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**VEGETABLE DISTRIBUTION PROJECT
FINAL REPORT**

**Prepared by
THE BOSTON CONSULTING GROUP**

For

**THE UNITED STATES AGENCY FOR INTERNATIONAL
DEVELOPMENT**

and

GOSKOMMUSHSTVO



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EXECUTIVE SUMMARY

The Boston Consulting Group (BCG) carried out a five month project to diagnose and address the problems of vegetable distribution in Russia for the Russian State Property Committee, sponsored by the United States Agency for International Development. The project centred on the privatisation and restructuring of vegetable wholesalers in Perm.

Consumer research revealed widespread dissatisfaction with the poor availability and high prices of vegetables, especially in Spring and the low quality of vegetables sold in retail stores. The vegetable distribution system is in a state of crisis, with many wholesalers in a state of operational and financial collapse.

The current distribution system is extremely inefficient, with total losses of up to 50% between farms and consumers. Losses in storage in municipal wholesale enterprises can be 30% or more. Such high losses are due to a combination of weaknesses in purchasing, handling, warehousing and sorting procedures. They are compounded by weaknesses in marketing, finance and general management. The root cause of operational and managerial weaknesses is a lack of motivation and incentives to improve performance under municipal control.

BCG worked closely with Perm vegetable wholesalers, the Perm municipal property committee and the city administration and council to develop and implement a project to improve vegetable supply by privatising and restructuring municipal vegetable wholesalers.

Detailed restructuring and privatisation plans were developed and implemented for the pilot enterprise Permplodovoshprom. A general approach for privatising and restructuring vegetable wholesalers was developed and the process of privatisation initiated for all vegetable wholesalers in Perm. A specific approach was developed for wholesalers in acute financial distress.

At the time of writing the following results have been achieved:

- "Permplodovoshprom" sold by commercial tender on August 19th. Detailed restructuring plans designed and implemented
- "Kirovskaya" commercial tender announced for September 16th. Detailed restructuring plans designed and agreed.
- "PAKT" sold by lease buy out
- "KOD" to be sold by lease buy out shortly
- Privatisation commissions held for 3 further vegetable wholesalers
- Privatisation applications submitted for a further 6 vegetable wholesalers
- General template for privatising vegetable wholesalers developed
- General template for restructuring vegetable wholesalers developed

A plan for the replication of the Perm project in other cities and oblasts has been developed and submitted to the GKI.

INTRODUCTION

The Boston Consulting Group carried out a project to diagnose and address the problems of food distribution in Russia for the Russian State Property Committee (GKI) as part of the Russian Government's programme of privatisation and market reform. The project was sponsored by the United States Agency for International Development.

A six week diagnostic phase examined the symptoms, causes and possible solutions for distribution failure for bread, milk and vegetables in Perm and Novgorod oblasts. The diagnostic phase was followed by a

twelve week pilot project which focused on implementing measures to improve vegetable supply in Perm city by privatising and restructuring vegetable wholesalers.

This report summarises the diagnosis and pilot project relating to vegetables. Diagnostic analyses of bread and milk distribution were incorporated into an earlier report already submitted to USAID and GKI.

OBJECTIVES

The overall project objective was to suggest and implement measures to improve the effectiveness of distribution for staple foodstuffs in Russia. Firstly, this involved identifying the symptoms of distribution failure. Secondly, it involved diagnosing bottlenecks and root causes of distribution failure. Thirdly, it involved proposing possible solutions to distribution failure, including both regional and federal government policy measures and also enterprise level initiatives. Fourthly, it involved formulating and executing a pilot project to implement practical measures for one major food supply chain. Lastly, it involved evaluating the results of the pilot project and proposing a mechanism for replicating the project in other cities and oblasts.

APPROACH

Location

The diagnosis was focused on two locations, Novgorod and Perm. Locations were selected firstly on the basis of a good privatisation track record, specifically a high proportion of small enterprises privatised and some medium and large enterprises. Secondly, locations were screened to avoid duplication with other major technical aid projects related to distribution, transport or food processing. Thirdly locations were selected on the basis of federal GKI recommendation. Lastly, locations were screened on the basis of enthusiasm and support for the project shown in initial visits and interviews.

Products

The three specific products - bread, vegetables (potatoes, carrots and cabbages) and milk were selected for detailed study as staple foodstuffs whose distribution was a major concern for the city and oblast authorities in Perm and Novgorod. For each product, there were significant concerns about price, availability, quality, losses and other issues relating to distribution efficiency.

Team

Two teams of five BCG consultants were located full time for 6 weeks in Novgorod and Perm for the diagnostic phase. They were supplemented by trained local consultants, especially for market research activities. For the Perm pilot project, a team of seven BCG consultants worked full time in Perm for twelve weeks. BCG was supported throughout by Russian (Injurcolegia) and international (White and Case) law firms and by Systecon, a specialist logistics consultancy, on technical issues.

Steering committee

Project steering committees established in Novgorod and Perm were an essential ingredient in the success of the project. Steering committees met weekly and were attended by senior members of the municipal property committee (MKI), the city administration, the city council, agriculture, transport, and trade committees as well as local entrepreneurs and municipal enterprise managers. Steering committees served as a forum for presenting and discussing interim results, debating contentious issues and developing consensus on solutions. Meetings were held fortnightly.

Questionnaires and interviews

A major component of the diagnostic analysis was the administration of a series of structured quantitative questionnaires to consumers, retailers, wholesalers, transport companies, food processors and farms. Questionnaire data was supplemented by in depth qualitative interviews and analysis of official statistics and comparative international data. Interviews were also carried out with foreign food companies operating in Russia, government officials and consultants performing related projects in order to leverage existing research and avoid unnecessary duplication. In total over 800 interviews were carried out.

Pilot project selection

From a list of 19 possible pilot projects suggested by BCG, the privatisation and restructuring of vegetable wholesalers in Perm was selected for implementation in consultation with the GKI and USAID. This selection was based on the severity of the problems diagnosed, the potential to make a significant impact in the time available, the potential for generalisation and roll out and the fact that capital investment was not necessary.

Demonstration enterprises

During the pilot project BCG worked very closely with the employees and managers of two demonstration enterprises, Permplodovoshprom and Kirovskaya, to diagnose problems, to develop and implement improvement plans for operations, marketing, finance and organisation and to develop a privatisation plan. One objective of focusing resources on these two enterprises was to gain a deep insight into the operations of Russian vegetable wholesalers that could later be applied to other enterprises. A second objective was to make rapid progress in implementing restructuring and privatisation recommendations, to lend credibility to the overall process and to generate enthusiasm from other wholesalers. A third objective was to use the director of Permplodovoshprom as a project champion, to promote and publicise the project, initially in Perm and later in other cities and oblasts.

Working with the municipal property committee

In parallel, BCG worked closely with the Perm city property committee (MKI) to develop a general approach for privatising vegetable wholesalers, to develop a privatisation plan for all Perm wholesalers, to promote this to wholesalers themselves and to expedite individual privatisation transactions.

CONFIGURATION OF VEGETABLE DISTRIBUTION SYSTEM

The vegetable distribution system in Russia consists of collective, state and private farms supplying vegetables to wholesale bases which in turn supply retail stores. State and privatised retail stores typically supply a limited variety of low quality locally grown basic vegetables and fruits to consumers and social institutions. Lower volumes of higher quality seasonal produce are supplied to consumers at high prices via city markets, mainly by private farmers. In country areas and small towns, self supply from dachas and allotments can dominate supply. Increasingly, and especially during the harvest season, channels which bypass the wholesaler predominate.

City authorities intervene extensively in food supply and distribution. In Perm, the first deputy mayor is responsible for food supply, the agricultural committee for farms and wholesalers and the trade committee for retailers. City authorities supply subsidised finance, coordinate between farms, banks and wholesalers and advise wholesaler managers on many operational decisions, especially purchasing.

Until recently, wholesale and retail enterprises were grouped into monopolistic "torgs" covering broad groups of products, such as fruits and vegetables. In Perm, the five largest wholesalers and many vegetable retailers were part of Gorplodovoshtorg. Following a presidential decree, retail outlets and individual warehousing sites were separated to form separate retail and wholesale businesses.

Privatisation of retail outlets is very advanced, with more than 60% sold off, mostly to workers collectives. Apart from ex-Gorplodovoshtorg enterprises there are 8 other vegetable wholesalers in Perm, mostly associated with social institutions. At the beginning of the project no vegetable wholesalers had been privatised.

Potatoes

Potatoes are supplied to Perm city from within Perm oblast. The private sector supplies around 50% of total demand, if peasant farming is included. An intermediary cooperative organisation buys potatoes from the private sector and sells them to wholesalers and institutions. Total potato supply to the city region is around 70,000 tonnes per annum.

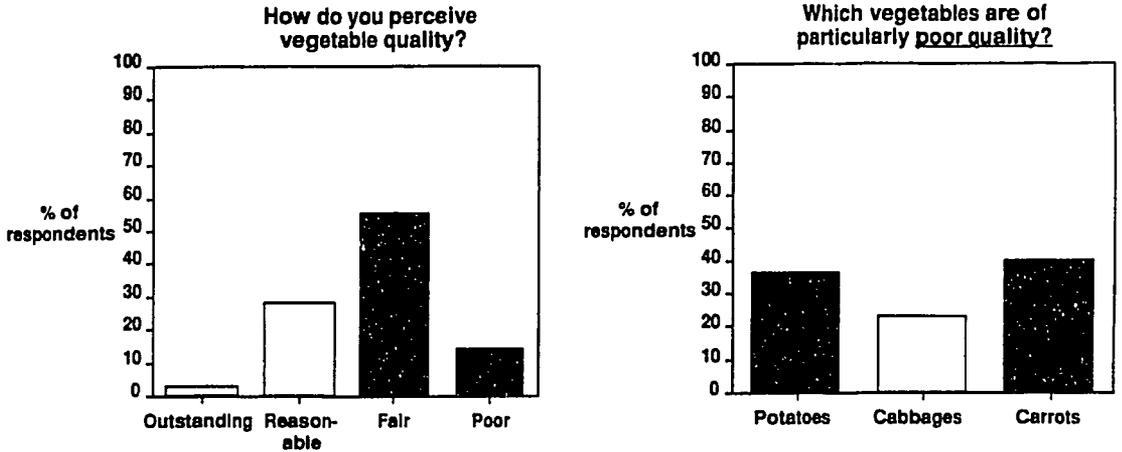
Cabbages and carrots

Cabbages and carrots are supplied to Perm city predominantly from seven large municipal and collective farms within Perm oblast, with less than 20% of the total quantity being imported from other oblasts and CIS states. There are no intermediaries between farms and wholesalers. The total annual supply of carrots and cabbages is around 50,000 tonnes.

Figure 1

CONSUMERS RECEIVE VEGETABLES OF INFERIOR QUALITY

- More of a problem for carrots and potatoes



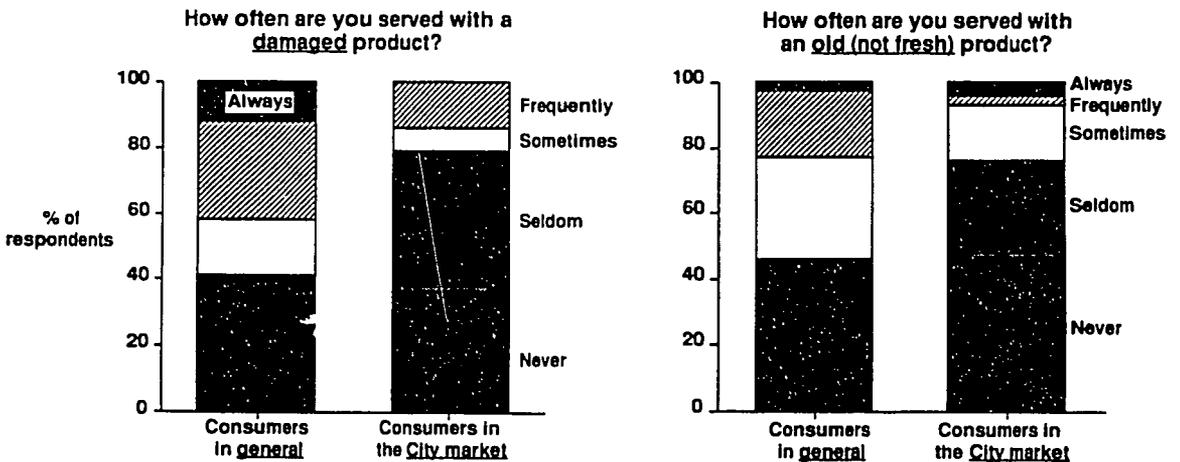
Source: BCG Consumer Interviews, Sample size 135

The Boston Consulting Group

Figure 2

CONSUMERS ARE FREQUENTLY SERVED WITH DAMAGED OR OLD VEGETABLES

- Quality in City markets is significantly better



Source: BCG Consumer Interviews, Sample Size 135, Interviews in City Market, Sample Size 30

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Characteristics of Russian vegetable distribution

The Russian distribution system for vegetables has a number of specific characteristics and weaknesses compared to western Europe and North America. Vegetables are predominantly locally grown rather than traded inter-regionally or internationally. The extent of vegetable processing (canning, freezing etc) is very limited. Storage is predominantly on wholesale bases rather than on farms. Wholesalers store large quantities of a limited variety of vegetables for periods of up to nine months, rather than providing a wide range of fresh produce. Intermediaries play only a limited role between farmers and wholesalers in Russia but an important role elsewhere. Wholesale markets and supermarkets are not important distribution channels in Russia, unlike elsewhere. Each of these structural characteristics has important implications for overall distribution effectiveness, as explained below.

SYMPTOMS OF DISTRIBUTION FAILURE

Extensive market research revealed widespread discontent with the effectiveness of the vegetable supply system, with consumers voicing concerns about the quality, availability and price of vegetables.

Quality

A large proportion of consumers interviewed indicated that they were often served with damaged and unfresh vegetables in retail shops (Figure 1). Visual inspection confirmed the very poor quality of vegetables available in retail stores. City market customers showed significantly lower levels of dissatisfaction with product quality (Figure 2), but prices are beyond the reach of most consumers and the total proportion of demand supplied via this channel remains very low.

Availability

Around 40% of consumers indicated that basic vegetables were often totally unavailable, especially carrots and cabbages in the Spring months (Figures 3 and 4).

Prices

The prices of basic vegetables often rise sharply in Spring, reflecting poor availability. Price is the predominant concern of consumers, followed by poor quality. The prices of city market produce were beyond the reach of most consumers.

Other consumer concerns

Consumers also voiced dissatisfaction with the limited variety of vegetables available and the long waiting times for service in retail stores.

