PN-ABZ-906

RED OCTOBER CASE A: THE CORPORATE FINANCE DECISION

In mid-October 1994, Vladimir Nikolov[1], Deputy Director General of Red October (RO), Russia's largest confectionery plant, reflected on the company's comparatively limited options for meeting its financing needs. RO required additional working capital in order to meet the demand for its products -- order books remained full well into the future. The company had also recently ordered a $4.5 million new production line from a European supplier. In addition, RO had plans to operate a new chocolate factory with a joint venture partner. Keeping these issues in mind, Mr. Nikolov realized that the company required new capital.

In the summer of 1994, RO authorized its third issuance of new shares. Two million of these new shares were distributed to shareholders as dividends, while 15,000 shares were bought by existing shareholders at the going price of the issue (10,000 Roubles/share). When the issuance closed in early October 1994, RO remained without capital needed to finance new investment and to maintain plant and equipment.

Background on the Company and its Markets

RO's Privatization and Existing Ownership

Founded in 1867, Red October and its brands were widely known to Russian consumers. After 75 years as a nationalized enterprise, the company registered as a joint stock company in November 1992[2]. The following year, through a combination of share purchases by suppliers and cash and voucher auctions[3], the company completed its privatization. The post-privatization ownership structure of the company consisted of 51% employee ownership, 20% supplier ownership, with the balance held by diverse shareholders who participated in the cash and voucher auctions.

This case was written by Kerry McKeon of *Price Waterhouse LLP* and is intended to serve as a basis for class discussion, rather than to illustrate either effective or ineffective handling of a particular situation. The author wishes to thank representatives of Red October, Grant Financial, Samuel Montagu,and Barents Group for sharing their views on the offering. This case study was undertaken in cooperation with the New Issues facility, a project funded by the

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[1]Names have been fictionalized for the purposes of case writing.

[2]Exhibit 1 illustrates a chronology of key events for Red October.

[3]According to GKI, Red October had the highest demand for shares during the voucher privatization.

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Company Results, Markets and Product Lines

According to a financial audit performed by Grant Audit, in 1993 and in 1994 (from January to July), RO's post-tax profit was 18.0 billion Rubles and 16.6 billion Rubles, respectively. These figures represented post-tax profit margins of 28% and 23%. Despite its profitability, RO often lacked cash necessary to meet working capital requirements and to finance new investment. In the autumn of 1994, for example, delays in accounts receivable and a large increase in short-term debt constrained cash availability. (Exhibits 2a and 2b).

In 1993, RO produced 59,179 tons of confectionery products, 60% of which were sold in the Moscow area, 28% were sold to regions in Russia, and 12% were exported (primarily to Afghanistan and Mongolia). Because of the backlog in demand, RO usually sold everything that it produced. The company's product mix consisted primarily of hard candies (36%) and caramels (37%). The remaining 27% of RO's product mix consisted of a variety of confectionery products, predominately chocolates, as well as toffee and cocoa powder. RO sold candies under more than 250 different brand names, including: Mishka and Truffles chocolates, Lobster Tail hard candy, and Lux chocolate bars.

Although toffee and cocoa powder sales dropped in years preceding 1994, chocolate sales increased since 1993, when the government lifted the excise tax on chocolate products. Foreign competitors also took advantage of the abolition of the tax by increasing their chocolate product exports to Russia. Mr. Nikolov aimed to counteract the competition by bolstering the production of Mishka-brand chocolates, RO's most popular chocolate brand and a favorite of Russian consumers.

Corporate Strategy

Mr. Nikolov and the Board believed that RO's future business strategy should focus upon maintaining the company's position as Russia's leading confectionery in terms of sales, volume, and quality. Safeguarding RO's image as a producer top-quality candies would be key to achieving this goal.

Because of the high-quality image of RO's candies, particularly its chocolates, Russian consumers paid premium prices. RO's distribution strategy was also driven by its premium reputation: most retail sales occurred in specialty stores, and chocolates were not readily accessible in street kiosks. Although Mr. Nikolov wished to maintain RO's image on a par with international candy manufacturers, he and the Board thought it important that RO should not compromise either the Russian character of its products (*i.e.*, Russia-specific brand names and assortments) or the company's Russian ownership and control. After all, RO functioned successfully for nearly 130 years -- they did not need to alter their Russian "flavor" because of the recent onslaught of foreign competition.

Although high duties on foreign chocolates helped protect RO from imports, Mr. Nikolov knew that several multi-national confectioneries intended to penetrate Russia's borders in order to gain direct access to Russian consumers. Both Mars, Inc. and Nestlé, for example, had future plans to make either greenfield or joint venture investments in Russia. As a result, he expected the Russian confectionery industry to undergo a period of consolidation, as powerful multinational firms merged with or acquired less efficient domestic ones. Mr. Nikolov concluded: "Waiting means death. It's either us or foreigners. I don't want Russians to forget the taste of Russian chocolate!"

A few months before the shareholders meeting in March 1994, Mr. Nikolov envisioned several important elements of the company's strategy:

1) A stronger presence needed to be developed in Russia's regions: RO should seek joint venture capital to complete construction of the Kolumna plant -- a production facility situated a considerable distance from Moscow -- for which RO hoped to find a joint venture partner.

2) In preparation for eventual industry consolidation, RO should create a financial holding group to take stakes in Russian confectioneries.

3) RO should enhance the production of one of its more popular brands -- Mishka chocolates -- by acquiring a new production line from Europe.

