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INDUSTRY AND GOVERNANCE IN RUSSIAN ENTERPRISE RESTRUCTURING

GARY KRUEGER

Executive Summary

Introduction

This Report consists of two papers, distributed separately as Parts I and II by the National Council. Part I: Passive Adjustment, was distributed on May 23, 1997. This is Part II.

The papers use case studies to examine the evolution in survival strategies and restructuring of ten formerly state owned enterprises (FSOE) in Russia. The cases provide insights into the role of industrial branch, the impact of privatization, the level of managerial human capital and barriers to further restructuring of FSOEs in Russia. The ten firms were selected among forty or so that had been interviewed over a three-year period beginning in 1994. The forty interviews were conducted in four cities – Moscow, two cities in the Volga region and one in Siberia – although the cases come from only two cities, Moscow and one of the Volga cities. The selection of the ten used in the cases were based on two criteria: 1) a desire to examine changes in managerial attitudes and behavior over multiple years and 2) a desire to obtain a cross section from different branches of industry. The cases allow very detailed examination of the changes in behavior and material conditions of the FSOE, and are divided into two separate papers.

The first paper looks at the experiences of six "passive adjusters." In the main, these firms tend to have adopted a "wait and see approach" to restructuring, mostly serving as caretakers for their ailing enterprises. More often than not, these firms are in machinery and light industry.

This second installment (Part II: Cases of Pro-Active Adjustment) examines the cases of four firms that are considered to have been exceptionally pro-active in making the transition to market oriented firms. Three of these firms are from the food branch, while one is a manufacturer of motor vehicle tires. Since priority was placed on follow-up interviews in which the same person was interviewed over time, the analysis is mainly on FSOEs in Moscow and in one of the nearby Volga cities, which, as has been documented, tend to outperform firms in other regions. Experiences of FSOEs from other regions are referred to from time to time in situations where these experiences reinforce or contradict those of the particular firm in our case.

Description of the Sample

Although the firms selected for the case studies are from a relatively narrow geographic area, they form a nice cross section from several industries. As industry tends to be more significant than location in determining behavior, this set of cases provides good coverage of the scope of transition

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strategies and outcomes. No claims are made as to the representativeness of this set of cases with respect to Russian industry as a whole, nor should representativeness be inferred. The proximity of these firms to Moscow, and the mere fact that they consented to multiple interviews, most likely indicate a bias towards the upper end of the distribution of FSOEs in Russia.

The Case Studies

Each case is structured similarly, beginning with a brief historical introduction of the firm as it operated under the centrally planned system, including its employment level, basic assortment and primary customers and suppliers. The central focus of each case study is the physical restructuring of each firm during the transition, including changes in total physical output, employment and, most importantly, the enterprise assortment. Specific coping strategies are examined, when they prove revealing or exceptional. Following the review of the physical circumstances of each firm, the financial situation is examined, including average wages and other related items. The ownership structure and the method of privatization is next examined, along with any substantial changes in managerial personnel or allocation of ownership, for example, managerial purchases of shares held by workers. Each case ends with an assessment of the role of various factors in explaining the firm’s restructuring, or lack thereof, during the transition.

Basic Survival Strategies

The FSOEs included in this study are in vastly different circumstances in terms of long-run viability. FSOEs in food processing are adding employment, paying high wages and increasing output. Firms in light industry, MBMW and numerous other branches of heavy industry, for example primary chemical goods, are withering away. These firms are paying below average wages (rarely on time), losing their best workers and have experienced declines in output well in excess of 50 percent since 1992. As we will see, one key difference among poorly performing FSOEs and their more successful counterparts is their relative access to working capital. The prerequisite for survival in Russia’s market economy is cash-flow, which requires resolution of non-payments (arrears) problems. Banks tend not to be a viable option as a source of cash for most enterprises because they tend not to concern themselves with lending to FSOEs. Ignoring the industrial sector as a potential profit center is possible because banks have been able to make profits through speculation against the ruble (1992-1995) and through purchases of GKOs (1995-1996). That financial acumen would play a pivotal role in success or failure during the transition should come as no surprise, since the financial system was in many respects the most undeveloped aspect of the former economic system.

Survival in the transition economy is effected through strategies and tactics that may be broadly classified as either defensive (passive) or pro-active. Defensive strategies tend to be adopted by firms
in heavy industry, while firms in consumer-related branches tend toward much more pro-active approaches to solving cash-flow and related problems of survival. For those that succeeded a virtuous circle was established: improved cash flow led to higher and more timely wages, financed changes in product mix and enhancements in quality, allowing these firms to demand (and receive) payment in advance, reducing arrears to more manageable levels. In the longer run these firms went on to use their retained earnings to expand their network of retail shops and make more significant improvements in assortment and quality, without the expense of bank credit. As these firms were able to pay wages in a timely manner at levels above market norms, they were able to attract and retain the best workers and to demand long hours and hard work from their employees. As the returns to labor were now significant (in terms of availability of consumer goods) and the threat of unemployment real, workers obliged these demands. Firms that adopted passive adjustment strategies tended to have little to no cash on hand, paid wages late at levels below average, lost their best workers and middle managers and lacked finance for the most basic restructuring projects, however potentially profitable they might have been.

**Explaining Restructuring Propensity in Russian Enterprises**

The reasons why some FSOEs chose passive strategies while others chose pro-active strategies are not always transparent. Six variables did, however, emerge as predictors of what may be termed "pro-active restructuring propensity": luck, tenure of the director, western training of management, foreign partner/joint venture, degree of monopolization in the market and ownership structure/governance within the firm. Lucky firms with younger directors with some western training, a foreign partner or relationship, situated in a competitive market, in a firm with concentrated ownership were more likely to behave pro-actively. It should be noted, however, that identifying exact relationships among the variables is difficult in that they all tended to move together (i.e., a high degree of multicollinearity exists among these variables) and inferring precise lines of causality is next to impossible. Together the two papers indicate that the restructuring propensity of a FSOE is largely determined by the particular industrial branch in which the firm resides. Ownership structure and method of privatization – in short, governance – contribute positively to restructuring propensity; however, it is difficult to extract the "signal" of governance in FSOE restructuring as good governance correlates positively with viable industries.