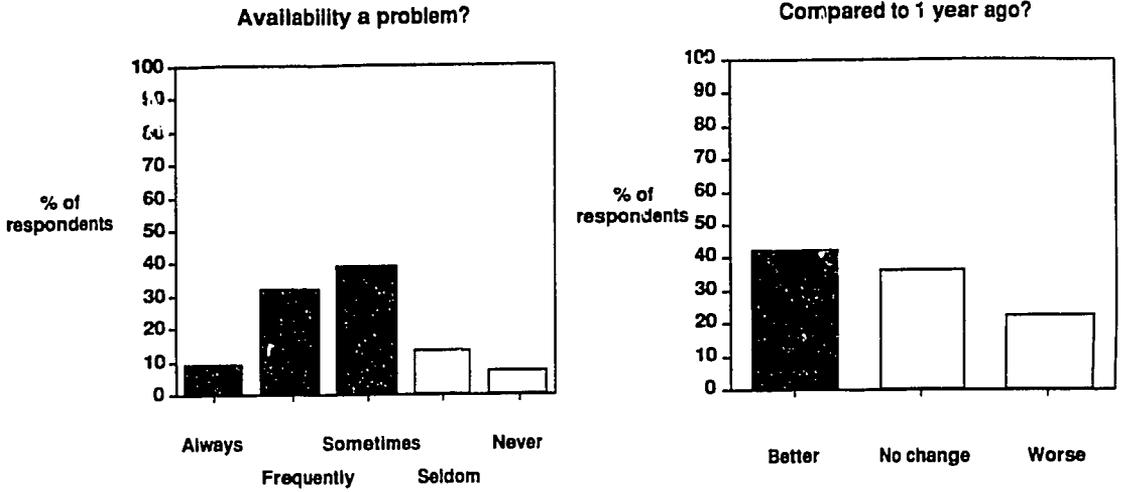
Losses in storage

Analysis of product flows shows that around 50% of vegetables produced do not reach the consumer (Figure 5). In many cases losses are even higher. Some produce is never harvested or is stolen, damaged or spoiled before it leaves the farm. A very small proportion is lost in transport or spoils as retail stocks. A small portion reaches consumers but is spoiled and inedible. The largest single component of loss occurs in

Figure 3

VEGETABLES ARE OFTEN UNAVAILABLE

- Some improvement on last year



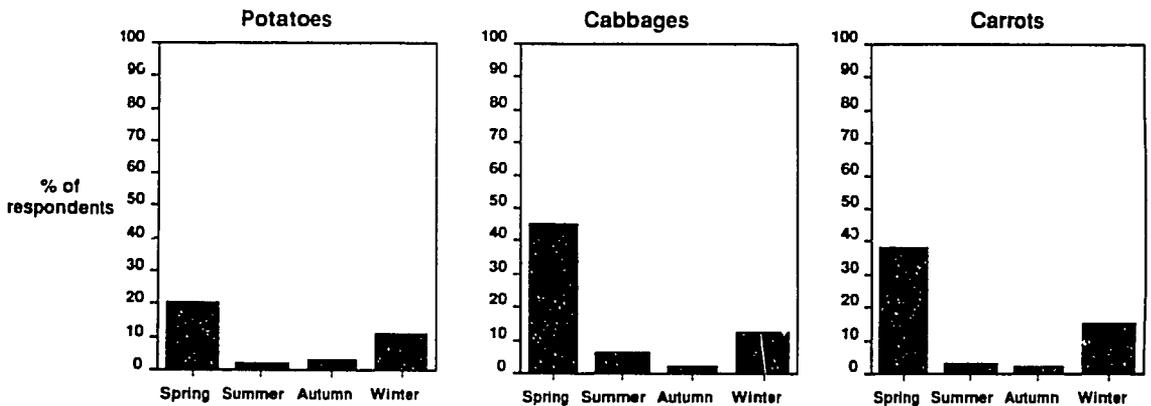
Source: BCG Consumer Interviews, Sample Size 135, Interviews in City Market, Sample Size 30

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Figure 4

IT IS ESPECIALLY DIFFICULT TO FIND CABBAGES AND CARROTS IN SPRING

In which seasons are the following vegetables unavailable?



Availability problems drive up prices in spring

Source: BCG Consumer Interviews, Sample Size 135

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long term storage on wholesale bases however. This component typically accounts for 20% of total production or 40% of total consumption for potatoes, carrots and cabbages.

Crisis in vegetable wholesaling

The wholesale system is observed to be in a state of crisis. Revenues and profits are falling as the channel share of wholesalers collapses due to farms bypassing wholesalers and selling direct to retailers. Debt levels have risen to unsustainable levels (4 times sustainable levels for 9 largest wholesalers in Perm) in many cases, leaving wholesalers unable to raise finance for harvest purchases, except through increasingly scarce subsidised federal credits dispersed by municipal authorities. BCG witnessed crisis meetings between banks, farms, wholesalers and the local authority at which banks refused to finance harvest purchases and threatened court action to recover outstanding debt, local authorities were unable to promise unconditional guarantees to banks or subsidise loans, farms were reluctant to supply wholesalers without payment and wholesalers were unable to finance purchases from internal cash flow. Privatisation had been stalled by the municipal authorities, who were worried about further deterioration in vegetable supply and there was a general impression of managerial and operational collapse in the majority of municipal wholesale enterprises.

CAUSES OF DISTRIBUTION FAILURE

Losses in storage: the single biggest problem

The problems of poor quality, poor availability, high prices, wholesaler bypass, financial deterioration and the reluctance of municipal authorities to privatise wholesalers are intimately linked to the problem of high losses in storage. Spoilage in storage leads to a deterioration in product quality and high losses reduce product availability and inflate prices, especially out of season. High prices prompt retailers and institutions to buy directly from farms which reduces wholesaler revenues, depresses profitability and deteriorates debt service. Municipal authorities are reluctant to relinquish control of the vegetable supply by allowing privatisation given the intensity and complexity of these problems.

Current wholesaling paradigm

One root cause of supply failure is the overall business paradigm of Russian vegetable wholesaling. Russian vegetable wholesalers can be characterised as passive long term storers. By storing local products for long periods (up to 9 months) of time, losses are inevitable even with optimal storage conditions, facilities and handling procedures. A lack of interregional trade also reduces the variety of products available to consumers. By storing products remotely from farms, handling damage is exacerbated prior to storage, which increases losses during storage, thereby inflating costs and prices.

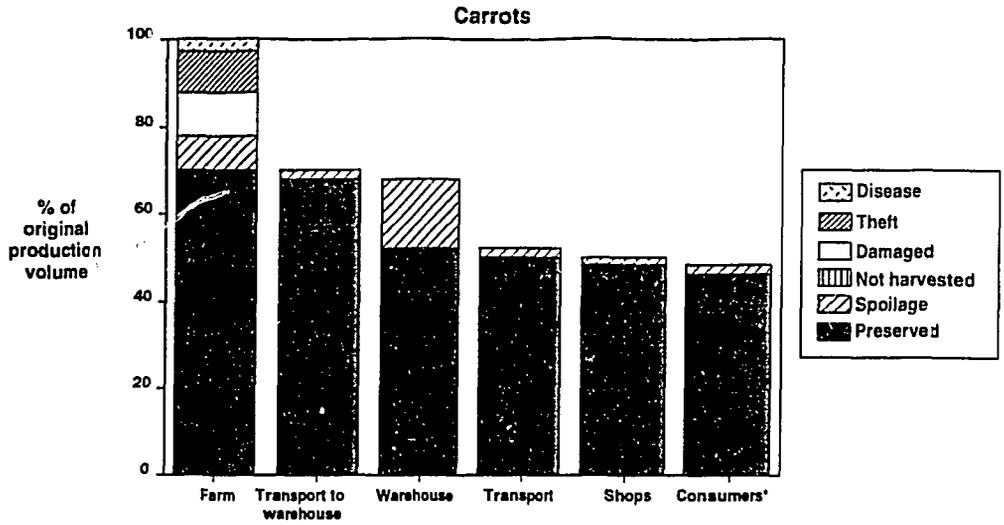
Operational effectiveness of wholesalers

Perm vegetable wholesalers exhibit operational weaknesses which contribute to distribution failure in all main areas of activity: purchasing, handling, storage, post-storage operations, sales and marketing. There are also a number of important weaknesses in financial management, organisational structure and personnel management. Each of these areas is explored in greater detail below.

Figure 5

CARROTS SHOW THE HIGHEST LOSSES

- Delicate product requiring refrigeration



* Percentage discarded as unusable before consumption
Source: BCG Interviews

The Boston Consulting Group

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Purchasing

Purchasing is predominantly from a small number of local state and cooperative farms with which wholesale bases have historical relationships. Although wholesalers have been free to choose their own suppliers for 2 years, they show considerable inertia in exercising this freedom. This minimises competition in supply and reduces incentives for farms to lower costs and improve quality and delivery performance. The limited number of suppliers also reduces the variety of produce available. Reliance on local suppliers creates the need to store products for long periods after the local growing season, which increases losses and reduces quality.

Purchases are concentrated during a short period during the local harvest season. Handling large volumes of product in a short period of time increases mechanical damage and prevents effective inbound inspection and sorting, which in turn increase losses and reduce quality.

Quality is largely determined by the supplier. Contracts are insufficiently precise on quality standards, inspection, dispute resolution, product acceptance procedures and the link between price and quality. The failure of wholesalers to control input quality is an important cause of low quality and high losses in storage. Diseased or mechanically damaged vegetables cause high loss rates.

There is a tendency for the availability of produce from regular suppliers to drive purchasing behaviour and for purchasing to drive sales. This supply-driven behaviour results in the purchase of inappropriate quantities and products, which causes physical and financial loss and inability to accurately match consumer demand.

Pre-storage operations

Field and delivery acceptance testing is minimal, which reduces the incentive for suppliers to improve quality. Upon receipt, products are not sampled to determine the proportion of non-standard or reject produce to determine conformance with contract specifications.

Products are generally not sorted prior to storage to identify rejects or quick sale items, which results in damaged and diseased product being placed into storage, thereby accelerating product deterioration and loss.

Mechanical handling procedures are frequently poor, with drop heights exceeding safe limits and causing mechanical damage. In some cases poor handling and sorting are due to lack of suitable chutes and conveyors. In many cases it is due to neglect of available machinery and management of the product receiving process. BCG came across many cases where expensive machinery had simply been cast aside and allowed to rust and deteriorate.

Handling problems are exacerbated by a failure to schedule and spread product receipts to match receiving capacity, such that the emphasis is on speed rather than quality assurance.

Storage

It is widely assumed that there is an insufficient quantity of specialised refrigerated and ventilated warehousing available and consequently that a major capital investment programme is required to address the problems of vegetable distribution.

The current regime of storing locally produced products for long periods creates excessive demand for specialised warehousing. This demand is also highly seasonal, causing annual average capacity utilisation rates to be as low as 30-40%. A paradigm

shift to lower levels of storage and more interregional trade in fresh produce would place greater demands on long distance transport and trade mechanisms but would require less warehousing and result in more efficient utilisation of specialised warehousing.

A more immediate problem than the total quantity of available warehousing is the utilisation and management of existing capacity. Poor maintenance of ventilation and cooling equipment limits effective capacity and leads to the storage of products under suboptimal temperature and humidity conditions, which causes degradation and losses.

Failure to find alternative uses for excess warehousing space, including renting to other operators, lowers utilisation, raises costs and creates an artificial shortage of warehousing space. Reasons for not renting out excess space include the fear that renting out may demonstrate a lack of need for particular premises and tempt a privatisation commission not to include these in the entity of privatisation. The need for permission to rent out from the local GKI and the need to give up a proportion of rental income are additional disincentives. Fundamentally however, the managers of unprivatised enterprises have no incentive or motivation to maximise storage efficiency and profits by renting out.

The allocation of products between warehouses is frequently suboptimal. One pattern is for each group of warehouses within an enterprise to carry a complete range of products, leading to the storage of all products under suboptimal conditions. In many cases products which require refrigeration can be found in unspecialised warehouses whilst furniture, dry goods, alcohol and other products are stored in refrigerated warehouses. This can be attributed to poorly communicated operating procedures, poor training, poorly defined responsibilities, inappropriate organisational structure, lack of performance incentives and management indifference.

A "curing" period prior to storage is known to reduce perishability in storage. In most cases effective curing periods are not employed however. Neither are rotten products routinely removed from storage, resulting in amplification of losses.

Post-storage handling

Products are inadequately sorted before sale. Only 2 grades, "standard" and "non-standard" are recognised and products are often not sorted at all. This results in missed opportunities to segment products according to customer needs and foregone revenue.

Operations such as grading, washing and packing are rarely encountered in Russian vegetable wholesalers. This also represents a foregone opportunity to generate added value and higher margins. This is in spite of the fact that ownership of washing and grading equipment appears to be reasonably widespread.

Sales and marketing

The selling and marketing activities of vegetable wholesalers show a number of important weaknesses.

Sales is generally subsidiary in importance to purchasing, resulting in lack of responsiveness to customer needs and foregone revenue and margin opportunities. There is insufficient coordination between sales, warehousing and purchasing and no regular exchange of information on sales opportunities, products in stock, quick sale items and purchasing opportunities.

Wholesalers generally have no organised sales force. Sales are usually the responsibility of warehouse managers and are limited to passive order taking from

regular customers, predominantly retailers or social institutions which were formerly part of the same enterprise. Face to face contact with clients is very limited and most orders are taken by telephone. Permplodovoshprom for example had not visited any stores at all since being broken up. This results in forgone sales opportunities.

Limited efforts are made to recruit new customers. Those responsible for selling lack suitable training and are not incentivised to improve performance by recruiting new customers or improving sales volumes or margins.

Former *torg* personnel still feel that retailers are subordinates rather than clients. This is a major barrier for sales development.

Use of advertising and promotion is very limited. A few wholesalers have used expensive television advertising without regard to effectiveness or cost. Customers are provided with virtually no information on services or products offered by wholesalers.

Knowledge of competitor activities, client needs, demand or price trends and other market parameters is very limited and there is no systematic attempt to acquire such information.

There is virtually no attempt to segment and prioritise different types of customers according to attractiveness (size, growth, stability, payment, margin) and fit with competitive advantage (customer needs vs company facilities, skills, experience or capabilities). Retailers, social institutions, restaurants and other wholesalers are all offered the same products, quality mix, delivery service and prices. A uniform quality mix is neither of sufficiently high quality to satisfy restaurants and cafes nor sufficiently price competitive to satisfy low end customers. This results in wholesalers foregoing profit opportunities and failing to accurately meet customer needs.

Deliveries are largely unplanned, with no clear policy for consolidating or prioritising orders or setting appropriate service standards. This results in high transport costs, failure to meet customer needs and foregone profit opportunities.

Pricing policy is extremely primitive and is generally based on a cost plus concept which makes no allowance for competitor pricing, quality mix, delivery service, the financial and spoilage costs of long term storage, order size or the price sensitivity of different market segments. This results in lost market share, unprofitable transactions and foregone differentiation and margin opportunities.

The introduction of new products and services is minimal and haphazard. There is only limited effort to improve warehouse utilisation above current low levels by renting out excess space. For example, in spite of growing demand for exotic fruits, few wholesalers have made serious efforts to expand their product range beyond traditional basic vegetables and fruits.

Financial management

Many vegetable wholesalers are carrying excessive levels of debt, which compromise their ability to fund harvest season product purchases. Cashflow from operations is insufficient to cover interest payments, causing debt to accumulate due to capitalisation of interest and the imposition of penalty charges. In many cases banks have refused further loans, demanded repayment of outstanding loans and threatened legal proceedings. Wholesalers in financial crisis require urgent rescue measures, as described below.