4) RO should diversify its confectionery products by starting a peanut roasting and packaging line. These would be used as ingredients and sold separately on the market.

5) Although domestic markets are more profitable, exports should be increased to ensure a steady supply of hard currency.

6) Production targets for all lines should be set to in order to improve plant efficiency and better meet demand.

Supporting the Strategy: The Need to Increase Charter Capital

RO's ambitious strategy presented the company with large financial requirements, as explained by Mr. Nikolov during the March shareholders meeting. The shareholders agreed that RO's charter capital would indeed need to be increased for the second time (Exhibit 1), but the question remained: "By how much?".

Shareholders knew that the company would need approximately $4.5 million to complete the financing of the new production line for Mishka-brand chocolates. Furthermore, millions of dollars would be needed to replenish working capital and to improve the 43 production lines. Finally, shareholders took into account investment requirements for RO's stake in the new plant in Kolumna.

By the end of the meeting, shareholders agreed to a 7.76 billion Rouble increase in charter capital (for a total charter capital of 10 billion Rubles) -- to be achieved by issuing 7.76 million shares with a nominal value of 1000 Roubles each. Shareholders also voted to pay out dividends consisting of 2.24 million shares.

With the assistance of Grant Financial, RO's financial advisor, RO sold only 15,000 of the remaining 5.2 million shares (7.76 million - 2.24 million in dividends) from the period from May to July 1995. Given the possibility of finding a more effective means of obtaining the capital increase, management cancelled the issue and began to examine other options.

Several factors counted against the success of the summer offering:

- no advertising
- traditionally low sales in summer months
- strong rivals promising high returns (MMM, etc.)

Options for Raising the Capital

In October, RO's cash shortage worsened, and Mr. Nikolov and his staff began to review other possibilities for raising the needed capital. RO had eliminated the option of acquiring debt long before. Both foreign commercial banks and bond underwriters demanded prohibitively high interest rates with short maturities in order to offset inflationary risk in Russia.

Management also considered private placements, the most frequent form of new issues at that time. In comparison with public offerings, these were characterized by simplified registration procedures and limited financial disclosure requirements. Options were limited, however, because regulations prohibited private placements for issues in excess of 50 millon Roubles. The Board also determined that no single investor could buy more than 10,000 shares in any one public offering, and that more than 300,000 shares could not be sold to institutional investors without Board approval. The Board wished to ensure that the share limit was not set too high so as to deter potential strategic investors concerned with control issues *vis à vis* other shareholders.

The Decision

A day later, Mr. Nikolov received a call from his boss, Mr. Frederik Bilitnikoff, Chief Executive Officer. Mr. Bilitnikoff told his deputy that RO had been approached by a Western (English) merchant bank, Samuel Montagu (SM)[4], which offered assistance to both RO and its financial advisor in the implementation of a public offering. Mr. Bilitnikoff realized that by having SM's name behind the issue, as well as the names of the other consortium members, RO could possibly increase investor trust, and sell more shares at higher prices.

Mr. Nikolov suggested that 2 million of the 5.5 million authorized shares should be set aside for a strategic investor, one who could bring technology and processing know-how to the company. The combination of public offering and strategic equity investment could serve the respective goals of: (i) providing the company with relatively quick cash and broadening its investor base and (ii) enabling a confectionery industry player (domestic or international) to take a long term stake in RO.

Messrs. Bilitnikoff and Nikolov needed to consider several issues if they were to proceed with both a "trade sale" and a new public offering under the same tranche of authorized capital (5.5 million shares) :

- What the timing of the two offers should be in relation to one another.
  - Given the immediate financial needs of RO, a public offering of the 3.5 million remaining shares would be a quicker means of raising the capital (*i.e.*, the process of the investor search and negotiations was more time consuming).
  - The sponsors of the consortium, including the Know-How Fund (KHF) and the Russian Securities and Exchange Commission (RSEC), believed that by encouraging immediate, broad-based shareholder participation, the public offering would pave the way for other Russian new issues.

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[4] Samuel Montagu was the leader of a consortium of firms hired by the UK Know-How Fund to assist Russian companies with new issues. Other members of the consortium included: Burson-Marstellar (public relations); Deloitte & Touche (accountants); and Linklaters and Paines (attorneys). The Know-How Fund was managed by the Overseas Development Administration (ODA), part of the UK Foreign Office.

- If launched under the same prospectus, the share price of both the public offer and strategic offer would have to be the same.[5]

- Who to select as lead manager of the public offering.

[5]MoF Law 78, IV, 35 stated that all shares of a certain offering must be of the same price.