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3 By 1995 and more so in 1996 scheduling interviews with managerial personnel in successful establishments became increasingly difficult as the opportunity cost of speaking to an American economist became significant. This problem was most acute in Moscow where the opportunity cost is greatest.

4 Aslund, Boone, Johnson (1996) in their paper "How to Stabilize: Lessons from Post-Communist Countries." *Brookings Papers on Economic Activity.* #1, refer to this phenomenon as "complementarity" of reforms.
Lucky firms attract and retain good managers and workers who are receptive to learning new methods and techniques. These firms are more likely to institute good governance structures because the returns to doing so are higher than in their less fortunate brethren. Finally, the good fortune of these firms has left them with the cash on hand to pro-actively restructure their operations, attract foreign investment, train managerial personnel in western business practices and secure financing for further expansion and restructuring.

By contrast, firms in difficult industries, such as machinery, suffer from severe overcapacity, require massive amounts of new physical capital to restructure and also face highly elastic (short to medium-run) demand for their products. Firms in these industries have spent a significant fraction of the transition period on the sidelines. Managers in machinery and related branches of heavy industry tend to see their salvation in government assistance of one form or another and they tend to be very reluctant to cede control to outsiders for fear of foreclosure, even if outsiders would bring desperately needed working capital to the firm. These managers tend to be hostile to the whole experience of the transition, including western business practices, and they are generally pro-communist. Governance in these firms remains "poor" in the sense that old directors remain in control and insiders control large blocs of equity. Tight money and stabilization since 1995 has induced these managers to revert to their former dependence on barter – a situation that has been referred to as the "re-demonetization" of the Russian economy.5

This study also is less critical of emerging Russian governance structures than most previous work. Although many firms are indeed poorly, even horribly governed, a sizable fraction are not. Increasingly, over the three year period under study, many Russian firms, although lacking significant outside presence on their boards, have begun to resemble sole proprietorships of early American capitalism. This result suggests that the standard of comparison for evaluating the governance structure of Russian firms ought not to be the modern publicly traded firm of the advanced market economies, but rather its earlier antecedent, the sole proprietorship. The important question for the future evolution of Russia’s economy will be the receptivity of these manager/proprietors to outside influence-ownership- in exchange for investment capital and technology sufficient to take advantage of Russia’s considerable economic potential. The early results on this score are decidedly mixed.

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5 Rick Ericson at the AEA meetings in New Orleans, January 1997.
Introduction

This paper examines the case studies of four firms that have moved very aggressively in the first four years of the transition. Admittedly, they have all had their share of good fortune in that they found themselves at the start of the transition in industries with high demand and relatively little direct competition. What is noteworthy, however, is the ability of these firms to leverage their good fortune into what appears to be a sustainable competitive advantage. Managerial practices in these firms are, for the most part, indistinguishable from those in the west except where they were forced to adopt tactics necessitated by the unique characteristics of the Russian economy. In addition to having had relatively good luck through the early phase of the transition and good governance structures within their firms, many managers also received western training in business and economics, or have at least travelled abroad. This exposure to foreign business conditions has proved critical in opening up the minds of these managers and also in establishing standards of quality, customer service and basic re-conceptualizations of the core of their businesses.

Three of these cases are in the food industry, which was a lucky industry to be in at the start of 1992. Capital is relatively un-specific, allowing assortment and quality to be easily altered, demand is inelastic and the products are basically un-storable, due to the small storage capacity of the average Russian household. Most importantly, however, producers are close to the final customer providing firms in the food industry ready access to cash. The fourth firm examined in this study is a large producer of tires, which appears to have succeeded despite formidable odds. The case of the tire firm is exceptional and in all likelihood represents best practice among Russian firms. It is unlikely that these four firms are representative among Russian firms, even controlling for the special circumstances of industry and location. It is, however, a worthwhile exercise to examine best practice in Russian industry if we are to gain some insight into the possibilities of Russia’s transition economy. It should also be noted that the cases examined in this paper are not unique, however, and at least four other firms interviewed in this study would provide similar best-practice insights. In the interest of space the stories of these firms are not included.

As will be seen shortly, Russia’s economic situation places a higher premium on cash flow than that found in a more developed market economy.
1: Basic Strategies

As noted in part 1 of this study, arrears – late payments – has remained the most vexing problem for the vast majority of managers throughout the three years of Russia’s transition – a problem that did not appreciably subside with stabilization in 1995 and 1996. As the capital market in Russia remains seriously underdeveloped, in terms of providing capital for restructuring, it became of paramount importance for successful formerly state owned enterprises (FSOEs) to solve non-payments problems and ensure a reliable cash-flow. The most lucrative strategy, for those able to implement it, was selling one’s output through one’s own channels. Self-selling guarantees at least some cash flow and provides the firm with low cost market research, setting in motion a virtuous circle. The extra cash on hand allows modest alterations in the mix of output and improvements in quality, leading directly to increases in sales and profits. The direct contacts with the customer provide the compass, pointing the way for the firm as it makes further structural changes. As this process continues, employment and wage increases follow, allowing these firms to retain and attract more highly skilled workers and further consolidate or expand their retail network and competitive advantages. Because these firms have cash on hand, they are well positioned to avail themselves of opportunities outside the FSU – for example, engaging foreign suppliers for one or two strategic inputs – permitting further alterations in their mix or quality enhancements. Foreign contacts may later blossom into joint ventures and provide the firm with technical expertise and also investment capital. Although more easily implemented in food industry, the advantages of downstream integration of retail sales and distribution have not been lost on firms in heavy industry. Roughly half of the enterprises interviewed in this study in machinery and metal working owned one or more shops through which they sold some of their output. One machinery firm in Siberia used his shop to “sell anything,” including meat imported from Belgium.

