the continuing decline in the purchasing capacity of the population amid ongoing increases in retail prices.

Another serious problem that has to be addressed by practically all retail market operators is the financing of company development. The corporate lending sector is recovering, but this process is moving slower than required by the market situation. According to retailers, the current interest rates on loans to retailers are 13-14% minimum, with the only exception being major companies for which these rates may be lower (8-10%). Moreover, almost all loans have to be collateralized, although the only eligible collateral is, in effect, real property and equipment, which are valued at a significant discount by banks. The difficulties with credit financing slow down the development of retail chains, especially regional companies.

Figure 1. Retail sector's contribution to Russia's GDP, %, 2004-2010



Source: RF Ministry of Industry and Commerce

The contribution of the retail sector to Russia's GDP continued to decline in 2010, suggesting a slowdown in the sector's growth rates and a certain stagnation in the market. Apart from that, the slowdown in the development of retail is associated with a decline in consumer demand.

Food retail market development indicators in 2010

In 2010, the retail food chain sector started to emerge from the crisis following recovery in Russia's economy. The rates of growth in retailers' revenues were conspicuously higher than in 2009, which was partly attributable to a low-base effect.

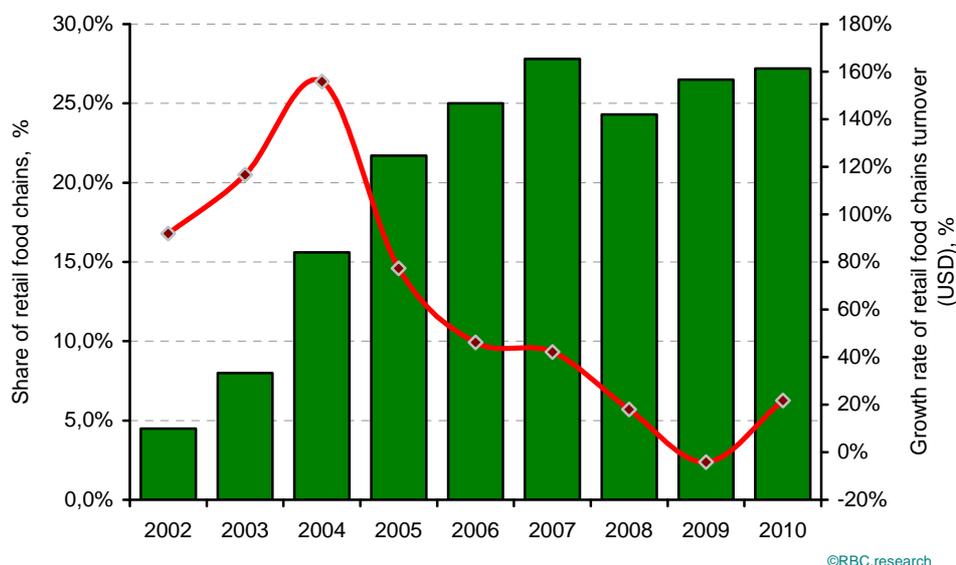
Before the crisis, most Russian chains were developing extensively - companies were increasing the number of stores and market capitalization, sometimes failing to pay attention to their long-term market strategy. In the crisis environment, extensive growth was difficult to pursue, and this suspended expansion by federal companies and diminished the number of M&A deals. However, as soon as in 2010 major chains started to return to their pre-crisis strategy models, while medium-sized and small

retailers continued to stick to cost-reduction strategies, virtually refraining from opening new stores. Bankruptcies of companies that were unable to survive the crisis continued. The property redistribution process in the market carried on, with retail facilities of bankrupt chains passing to new owners.

One of the results of the crisis was the transfer of retailers' assets to banks, which became owners of retail chains (Vester, Mosmart, ALPI, etc.). Some these assets were sold by banks to other market operators. In the opinion of RBC.research analysts, banks will soon start selling away their retail assets, with potential buyers including both former owners and other retail companies.