EXHIBIT 1

A CHRONOLOGY OF KEY EVENTS FOR RED OCTOBER
(November 1992 to July 1994)

DATE	EVENT
1992	
November	Upon registration as a joint stock company. RO's charter capital consisted of 224 million Rubles, composed of 159,041 common shares and 64,960 preference shares (owned by the Property Fund of Moscow), all having a nominal share value of 1,000 Rubles
1993	
January	Privatization of RO completed via voucher and cash auctions--"1st Issue"*
August	In August 1993, the Property Fund transferred the preferred shares back to RO, at which time all of the shares became common shares. The shares were then split, which resulted in a nominal value of 100 Rubles per share (2.24 million shares x 100 = 224 million Rubles).
December	First charter capital increase: assets revalued from 100 to 1000 R/share--"2nd Issue" (2.24 million shares x 1000 R/share = 2.24 billion Rubles in charter capital)
1994	
March	7.76 million new shares authorized at shareholders meeting--2nd Charter capital increase (10 million total shares of charter capital x 1000 Rubles per share = 10 billion Rubles)
April	Shareholders are paid 2.2 million shares in dividends
July	Offering of the "3rd Issue" (5.5 million shares were offered in Moscow) during the period from May to July 15,000 of shares were sold.
Summer	Domestic and international exposure of MMM pyramid investment scam. Thousands of investors lost their investments after being promised returns in excess of 100%

*Under Russian law, an increase in charter capital and an issuance of stock are synonymous activities. MinFin 78, IV,35 states that all shares sold under the same charter capital increase should be of the same price. Under U.S. law, these are two distinct activities. Issuances of shares authorized under the same increase in charter capital may be priced differently.

(Exhibit 2a)

Red October:
Profit/Loss Statement Summary

	Jan. 1993-Jan 1994 (Rouble millions)	Jan. 1994 - July 1994 (Rouble Millions)
Gross Turnover	70,931	80,983
Turnover Taxes	(6,632)	(9,734)
Net Turnover	64,299	71,249
Production Costs	(39,069)	(46,176)
Gross Profit	25,230	25,073
Profit from other Sales	98	19
Other Net Income (losses)	566	(269)
Profit before Tax	25,894	24,823
Profit Tax	(7,823)	(8,188)
Net Profit After Tax	18,071	16,635

(Exhibit 2b)

Red October:
Balance Sheet Summary

	1 January 1994 (Rouble millions)	1 July 1994 (Rouble Millions)
Fixed Assets	8,802	34,887
Intangible Fixed Assets	0	3
Tangible Fixed Assets	4,291	26,878
Construction in Progress	2,707	6,389
Long-Term Investments	1,084	1,617
Current Assets	20,811	47,181
Cash and Bank	1,605	2,996
Debtors	9,691	23,762
Taxes Recoverable	0	1,290
Inventories	9,515	19,133
Other Assets	0	1
Current Liabilities	9,204	19,555
Short-term Loans	0	4,210
Creditors and Accruals	7,840	13,455
Taxation and Social Security	1,364	1,890
Net Current Assets	11,607	27,626
Net Assets	19,689	62,513
Charter Capital and Funds	19,689	62,513

RED OCTOBER CASE B: DISTRIBUTION AND SALES

In late December 1994, Yuri Petrov[1], Deputy Chairman of Grant Financial, paused to evaluate how his firm had a managed public offering of shares. Beginning in October 1994, Grant had worked diligently to bring Red October's shares to domestic and international markets.

The work on the December offering began when Mr. Petrov received a call from Alan Brown of Samuel Montagu (SM), a merchant bank in London. Mr. Brown explained that SM, and a consortium of firms, had been retained by the UK Know-How[2] fund to assist promising Russian companies with new share issues. He understood that RO needed new capital, especially after the July 1994 offering which placed only 15,000 out of 5.52 million shares. Mr. Brown offered SM's assistance to help Grant place the remaining 5.5 million shares via public offering (see Exhibit 4).

Following discussions with RO, Mr. Petrov welcomed SM's assistance. He determined that 2 million of the 5.5 million authorized shares would be sold to a strategic investor in a trade sale. The balance, 3.5 million, would be sold through the public offering. According to Russian law, because both offerings would occur under the same charter capital increase (authorized during the March 1994 shareholder's meeting), they would be subject to the same pricing arrangements.

RO and Grant decided that the timing of the public offer should take priority over the trade sale. Mr. Petrov immediately began to develop a sales strategy, arrange a selling group and prepare a prospectus for this (RO's fourth) share issue.[3]

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[1]Names have been fictionalized for the purposes of case writing.

[2]The Know-How Fund served under the auspices of the Overseas Development Administration (ODA), part of the UK Foreign Office.

[3]Exhibit 1 lists a chronology of key events leading up to the offer.

Selling Group and Distribution of Shares

Sales Strategy

Mr. Petrov reflected on the underlying objectives of the offering. These would ultimately determine the market segments to be targeted (both by geography and by investor base), as well as the allocation of shares by market segments. Since the Federal Commission on Securities and the Stock Market supervised the offering -- with partial sponsorship from foreign donors -- the offering served both commercial (i.e., raising capital) and non-commercial (i.e., political and developmental) objectives. In Mr. Petrov's view, the following elements affected the sales strategy:

- In the wake of the MMM pyramid investment scam, both the Russian government and international donors wanted to restore the public's confidence in local capital markets by "reliable" shares to a broad investor base. This made it imperative that a significant portion of RO's shares be allocated to small, local investors.

- Red October shareholder agreements forbade individual shareholder from buying more than 10,000 shares during the public offering. These agreements limited institutional investors to 300,000 shares.

- The offer had to be seen as a commercial success, with the 3.5 million shares being fully subscribed.

Given the above, Mr. Petrov figured that at least half of the shares had to be allocated among Russian institutional (e.g., banks, investment funds) and retail (i.e, smaller, individual) investors. Moreover, following discussions with the SM consortium, it appeared that there was a significant international market for RO's shares. Several institutional investors had expressed interest in RO shares to James Capel, a merchant bank/brokerage and SM's sister company. Although an international placement could raise the profile of the offering, Mr. Petrov realized that many investors remained skeptical of Russian shares due to unclear registry procedures, macroeconomic uncertainties and political risks. International selling agents could also demand higher commissions than domestic ones.