Successful implementation of the self-selling and the pre-payment strategies in combating non-payments requires at least a minimum level of product quality. For firms in the food industry, improving quality was often a simple matter of obtaining better and more consistent ingredients. Frequently, better ingredients were obtainable only from foreign suppliers, so liquidity was essential. For light industry firms, quality was also a matter of materials and ingredients, but quality was more dependent on skilled labor, making it more difficult for light industry firms lacking cash flow. In heavy industry attaining acceptable levels of quality was much more problematic, requiring high quality materials, skilled labor, modern designs and sophisticated capital equipment, usually available only from the west.

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7 One method for self-selling in the bread and meat industries was to simply sell off the back of trucks.
For many FSOEs relying on a quality-based strategy, it soon became apparent that quality was not only efficacious in enhancing the firm's balance sheet, but also in beating back nascent foreign competitors which, with attractive packaging and perceived higher quality, were able to capture premium prices on retail markets. The adoption of the "foreign emulation" strategy designed to compete directly with imports and increase the FSOE's market share (including imports) became evident in 1995 and continued into 1996. Implementing the foreign emulation strategy was mostly a matter of marketing (once quality reached a sufficiently high level), usually altering the product's packaging, while alterations in the product itself tended to be relatively slight. Often, the foreign emulation strategy is implemented with assistance from a foreign partner. The assistance may be in the form of a marketing agreement or a more formal joint venture, although the latter seems less common. A recent phenomenon in 1996 among these pro-active FSOEs has been significant attention to the production process and costs of production, particularly energy consumption. By 1995/1996 increasing energy prices had induced many FSOEs into energy conservation measures such as shutting off lights in central offices, shutting down the entire factory through forced vacations and other similar measures. Among the more sophisticated FSOEs, however, 1996 saw a willingness to re-think the entire production process with an eye to significant reductions in labor costs and consumption of materials and energy. This orientation towards the production process appeared widespread and was evident in one or two firms in all four cities in 1996. In at least two firms, reworking the production process was slated to consume the majority of their investment during 1996.

Over the course of three years the interviews have revealed a natural evolution in managerial thinking: find a market niche through changes in assortment and improvements in quality and make the most of that niche through non-price, Hottelling competition. Once the niche is established managers direct their energies to cost reduction, improving competitiveness and increasing profits. In short, up to 1995 pro-active managers struggled with problems that would, in the main, be considered market research, while after 1995 they began to direct their attention to the production side of their operations.

2: Cases from the Food Industry

The unique conditions of Russia's food industry provide some insights into the opportunities available to aggressive and savvy managers under the right conditions. The food industry cases leads to a reconsideration of the quality of Russian managers, who, when given the opportunity to succeed, demonstrate exceptional competitive spirit and savvy. Because demand for food is inelastic, "payability" (low income of customers) problems have a much smaller impact on food industry firms. As food is non-durable and purchased frequently, demand is relatively stable and predictable compared to other industries, providing good cash flow and less inflationary risk for producers.
Finally, production technologies are such that major changes in assortment and quality are possible with little to no investment. On the downside, costs of entry are low and imported food products have a significant market-share. Thus, these markets are quite competitive and food processors have responded with very aggressive marketing and production strategies. Optimistically, the experiences of firms in the food industry are a harbinger of Russian industry, foreshadowing a dynamic competitive economic future. It is also possible that the conditions in the food industry are sufficiently unique that their experiences are unlikely to be replicated throughout Russian industry in the near term. The key to which future scenario evolves in Russia will be the development of capital markets capable of financing restructuring in machinery and other durable goods branches and (related) improvements in governance and management within these firms.

The Bread Industry in a Volga City: The Evolution of Competition

The bread industry in one of the Volga cities studied in this project is dominated by three large firms, all of which were interviewed during the course of this study. Two of the three bread factories that were interviewed in all three years will be the focus of this section, although the single interview from the third firm is used in places to provide a more complete picture of the market. The data from these interviews permit the rather unique opportunity to examine the bread market from the perspective of its three largest producers and to do so over the course of a three year period. No other bread factories were interviewed in this study, so it is impossible to infer the degree to which the conclusions of this section are representative of conditions in Russia as a whole. Similar behaviors were revealed in other food processing firms, in Moscow and other cities, so there is no reason to suspect that the experiences of these bread factories are atypical.

Prior to transition, the industry was highly segmented along product lines. Khleb 1 and 3 produced 90 percent of their output in black bread, while Khleb 2 produced the city’s white bread and also produced confectioneries including some elaborate cakes and pastries. Each factory had similar market shares, although the two factories that specialized in black bread had one tenth the number of employees of factory 2, which employed almost 1,000 people in 1990. The two smaller firms were leased in advance of liberalization and later converted into private firms under special arrangements. Khleb 2 was privatized under variant 2 with a 70 percent stake to insiders.

Khleb 1

As noted above, Khelb 1 specialized almost entirely in black bread before 1992, employing slightly more than 100 workers. Measured in tons of bread output fell by 18 percent from 1990 to 1994, with most of the decline occurring in 1994. By 1994, the director realized the need to diversify the factory’s assortment and the firm soon began production of white bread, to which she
referred as her "present to the competition," thereby reducing the share of production in black bread to 80 percent. The firm also introduced some confectionery products in order to compete more directly with factory 1. By 1996, a near doubling in the production of white bread from 1994 levels had reduced the share of black bread still further.