In the first half of 2010, consumers began to return to the pre-crisis behavior model, but a sharp rise in food prices forced them to start economizing again. However, the share of cheap products in the sales of chains shrank as the most difficult moment of the crisis had passed and customers began to pay more attention to product quality. This trend was reflected in changes in product mix of chain stores: the share of medium-price goods and a number of premium categories began to expand. It should be emphasized that consumer demand has not yet recovered in many Russian regions with low household income levels and therefore the share of low-price products in retailers' turnover remains rather high (more than 60%).

Growth in the share of retail food chains in total food retail turnover in Russia (USD), 2002–2010



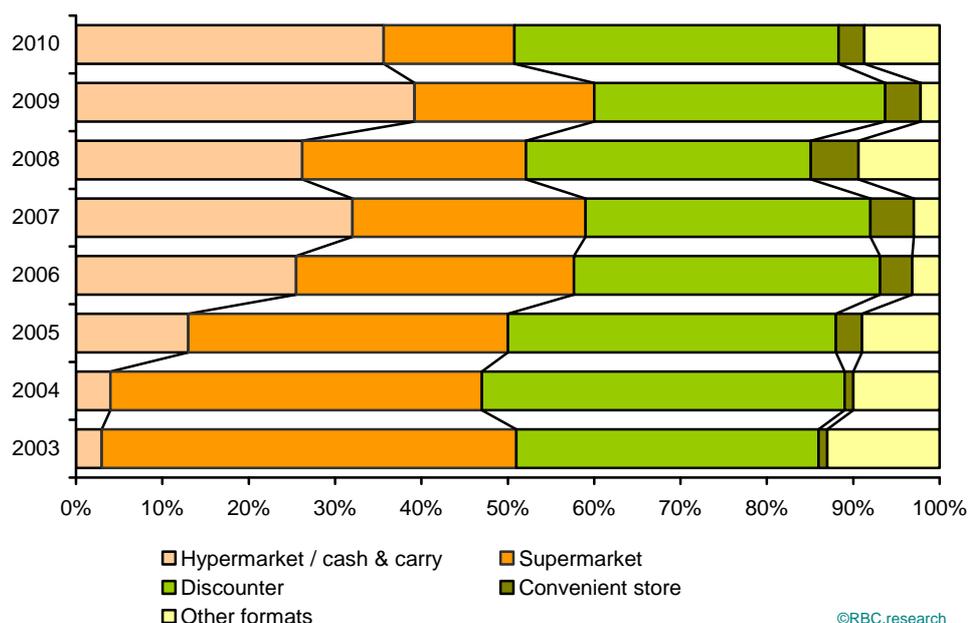
Source: RBC.research

Russia's food retail sector is gradually consolidating. The crisis has given an additional impetus to this process: as the number of small and medium-sized retail chains had decreased by the middle of 2010, major companies expanded their market share by capitalizing on emerging opportunities. The competition on the market, notably increased, especially in regional markets. However, the market consolidation rate in 2010 somewhat declined.

Changes in the structure of retail formats induced by the crisis

The trend towards an increase in the number of discounters continued in 2010, with other retail formats such as supermarkets, minimarkets and small wholesale stores, however, picking up momentum, too. Yet, discount formats were developing most successfully: in 2010, discounters accounted for ...% of total turnover in the retail food chain sector.

Structure of food retail turnover by retail chain format, 2003-2010



Source: companies' data, RBC.research estimates

Key characteristics of Russian chains

Based on the data collected during the survey among Russian food retail operators, we have made a list of key characteristics of retailers' business and parameters reflecting the operating performance of retail chains. The tables below contain the highest, lowest and average values.

General characteristics (average sales area, headcount, chain store traffic)

Average sales area of stores, distribution by format, sq. m, 2009-2010

Format	Min, 2009	Min, 2010	Max, 2009	Max, 2010	Average, 2009	Average, 2010
Hard discounter						
Soft discounter (economic supermarket)						
Supermarket						
Hypermarket / cash & carry						
Convenient store						

Source: companies' data, RBC.research estimates

Personnel size per store, persons, distribution by format, 2009-2010

Format	Min, 2009	Min, 2010	Max, 2009	Max, 2010	Average, 2009	Average, 2010
Hard discounter						
Soft discounter (economic supermarket)						
Supermarket						
Hypermarket / cash & carry						
Convenient store						