Many wholesalers are currently dependent on increasingly scarce subsidised rate credits from municipal authorities. Such credits should be unnecessary if operational efficiency

is improved. They undermine competition from new entrants and create a disincentive to enforce strict financial management.

Wholesalers make little attempt to forecast cashflows and loans are taken out against separate purchases. Frequently larger loans are taken than are strictly necessary. Another consequence of failure to construct financial plans is that wholesalers have no basis for soliciting new financing.

For example, one wholesaler took out a loan without any purchasing plan. Only 60% of the money could be used within one week. In desperation the company advanced the rest to an unknown supplier who did not deliver. The goods purchased with the loan had low margins and turnover (long storage period) and were clearly unprofitable after financing costs.

Wholesalers generally use only one bank, which undermines their bargaining position and reduces flexibility. A survey of local banks performed by BCG in conjunction with Permprodovoshprom revealed that they varied widely in their attitudes and conditions of lending.

Central bank regulations (nos 23 and 28) prohibiting companies from opening more than one cheque account and requiring the mandatory depositing of cash greatly reduce flexibility for payments and borrowing and limit competition in banking.

Wholesalers use no mechanism for evaluating the attractiveness of investments, which results in a suboptimal allocation of resources. Investments in the maintenance and repair of refrigeration or ventilation equipment, which have payback periods of less than one year, are neglected, resulting in suboptimal storage conditions and spoilage.

Organisation and personnel

Wholesalers exhibit some weaknesses of organisational structure, roles and responsibilities, incentives and communications.

The primary structural weakness is the absence of a proper sales department and the joint responsibility of warehouse managers for both sales and storage.

Roles and responsibilities are vague and most jobs have no performance measures or incentives associated with them. There is a lack of accountability at all levels of the organisation.

Communication between sales, warehouses and purchasing functions is poor, resulting in the purchase of products in excess of demand, failure to expedite sales of spoiling products and lack of information on product availability.

Motivation amongst workers and managers to implement optimal procedures and improve performance is generally extremely poor. This can be attributed to inertia to change ingrained habits and lack of performance incentives, underpinned by the opposition to privatisation by municipal authorities.

Competition

The existence of 13 vegetable wholesalers in Perm structurally provides a sufficient level of competition. Indeed the equivalent figure for many Western cities is generally much lower. The separation of retailers from wholesaler bases again provides a sufficiently competitive supply structure.

Behaviourally however, some degree of collusion was observed between large wholesalers, in part attributable to strong personal relationships between former *torg* colleagues. Large wholesale bases have traditional sales territories within the city and tend not to compete for each other's customers.

A limited number of visits to other cities revealed very different structures. For example, in Samara there are 5 vegetable wholesalers. The largest has 35,000 tonnes of warehouse capacity, accounting for over 50% of the city total. Furthermore it was privatised together with a chain of 31 retail stores. Such a structure does not ensure an adequate level of competition and according to city officials, there has been no improvement in vegetable supply since privatisation. One large wholesaling site had been divided into three companies resulting in acrimonious disputes concerning rights for common facilities.

The case of Samara underlines the importance of ensuring a competitive structure in vegetable wholesaling before privatisation. It also raises the difficult problem of how to correct an inappropriate structure after privatisation.

Privatisation

At the beginning of the project, no vegetable wholesalers in Perm had been privatised, the city administration opposed privatisation and the city council had issued an illegal decision¹ placing vegetable wholesalers on a list of unprivatisable companies.

There was a concern that vegetable supply, already acknowledged to be problematic, should not deteriorate further. City officials were also reluctant to relinquish control. Municipal authorities exercise considerable influence over vegetable distribution by owning wholesalers, controlling the allocation of subsidised credits and influencing decisions on vegetable purchases from farms. This intervention fostered a high level of passivity and a fatalistic attitude on the part of wholesale managers.

In other cities differing attitudes towards privatisation were encountered. In Samara for example, all wholesalers were either already privatised or in the process of being privatised, mostly via lease buy-outs.

Transport

The diagnostic survey revealed that transport is not the main bottleneck in vegetable supply.

In questionnaires administered to farms, wholesalers and retailers, transport was not identified by respondents as a major cause of distribution inefficiency.

Real transport prices have fallen and transport is not the main cost element for farms, wholesalers or retailers. The very low and falling level of truck utilisation has prompted transport and wholesale enterprises to sell off trucks, resulting in the spontaneous emergence of a private trucking sector, the introduction of competition and downward pressure on transportation prices. The transport of vegetables from farms to wholesalers is dominated by trucks owned by farms but common carriers and wholesalers also compete to provide this service.

Except perhaps at the very peak of the harvest season, transport capacity is significantly greater than demand.

¹Decision 56

Although the density of truck service facilities is limited compared to market economies, the ability to repair trucks is widely distributed and was not identified as a distribution bottleneck in questionnaire responses.

Although transport is not the bottleneck for vegetable supply, several significant problems were identified in the diagnostic phase.

Local authorities have been slow to subdivide and privatise common carriers, thereby losing an opportunity to improve incentives and competition.

Long distance transport capacity and infrastructure may become limiting if inter-regional trade in vegetables increases as envisaged. At present rail is the predominant mode for long distance transport. Barge transport is important in Perm but has limited significance overall. The development of inter-regional trade will require large fuel efficient, climate controlled trucks, wider availability of open service points, the improvement of the road network and effective packing and containerisation.

The availability of spare parts was identified by many questionnaire respondents as a factor limiting truck utilisation. Parts are difficult to obtain even for common models.

The ownership of delivery vehicles by vegetable retailers is very limited. This is a limiting factor for the formation of wholesale markets.

SOLUTIONS TO DISTRIBUTION FAILURE AND PERM PILOT PROJECT

Perm pilot project

BCG designed a pilot project to address the problems of vegetable distribution identified in Perm during the diagnostic phase. This involved working closely with city officials, the municipal property committee (MKI) and enterprise managers to develop a programme of privatisation and restructuring for vegetable wholesale enterprises.

Significant resource was devoted to the "demonstration" enterprise Permplodovoshprom in order to gain a deep insight into the operational and strategic problems of vegetable wholesalers, to develop and pilot solutions to these problems, to develop and test an approach to privatisation and to make early and visible progress in each of these areas to gain local credibility for the project.

Permplodovoshprom

Permplodovoshprom is one of the largest of the 13 vegetable wholesalers in Perm with 130 employees, a 1992 turnover of 300 million roubles and a warehouse capacity of approximately 5000 tonnes. It is a major supplier of fresh fruits and vegetables to Perm city. Products are purchased predominantly from farms within Perm oblast but also in much smaller amounts from other CIS republics. The director, Alfred Kasimov gave BCG his full support throughout the project.

Need for privatisation

Since a major cause of many of the operational and managerial weaknesses of vegetable wholesalers is the lack of managerial incentives and motivation under municipal ownership and control, rapid privatisation is an essential component of any solution. BCG's experience with vegetable wholesalers in Perm suggests that without autonomous, profit motivated management, restructuring measures will at best be only half-heartedly implemented.

The large variation in loss levels between wholesalers with broadly similar facilities indicates that radical improvement is possible without major capital investment. Some of the lowest loss levels were found in the leased enterprise, KOD, which was spontaneously employing many of the restructuring practices suggested below. Motivation and managerial autonomy were also clearly superior to municipally owned vegetable wholesalers.

Overcoming resistance of local authorities

Although the 1992 Federal Privatisation Programme states that wholesale enterprises are subject to mandatory privatisation and presidential decree 640 specifies that all trade enterprises should be privatised by August 1st 1993, city councils and administrations have generally been reluctant to relinquish ownership and control of municipally owned vegetable wholesalers. In Perm, the city council passed an illegal decision (no 56) excluding vegetable wholesale enterprises from their 1993 privatisation programme.

It is therefore essential to work with city administrations, technical committees and city councils to convince them of the lack of viability of the current system for vegetable distribution and the economic and social benefits of early privatisation and restructuring including:

- reduced wastage due to reduced losses in storage
- improved vegetable availability
- improved vegetable quality
- improved variety of vegetables
- enhanced tax revenue to local authorities through higher wholesaler profitability
- reduced dependence on subsidised credits and burden on city budget

The diagnostic phase not only enabled consultants to understand the problems of vegetable supply but also generated valuable data to construct arguments for privatisation and restructuring and the opportunity to form relationships with key city officials. The process of creating a consensus for privatisation and restructuring in Perm relied heavily on regular meetings of a steering committee attended by senior members of the city administration, enterprise managers, the GKI, technical committees and local entrepreneurs. Results and hypotheses were debated openly.

It is equally important to understand and respond with counter arguments to the specific objections raised against privatising vegetable wholesalers. The main objections raised by enterprises and local authorities during the course of the pilot project and counter arguments put by BCG are described below.

"Wholesalers will switch profile to more profitable products"

With current levels of spoilage in storage and inefficient operating practices, vegetable wholesalers are unprofitable with net margins of less than 5%. Improving margins by simply raising prices would be not only politically and socially unacceptable but would also accelerate the bypassing of wholesalers by direct channels. If the simple restructuring measures described below are implemented however, profitability will be substantially improved.

To guard against any short term danger that wholesalers will switch to more profitable products such as sugar and alcohol at the expense of vegetables, a simple profile condition on staple vegetables (carrots, potatoes, cabbages and beets) can be imposed, as allowed under privatisation law for certain privatisation routes.

"Wholesalers will stop storing vegetables and there will be shortages of vegetables after the harvest season"

The amount of vegetables sold in relation to demand is important, not the amount stored. Significant reductions in the total volume of vegetables stored are anticipated as the "storage" paradigm shifts to a "trade" paradigm and as losses in storage are reduced substantially due to the implementation of operational improvements.

The main factor impeding the storage of vegetables this year is lack of funds to purchase vegetables. Radical improvement in the financial position of wholesalers can be expected from privatisation and restructuring.

"Wholesalers will not be able to survive without subsidised loans"

BCG calculations show that after operational improvements have been implemented, profitability will improve sufficiently to eliminate the current dependence on subsidised loans from the municipality.

It will in any case be illegal for the city to discriminate against privatised enterprises in the allocation of subsidies and loans according to the Law on Enterprises of 1990 and Presidential decree 1483.

"Restructuring not privatisation is required"

Privatisation and operational restructuring are complementary. Restructuring is unlikely to succeed without the managerial autonomy and profit incentives created by privatisation. BCG experience shows that at best only half hearted implementation is possible without privatisation.

"Wholesalers may be purchased by non-specialists"

Ownership does not have to coincide with management. That is, professional managers can be employed by new owners, including existing management if they are judged to be competent.

The operating philosophy of current managers is in any case inadequate and substantial changes in procedures, practices and attitudes will be required in order to improve efficiency and reduce losses.

"Farms will not be able to sell their products to wholesalers"

Maintenance of profile will ensure continued purchases from farms.

The improved financial condition of wholesalers resulting from privatisation and restructuring will improve ability to finance purchases from farms.

Higher quality vegetables and lower prices resulting from reduced losses will stimulate demand, especially for the most effective farms.

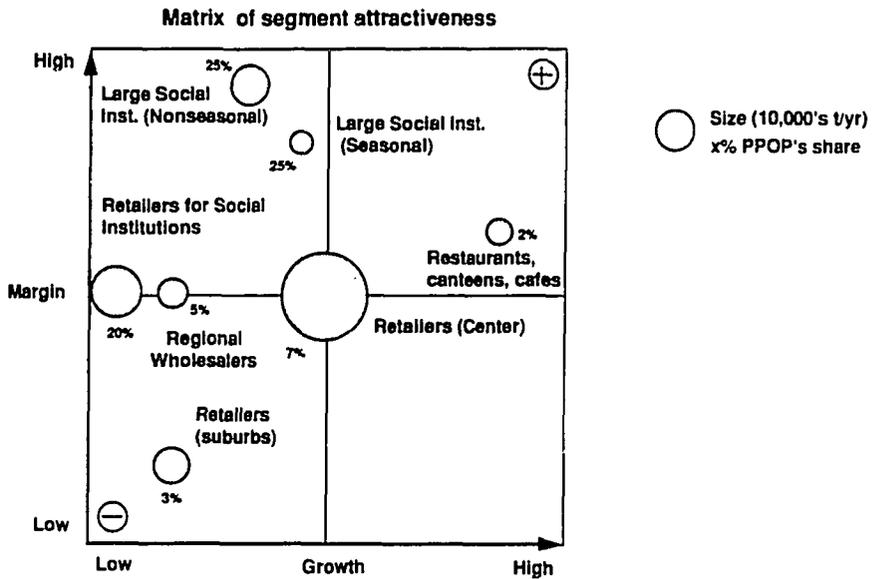
"Wholesalers will increase prices to consumers"

Vegetable prices are already uncontrolled and set by the market. In Perm there are 13 vegetable wholesalers, ensuring an adequate level of competition to prevent monopolistic pricing.

Implementation of restructuring measures will reduce losses in storage substantially, reducing the operating costs of wholesalers, which will result in lower prices for consumers.

Figure 6

SEGMENTS OF LARGE SOCIAL INSTITUTIONS, CENTRAL RETAILERS AND RESTAURANTS ARE MOST ATTRACTIVE
 • Best combination of size, growth and margins

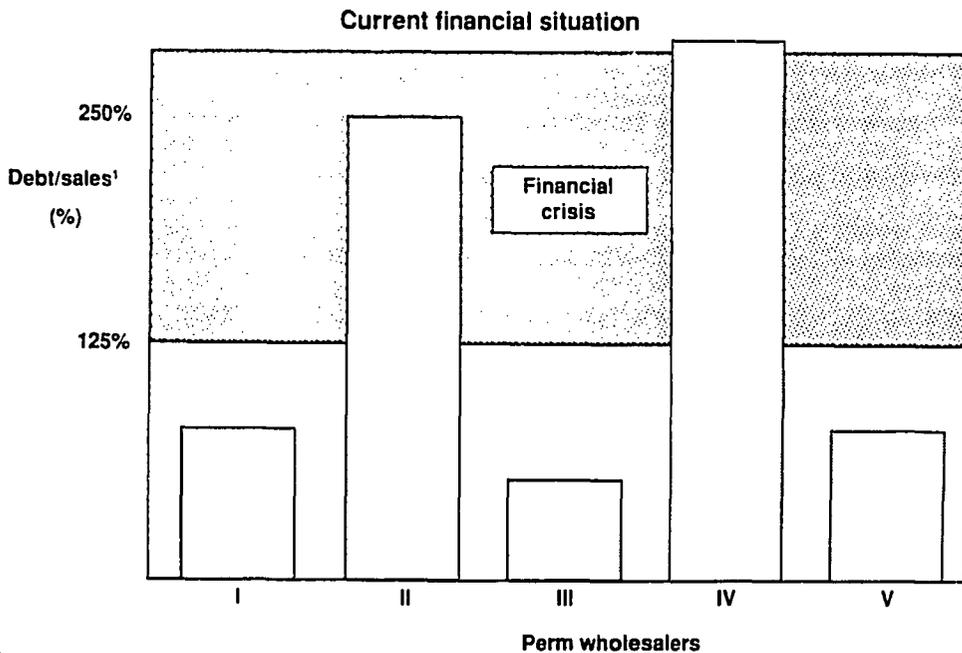


Source: BCG Analysis

The Boston Consulting Group

Figure 7

FINANCIAL CRISIS IS COMMON AMONG WHOLESALERS
 • 2 out of 5 largest wholesalers are in financial crisis



¹ Average expected sales over next 3 months
 Source: BCG Analysis

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High quality city market produce is currently too expensive for most consumers to afford. With improved quality management and the introduction of quality segmentation, wholesalers will be able to provide high quality vegetables at low prices.