Two years after liberalization the basic survival strategy of spatial competition through integration and establishment of retail outlets had crystallized, although early incarnations were somewhat crude. In 1994 the firm had established five retail outlets; one located on the factory premises operated 24 hours a day. The less refined method of retail was direct sale from the backs of trucks, which, the director informed, was exceptionally useful at locations where customers did not pay on time. The integration of retail operations was complemented by integration of truck maintenance facilities, ensuring the firm reliable distribution. In 1995 the firm opened a much more elaborate store patterned after those the director toured in the West. To attract business at the new store, the firm discounted its increasingly wide assortment of bread products ten percent and stocked the store with high quality European foodstuffs.

Integration of retail and distribution functions and widening of the firm's assortment led to substantial increases in employment. Production employment tripled by 1995 to 300 workers, with an additional 200 workers in retail and truck maintenance. The director reported 900 total employees by 1996, a nine-fold increase from 1990. Equally impressive, the firm paid wages well above average, as did all the bread factories in the city. The wage level was sufficiently high that the director was able to boast in 1995 that her firm paid the excess wage tax.

By 1996 competition had racheted to a brisk pace. As the director explained:

"Competition is stronger, but competition promotes development. Our competition produced Turkish bread, we countered the next week. [But there is] a place for everybody under the sun."

In order to keep pace, Khleb 1 had recently added a new automated line equipped with foreign equipment, and began using its growing fleet of trucks to sell bread in the lucrative Moscow market. The director spoke positively of the future of her firm and had in place a long-run strategy for future expansion, demonstrating an unusually long time horizon among Russian managers.

Finance for these improvements and additions was internally generated through retained earnings, in spite of the fact that non-payments remained problematic. In addition to expanding production, there were plans to further expand the retail and distribution network to get ahead of the increasingly tough competition.

Khleb 1 was leased from the government in the late 1980s and then privatized with ownership limited to the nearly 100 workers and pensioners then in residence. By 1994 the number of owners

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8 The director indicated that these were her best weapons to combat non-payments.
9 Wages remained high in 1996, although the excess wage tax was eliminated.
had dwindled to 70, at which time the director remarked, "Only ten understand ownership, sixty don’t know why they receive dividends." Over the course of the next two years the number of owners continued to decline until in 1996 only 25 owners remained. By this time management was in majority control, having purchased the shares of workers and pensioners.

It is evident that the concentrated ownership structure is a contributing factor, along with the good fortune of being a producer of bread, to this firm’s aggressive restructuring and rapid growth. As has been noted by other observers of Russian enterprises, directors who participated in leasing arrangements in the late 1980s and early 1990s were pro-reform to begin with and it is not surprising to witness pro-active restructuring from these directors.10

There is more to the situation than mere self-selection, however. Leased enterprises have been privatized longer and have had more time to adjust to market conditions, discover consumer demands and seek out the best suppliers. In short, they have had all the advantages of first movers in any market, staking out the most advantageous market locations and niches whenever possible.

When the director was asked her opinion as to why Russian managers differed so widely in their restructuring behavior, she offered neither luck nor ownership as explanations. Rather, for her it was simply a matter of attitude. Offering commentary on both the attitudes of managers and tax policy, the director observed:

"When change came, the gates of the stable were opened. Some [managers] stayed in the stable, some crossed into freedom. Tax politics is the new stable. It provides a puppet show everyday."

Khleb 2

Khleb 2 began the transition as the major producer of white bread and confectioneries in the city. Employing roughly ten times the number of workers, Khleb 2 was also significantly larger than either of its two major competitors. Khleb 2’s production was, however, significantly less automated than its competitors and its productivity, measured in terms of raw output per person, was lower. It did, however, possess a work force that was capable of excellent work in the higher value-added confectionery end of the market.

The experiences of Khelb 2 illustrate the comparative ease with which change was effected for food industry firms. Like its two major competitors, Khleb 2 was very aggressive in expanding its retail network and in filling up as many market niches as quickly as possible, ensuring a stable cash flow. As early as 1994 two-fifths of the firm’s production was sold through its own channels and the following year the share that was self-sold had increased to one-half. Significant improvements in quality and wider assortment (especially in confectioneries) became possible with the use of imported butter and other ingredients from Western Europe. With superior quality and assortment, it was

possible to demand (and receive!) pre-payment from large retailers and charge higher prices, although the local government still "watched" the profitability of bread in the city.

In addition to controlling half of its retail outlets, the director spoke of increased cooperation with her large retail customers and offered them marketing and other retail assistance in order to increase their sales. For example, the director had gone to some length to simplify her large customers' financial situation, repurchasing bread they were unable to sell and relocating her cash office to the first from the third floor of her factory to expedite transactions. The director explained her desire to take care of her larger dealers: "Private businessmen work faster [and are] closer to the customer than state stores," and thus providing her with up-to-date information on her competitors.

In 1996, competition heated up further with the introduction of packaged bread, cakes and related products. Packaged bread products appear to have been introduced first by Khleb 2, induced by the director's short study and visit in the U.S. With a longer shelf life the packaged products allowed the firm to reach a larger geographic area and obtain more reliable sales as daily fluctuations in demand could be smoothed over a two- or three-day shelf life. Khleb 2's packaging initiative was countered, however, within six months by its competitors, one of which had placed significant resources into packaged breads as a competitive strategy.11

Like its competition, Khleb 2 had increased employment, but not nearly as dramatically as Khleb 1. Before transition the firm employed 900 employees and by 1996 this had increased to nearly 1,200. However, it appears that a significant reduction in employment within the factory had taken place, as it was indicated that 500 employees worked in retail outlets, with an additional 80 in transport. It should be noted that all three bread factories paid nearly identical wages, which were above regional averages.