Keeping in mind both market demand and offering objectives, in early October Mr. Petrov and Mr. Brown envisioned the following allocation and distribution arrangements for RO's 3.5 million shares:

RUSSIAN RETAIL	RUSSIAN INSTITUTIONAL	INTERNATIONAL
1,000,000	1,500,000	1,000,000

Within Russia itself, Mr. Petrov initially considered several potential regions for distribution. In order to minimize costs and facilitate logistical arrangements, Grant and RO settled on three major "hub cities" from which shares would be distributed: Moscow, St. Petersburg, and Ekaterinburg.

In addition, Mr. Petrov determined that the length of the offering period would be similar to that of United Kingdom public offerings (e.g., 2 weeks). Keeping the offering period short would reduce the possibility that inflation would erode share value. He figured a two-week offering period would be adequate to help insulate the deal from macroeconomic risk.

Arranging the Selling Group

Grant's management knew that ultimately the success of the offering would depend on the capabilities of the selling group[4]. A successful share issue must raise the maximum amount of capital for the client at a reasonable cost. The selling group needed to have strong share placement capability in Russia's three regional hubs. SM put forth several criteria to assist Grant in the selection of the selling group in Russia :

- Coverage (e.g., geographic placement capability)
- Relevant experience (e.g., knowledge of sales, cash administration and processing)
- Cost (e.g, commissions charged)
- Accessibility (e.g., ease with which investors can reach the agent)
- Profile and reputation (e.g, perception of trust among clients)
- Personal linkages (e.g., networks developed between Grant and other brokers/underwriters)

The Russian Selling Group

SM believed that Russian banks provided the most effective vehicle for selling shares in the three regions. In contrast to brokers, bankers had far superior placing capacity due to their longstanding relationships with large numbers of potential investors. After surveying Russian brokerages in the three regions for some time, Mr. Brown concluded that most of the brokers did not possess a sufficiently large client base. SM therefore recommended to Grant that, to the extent possible, banks be involved in the selling group.

Mr. Petrov and his staff were not convinced that involving banks would achieve the desired objectives of the offering. First, participation by the large banks would clearly not meet the non-commercial objectives of the offering, such as the strengthening of broker networks and

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[4] Those brokerage firms which sold RO's shares.

broad-based market participation. Another major obstacle was the banks' demand for commissions well above the 3% that Grant was prepared to offer brokers in the selling group.[5] (Grant had negotiated a 5% commission with RO to coordinate and sell the public offering).

Furthermore, Grant felt most comfortable by relying on business relationships they had established with other brokers over the past three years. Natalia Tarkov, of Grant's sales and trading division, observed: "It is often easier to bring aboard a broker you already know, rather than dealing with the bureaucracy of an unfamiliar bank".

The International Selling Agent

Following advice from SM, Mr. Petrov concluded that one reputable selling agent would suffice to distribute RO's international tranche of shares[6]. James Capel seemed the logical choice. The merchant bank possessed a strong brokerage network in London and had already perceived a noticeable interest in the deal from their institutional clients.

Securing Investment Commitments

During the early part of October, SM management and Mr. Petrov began soliciting investment commitments in Russia. The type of commitments sought were akin to those used in a traditional UK public offering, whereby the underwriter, typically a large institutional investor such as pension fund or a financial institution, committed to "clawback" and/or "firm" underwriting.[7] Grant sent letters outlining the details of the offer to several potential institutional investors. With legal advisors, Linklaters & Paines, and SM, Mr. Petrov also developed an offer and underwriting agreement which disclosed the terms of the investment commitment as well as the commission structure for share sales.[8] Grant management hoped that it would secure investment commitments for up to 2 million shares.

[5]The terms of the commission were disclosed in a Selling Agreement between Grant and each of the brokers.

[6]For legal reasons, the British broker could not market the shares outside the UK.

[7]The latter occurs when the underwriter agrees to buy, outright, X number of shares. The former occurs when the underwriter commits to purchase X number of shares which are not sold.

[8]The underwriting agreement was between the issuer (RO), the Lead Manager (Grant) and the underwriter.

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Procedural and Operational Arrangements

In order to ensure full accountability in the transaction for both sellers and the buyers, Mr. Petrov worked with SM consortium and Price Waterhouse to develop institutional and financial controls for share distribution.

The parties to the issue consisted of four separate axes (see Exhibit 2): the Selling Agents (responsible for share sales); the Underwriters (committing to purchase shares in large blocks and perhaps reselling them); Regional and Central Processing Agents (responsible for processing the regional sales data); and the Regional and Central Receiving Banks (responsible for banking the sale's proceeds).

Receiving Banks played a central role by functioning as the custodian of cash received from the sale. After negotiations with several potential receiving banks, Grant signed an agreement with only one Receiving Bank before the offer opened. At the opening of the offer, four other banks had also expressed interest in working on the project.

The Prospectus and Share Pricing

Due Diligence and Disclosure

In preparing the prospectus for the offering, Grant and SM undertook a period of due diligence. They intended to make as transparent as possible the financial status of RO, so as to maximize disclosure and boost investor confidence.