"Privatised wholesalers will lay off workers"

Many vegetable wholesalers are currently financially unviable and unable to pay wages from operating cashflow. Without privatisation and restructuring further deterioration will occur, including the risk of enterprise collapse and unemployment. With privatisation and restructuring, certainly organisational structure, roles and responsibilities will need to change substantially, but enterprise survival and development will be guaranteed.

"Investment rather than privatisation is required"

Contrary to popular belief, extensive capital investment is generally not necessary to improve wholesaler performance. Better utilisation of existing facilities and equipment and the improvement of operating practices will yield immediate and substantial improvements in performance with minimal capital investment.

Officials frequently suggest that large scale investment in food processing is necessary to reduce losses and improve overall system efficiency. This is an unrealistic general solution in the short term however, given the magnitude of investments required.

In those cases where capital investment is required, privatisation and restructuring will improve ability to finance investment by increasing operational cashflow, reducing debt and increasing the willingness of investors and banks to provide funds.

"Wholesalers will stop supplying social institutions"

Social institutions such as hospitals and schools are currently subsidised directly and pay market prices for vegetables. The assumption that social institutions will be unattractive customers for vegetable wholesalers is false. They purchase high and stable volumes of staple vegetables and use long term purchasing contracts. At least in Perm, they currently buy vegetables at retail prices and therefore offer high margins to wholesalers. Based only on considerations of economic attractiveness, social institutions are a priority segment in the marketing plan developed for Permplodovoshprom (Figure 6)

"Wholesalers cannot be privatised until retailers have been privatised"

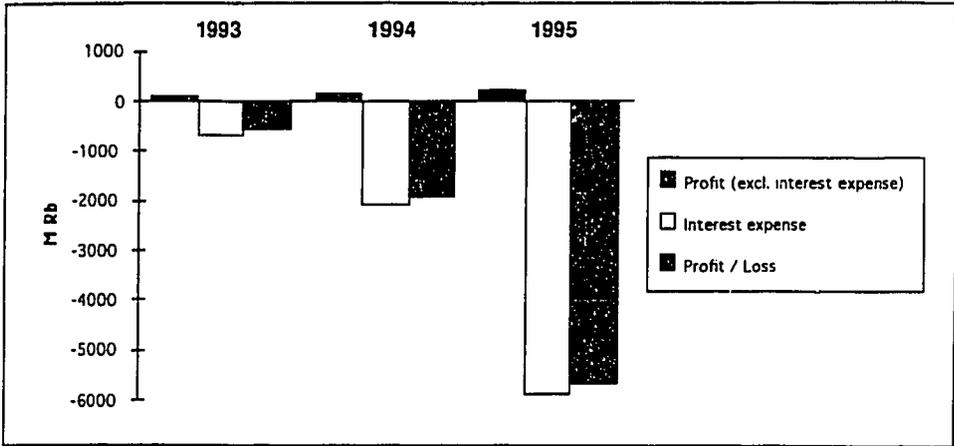
This objection misinterprets the GKI letter OK16/18, which states that a wholesaler cannot be privatised until 60% of its retailer customers are privatised *if* it comprises 50% of the total area of product warehousing and cannot be subdivided for technical reasons. In the case of Perm, the monopoly wholesale/retail enterprise Gorplodovoshtorg has been subdivided and no one wholesaler has 50% of total warehousing space. Further, more than 60% of retail stores have been privatised both overall and for the majority of individual enterprises. Hence, there is no valid reason for delaying privatisation.

Subdivision

In some cases vegetable wholesalers will require subdivision before privatisation to create economically optimal structures.

Figure 8

WITHOUT RESTRUCTURING, FINANCIAL POSITION OF KIROVSKAYA WILL DETERIORATE EVEN FURTHER REGARDLESS OF OWNERSHIP STATUS
 • Status Quo - 3 year projection



Restructuring is impossible without debt reduction

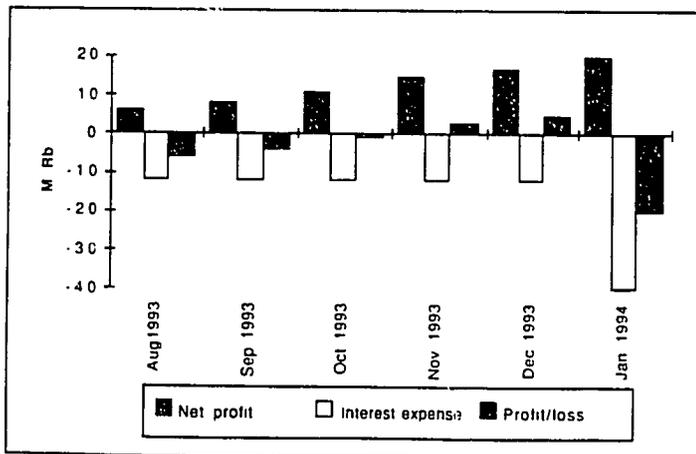
- debt drains all cash needed for operations

Assumptions: 280% annual interest (penalty rate), 120 M Rb of 1992 sales, 10% gross margin before tax and interest

The Boston Consulting Group

Figure 9

REDUCTION OF INTEREST RATE IS ONLY A TEMPORARY SOLUTION HOWEVER
 • It also generates additional negative effects



Negative effects

- Level of debt remains the same
- Other wholesalers will ask for the same loan terms
- Sets up a precedent for city administration to finance private enterprise
- Distorts competition
- Sponsor loses 140 M Rb

- Optimistic assumptions:
 - 5 months subsidised credit at 50%; then 170%
 - Very high sales projections (800 M Rb in 5 months)
 - 15% profit after all operational expenses

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Subdivision prior to privatisation was recommended by GKI letter OK16/18, which specified that, "Wholesaler trade enterprises consisting of several warehouse complexes separate from one another are subject to division". Apart from a few exceptional cases, this was carried out in Perm. In other cities or in individual cases, there may still be the need to execute subdivision of multiple warehousing sites in order to ensure a sufficiently competitive industry structure. For example, this type of subdivision was recommended in the case of the Perm wholesaler Sverdlovskaya.

Several other types of subdivision are also desirable. If the enterprise is composed of separable unrelated businesses, these should also be privatised separately. For example, some vegetable wholesalers in Perm included pig farms, construction businesses, cafes, school cafeterias and food processing facilities, located on separate sites. Except where these were insignificant in size, BCG recommended subdivision in such cases.

It is important to subdivide retail shops from warehouse bases. In Perm this was done in most cases. However at least in Samara, the largest wholesaler was privatised together with an extensive retail store network, which has led to a restriction of competition in the opinion of local authorities. Shops are constrained to buy only from their parent wholesale base. The enterprise is not subject to competitive pressures and is extremely inefficient. In spite of its structural monopoly and 0% interest subsidised loans it has high product losses and low profitability.

In several cases in Perm, local authorities tried to eject privatising enterprises from leased buildings. In commercial tenders, the owners of privatised enterprises have the legal right to conclude a lease of at least 15 years on similar terms, lease conditions can only be changed by agreement of both parties and new owners have the right to acquire such facilities after one year. BCG assisted Permplodovoshprom in retaining their office space on this basis.

Subdivision in the case of financial distress

An important case in which subdivision may be desirable is when important wholesalers are in acute financial distress.

Many Perm wholesalers have high debt levels in relation to operational cash flow. Two of the five largest wholesalers have debts so high (>200% monthly sales) that interest payments are not covered by operating cashflows and even rapid and complete implementation of radical operational restructuring measures will not be enough to avoid further debt accumulation and financial collapse (Figures 7 & 8).

Continued municipal ownership and support is not a solution for financially distressed vegetable wholesalers. Refinancing bank debt with low interest rate loans is at best only a temporary solution (Figure 9). Debt principal is not amortised, managerial and operational efficiency is unlikely to improve under municipal ownership and privatised wholesalers are likely to outperform and undermine the market position of such enterprises. Furthermore, the levels of subsidy required to address all enterprises in financial distress are likely to be beyond the capacity of municipal budgets (Figure 10).

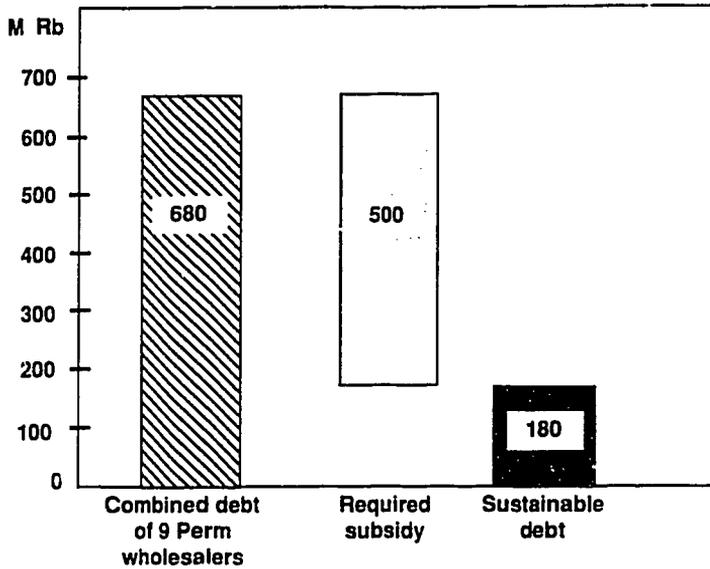
Substantial construction of new warehouse facilities by new entrants is not anticipated in the short term, given a general shortage of capital and the specific skills required for vegetable wholesaling. Neither are bankruptcy laws and procedures sufficiently effective to ensure that the assets of a failed enterprise would necessarily be rapidly restored to operation under a new owner. Further disruption of an already inefficient supply system would be politically unacceptable.

For enterprises judged to be critical to vegetable supply, it is therefore important that financial collapse is avoided. An enterprise might be judged as critical to supply if it

Figure 10

**REDUCTION OF DEBT TO SUSTAINABLE LEVEL¹ FOR ALL WHOLESALERS
REQUIRES AT LEAST 500 M RB SUBSIDY**

• Harvest purchase financing will require additional funds



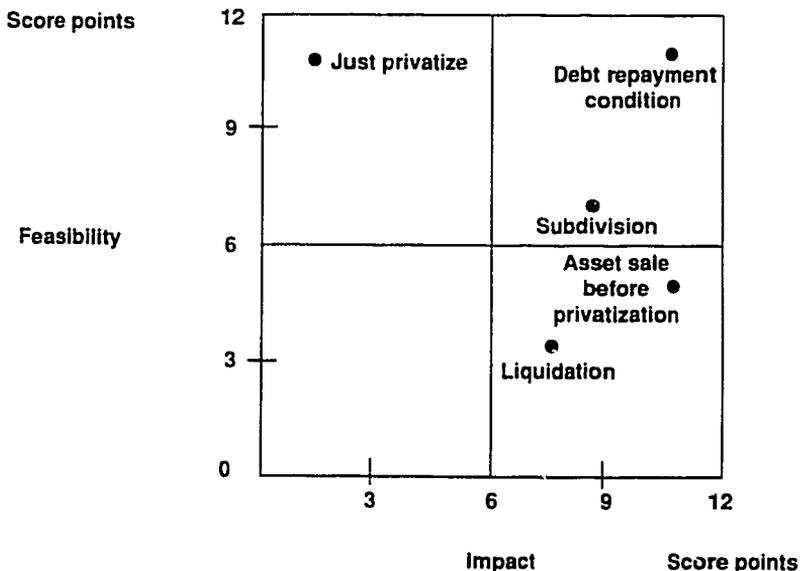
¹ 53% of monthly sales

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Figure 11

"DEBT REPAYMENT CONDITION" IS THE MOST ATTRACTIVE OPTION

• "Subdivision" and "asset sale before privatization" are second best options



Source: BCG Analysis

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accounted for a significant proportion (say 35% market share after the harvest season) of supply or specialised warehousing capacity, either for the city as a whole or an isolated part of the city (such as the Kirovsky region in Perm).

BCG investigated various financial rescue options including a debt repayment privatisation condition, pre-privatisation asset sale, subdivision, liquidation and simple privatisation. Solutions to the problem of financial distress should reduce debt to sustainable levels, have a low risk of failure or unintended consequences, preserve operational viability and integrity, be legally possible, simple to execute and replicate and not slow down the privatisation process.

Liquidation is clearly not an acceptable solution, since it does not preserve operation integrity and is a lengthy and complex procedure. It would be difficult to obtain political support for this option because of the short term unemployment consequences and the "destructive" connotations of liquidation.

Neither is simple privatisation an effective solution. It can be assumed debt is discounted in both the starting price for enterprises sold in auctions and commercial tenders and also in the eventual transaction price. However, employees are in a privileged position to purchase the enterprise because of a 30% price reduction and a 3 year payment period. A low nominal transaction price increases further the probability that existing managers will succeed in purchasing the enterprise. Managers will be keen to buy their own enterprises, even though they lack the financial resources to retire excessive debt. Furthermore, at least for Perm vegetable wholesalers, the enterprises in deepest financial distress were also clearly those with the weakest management; those least able to implement radical restructuring measures rapidly and effectively. If financially distressed enterprises were auctioned, it is therefore likely that they would be purchased by employees and collapse shortly thereafter.

It was concluded that the best solution to financial distress for vital wholesalers was a commercial tender with an investment condition of immediate debt repayment (Figure 11). It is a simple procedure requiring no new legal measures which fulfils all of the solution criteria listed above. It would effectively exclude irrational bids from existing managers, lead to an immediate relief from debt burden and preserve operational integrity.