Unlike its competitors that had been leased, Khleb 2 was privatized under variant 1, with 70 percent to insiders, 20 percent to outsiders and the remainder to legal organizations.12 In the period since privatization, workers had sold some of their shares, mostly to management, but these sales were relatively infrequent. As the director noted, "We pay good dividends." One respondent had indicated that management had amassed some 30 to 40 percent of the firm. In short, Khleb 2's ownership structure appeared very typical by Russian standards.

The large share held by management permitted them the largest voice in company affairs, but in a somewhat unusual situation the firm had a majority of its directors (four out of seven) from outside the firm.13 The board met monthly, an apparently high frequency. More unusual, considering the fact that the director had been in her position for 13 years, was her explanation as to

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11 The packaging technology and materials (shrink wrap) were imported from the U.S. and Turkey.
12 "Legal organizations" are other enterprises, usually with a supplier or customer relationship to the firm.
why the proportion of outsiders on their board was so high: "[It is] more interesting for us to have outsiders for new thinking."

By any assessment the bread market in the region has become quite competitive. All three factories are scrambling to introduce new products, capture increasingly scarce retail space in advance of their competitors, add new technology and equipment, improve their marketing and increase their sales territory through packaging and purchases of additional vehicles. Innovations in one or another contested area are quickly cloned by the other two major competitors. Increasingly, all three firms are seeking foreign expertise in marketing, packaging and processing in an attempt to gain a competitive edge.

At the root of this high level of performance lie three factors. First, as is evident from the cases, is the simple fact that the bread market is quite competitive and firms must scramble to stay in the game. In addition, costs of entry are relatively low and numerous newly created small bakeries are providing yet additional competition. Second, the fact that the directors of all three firms have travelled abroad and have either a foreign partner or a tight relationship with a foreign supplier is very important. One director received a short course on marketing in the United States that "was most helpful.... It led to the decision to buy our own shops." Finally, in spite of differences in the mechanism of privatization, all three could be said to have "good" governance structures, in the sense that ownership is relatively concentrated into major blocs, and by the demonstrable fact that management is making long-term investments in these firms. The good governance is in spite of the fact that these directors would generally be considered "red" in the sense that their tenure pre-dates the transition by a considerable period and at least one director was a former party functionary for the local raikom. It should be noted, however, that these directors also tended to be pro-reform and openly supportive of Yeltsin in the election.14

The cases from the bread industry suggest that the tendency to view red directors as the impediment to enterprise restructuring, and by implication define "good governance" as situations in which the old director is replaced, is a vast oversimplification. Not all red directors are incompetent, inflexible intransigents, seeking the quickest profit with the least risk. A significant fraction of incumbent directors, under the right competitive conditions, have demonstrated that they are capable of quickly adapting to market conditions, are sufficiently open minded to absorb lessons from outsiders, and are willing to make long-term investments to ensure a viable future for their firms.

14 In general, it was the case that directors of firms that were doing relatively well supported Yeltsin in the 1996 election, while those that were doing poorly supported his main rival, Gennady Zuzanov.
2.2 The Role of Government

Possibly because of the historic political importance of bread in Russia, the local government had a significant role in and impact on this market. It worth a short digression to more fully understand the nature of local government interference/regulation in this strategic market. Until January 1994 anti-monopoly committees could regulate the price of bread in cities in which the three largest producers controlled in excess of 35 percent of the market. Interviews with the anti-monopoly committee in this particular city in 1993 found them struggling with the question of intervening in bread pricing in the local market. According to the head of the regional anti-monopoly committee, bread prices in the city were among the highest in the region, suggesting that the committee did not fully exercise their regulatory authority. This may have had the [unintended] advantage of encouraging the bread firms in the city to engage in a higher level of non-price competition than they would have otherwise, spurring innovation.

Although anti-monopoly regulations on pricing were removed after January 1994 throughout Russia, local governments often applied pressure, especially before the election in 1996, to not raise bread prices and keep profitability at 15 percent for bread. It appears as though these restrictions tended not to apply to the higher value-added confectioneries, however, inducing expansion into this market by all three firms. This type of governmental pressure was reported by several firms in the region and was also noted elsewhere. One director claimed local government interference was their biggest problem. "They interfere with everything. This is the main problem.... Competition has less power than local authorities." In one very blatant case of government heavy-handedness, the city administration wrote to the director of one bread factory "requesting" that their firm hire one or two of the bureaucrats working in the city government, as it "was evident that your firm needs the expertise of our government officials." It is unclear as to the degree to which local government represents a serious impediment to enterprise restructuring and, therefore, the creation of competition, or simply an annoyance that directors can ignore with little consequence. Undoubtedly, the level of government involvement in the affairs of the enterprise differs vastly from region to region and is also dependent upon the particular industry as well.

3. Best Practice

The two remaining cases echo the strategies and successes evidenced in the cases of the bakeries, only more so. These two firms are much larger than the bakeries and have gone further, faster in the transition process – making substantial investments in new production capacity, creating substantial ties with foreign suppliers and pioneering aggressive retailing of their products. The goals and essential elements of the strategies are the same as that for the bakeries: maximize cash flow through a combination of superior quality and self-selling through one’s own retail outlets. Superior quality allows these firms to demand pre-payment from non-owned retailers and charge premium
prices for their products. These two firms are clearly in a league of their own and must be considered best practice by Russian (or any) standards. They are not representative of Russian industry as a whole, but they are suggestive of the possibilities, under the right conditions, of what some former state owned firms are capable. One of these two firms is located in Moscow, a circumstance that has greatly facilitated their success. These two firms are also well governed. In the one case good governance was the result of concentrated ownership by the pre-existing director, while in the other case middle management removed the red director, allowing the firm to effect greater change in the firm's operations, especially when it came to soliciting a potential foreign partner. Both firms participated in the lease-holding experiment of the late Gorbachev period which meant they were privatized in advance of most of their competitors.