However, time did not allow the consortium to make RO's financial statements conform with International Accounting Standards (IAS). Nor was the consortium able to review the 1993 financials or Grant Audit's audit opinion for FY 1993-94. Nonetheless, Deloitte & Touche (D&T) did make a pronouncement regarding the first six months of 1994: "....the financial statements for the six month period to July 1, 1994 of RO are (not) materially misstated with respect to compliance with Russian accounting and reporting regulations."

Creating a Prospectus and an Offering Memorandum

Mr. Petrov remarked that the Ministry of Finance (MoF) requirement[9] to disclose all relevant information to potential investors seemed at odds with the MoF rule that the issuer should not submit a prospectus longer than thirty paragraphs. Therefore, in addition to prospectuses issued in Russian and in English, the consortium produced supplementary Russian and English offering memoranda which contained substantially more information such as risk factors and

[9] Article 34 of Regulation 78.

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detailed financial information. The memoranda served as the principal documents for the offer. Finally, the consortium and Grant produced approximately 200,000 "mini-prospectuses", primarily aimed at retail investors, which Grant distributed to both selling agents and high net worth individuals in the three Russian sales regions.

The large numbers of parties involved in the consortium created a lengthy review process for the prospectus and offering memorandum. As a result, Grant and SM three times postponed the initial offer date.[10]

Share Pricing and Market Window

Russian law required the issuer to submit to the Ministry the price and quantity of shares in the prospectus. This meant that Messrs. Petrov and Brown would need to develop a pricing strategy well in advance of the share offering.[11] Both men knew that the price needed to account for any macroeconomic changes that could occur during the 45 days Russian law legally permitted the MoF to review the prospectus.

In determining the share value for the fourth issue, Mr. Petrov considered the results of at least three previous valuations that had been performed.

- A Price Waterhouse discounted cash flow (DCF) valuation, performed in January 1993-- not in conjunction with the public offering, suggesting a value of US$5 per share.

- A rudimentary SM net asset valuation which suggested a value of US$10 per share.

- A James Capel valuation which examined comparable values of similar plants in Eastern Europe and suggested a price of US$ 6.50 per share.

Although the valuations provided a starting point, other factors needed to be taken into account when pricing the shares. First, in Mr. Petrov's view, RO shares should be sold at less of a discount than other Russian shares, due to both RO's proven reputation in the marketplace and the high disclosure standards associated with this offering.

[10]The launch of the IPO occurred five weeks later than initially scheduled.

[11] The requirement here to provide share prices in the prospectus (i.e., "Red Herring") differed markedly from US practice, where share prices were only determined shortly before the offering.

Moreover, because a portion of the shares were slated for the international offering, they factored into the price the falling value of the Rouble.[12] Mr. Petrov estimated that if Grant priced the shares at the existing Rouble equivalent of approximately US$ 6 (20,000 Roubles) when they submitted the prospectus (approximately three weeks before the offering), the falling rouble would bring the dollar value down to approximately US$ 5 at the time Grant launched the offering (see Exhibits 3a,3b).

The SM consortium and Grant realized that the offering price of 20,000 Roubles per share significantly exceeded the current trading price of approximately 10,000 Roubles per share. Yet trading activity did not reliably indicate market value and many of the trades were not reported. Moreover, although RO shares traded at lower prices and quantities before the December offering, SM and Grant argued that large quantities of the shares, such as those available in the public offering, could not be found for any price.

The Trade Sale

Grant and RO determined that the trade sale should occur immediately after the public offering. Preparations for the trade sale began well before December, as Barents Group began its search for potential investors. Since Grant and the SM consortium launched both the trade sale and public offering under the same authorization of charter capital, Russian law obliged the Barents Group to sell the 20% stake in RO for the same price per share as the public offering. Melissa Simpkins, manager of the Barents Group investor search, believed that a 20,000 Rouble share price would make the trade sale more difficult.

Public Relations and Marketing

Russian Retail and Institutional Buyers

In addition to the offering memoranda and the prospectuses which Grant disseminated among selling agents and potential investors, Grant and Burson Marstellar (B-M) launched a public relations campaign for Russian institutional and retail investors. Based on previous market surveys and the high profile of the offering, the SM consortium anticipated high subscription rates from both types of buyers. However, B-M decided that public relations efforts should be especially focused on smaller (i.e, retail) investors. Many of them remained hesitant to buy shares with uncertain political and macroeconomic effects resulting from the beginning of the war of Chechen secession. In addition, many individuals remained deterred after the summer's investment debacle in which thousands of individuals, after being guaranteed high yields, lost their investments in the MMM company's pyramid investment scheme.

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[12] In mid-October 1994,the Rouble depreciated more than 30% against the dollar (See Exhibit 3a).

Working with B-M, Mr. Petrov developed the following matrix to define the public relations strategy for the offering in Russia:

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State of Existing Russian IPO Market	PR Strategy
Low level of individual understanding and sophistication in investment matters	Create awareness and interest in offer in order to generate word-of-mouth advertising
Lack of local precedent (particularly in regulation governing advertising of IPO)	Position RO shares as being a safe and stable investment
Recent history of consumerism	Provide requisite information needed to purchase shares
Uncertainties about the buying habits of retail investors (e.g., disposable income)	Create the impression of scarcity to motivate action

Yet two major legal obstacles impeded the implementation of the strategy:

- Because all advertisements needed to have the prospectus number visibly marked on them, all documentation needed to be completed before advertising could begin;
- Since the law required all media advertisements to mention all sales sites (approximately 30), it made cumbersome many forms of advertisement (e.g, radio).