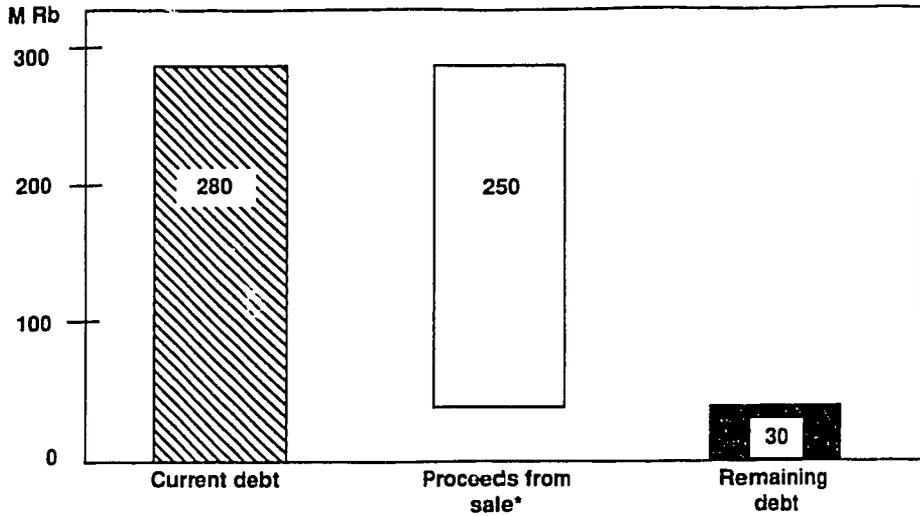
Asset disposal is a second possible solution to financial crisis. Analysis of Perm vegetable wholesalers suggests that capacity utilisation is very low, averaging only 40-50%. Furthermore, a brief real estate market survey indicated that warehousing space is in short supply and that even under conservative price assumptions, debt could be reduced to sustainable levels by selling only a small proportion of total capacity, thereby not restricting ability to supply vegetables. In the case of Kirovskaya only 10-15% of capacity (1 or 2 warehouses) is required to retire all debt (Figures 12 and 13). Operational integrity would therefore be preserved. Perm city officials accepted in principle that asset sale might be an alternative rescue method for heavily indebted enterprises.

Asset sale should be controlled so that it does not compromise vegetable wholesaling operations. Assets selected for sale should be sufficient to retire debt whilst preserving sufficient warehousing capacity of sufficient quality. Unless conditions are written into the contract of sale, it will be difficult to ensure orderly disposal after privatisation.

Asset disposal for financially distressed enterprises should also be promptly executed. The financial condition of some Perm wholesalers is so poor that they are unable to obtain credits to purchase vegetables during the forthcoming harvest season, which further undermines their viability. This is a further argument for asset sale solutions to be executed before privatisation. However pre-privatisation asset sale solutions need to

Figure 12

SALE OF A WAREHOUSE, HOWEVER, WILL SOLVE KIROVSKAYA'S DEBT PROBLEM EVEN UNDER CONSERVATIVE ASSUMPTIONS



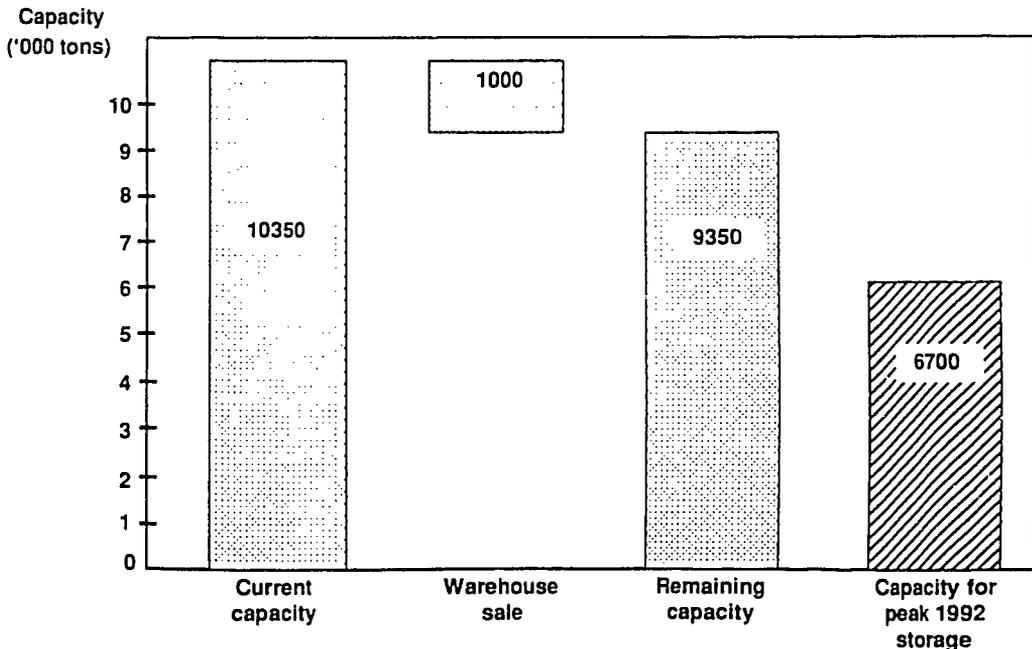
With the new debt level Kirovskaya has good chances of success

- debt can be amortised in 6 months
- possible to obtain further financing for purchases

* Conservative estimate of proceeds from sale of 1,850 m² refrigerated warehouse in average condition. Proceeds are net of all sales expenses and taxes
The Boston Consulting Group

Figure 13

CAPACITY AFTER WAREHOUSE SALE FAR EXCEEDS LEVEL NEEDED EVEN TO MAINTAIN CURRENT LEVEL OF ACTIVITY



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be simple enough to avoid slowing down privatisation and to be easily executable by municipal property committees.

Subdivision before privatisation is one possible asset disposal solution. MKIs would adopt a model privatisation plan which stated that all financially distressed vegetable wholesalers which were judged to be critical to city vegetable supply would be subject to subdivision. This would remove the enterprise's right of veto. The distressed enterprise would then be divided into a debt free and a debt bearing enterprise. The former would contain all of the employees, most of the warehouses and infrastructure and none of the debt. The latter would contain all of the debt, sufficient warehousing to repay debt and no employees. The debt free enterprise would be privatised without delay and the debt bearing enterprise would be liquidated and the debt retired.

Warehouses selected for disposal would fulfil certain criteria. To maximise attractiveness to buyers and minimise later legal disputes, warehouses would be physically self contained and ideally permit separate access. Warehouses selected would not compromise operational viability. Warehouses would be sufficient to cover debt repayment, calculated using recent transaction prices per m² for comparable warehousing, and allowing a 10% safety margin. If transaction prices were initially unavailable, residential property would be used as a basis for calculations, using an appropriate discount factor.

Simple asset sale before privatisation is also possible. MKIs are allowed to dispose of selected fixed assets of municipal enterprises, with the consent of enterprise management. Proceeds would be used to retire debt. To guard against the danger that enterprises might withhold their consent, oblast privatisation committees would have to pass a regulation stating that asset sale could be imposed on wholesalers in financial distress.

BCG therefore proposes the following solution (Figure 14). Firstly it is determined whether a vegetable wholesaler is in financial distress. This is the case if debt is more than 125% of monthly sales, if the ratio of profit before interest to interest is less than 1 or if the ratio of monthly sales to interest is less than 5. If the enterprise is determined to be in financial distress, its importance to municipal vegetable supply is determined. This is done by examining the relative size, specialisation and quality of facilities and the proportion of vegetable supply accounted for by the enterprise. If the enterprise has more than a 35% market or capacity share it is determined to be an important enterprise. If the enterprise is determined not to be critical, then it is auctioned with no conditions. If the enterprise is determined to be critical, then it is sold via commercial tender with an immediate debt repayment condition. Recommended second best solutions would be subdivision into debt bearing and debt free enterprises or pre-privatisation asset sale.

Privatisation route choice

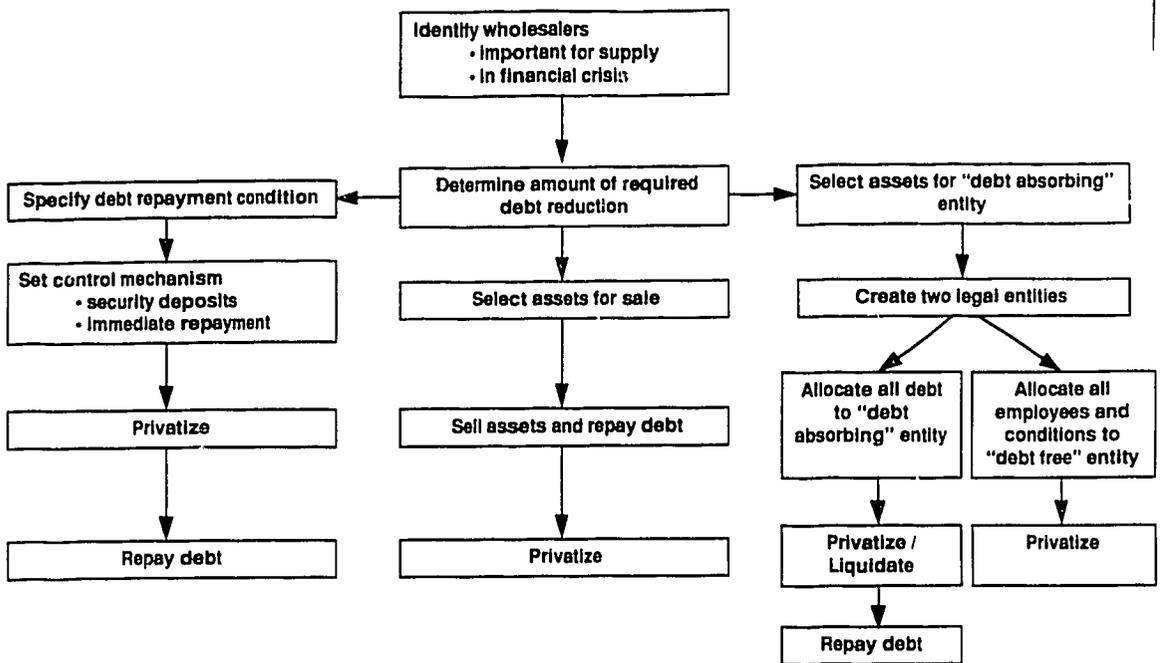
BCG explored the issue of optimal privatisation route with the Perm MKI in order to develop a general approach applicable to all vegetable wholesalers.

All vegetable wholesalers in Perm and other cities visited were either medium or small scale enterprises. For medium sized enterprises, which have the option of converting to a joint stock company, option 2 is considered to be undesirable. Even the most effective vegetable wholesalers inspected needed radical improvements in purchasing, product handling, storage, sales, marketing, financial management, organisational structure and general management. This will necessitate decisive management and is thought to be incompatible with 51% worker control.

Joint stock company option three is only available to enterprises with more than 200 employees, making most vegetable wholesalers inapplicable. It has also not proved

Figure 14

RECOMMENDED PROCESSES ALLOW FOR ORDERLY RESOLUTION OF FINANCIAL CRISIS



Source: BCCG Analysis

The Boston Consulting Group

Figure 15

THE OPTIMAL PRIVATIZATION ROUTE IS DEPENDENT UPON THE CHARACTERISTICS OF EACH WHOLESALE ENTERPRISE

• Commercial tender preferred in most cases

Situation	Optimal Priv. Route*	2nd order Priv. Route*	Undesirable Priv. Route	Conditions
Equipment in very poor condition, uneconomic to repair/invest.	A	-	All others	• Conditions illegal for auction
Investment needed and essential for enterprise survival	IT	CT	JSC 1, 2, 3	• Specify investment condition to address needs of enterprise • Minimal profile condition
Investment needed but not essential	CT	IT	JSC 1, 2, 3	• Possible investment cond. • Minimal profile condition
Minimal investment needed	CT	-	JSC 1, 2, 3	• Minimal profile condition
Management incompetence extreme	CT	IT	JSC 1, 2, 3	• Minimal profile condition
Possible problem with management competence	CT	IT	JSC 1, 2, 3	• Minimal profile condition
Collusion possible between local wholesalers	CT	All others*	-	• Minimal profile condition
Local government "conservative"	CT	All others	-	• Minimal profile condition • Minimal amount of others if their omission will halt privatization

Key	
A	- Auction
C1	- Commercial Tender
IT	- Investment Tender
JSC1	- Joint Stock Var.1
JSC2	- Joint Stock Var.2
JSC3	- Joint Stock Var.3

Need for speed, transparency and strong management dictate route choice

* Alternative routes possible means to make collusion difficult

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popular since management are only guaranteed to obtain 20% of stock and must put up 200 monthly salaries. Workers only get 20% of stock free (compared to 25% under option 1) and the workers collective gives up right of control to a smaller group. Joint stock company option 3 is therefore not considered to be a preferred route for vegetable wholesalers.

Local authorities are likely to strongly insist upon at least minimal product profile conditions for privatised vegetable wholesalers to guarantee minimal vegetable supply during a transitional period. An unconditional auction will therefore not be applicable in most cases.

Commercial tender is recommended as the preferred route for vegetable wholesaler privatisation in most cases. Most importantly, it delivers control to the successful bidder in one step and is more likely to yield the strong management required for radical restructuring than other routes. Unlike joint stock company options, it is available to both medium and small companies, thereby permitting simplicity of overall approach. It permits the imposition of a simple product profile condition, which is likely to be insisted upon by municipal authorities. Procedurally it is relatively fast and simple compared to joint stock options. It is transparent and without the subjective interpretation required by investment tenders.

Quantitative method for privatisation route choice

Anticipating national roll out, BCG developed an approach for selecting the optimal privatisation route for vegetable wholesalers which can be used flexibly at various levels of detail.

On the highest level, a simple recommendation that commercial tender is the optimal route can be given.

At a more detailed level, generic recommendations were developed for different situations (Figure 15). According to the level of investment needs, the degree of perceived management competence and the local political and competitive environment (risk of collusion), different first choice, second choice and undesirable routes are recommended. For example, if facilities are so poor that prohibitive investment is required, then the first choice is to auction the enterprise with no conditions so that warehouses can be used for alternative purposes. If on the other hand, existing management are judged to be extremely incompetent then commercial tender is the only preferred route. If the local political environment is extremely hostile to privatisation, then joint stock company option 2 may be preferable to no privatisation at all, and so on.

At a more detailed level still, lists of factors are given which should be considered qualitatively by privatisation commissions and the MKI in assessing the degree of investment required, the competence of existing managers and the local political and competitive environment.

At the most detailed level, a quantitative scoring system, linking various quantifiable parameters to recommended privatisation route is proposed (Figures 16 & 17). Investment needs are quantified by examining needs for refrigeration, ventilation, insulation and equipment. Management competence is assessed by examining losses in storage, the level of imports from other regions, warehouse utilisation and management reputation. The local environment is characterised by the degree of local government opposition to privatisation and the probability of collusion between wholesalers.