A Meat Processor in Moscow

Like its counterparts in the bread industry, this meat factory has experienced stable to increasing demand since 1992. Inelasticity of demand for food products, high quality and ready access to the booming Moscow economy explain the firm's success in the early phase of the transition. In short, this firm began the transition in the right place at the right time. We will see, however, that the firm has made the most of its good luck since stabilization.

The meat firm began the transition as one of the largest meat processors in the FSU, employing 1,000 production employees. The firm specialized in sausages, producing a large fraction of the total dry sausage sold in Russia, which accounted for 35 to 40 percent of the firm's total production. The remainder of the firm's assortment was in various processed meats that encompassed "everything except canned meats." During the course of the transition the assortment of dry sausages widened and the firm increased sales through vacuum packaging of pre-sliced meats. Packaging allowed for longer storage and transshipment to any point in the Russian Federation, and the extra processing also added value, contributing directly to the firm's sales. An equally dramatic change in the firm's products was an improvement in quality brought about by a complete switch to imported meat from North America and England.

A significant change in the firm's profile, echoing a tactic replicated by many best-practice firms, was an attempt to take on foreign competition, especially in the market for canned meats. In 1995 the firm imported canned meats, placing its own label on the tin. As part of a major expansion in 1996, a newly installed production line was producing and packaging canned meats in house, saving the firm the expenses of the foreign processing. In addition, 1996 saw the firm branch out into sales and distribution of bottled mineral water. By 1996 management was rethinking its move to high quality produce as it was beginning to price many Russians out of the market. "We need to produce lower quality, a little, in order to have lower price. We will use a different trademark so as not to corrupt our brand image."
As did many other food processors, the firm sold a large fraction, upwards of 30 percent, of its production from its own trucks and retail outlets. The firm took this strategy far beyond simple retailing from the back of an old Zil truck, however. By 1995 the firm had a fleet of 60 imported DAF trucks which were literally retail meat counters on wheels. In order to encourage sales the trucks were well maintained, clean and staffed by workers dressed in the traditional white smocks of butchers. The firm placed its trucks at metro stations and other lucrative locations such as parks which began retailing within minutes after their arrival. These meat counters on wheels allowed for an exceptionally flexible system of retail that could target the most lucrative locations in Moscow at a moment’s notice. The respondent indicated that within three or four days after moving to a new location the firm was able to secure all the necessary permits and paper work from the city government. The retail truck strategy had advantages over a retail storefront in a building in that new capacity could be added in small increments at lower cost. The trucks also were intrinsically more flexible than kiosks. Very little of the investment in these trucks represented sunk costs in that demand for imported vehicles of this type is quite high, and reselling them in the event it proved necessary, for example due to legal prohibition of such retailing, would be relatively easy.

As early as 1995, competition had become so intense that management had sought expansion outside the city. The respondent indicated that "Moscow is saturated with competitors, the impression is that they are foreign, but in reality 90 percent of them are Russian. In the regions there is less competition." In 1996 the respondent declared that "Moscow is no longer interesting for us" as he explained the firm’s expansion into Nizhny Novgorod and St. Petersburg. By 1996 the firm’s retail strategy was being copied by competitors, and a frequent sight at Moscow metro stations were the trucks of one or two competitors situated nearby.

To keep pace with its expanding retail capacity the firm had begun construction of three new processing plants. Matching this expansion in capacity was a 300 percent increase in employment from 1990 to 1996, leaving the firm with 3,000 production workers in 1996. An additional 4,000 workers were employed in retail and distribution, supporting the ever expanding fleet of trucks, bringing total employment to 7,000 workers-a seven fold increase compared to 1990. According to management, workers were paid exceptionally well, nearly twice the Moscow average; however, they were required to work over 40 hours each week and the director imposed strict discipline on employees.

Like most of the successful firms portrayed in these cases, this meat processor was privatized early in the transition as part of conversions of leased enterprises into privately held firms. Very quickly, management had obtained a controlling interest, with the largest block going to the director, who had been in his position for the previous seven years. The respondent indicated that the tight rein held by the director was the "...reason we are profitable. We are run and governed by one person. He is aggressive and entrepreneurial. [But] he trains and works with his team.... [He]
achieves any goal he sets." The director was able to assert a high level of control over the firm due to the controlling interest he held in the firm which made "the board of directors irrelevant" in company decision making. Centralized ownership allowed management to think long term and lay down specific goals for the near term, medium term and long term (beyond five years), after which management envisioned "locations all over Russia, with a developed distribution network, linked via a good information system."

By any reasonable standard this firm has done exceptionally well in Russia’s transition. Employment has increased seven fold, major new capacity is being added in the form of three new factories, product quality is high and assortment is wide. Wages are competitive and management is attracting a cadre of dedicated workers. Clearly, this firm was in the right place – Moscow – in the right industry – high value-added food processing. The importance of these two factors should not be underestimated. The Moscow location provides the firm with a large and growing market upon which the firm is able to capitalize. Moscow also provides ready access to capital and foreign trade, necessary for expansion of its facilities and importation of its primary ingredients. Equally noteworthy, however, is the fact that the firm appears to have missed very few opportunities. Management has skillfully navigated some very turbulent waters and has made the most of its opportunities. In short, the firm has been well governed. As in the case of the bread factories, the experiences of this Moscow-based meat processor contradicts the widely held view that incumbent directors lack entrepreneurial skills and the desire to restructure their operations to maximize the value of their firms.

**The Case of a Tire Manufacturer**

Although not matching the growth in output and employment of our meat processor, the case of a large tire company is equally if not more impressive due to the increased difficulty of prospering in heavy industry during Russia’s economic transition. As the cases from part I of this study have amply illustrated, firms in heavy industry have been in stasis throughout much of the transition. As will be seen presently, the case of the tire manufacturer shatters some of the stereotypes concerning Russian managers and Russia’s transition economy. Managers in this firm quickly learned the ropes of the market economy, have proved receptive to western ideas and business practices, introduced new products and have attracted foreign capital and technology. As in all successful firms in Russia’s transition, the tire firm’s success is a combination of luck, good management and good governance.