Furthermore, funding for the campaign proved to be a contentious issue. Although the Know-How Fund agreed to meet the professional fees of the public relations team, the SM consortium expected RO to meet local costs such as buying media space. To RO, the high expenses for advertising, printing and filming (particularly in Moscow) represented opportunity costs for more urgent matters such as replenishing working capital and meeting production orders.

Given the preceding parameters, Messrs. Petrov and the B-M team knew their marketing strategy would have to be implemented on a budget of approximately USD $300,000. The challenge remained how to allocate scarce advertising resources among the three targeted regions.

Substantial coverage of the offer by international and domestic media complemented public relations and advertising efforts. Grant and the SM consortium hosted two media lunches prior to the offer. Coverage of the event ensued in domestic and international financial journals and domestic television, as well as in international news services.[13] Messrs. Brown and Petrov concluded that the offer did not suffer from any lack of media or public interest.

[13]Newspaper/Magazine coverage included: Financial Times, Wall Street Journal, Emerging Markets Investor, Moscow Times, and Financial Izvestia. International news services included: Reuters, France Presse, and AP-Dow Jones. International television and radio coverage included: BBC, TF-1, and CBC.

International Institutional Investor Interest

Long before the offer and the issuance of the English prospectus offering memorandum, James Capel had solicited the interest of several prospective investors such as emerging markets fund portfolio managers. Although preparations for the UK offer began in an ambitious way, the marketing campaign relented as the offering drew closer. Compliance issues surfaced which may have deterred the sale of RO shares to many prospective clients.

In line with the magnitude of media coverage in Russia, the UK media substantially covered the UK offering of RO's shares. The Know-How Fund sponsored a UK media lunch which several of the UK's leading newspapers and news services attended. Articles about the offer ensued in several of these, including: Financial Times, The Guardian, and The Times.

Overall, media coverage heralded the RO offer as a positive and unique event. However, less than one week before the offering (November 29), an article appeared in the Financial Times which discussed, in general terms, share registry problems in Russia. In addition to mentioning custody issues, the article pointed out that the standards of the offering were not on par with UK financial disclosure standards. Attorneys advised James Capel to consider the risks of selling shares which did not comply with UK standards.

The Decision

Two weeks after the closing of the offering, Mr. Petrov considered what could have been done differently given the circumstances. In particular, he paused to analyze the composition of the selling group; investor commitments to buy shares; and share pricing and marketing arrangements.

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EXHIBIT 1:

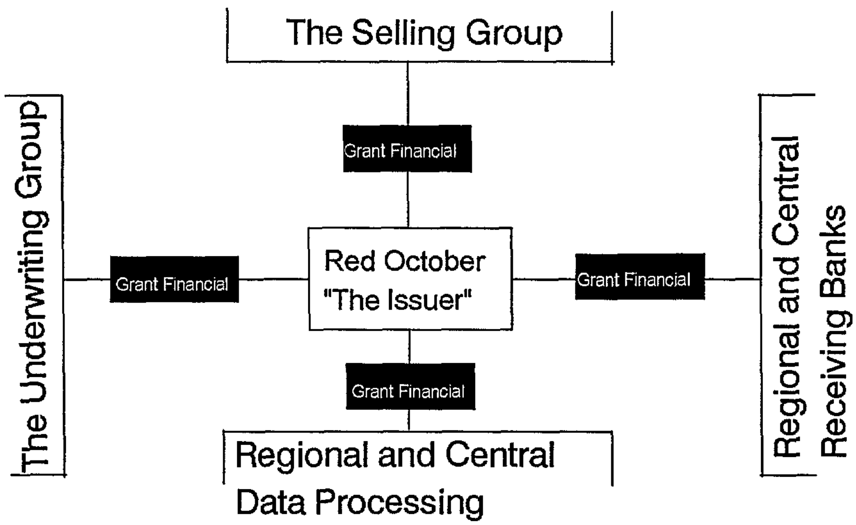
:CHRONOLOGY OF KEY EVENTS: THE RED OCTOBER (RO) PUBLIC OFFERING

DATE	EVENT
1992	
November	RO registers as a joint stock company
1993	
January	Privatization of RO completed via voucher and cash auctions--"1st Issue"*
December	First charter capital increase: assets revalued from 100 to 1000 R/share-- "2nd Issue"
1994	
March	7.76 million new shares authorized at shareholders meeting--2nd Charter capital increase (making 10 million total shares of charter capital)
April	Shareholders are paid 2.2 million shares in dividends
July	Opening of "3rd Issue" (5.5 million shares offered)
Summer	Domestic and international exposure of MMM pyramid investment scam
Early October	"3rd Issue" -- July 1994 issue cancelled (15,000 shares sold)
Early October	RO, Grant and SM consortium agree to launch IPO--"4th Issue"
Week of Oct. 15	Rouble drops at least 30% against the dollar
Autumn	Barents Group gets trade sale mandate (2 million shares + J partner)
November 16	Prospectus submitted to Russian Ministry of Finance
End November	News Chechen war reaches domestic and international public
December 5	Opening of RO offer (3.5 million shares offered at 20,000 R each)
December 17	Closing of 2 week RO offering period (1.9/3.5 million shares sold)

*Under Russian law, an increase in charter capital and an issuance of stock are synonymous activities. MinFin 78, IV,35 states that all shares sold under the same charter capital increase should be of the same price. Under U.S. law, these are two distinct activities. Issuances of shares authorized under the same increase in charter capital may be priced differently.