At which level of detail the framework should be used, depends upon the attitude of and resources available to municipal property committees. In the case of Perm, a high level of consulting support was available and a high degree of persuasion of local

Figure 16

A DETAILED SCORING SYSTEM CAN BE USED TO ANALYSE MORE PRECISELY THE THREE MAIN CHARACTERISTICS

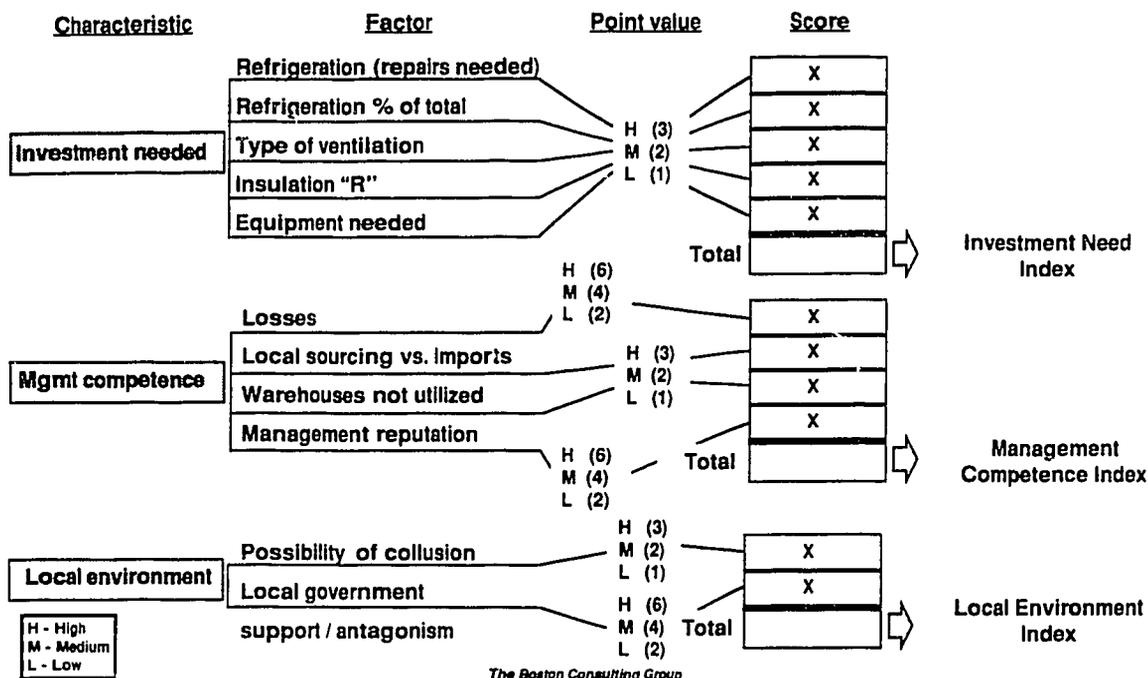


Figure 17

INDEX SCORES WILL INDICATE WHICH PRIVATIZATION ROUTE IS PREFERRED

Index level	Investment needed	Best*	Second*	Undesirable
> 16	Investment need so high, it is uneconomical	A	--	all others
13 - 16	Considerable need and essential for enterprise survival	IT	CT	JSC1, 2, 3
9 - 12	Investment needed but not essential, possible condition for sale	CT	IT	JSC1, 2, 3
0 - 8	Investment decisions not necessary to be made by privatisation commission, not a factor for decision making	CT	-	all others

Index level	Management competence	Best*	Second*	Undesirable
> 12	Management competence is critically low. High need for empowered, motivated leadership. JSC Option 2 threatens enterprises viability	CT	IT	JSC 1, 2, 3
9 - 12	Possible problem with management situation. JSC options are undesirable	CT	IT	JSC 1, 2, 3
0 - 8	Current management acceptable, CT preferred, but other options not excluded	CT	all others	-

Index level	Local environment	Best*	Second*	Undesirable
> 7	Political climate forces uneconomic decisions, but it is preferable to no privatization	CT	all others	-
3 - 7	Inconclusive: follow other dimensions as guide (investment, management)	CT	IT	JSC 1, 2, 3
0 - 3	Speed and flexibility are possible, transparency of process	CT	-	all others

* In cases of contradiction between 3 dimensions, the dimension which is graded with the highest point score should dictate the selected route

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authorities was required. A very quantitative approach was therefore appropriate. In most other cases a simpler framework will suffice.

Conditions

Product profile

The scope and duration of conditions which can be placed on privatised enterprises are legally ill defined and BCG observed a tendency for privatisation commissions and local authorities to apply arbitrary and excessive conditions. In privatisation commissions, conditions tend to be "negotiated", with conservative members suggesting strict conditions, opposed by progressives and neither side basing its position on a clear economic rationale. Enterprise directors either tend to oppose conditions to maximise flexibility or maximise conditions, with no regard for their impact, in order to reduce competition from other investors. In the case of Perm, given the poor state of the vegetable supply system and the understandable desire to avoid disruption and preserve security and stability of food supply, city officials initially sought for a wide range of complex privatisation conditions to be applied.

BCG examined the issue of conditions from the viewpoint of ensuring food supply whilst safeguarding the viability and flexibility of the privatised enterprise, avoiding unnecessary restriction of competition and striking a pragmatic political compromise which would allow privatisation to proceed rapidly.

It was concluded that a minimal product profile condition of limited duration was reasonable. Given the current low profitability of vegetable wholesalers, the general shortage of warehousing space, the availability of alternative products with higher margins and the difficulty in substantially raising vegetable prices due to political unacceptability and the danger of accelerating the bypassing of wholesalers by direct distribution channels, there is a significant short term risk that privatised vegetable wholesalers would change their profile substantially towards other products. However, in the medium term, after operational restructuring, the profitability and attractiveness of the vegetable wholesaling business should improve substantially and profile conditions will no longer be necessary.

Any profile condition should be on sales volume rather than sales value to be easily enforceable in a high inflation environment.

Profile conditions should not be expressed as a proportion of total turnover, since this restricts the development of other businesses which would not affect the ability of the enterprise to supply a stable volume of vegetables (Figure 18).

The profile condition should be on sales volume rather than amount stored. Significant reductions in the volume of stored product are anticipated as the proportion of interregional trade is increased, as storage is displaced from wholesalers to farms and as losses in storage are reduced due to operational improvements. A condition on storage would act as a disincentive to improve industry structure and operational efficiency.

The profile condition should be for a maximum of three years², the maximum allowed according to law. In many cases profile restrictions of 15 years or more have been imposed.

The profile restriction should be based only on sales for human consumption. Russian vegetable wholesalers have traditionally included disposal of rotten vegetables to farms

²According to presidential decree 640

Figure 18

MANY TYPES OF PRIVATIZATION CONDITIONS THAT HAVE BEEN SUGGESTED ARE ILLEGAL OR UNDERSIRABLE

Type	Condition	Legal?*	Why undesirable?
Profile	<ul style="list-style-type: none"> • 100% retention of current tonnes product range <ul style="list-style-type: none"> - 3 yrs - 5 yrs - 10 yrs • x% of historic volume to be sold in a specific season (eg. first half of year) • x% turnover in rubles to come from specific products <ul style="list-style-type: none"> - 3 yrs - 5 yrs - 10 yrs • x amount of product (veg/fruit) must be stored each year • Sales condition based on total sales (including to farms for fodder) 	<ul style="list-style-type: none"> • Yes • No** • No** • No* • Yes • No** • No** • No • Yes 	<ul style="list-style-type: none"> • Wholesalers are being bypassed in supply chain by farms • A profile condition that is too restrictive will not allow entrepreneurial activity • Sales should be based on demand, not planned supply • Restricts ability to enter new businesses • Sales are important, not what is stored in warehouse • Disincentive to reduce losses • Sales to humans important. Reduces incentive to cut losses and improve operations
Investment	<ul style="list-style-type: none"> • Specific investment obligation 	<ul style="list-style-type: none"> • Yes 	<ul style="list-style-type: none"> • Privatization commission not qualified to judge investment needs. Tendency to overestimate needs
Employment	<ul style="list-style-type: none"> • Hold employment at 100% for 1yr 	<ul style="list-style-type: none"> • Yes 	<ul style="list-style-type: none"> • New owner should decide his staffing needs, old staffing not economically rational
Activities	<ul style="list-style-type: none"> • Require sales to social institutions (not on B/S) • Require specific goods be provided to social institutions 	<ul style="list-style-type: none"> • No • No 	<ul style="list-style-type: none"> • All social institutions pay full price for goods, no need to dictate client list • Demand of goods should dictate supply levels and variety

* Perm GKI believes this conditions to be legal

** Illegal due to Decree 640 / 1108

*** Illegal based on Decree Interim Regulations on "Privatization of enterprises via Tender"

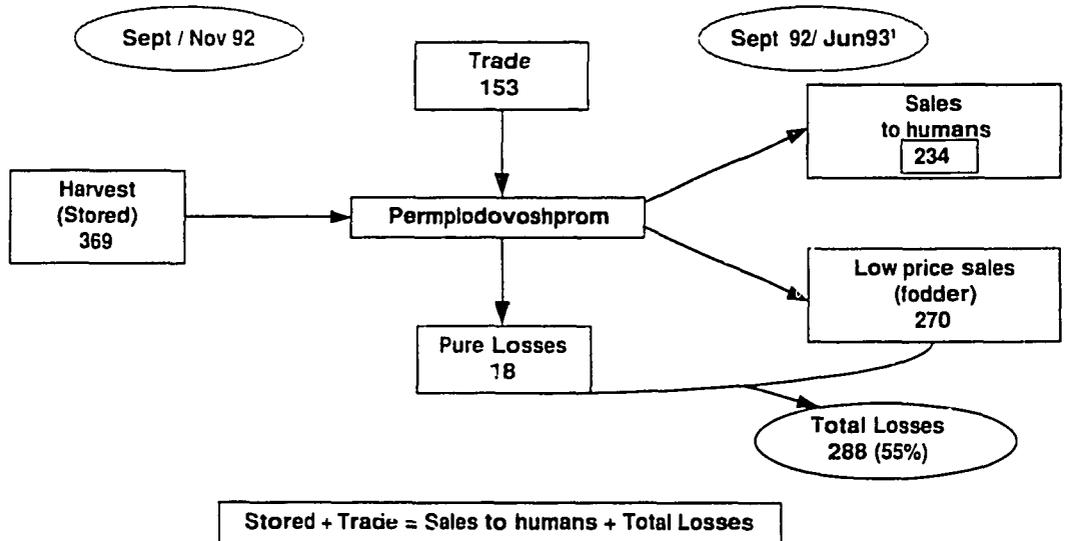
Legal source: According to White & Case

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Figure 19

PROFILE CONDITION SHOULD BE PLACED ON HUMAN SALES, NOT TOTAL SALES OF STORAGE

• Example of Perm vegetable wholesaler, carrots



369 + 153 = 234 + 288

* Some figures are estimated due to lack of data May / Jun 1993

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for animal fodder in sales figures (Figure 19). With operational improvements, the volume of such sales is expected to decrease. A condition on total sales would serve as a disincentive to reduce losses in storage.

Profile conditions should only apply to low margin staple vegetables such as beets, carrots, potatoes and cabbages rather than to all fruit and vegetable products.

The profile condition should contain an annual review clause to allow for downwards revision if the pattern of vegetable demand or supply changes.

The level of the condition should be at least 40% lower than recent historical sales to allow for fluctuations in supply and demand and to compensate for the recent tendency for wholesalers to be bypassed by farms distributing directly.

Enterprises in acute financial distress should be at least temporarily (1 year) exempted from conditions, since overtrading in the absence of purchasing finance could precipitate bankruptcy.

These concepts were incorporated into a draft instruction letter, which was separately delivered to the GKI.

Investment

Investment conditions should be resisted. Investment does not limit significant operational improvement in most cases. There is a general tendency to overestimate the importance of capital investment as a solution to the problems of vegetable supply. Imposing investment conditions could jeopardise the financial viability of wholesalers with high debt levels. Even in cases where investment is required, the privatisation commission is not technically qualified to determine the necessity, nature or financial implications of specific investments.

Employment

Employment conditions should also be resisted. Radical organisational restructuring will be required to ensure survival and new owners should not be restricted in setting the appropriate level and structure of employment. Contrary to expectations, it was not difficult to persuade people of this argument in Perm.

Social institutions

Conditions to enforce sales to social institutions are unnecessary and illegal. Social institutions already pay market prices for vegetables and are attractive customers by virtue of high margins, high and stable volumes, relatively prompt payment and long term purchasing contracts. The marketing plan of Permolodovshprom prioritises this segment.

To allay local authority concerns whilst at the same time reducing market risk for privatised vegetable wholesalers, social institutions could be encouraged to invite competitive tenders for vegetable supply.

Enforcement of conditions

One justification given by proponents of excessive privatisation conditions is that conditions are practically unenforceable, and the probability of compliance is increased by imposing excessive conditions. However the State Property Fund can enforce compliance and the Council of People's Deputies can appeal to have privatisation annulled if conditions are not met.

Process of expediting privatisation of vegetable wholesalers

BCG worked closely with wholesalers and the Perm MKI to plan and expedite the privatisation of vegetable wholesalers.

Initial site inspections were carried out with municipal GKI representatives. Two wholesalers were selected for in depth attention, Permplodovoshprom and Kirovskaya.

Issues of route choice, conditions and privatisation entity were debated with enterprise managers and GKI representatives and agreement was reached that commercial tender with limited product profile conditions was the optimal choice.

Assistance was given to Permplodovoshprom and Kirovskaya with document preparation and interactions with banks, the land committee, the GKI and the BTI.

BCG supported the privatisation commission for these two companies by providing route choice, privatisation conditions and entity recommendations and analysis and data to support recommendations. In both cases, the commission accepted BCG's recommendation for a commercial tender with a simple product profile condition.

A generic approach for privatising all vegetable wholesalers in Perm was developed in collaboration with the city MKI.

A seminar for all vegetable wholesalers in Perm and some general wholesalers was hosted by the MKI and BCG. The MKI presented arguments as to why enterprises should apply for privatisation and explained the process and options available. The director of Permplodovoshprom presented a summary of his restructuring and privatisation plans. There was an open question and answer session to BCG, the MKI and Permplodovoshprom, after which packs of application documents and instructions were handed out. The seminar led to the "recruitment" of 4 other vegetable wholesalers.

Further site visits were conducted with the MKI to collect the data necessary to determine the privatisation approach for each enterprise.

Applications were submitted for all remaining wholesalers, third party applications being submitted for four reluctant enterprises, and the privatisation process was expedited. This entailed assisting companies with filling in documentation, chasing stalled applications through district and city councils, debating the legality of "extra" conditions imposed by district councils, lobbying local officials for their support, negotiating valuation fees with the BTI and numerous other tasks. In addition to the narrow objective of expediting Perm privatisations, the aim was to gain in depth experience of the privatisation process as a basis for designing the next phase of national roll out.

Weaknesses in the current privatisation process

In depth involvement in the privatisation process gave some insights into weaknesses of current systems and procedures.

In spite of its apparent simplicity, privatisation documentation is very difficult for small and medium sized companies to complete. In Perm the process was accelerated simply by providing blank sets of forms and minimal instructions. The distribution of instruction materials to small enterprises in general is recommended.