The tire company began the transition as the primary supplier of tires to two customers, Zil and AZLK, maker of the Moskvich, with its production evenly divided between the two companies.

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15 The location of this particular firm is suppressed as it would result in disclosure.
By 1994, with declining military and industrial orders and the near closure of Zil, sales of automotive tires had increased to 70 percent of the total. Although sales of truck tires had fallen threefold during the early phase of transition, pent up demand for automotive tires carried the firm through the most turbulent period of the transition.\textsuperscript{16} By 1994 output stood at 80 percent of 1990 levels which, by the standards of other heavy industry firms, represented a comparatively mild decline.

Stabilization in output arrived relatively earlier for the tire firm and was evident as early as late fall 1994. The arrest in decline was brought about through aggressive widening of its assortment of car and, later, truck tires. In 1994, through an investment plan that returned one fifth of profits to purchases of new machinery, the firm introduced seven new tires and 11 new variants. This strategy continued in 1995 with the introduction of a low profile tire for the Moskvich and a 13" tire that would fit the more popular Lada (Zhiguli), a market from which the firm had previously been excluded. By 1996 the rate of introduction of new products accelerated, due to increasing competition in the robust market for automotive products in the region, as the firm introduce nine new automotive tires and a range of tires to fit GAZ’s new light truck the Gazell.\textsuperscript{17} Winnowing out the "dead meat" in the firm’s assortment continued and several variants of truck tires were discontinued, leaving only 20 percent of the firm’s production in truck tires.

Competition in the early part of the decade came primarily from domestic producers of truck tires and from a Ukrainian producer of automotive tires that was selling at distress prices in the Russian market. Very little foreign competition existed in the retail market in 1994 and 1995, due to the high price of imported tires. The respondent noted, however, that foreigners competed intensely for wholesale deals with AZLK and VAZ.\textsuperscript{18} By 1996 competition was heating up and the respondent indicated that "1996 looks lower [than 1995]. The market is bad due to competition." Competition was from Turkish subsidiaries of Goodyear which sold a "cheap, old design," and from Finnish, Slovak and other Russian firms, although the quality from the Russian competitors was reportedly very poor.

Rare among firms situated in heavy industry, the tire factory established a fairly tight retail network, including several company owned stores and long-term contracts with 50 stores. Sales through these channels steadily increased and by 1996 more than half of the firm’s production was sold through direct retail outlets, rather than to auto/truck manufacturers. The retail outlets were scattered throughout the region and were at least as far as 180 km from the base of production. As

\begin{itemize}
\item \textsuperscript{16}One should note, also, that the conditions of Russian roads contributes greatly to the demand for automotive tires. Even high quality western tires rarely last one year under Russian conditions.
\item \textsuperscript{17}GAZ is short for Gorky Automotive Zavod. The Gazell is a light truck built off of the Volga automobile chassis and drive train. The vehicle proved immensely popular among small businesses for its low cost and large carrying capacity.
\item \textsuperscript{18}VAZ is short for Vloga Automotive Zavod, manufacturer of the Lada, Zhiguli and Niva vehicles.
\end{itemize}
retail sales increased, the share of sales to the firm's two large former customers, AZLK and Zil, fell below 40 percent, diversifying its customer base in a relatively short period of time.

Partly due to the fact that the firm did not own its retail network, employment, which had originally been stable from 1990 to 1994, fell from 3,500 to less than 2,500 by 1996. The respondent indicated that a large percentage of the reductions in employment were due to reductions in white collar employment, especially at the central office. As the firm paid competitive wages, above the regional average, the declines in employment were unlikely to be the result of employees voluntarily separating to seek higher wage occupations elsewhere. The tire factory was therefore not subject to the "decapitation" of its best workers as were many other industrial firms in the region that had failed to keep pace with the conditions in the labor market. To the contrary, the respondent indicted that it was a very conscious policy on the part of top management to differentiate salaries in order to attract and retain the most highly skilled workers. Reflecting this policy, salaries for shop supervisors were three times the factory average and up to six times those of an entry level employee.

The interviews over the three year period from 1994 to 1996 illustrate the evolution of the firm's basic competitive and survival strategies, as well as the changes in Russia's transition economy. In 1994, the firm was primarily focused on survival and on serving its pre-transition customers as indicated by the following two quotes concerning the long run strategy for the firm:

"Right now there are seven tires for a Zil (truck), two from our tire plant, four from competitor number 1, and three from competitor number 2. Our object is to hang in there until one of our competitors fails."

"Five years is too long to plan, after stabilization then we will find our niche, now can't find our [market] niche."

By 1995, partly due to an improvement in the operations of Zil through a takeover by the computer firm Mikrodyne, the situation at the tire factory had stabilized. More importantly for the tire factory, a board-room coup in 1994 replaced the old director with the much younger commercial director resulting in a more aggressive competitive strategy for the firm. When asked about the firm's future in 1995, the respondent replied:

"Quality is our biggest problem. Finance is also a problem, but if we don't solve quality, then we won't solve finance."

The interview from 1996 witnessed a further evolution in focus:

"The basic question is to decrease cost to maintain competitive price. [There are] lots of things we can do to decrease costs. The energy system needs reconstruction. The old system had no regulators."

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19See part I of this study for additional information and references concerning this phenomenon.
The sequence of finding market niche (1992-1994), improving quality and other methods of product differentiation (1994-1996), followed by efforts at cost reduction and other improvements in the process (1996-?) was played out at several other "leading edge" firms interviewed in this study. In retrospect it is a sensible response to the uncertainty inherent in the transition. The primary task is finding one’s market niche, then consolidating and perfecting one’s hold on that niche as best one can. This crystallization of competitive strategy and lengthening time horizon of managerial personnel, although not common, was evident on numerous occasions throughout Russia by 1996.