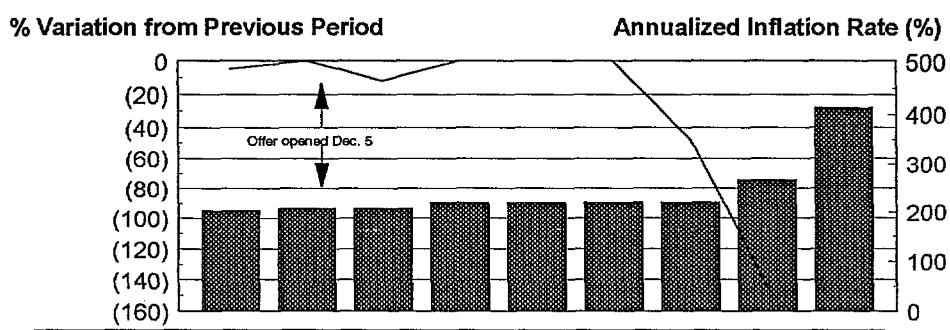
Red October: The Selling Group and Offering Logistics

(Exhibit 2)



Red October:
Russian Annualized Inflation Rates and % Change from Previous Period

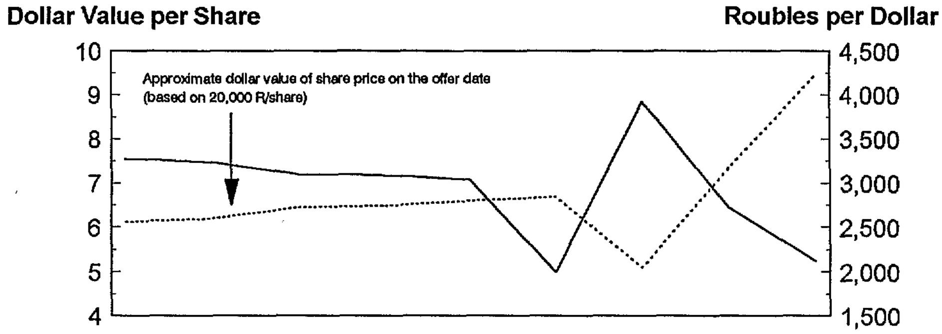
(Exhibit 3a)



	Week of Dec. 10	Week of Dec. 3	Week of Nov. 12*	Week of Nov.5	Week of Oct. 29	Week of Oct. 22	Week of Oct. 15	Week of Sep. 17	Week of Aug. 20
Annualized inflation rate	203	208	208	220	220	220	220	267	412
[illegible]te change from previous period	(5)	0	(12)	0	0	0	(47)	(145)	

Red October:
Illustration of Dollar Value per Share and Rouble Exchange Rate

(Exhibit 3b)



	Week of Dec. 10	Week of Dec. 3	Week of Nov. 12*	Week of Nov.5	Week of Oct. 29	Week of Oct. 22	Week of Oct. 15	Week of Sep. 17	Week of Aug. 20
Rouble/$ —	3,275.00	3,232.00	3,102.00	3,085.00	3,036.00	1,996.00	3,926.00	2,721.00	2,117.00
$/Share --	6.11	6.19	6.45	6.48	6.59	6.68	5.09	7.35	9.45

*Note: The consortium did not actually set the share price until the week of Nov. 12, the time at which they submitted the prospectus.
The share dollar value shown before the offer date of December 5th is merely illustrative.

RED OCTOBER CASE C: RESULTS AND LESSONS LEARNED

Red October (RO), Russia's premier manufacturer of confectionery goods, launched the country's first public offering on December 5th, 1994. RO distributed 1.9 million shares to be sold to domestic retail, domestic institutional and international institutional investors. The following is a summary of some of the results and lessons learned from the offering.

Prospectus and Share Pricing

Share Pricing and Market Window

The prospectus submitted with the Ministry of Finance on November 16, 1994 reflected a final share price of 20,000 Roubles per share.

The Trade Sale

By December 5th, the trade sale had not been closed.

Selling Group

The selling group participants changed many times before Grant launched the offer on December 5, 1994 (Exhibit 1 gives a final list of selling group participants).

Investor Commitments

However, uncertainty about the composition of the underwriting group remained up until the time the Grant launched the offer. In fact, Grant secured most of the commitments after the offer's opening date. The final composition of the underwriting group, and the nature of their commitments, was known only by Grant.

This case was written by Kerry McKeon of *Price Waterhouse LLP* and is intended to serve as a basis for class discussion, rather than to illustrate either effective or ineffective handling of a particular situation. The author wishes to thank representatives of Red October, Grant Financial, Samuel Montagu,and Barents Group for sharing their views on the offering. This case study was undertaken in cooperation with the New Issues facility, a project funded by the US Agency for International Development (USAID). **Further use or reproduction of this case is forbidden without permission from *Price Waterhouse LLP*.**

Public Relations and Marketing

Russian Retail and Institutional Buyers

The consortium relied on a combination of print, television and radio advertisements to reach both institutional and retail investors. They focused the preponderance of advertising on Moscow. Due to lack of funds, they did little advertising in the other two regions.