Source: companies' data, RBC.research estimates

Daily number of customers (sales checks), persons, distribution by format, 2009-2010

Format	Min, 2009	Min, 2010	Max, 2009	Max, 2010	Average, 2009	Average, 2010
Hard discounter						
Soft discounter (economic supermarket)						
Supermarket						
Hypermarket / cash & carry						
Convenient store						

Source: companies' data, RBC.research estimates

Range of food and non-food products

Total product range, SKUs, 2010-2011

Format	Min, 2010	Min, 2011	Max, 2010	Max, 2011	Average, 2010	Average, 2011
Hard discounter						
Soft discounter (economic supermarket)						
Supermarket						
Hypermarket / cash & carry						
Convenient store						

Source: companies' data for April 2010 and 2011, RBC.research estimates

Range of food products, SKUs, 2010-2011

Format	Min, 2010	Min, 2011	Max, 2010	Max, 2011	Average, 2010	Average, 2011
Hard discounter						
Soft discounter (economic supermarket)						
Supermarket						
Hypermarket / cash & carry						
Convenient store						

Source: companies' data for April 2010 and 2011, RBC.research estimates

Range of non-food products, SKUs, 2010-2010

Format	Min, 2010	Min, 2011	Max, 2010	Max, 2011	Average, 2010	Average, 2011
Hard discounter						
Soft discounter (economic supermarket)						
Supermarket						

Format	Min, 2010	Min, 2011	Max, 2010	Max, 2011	Average, 2010	Average, 2011
Hypermarket / cash & carry						
Convenient store						

Source: companies' data for April 2010 and 2011, RBC.research estimates

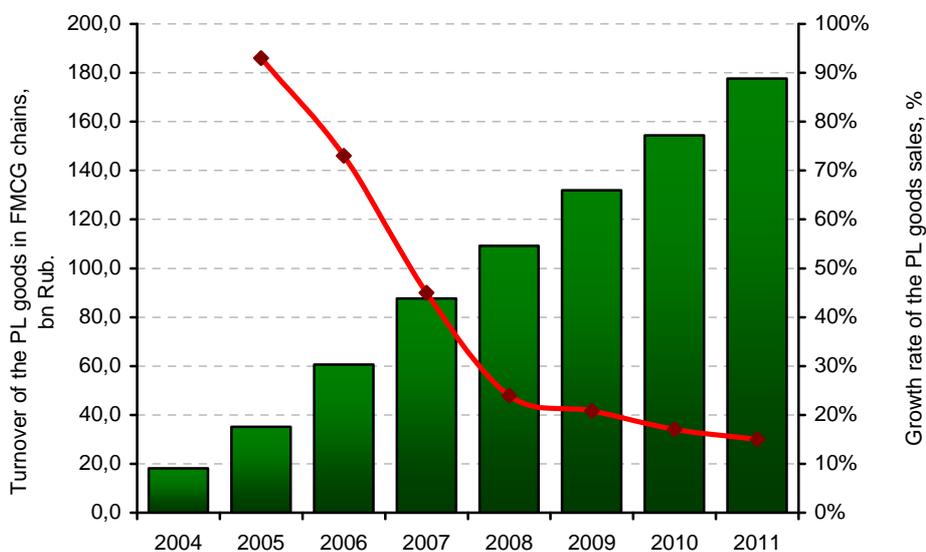
Food/non-food ratio in the store's product range, average for format, %, 2010-2011

Format	Food, 2010	Non-Food, 2010	Food, 2011	Non-Food, 2011
Hard discounter				
Soft discounter (economic supermarket)				
Supermarket				
Convenient store				
Hypermarket / cash & carry				

Source: companies' data for April 2010 and 2011, RBC.research estimates

Private label products (PLPs)

Private label turnover in food chains operating in Russia, rubles, 2004-2010 and forecast for 2011



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Source: RBC.research

Despite a slowdown in its growth in 2009-2010, the market for private label products will continue to grow owing to a low consumer demand, tightening of the regulation of relations between retailers and suppliers and advance in prices for branded products. Besides, most of Russian private retail label products belong to the low and medium-price segments, giving them an additional competitive advantage in the crisis environment.