As evident from its relative prosperity during the first four years of transition, the tire plant is well governed by Russian standards. As was true of other successful firms, the firm was privatized under the provisions governing leased enterprises which, as we have seen, suggested that top management was pro-reform to begin with and, equally important, the firm had a head start on restructuring during the critical early phase of the transition. Initially, insiders held the entire stock of the firm with management taking a 30 percent stake. Over the years, an unspecified amount of equity was bought up by management resulting in a still more concentrated ownership structure.

The removal of the old director as early as December 1994 is also atypical and is indicative of an exceptionally well functioning governance structure. The causes behind the replacement of the old director in 1994 is not entirely known. This much is known, however. In 1994, the management team had elected to sell up to 51 percent of the firm to a foreign partner, under the right conditions. Apparently management had obtained the consent of enough workers that this was voted through. As a measure of the firm’s earnestness, it had employed an American accounting/consulting firm to facilitate the transaction. In December of 1994, apparently due to the fact that the director was unable to deal effectively with foreigners, middle management voted the old director out of office. The respondent characterized the attitude of the old director as "give us 200 million (dollars) then we will talk [to foreigners]. The new director, the 40-year-old former commercial director, had a completely different attitude which was characterized by the respondent as "let’s show that we can work with foreigners first, then we will make a deal." By 1996 the firm finalized an agreement with a large western tire company to engage in joint production and marketing throughout Russia. "By the year 2,000 we will be giving headaches to Goodyear," claimed the respondent.

The tire plant is exceptional among firms in heavy industry in that it has been able to proactively introduce new products, find and exploit new market niches, secure reliable cash-flow and compensate its employees at levels well above average and on time. As in most firms in Russia’s transition, the tire factory’s success was a combination of luck, in this case pent up demand for tires during the early phase of transition, and excellent management – management that had plowed large amounts of money into renewing its assortment, raising quality and securing cash flow by the establishment of a retail/dealer network through ownership and stable contractual agreements with retailers. The respondent indicated that its foreign contacts and technology were absolutely critical.
for raising the level of quality of the firm's products: "In 1995 we started going for quality like no one does in Russia.... Without western technology we could not compete."

Multicollinearity – complementarity – in the changes in the operations of the tire firm are strongly evident: managers had received western training, were 10 to 15 years younger than their peers, sought aggressively to renew their assortment, improve quality, diversify their customer base and secure a reliable source of cash, making the whole restructuring effort possible. Recognizing the potential value of their asset, managers sought whatever means at their disposal to maximize the value of the firm, in this case, ousting the old director. As a consequence of its restructuring efforts, the firm attracted a foreign partner and gained access to western production technology and marketing expertise.

4: Conclusion

Although many Russian firms stood idly by in the transition, a significant fraction, perhaps only a handful, have plunged into the waters of Russia's turbulent market economy. The management of these firms made significant investments of time and money in their firms to ensure the long-run survivability of their enterprises. A large fraction of these firms share two characteristics: they participated early on in the privatization process, generally through the lease-holding experiment of the late Gorbachev period, and they reside in industries that permit direct contact with retail customers. In short, successful firms self-selected – left the stable of the centrally planned system – early on in the transition and obtained significant first-mover advantages that carried them through the turbulent early years of the transition. In addition, these firms were lucky in that they usually found themselves in markets for which product demand was inelastic, storability of production was limited, and in which it was a relatively simple matter to obtain direct access to retail customers and cash. Equally important is the fact that management in these firms has done its best to maximize the value of their firms, make long run investments in new facilities and customer/supplier relationships and repair defective governance arrangements.

These pro-active cases demonstrate that incumbent managers are not always the impediment to restructuring that is frequently believed, or that recruiting new directors from within the ranks of incumbent (but younger) middle management represents an inconsequential change in management. Given the fact that Russia lacks a significantly large cadre of trained – generalist – managers, it is probably rational for new directors to be recruited from the ranks of middle management, who would be best informed as to the operations of their particular firm. As these new directors are 10 to 15 years younger than their predecessors, they are sufficiently flexible in their attitudes toward enterprise restructuring and generally less hostile to the transition as a whole. The finding of this study contrasts somewhat with those of Blasi et al (pp. 206-207) who consider the replacement of the general director with incumbent middle management as not representing a radical change in
management. Although this may be true in many cases, the increase in director turnover in the most recent two-year period must serve as a wake-up call to "red directors," who must now feel the pressure for substantial restructuring.

Most important, these cases demonstrate the potential of Russian managers under the right circumstances, and also the fact that successful and significant restructuring is possible within the constraints of Russia's transition economy. The surprising result of this study is that at least a handful of managers managed to peer through the fog of Russia's economic transition and engage in long-term restructuring of their firms. Equally impressive is the rapidity with which these managers learned the ropes of market economics, under circumstances that would test the most seasoned managers in the west. One interpretation of this outcome is that managerial human capital in Russia is considerably more flexible and, on average, of a higher level than previously considered.

This study also is less critical of emerging Russian governance structures than most previous work. Although many firms are indeed poorly, even horribly governed, a sizable fraction are not. Increasingly, over the three year period under study, many Russian firms, although lacking significant outside presence on their boards, have begun to resemble sole proprietorships of early American capitalism.20 This result suggests that the standard of comparison for evaluating the governance structure of Russian firms ought not to be the modern publicly traded firm of the advanced market economies, but rather its earlier antecedent, the sole proprietorship. The important question for the future evolution of Russia's economy will be the receptivity of these manager/proprietors to outside influence-ownership- in exchange for investment capital and technology sufficient to take advantage of Russia's considerable economic potential. The early results on this score are decidedly mixed.

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