Particular problems were experienced with obtaining asset valuations from the BTI. Fees quoted to enterprises were erratic and in some cases excessive. Valuations were

Figure 20

BCG AND THE PERM CITY GKI HAVE DEVELOPED A PRIVATIZATION PLAN FOR THE VEGETABLE WHOLESALING SECTOR

Firm	Subdivision recommend.	Privatization Application	Documentation		Comm meeting	Rec route	Workers vote	Region. council	Small council	Docs at GPF	Privatization
			In prepn	Finished							
PPOP	✓	✓	✓	✓	✓	CT	✓	✓	✓	✓	Aug 19
Kirovskaya Baza		✓	✓	✓	✓	CT	✓	✓	✓	✓	Sep 15
Kirovsky Comm. Center	✓	✓	✓	✓	✓	CT	✓				Sep 15
Sverdlovskaya	✓	✓	✓	✓	✓	CT/IT					Sep 15
Industrialnaya		✓	✓	✓	✓	CT	✓				Sep 15
Sodruzhestvo		✓	✓			CT					
Ordzhonikidze		✓				CT					
KOD*		✓	✓	✓		L1				✓	Sep 93?
Nagorny**		✓	✓	✓		N.A.					
Yunost	✓	✓				CT					
Obehepit	✓	✓	✓			CT					
GKP Baza		✓				CT					
Pakt		✓	✓	✓	✓	L1				✓	Jul 93
Mercury		✓	✓	✓	✓	-	✓	✓	✓	-	A/O Dec 1992

* Leased buyout, was stalled due to legal disputes but problems now appear to have been resolved

** Legal problems with sale of state property

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sometimes on a current basis rather than of January 1991, as required by law. Responsiveness was also very poor and the BTI was the privatisation bottleneck for many companies. It is proposed that a schedule of BTI prices be published and that the city administration monitored the responsiveness of the BTI closely. The Perm BTI needs to be provided with basic office equipment such as copiers and computers to increase their productivity and responsiveness. One solution to the problem of valuation slowing down privatisation would be to absorb the relevant unit of the BTI into the municipal GKI.

Great difficulty was experienced in obtaining basic accounting information from vegetable wholesalers. The break up of the wholesale/retail monopoly greatly increased the complexity of accounting tasks at each warehousing base. In the vast majority of cases, existing staff lack sufficient competence. Many "accountants" did not know how to complete a balance sheet properly. This highlights not only training and recruiting needs but also underlines the importance of providing instructional materials and assistance to small enterprises.

Privatisation was frequently observed to be stalled by some dispute between the enterprise and the GKI. Examples include cases in which assets had been illegally sold prior to privatisation or those in which documentary proof of right to lease was missing. In such situations, a time limit should be set before mandatory arbitration is initiated to resolve disputes.

Privatisation results in Perm

The current privatisation status of vegetable wholesalers in Perm is shown in Figure 20.

The demonstration enterprise Permplodovoshprom was sold in an open commercial tender on 19th August 1993. Management competed against two other bidders and succeeded in buying the enterprise for 26.1 million roubles, 3.5 times the opening price.

A lease buy out of the institutional vegetable wholesaler PAKT was completed.

A second Perm wholesaler, Kirovskaya, will be sold in a commercial tender on 16th September 1993 with a starting price of 12 million roubles. Kirovskaya is an enterprise in financial distress and consensus was reached with local authorities that limited asset disposal was required for survival. Less strict profile conditions than Permplodovoshprom were recommended by BCG and approved, in consideration of the acute financial position of the enterprise. The commercial tender for Kirovskaya should be aggressively advertised to encourage outside bidders.

BCG assisted the wholesaler KOD in legally establishing their right to lease buy out and privatisation is anticipated shortly. KOD is currently one of the most efficient wholesalers in Perm and KOD managers participated actively in the Steering Committee for the project.

The institutional vegetable wholesaler PAKT was privatised by lease buy out.

BCG assisted Kirovsky Trade Centre, Industrialnaya and Sverdlovskaya in completing and submitting all privatisation papers and the first privatisation commission for each enterprise took place on 23rd August 1993. A commercial tender with a limited product profile condition was recommended and accepted in each case. A simple product profile condition was imposed for Industrialnaya. Subdivision is recommended for Sverdlovskaya and Kirovsky Trade Centre, which have multiple warehouse sites and unrelated businesses. Depending on the magnitude of resistance from district councils

or legal problems encountered, these enterprises should be privatised within one month.

Privatisation applications have been submitted for five other vegetable wholesalers. In four cases these were submitted by third parties due to unwillingness on the part of directors.

ENTERPRISE RESTRUCTURING

Timing of restructuring

It could be argued that the restructuring measures described in this report should be performed after privatisation. Enterprise managers are reluctant to expend effort or resources before the identity of the new owner is known. Managerial motivation and commitment in unprivatised enterprises also significantly impedes implementation.

On the other hand, it is important to establish local credibility for such a project by obtaining early restructuring results in demonstration enterprises. Limited project resources and the urgency of restructuring measures also point to pre-privatisation restructuring.

BCG proposes that whilst the majority of restructuring will take place after privatisation, restructuring in demonstration enterprises should occur before privatisation and be conditional on a commitment from managers to privatise.

Development and implementation of restructuring plans with enterprise management

BCG worked closely with directors and departmental managers to develop restructuring plans for two vegetable wholesalers, Permplodovoshprom and Kirovskaya. This entailed analysing existing systems, facilities, procedures and capabilities, diagnosing key weaknesses, understanding root causes and developing, agreeing and implementing practical solutions.

Having established restructuring plans, BCG assisted the management of Permplodovoshprom in beginning the process of restructuring. This necessitated a significant communication and training effort involving workers and department managers.

Restructuring plans and early results were presented by the management of Permplodovoshprom to city officials and other members of the project steering committee. They were also presented in a seminar to which all Perm wholesalers were invited.

Purchasing

Wholesalers should negotiate with a larger number of suppliers, in order to increase competition and create an incentive for suppliers to reduce costs and improve quality and variety. Permplodovoshprom has already recruited and signed contracts with new private potato suppliers. Cost savings of at least 10% are anticipated.

A higher proportion of products should be purchased from outside the Perm city region in order to take advantage of different harvest seasons in different oblasts, thereby spreading deliveries over a longer period and reducing handling damage. Wider

purchasing will also increase the variety of products available and shorten the necessary storage period, thereby reducing spoilage in storage. Higher transport costs will be more than offset by lower spoilage costs.

Purchases and receipts could also be spread out by contracting with farmers to plant earlier or later than normal or to use cultivars with different growth characteristics.

Encouraging farms to store produce will also reduce damage by reducing the number of handling steps prior to long term storage. This will necessitate wholesalers developing their business to create value not by passively storing products but by guaranteeing quality, carrying a full range, offering delivery, washing and packing and other value added services.

New supply contracts are required, specifying quality standards and explicitly relating the acceptance of produce and the purchase price to the quality of delivered goods. Currently wholesalers have little recourse when low quality products are delivered. Such a contract was developed with Permplodovoshprom and Russian lawyers and has already been piloted with one supplier.

Given the financial straits of many wholesalers, non-cash contracts should be negotiated with farms for the forthcoming season. This could be achieved by deferring payment or alternatively by accepting products on a consignment basis.

Wholesalers should more actively inspect and qualify suppliers by observing disease levels and historic quality and delivery performance. Only the best performers should be selected as regular suppliers.

Pre-storage handling

Wholesalers should use acceptance testing procedures to assess the quality of goods delivered against contract specification. Product diverging in quantity, quality or delivery date should be rejected or penalties imposed.

Chutes or conveyors should be used to minimise handling damage and reduce subsequent losses in storage. In many cases such equipment is available but is poorly maintained or simply not used. In other cases modest investment may be required.

Diseased or damaged product should not be placed into storage. All products should be sorted prior to storage and reject or quick sale items identified and separated, thereby reducing early spoilage of healthy products.

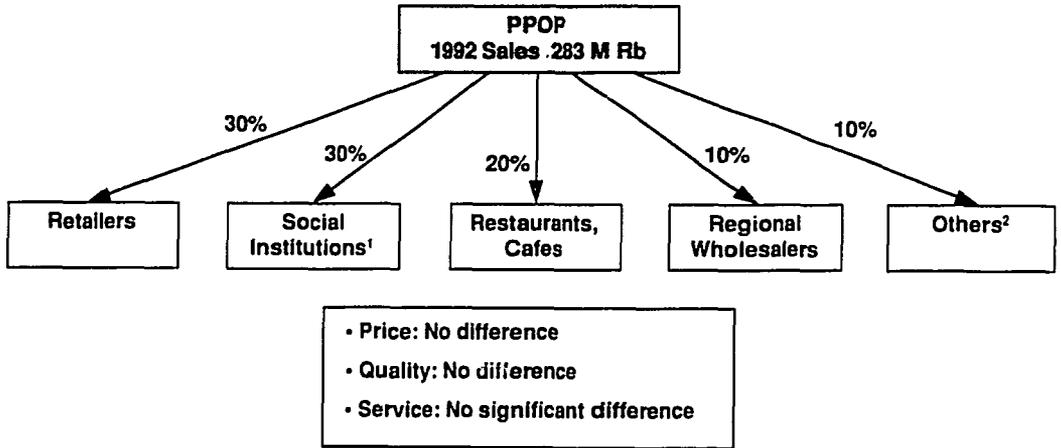
Storage

Products should be allocated between different warehouses according to optimal storage conditions. In Permplodovoshprom, the system of storing the full range of products in each group of warehouses was discontinued and products reallocated according to similarity of optimal storage conditions. Products requiring specific temperature and humidity conditions were moved to specialised facilities and incompatible combinations of products were avoided.

Wholesalers should ensure that storage conditions are monitored and that the correct conditions are maintained. In Permplodovoshprom, a table indicating optimal conditions for each type of product was constructed and displayed in each warehouse. Warehousing staff were assigned personal responsibility for maintaining conditions and given financial incentives to reduce losses.

Figure 21

**PPOP IS CURRENTLY SELLING
TO SEVERAL DIFFERENT GROUPS OF CUSTOMERS**
• Without differentiating them, however



¹ Through intermediaries

² include sales to farms (barter for vegetables) and truck sales to consumers

Source: BCG Interviews

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Wholesalers should maintain and repair refrigeration and ventilation equipment properly. BCG analysis showed that generally this would require minimal investment and that the payback period would be less than 1 year.

Wholesalers need to use a curing period, a short period at an elevated temperature at the beginning of storage, to reduce losses later in storage.

Spoiling products need to be removed from storage for rapid sale, to avoid amplification of losses. This could be achieved by daily inspection of the condition of products in storage.

The implementation of these simple measures will yield a significant reduction in losses in storage.

Post storage handling

Apart from reducing losses, one of the main mechanisms for improving profitability and customer service is to segment products according to quality. Products should be graded before delivery. The conventional division of produce into "standard" and "non-standard" is insufficiently discriminating and a new "market grade" needs to be introduced for high quality products.

Wholesalers can also add value by washing and packaging vegetables. Retailer interviews in Perm indicated a significant demand for such services. Ironically, washing and sorting equipment exists in many enterprises but it often lies unused. The main reason appears to be lack of personal incentives to improve performance.

Sales and marketing

Vegetable wholesalers need to make radical efforts to improve sales and marketing organisation, skills, systems and procedures.

Wholesalers need to establish sales departments and take away selling responsibility from warehouse managers. The sales department should be able to sell all products; in many Perm enterprises warehouse managers are only able to sell the products from their own warehouses.

Face to face sales calls and visits to recruit new customers should replace existing passive order taking by telephone.

Greater and more effective use needs to be made of advertising and promotion.

Wholesalers need to segment clients and products instead of providing all customers with the same products and service level at the same price (Figure 21). BCG analysed central retail, suburban retail, social institution, restaurant, regional wholesaler and other customer segments in order to construct segment specific marketing plans and establish segment priorities for Permplodovoshprom and Kirovskaya. This entailed analysing for each segment current volumes, quality, delivery and range requirements, margins, growth prospects, purchasing behaviour, intensity of competition and fit with individual wholesaler facilities, experience and capabilities.

In the case of Permplodovoshprom, BCG's recommendation was to focus on central retailers, restaurants and social institutions. Segment priorities were based on purely economic considerations, and contradict the commonly held belief that social institutions will be unattractive to privatised wholesalers. Indeed Permplodovoshprom

has already visited and signed contracts with new institutional customers, including a local prison.

Wholesalers need to improve current pricing methodology by introducing volume (order size) and loyalty (total volume per customer) discounts in order to stimulate sales and customer loyalty and minimise storage and transportation costs. Pricing should also reflect the credit period granted to clients. BCG developed new price lists incorporating these principles for Permplodovoshprom.

Wholesalers need to expand their product ranges beyond basic vegetables in order to maximise warehouse utilisation and profitability. This can easily be achieved without compromising ability to fulfil profile conditions for basic vegetables, given very low levels of warehouse utilisation, especially outside the harvest season. For example, municipal wholesalers have been slow to exploit demand for exotic fruits. BCG developed a framework for evaluating new product opportunities with Permplodovoshprom, taking into consideration mark up, transport costs, storage costs, perishability, handling costs, seasonality, volume and other factors.

Organisation

To counter the general lack of accountability and motivation observed at all levels within vegetable wholesalers, significant adjustments are required to remuneration systems, organisational structure, communications and responsibilities.

Dedicated sales and marketing departments need to be established, as described above.

Communication between departments needs to be improved by establishing a system of daily reports on sales, orders, stock available and products purchased or contracted. For example, sales representatives will be provided with weekly reports on products in stock. Rapid sale products will be identified on a daily basis. They will take and transmit orders to warehousing and be obliged to write sales call reports detailing customers' needs and comments, competitor activity and observed changes in prices or demand by product.

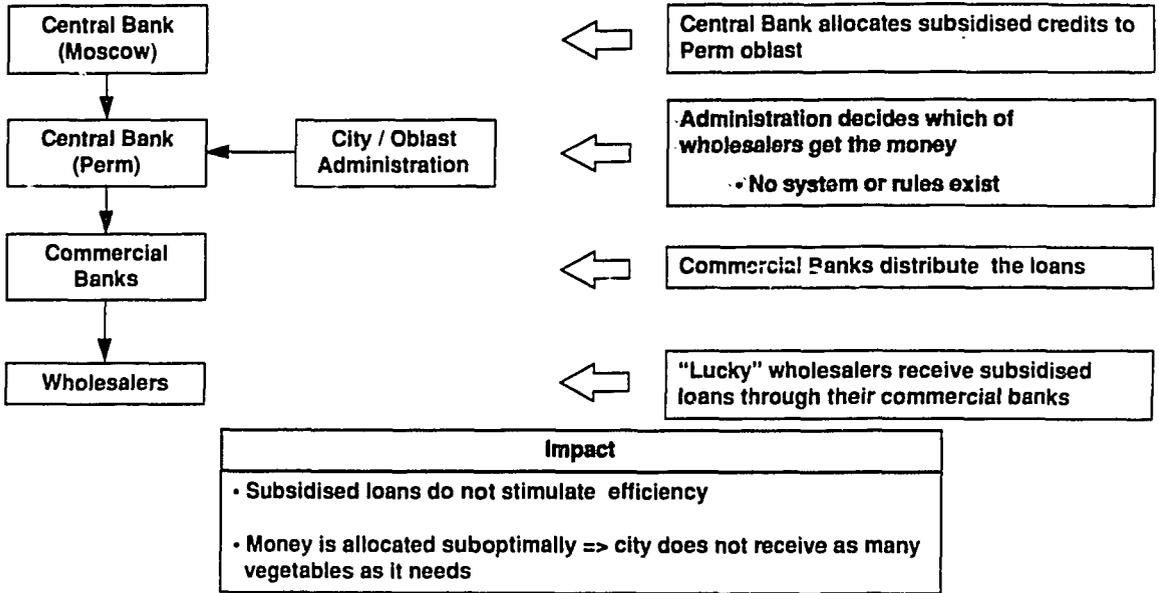
The purchasing department needs to be made explicitly responsible for supplier relations, price negotiation, quality assessment, recruiting new suppliers and coordinating with other departments. These activities can be measured and remunerated according to a set of performance measures including: numbers of visits and quality assessments, improvement in purchasing quality/price performance, number of weeks extension of product receiving window, improvement of losses in storage and timeliness of reports to warehousing and sales on planned receipts.