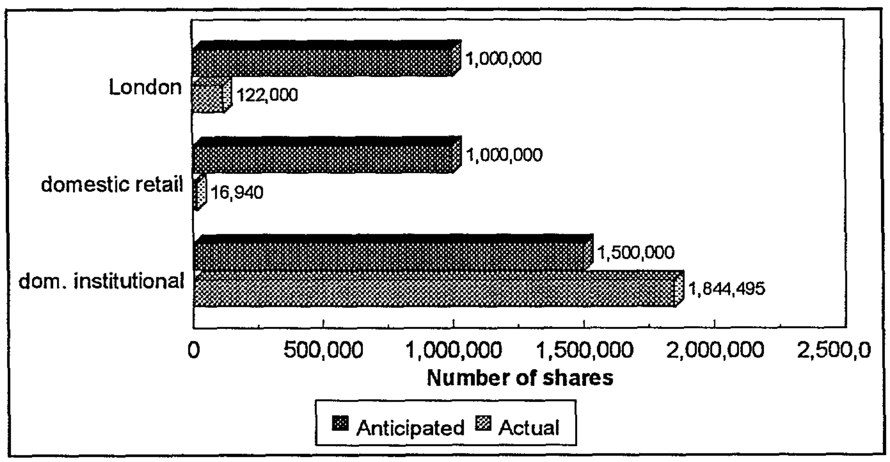
To add to investor confidence, RO set up an investor "hotline", a telephone number which potential investors could call during the pre-offer and offer periods in order to ask questions about RO and its shares.

International Institutional Investor Interest

Shortly before the launch of the offer, James Capel and the SM consortium perceived that a Financial Times article on the "Krasnoyarskiy aluminievîy zavod" share custody scandal might have effected a negative impression among fund managers and financial officers.

Results of the Offering

After two times being postponed -- a total of five weeks after the initially proposed offering date-- Grant launched the offer on December 5, 1994. When the offer closed two weeks later, it yielded the following sales results:



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The low results for domestic retail sales were quite understandable. One of the primary non-commercial objectives of the offering had been to have full subscription of the retail offer -- broadening share ownership without concentrating ownership.

Yet the actual performance of domestic institutional sales exceeded expectations. In poring over the results, Mr. Petrov realized that domestic institutional investors alone could have taken the entire offer to over-subscription. Indeed, one single institutional buyer committed to buy the whole offer. However, due to issues of control and corporate governance, the RO Board and Grant turned away several offers, some in excess of 1 million shares.

Although James Capel received some investment commitments at the outset of the pre-offer period, few institutional investors in London committed as the offering drew near .

Lessons Learned

Upon reflecting on the sales results in late December, Mr. Petrov analyzed why the offer had been drastically undersubscribed in the domestic retail and international institutional market segments. He attributed the undersubcription to a number of factors:

Factors Affecting Sales

Domestic Retail

Before the offering, Mr. Petrov had established that individual investors would be greatly influenced by externalities such as the existing political and macroeconomic environments. Several external factors may have dampened retail sales.

- MMM: In the wake of the collapse of the MMM pyramid scheme, in which fixed returns were guaranteed, investors were reluctant to part with their money for securities, particularly when RO did not guarantee a fixed dividend;
- absence of retail infrastructure and lack of a secondary market;
- the consortium devoted most of its marketing resources to Moscow, which may have accounted for the fact that RO sold 500 total shares in St.Petersburg and Ekaterinburg;
- the strengthening of the dollar;

- timing of the offer: late December was not a favorable period for investors.

London Institutional

Although macroeconomic risks in the Russian economy affected international investor perceptions, factors affecting their perceptions for the most part differed from those of domestic institutional investors, which centered on:

- the perceived macroeconomic risks stemming from the October drop in the Rouble and the fear of future inflation;

- concern with existing share custody procedures and regulations

- emerging markets portfolio managers may have preferred highly undervalued shares with potential to produce higher returns--even if risky.

A Deal Worth Doing?

Following the closure of the offering, several journalists and financial commentators had pronounced that the public offering's undersubscription indicated its failure. Surely, Mr. Petrov believed, the commentators made hasty judgements without knowing the context behind the offer. Instead, he believed the success of the deal needed to be judged against its original objectives.

1)	Objective:	A) To raise money to finance the company's working capital and capital investment program by selling 3.5 million shares at 20,000 Roubles each. Maximum to be raised equaled approximately USD $23 million. B) To keep transaction costs to a minimum.
	Result:	RO raised USD $ 13.5 million by selling 1.9 million shares.
2)	Objective:	To distribute a large number of shares to individual and retail investors in order to broaden shareholding.
	Result:	RO sold approximately 17,000 shares to retail investors.
3)	Objective:	To produce "reliable" shares for the public and to bring disclosure standards in line with those of Western offers.
	Result:	The RO prospectus/offer memorandum was the first of its kind to (i) disclose and analyze financial statements and (ii) discuss the use of future proceeds. Additionally, the offer established the first coherent set of offer agreements between the various participants.

EXHIBIT 1

PARTICIPANTS IN THE SELLING GROUP DISPLAYED BY REGION

ST. PETERSBURG	MOSCOW	EKATERINBURG	LONDON
Kartel	Moscow Auction Center	Urals Financial Center	James Capel
Glavstroiinvest	Grant Financial Center		
Nevskiy Depository Center	Ypravlyenie Investitsiyami		
Alexandr	Finabal		
Eltra	Olma		
Scorpion Securities	Nika		
Lyenstroimateriali	Analys		
Pifcorp	Troika Dialog		
Energocapital	Livera		
Kurs	Russian Credit Bank		
North-West Investments			

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