Warehouse managers and assistants should be made explicitly responsible for correct product allocation between warehouses, facility maintenance, maintaining proper storage conditions, coordination with sales and purchasing departments and managing order consolidation and shipment. These responsibilities can be measured and remunerated according to a set of performance measures including: improvement of losses in storage, adherence to optimal storage conditions, timeliness of stock reports to sales, adherence to delivery schedule, truck load utilisation and conformance to customer specification.

The sales department should be made explicitly responsible for customer relations, new customer recruitment, order taking, liaison with purchasing and warehousing, negotiating prices and collecting market intelligence on customer needs, demand and price movements and competitor activities. These activities can be measured and rewarded according to a set of performance measures including: exceeding sales targets, numbers of new customers recruited, sales margins, customer satisfaction from

Figure 22

ALLOCATION OF SUBSIDISED LOANS BETWEEN WHOLESALERS IS CURRENTLY AT FULL DISCRETION OF ADMINISTRATION
 • No systematic allocation criteria

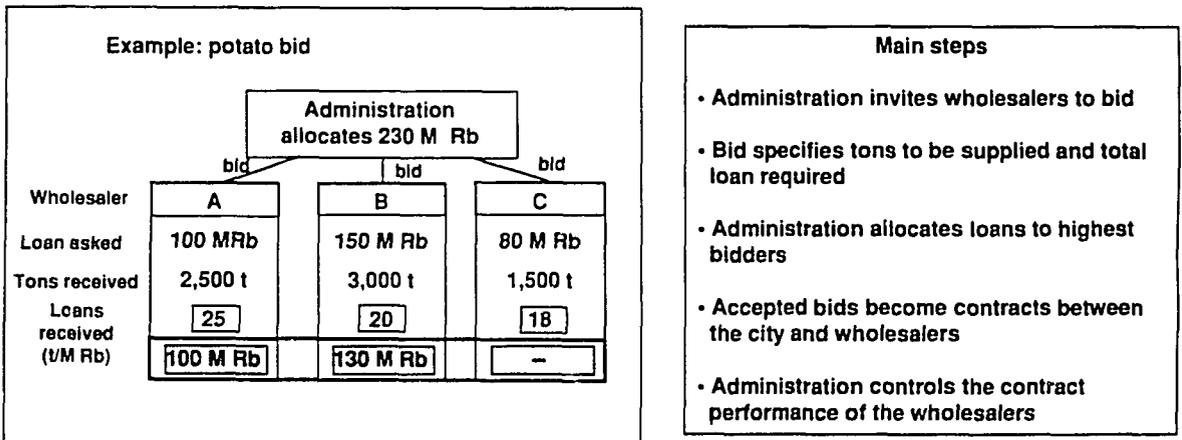


Source: BCG Interviews and Analysis

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Figure 23

A BIDDING SYSTEM LEADS TO FULFILMENT OF CITY NEEDS IN BASIC VEGETABLES AT THE LOWEST SUBSIDY COST



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telephone surveys, promptness of sales reports, number of sales calls made and client payment record.

Financial management

Vegetable wholesalers need to take a number of measures to improve financial management.

Debt levels should be reduced to sustainable levels by selling inventory, expediting receivables collection, improving financial planning and in extreme cases of financial distress, by selling assets. BCG worked with Permplodovoshprom and Kirovskaya to develop a simple approach for calculating sustainable debt levels from average margins, interest rates, sale revenues and a target interest cover ratio.

In cases where debt can be reduced to manageable levels rapidly enough for harvest purchases to be financed, wholesalers need to accept products from farms on consignment or negotiate deferred payment terms.

Cashflow planning should be introduced so that loans in excess of purchasing needs and at the wrong time are avoided.

Wholesalers should investigate alternative sources of finance. Reliance on one bank weakens the enterprises bargaining position and fails to optimise the terms of lending.

Central bank regulations prohibiting companies from opening more than one cheque account and requiring the mandatory depositing of cash should be repealed to provide more flexibility in payments and borrowing and to increase competition in banking.

Financial decisions including pricing, advertising, purchasing and capital investment need to be evaluated using simple techniques such as pay back period, break even analysis and discounted cash flow. This will result in better prioritising of projects and avoidance of loss generating actions.

In many cases, improvement of financial management will require recruiting new accountants. Base bookkeepers are struggling to cope as enterprise accountants and financial managers following the division of the vegetable wholesaling torgs.

Need for subsidised finance and allocation mechanisms

In the medium term, after operational restructuring, substantial improvements in financial performance are anticipated in vegetable wholesaling. The need for subsidised low interest loans from municipal authorities will be removed. In the medium term, subsidised loans may help alleviate the financing crisis for harvest purchases.

If local authorities continue to dispense subsidised loans, then improvements need to be made to current arbitrary allocation mechanisms (Figure 22). It is suggested that loans be allocated according to some relevant performance measure to ensure maximum impact. For example, wholesalers could be invited to submit bids to supply a specified quantity of basic vegetables for a specified amount of subsidised finance (Figure 23). Loans would be allocated according to the ratio of tonnes of vegetable offered per rouble of subsidised finance. A specific quality level would be specified and local authorities would be responsible for ensuring that genuine sales were made to retailers and institutions. Bids would be sealed to minimise collusion. The period during which sales would need to take place would begin in November to avoid harvest season dumping.

Figure 24

PRIVATIZATION AND RESTRUCTURING WILL ALLOW TO TURN PPOP AROUND AND RECIEVE AT LEAST 80 M OF PROFITS NEXT YEAR

Pro forma income statements for next 12 months¹

	Status Quo	Quick Operational Fixes ¹	Operational, Marketing, Financial Improvements
Sales	1,435.0	1,622	2,211.0
Purchasing costs	(1,070.0)	(1,185)	1,547.0
VAT	(80.3)	(96.1)	(146.1)
Operational Expenses	<u>(351.0)</u>	<u>(363.5)</u>	<u>(401.5)</u>
Profit (Loss) Before Tax	(66.5)	(22.6)	116.4
Profit Tax	<u>---</u>	<u>---</u>	<u>(37.2)</u>
Profit After Tax	(66.5)	(22.6)	79.2

¹ Under assumption of 15% per month general inflation, 20% per month rise in fuel and electricity prices. Interest rate of 250% per year. No subsidized credits. All estimates are based on conservative, least favourable assumptions of impact of the restructuring

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Financial impact of restructuring measures

The financial impact of proposed restructuring measures was estimated in detail for Permplodovoshprom.

It is estimated that implementing all recommended operational, marketing and financial measures would increase net profits from -67 million (-4.7% return on sales) to 79.2 million (+3.4% return on a 50% higher sales base) (Figure 24). These estimates used conservative assumptions and reflect the impact of only short term measures. Longer term improvement could be substantially greater.

Progress in implementing restructuring in Permplodovoshprom

BCG worked closely with the management of Permplodovoshprom to implement as many of the recommended restructuring measures as possible within the time frame of the project. At the time of writing the following measures had been executed:

- Announcement of restructuring campaign to workers
- Warehouse site cleaned up
- New job responsibilities defined
- New organisational structure agreed
- New supply contract developed and signed
- Introduction of an employee suggestion scheme
- New relationship established with Association of Private Farmers
- Contracts signed with new suppliers
- Advertising for new suppliers
- Spreading of harvest deliveries by agreement with existing suppliers
- Acceptance testing used for incoming produce
- Warehouses resegmented and specialised by product
- Curing period used prior to storage
- Refrigeration and ventilation equipment repaired
- Outbound sorting introduced
- New sales team formed and trained
- New customers recruited
- New incentive pay scheme agreed
- New system of volume and loyalty discounts implemented
- New system of quality based pricing agreed

PROJECT ROLL OUT

BCG has submitted a formal proposal to replicate the Perm vegetable wholesale pilot project in other cities and regions. Local consultants will be trained to provide privatisation and restructuring support to selected regions to minimise project costs. The approach will be sufficiently flexible to adapt to various local circumstances including proportion of wholesalers already privatised, the proportion of leased enterprises and the extent of tovg subdivision and restructuring.

Objectives

The objective of roll out will be to enhance the effectiveness of the vegetable supply system by accelerating the privatisation and restructuring of vegetable wholesalers in major cities throughout Russia, using the methodology developed during the Perm pilot project. This will require:

- selling the project to city authorities and MKIs
- advising MKIs on methodology for privatising wholesalers
- advising wholesalers on approach to privatisation and restructuring

- establishing "demonstration enterprises" in each oblast or region
- training local consultants to perform these tasks so that the project can be executed economically
- using written materials, mass media, seminars and other means to communicate the messages of the project effectively to MKIs, city councils, city administrations and wholesalers.

Approach

BCG will provide technical assistance in each of the following areas:

Establish project centre

A project centre will be established in Moscow, with the role of overall project management and coordination. This will be staffed by a full time project manager, four BCG consultants (including one technical specialist in vegetable storage) and an office coordinator. In addition to overall project coordination, the centre will be responsible for selecting and training local consultants, liaising with the GKI and USAID, producing written materials required by the project, answering queries from field staff and arranging a national seminar for MKI representatives.

Public relations approach

In consultation with a subcontracted public relations advisor, a public relations approach for the project will be developed. This will include:

- using local and national press and television
- using examples of successfully privatised and restructured wholesalers
- developing written materials for distribution to MKIs and wholesalers

Written materials aimed at MKIs will present advice on the optimal choice of privatisation entity, route and conditions for vegetable wholesalers and describe the example of Perm wholesaler privatisation. Materials will also deal with legal issues arising during the course of wholesaler privatisation including:

- The term and nature of product profile conditions, including stipulations on storage and the seasonality of sales
- Supply to social institutions
- Collusion between former Torg members during privatisation
- Local council decisions restricting the privatisation of wholesalers

Materials aimed at wholesalers will include the optimal approach to privatisation, a case study of successfully privatised and restructured wholesalers and generic restructuring recommendations including:

In purchasing:

- Purchasing contracts specifying quality standards
- Diversification of suppliers
- Increasing the proportion of inter-regional trade and decreasing the proportion of long term storage of local products
- Contracting before and after the harvest peak to minimise handling damage
- Acceptance testing of produce
- Field inspection and supplier qualification

In handling:

- Use of conveyers and chutes to minimise damage

- Sorting damaged produce for quick sale

In storage:

- Repairing refrigeration and ventilation equipment to achieve optimal storage conditions
- Reorganising warehouses to ensure optimal storage conditions by product
- Use of a curing period before storage
- Culling damaged product during storage

In organisation and personnel management:

- Assigning individual responsibilities for quality
- Training for warehouse staff
- Formation and training of a sales force
- Performance incentives

In sales and marketing:

- Recruiting new customers
- Segmenting the market and pricing according to quality and service
- Expanding product range beyond basic vegetables
- Volume and loyalty discounts
- Adding new services such as washing and packing

Host a conference for MKI representatives

A conference will be hosted in Moscow for MKI representatives, who will be the main driving force for the project locally. Consultants, Perm MKI representatives, directors of demonstration enterprises and GKI representatives will present:

- arguments for the early privatisation and restructuring of vegetable wholesalers
- the case study of Perm and Permplodovoshprom
- the proposed roll out process

Expressions of interest in replicating the Perm project in other cities will be sought.

Select and train local consultants

Approximately 8 local consultants will be recruited and trained by BCG. These will form the "field team" for implementing the roll out in various cities. Local consultant training will include:

- the technical and economic characteristics of vegetable wholesaling
- the problems of vegetable supply in Russia, as diagnosed in phase 1
- the aims and objectives of the national roll out
- the timetable and action plan for national roll out
- the specific responsibilities of local consultants
- the specific activities of local consultants including:
 - arranging and executing seminars for wholesalers
 - performing enterprise audits
 - working with local MKIs to expedite wholesaler privatisation
 - selling the project to local councils and technical committees
 - coaching demonstration enterprises in privatisation and restructuring

Sell project to individual cities

Individual oblast capital cities will be selected on the basis on interest expressed in the national seminar for MKIs, or via other routes. Consultants will visit candidate cities and attempt to sell the project to the MKI, city administration, city council and technical committee members in face to face meetings. Second and third cities within each oblast may be recruited if good progress is achieved in capital cities. The project is not applicable to rural areas where vegetable supply is directly from farms or own supply.

The aim will be to work in a minimum of 5 oblasts. The actual number will depend partially on the magnitude of any difficulties encountered. A phased approach will be adopted, starting with 2-3 oblasts.

Conduct local seminars for wholesalers and MKIs

Seminars will be arranged for vegetable wholesalers in each selected city, modelled on similar seminars in Perm. Arguments for privatisation and restructuring, generic restructuring recommendations and case studies of successful cities and enterprises will be presented. The necessary documentation for privatisation application and written materials on restructuring will be distributed.

Give restructuring assistance to demonstration enterprises

In oblast or regional capitals, deeper assistance will be given to demonstration enterprises. Consultants will coach enterprise managers in developing and implementing operational improvement plans. The results obtained in these enterprises will provide credibility for each local programme and materials for publicising the project. The aim will be to use the directors demonstration enterprises to help sell privatisation and restructuring to other wholesalers, following the example of the Perm project.

Work on demonstration enterprises will address the specific problem of inter-regional trade. Demonstration enterprises will be coached to make greater use of long distance trade in fresh produce.

Execute pro forma audits for other enterprises

A simple pro forma audit will be devised which can be administered by a local consultant spending 3-4 hours per enterprise. This will provide individual wholesalers with feedback on areas of their business where most attention is required. This will be based on experience in Perm, which suggested a great deal of commonality between the weaknesses and restructuring needs of wholesale enterprises.

Assist MKIs in expediting wholesaler privatisations

MKIs will be assisted in expediting wholesaler privatisations. This assistance will include:

- the production of document packs for privatisation applications
- helping remove local political blockages to privatisation
- advice on privatisation entities, routes and conditions in the form of a "decision tree" for different types of wholesalers
- helping resolve legal blockages or uncertainties including local council decisions and privatisation conditions

Recommendations concerning follow on projects

BCG will detailed provide recommendations on the optimal methodology for national roll out beyond the current contract.

Deliverables

The deliverables for a roll out project will consist of implemented privatisation and restructuring programmes in a minimum of 5 oblasts in addition to Perm. Specifically this will include:

- A national seminar for MKIs
- The production and distribution nationally of instruction and publicity materials for MKIs, wholesalers and local authorities
- A city privatisation plan for vegetable wholesalers in each selected region
- Seminars for wholesalers and MKIs in each selected region, explaining privatisation and restructuring approach for vegetable wholesalers
- Implemented privatisation and restructuring plans under BCG guidance for one demonstration enterprise in each selected region
- Operational and strategic audits for a minimum of 5 enterprises in each selected region
- A fully trained team of local consultants who are able to extend roll out to other regions at the conclusion of this contract