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**SMALL-SCALE ENTERPRISES:
Post Privatization Study in Nizhny Novgorod**

Final

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**Part I
The Setting
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Part I--The Setting

Introduction: Privatization in Russia 1992-1994

During the Gorbachev period prior to the break-up of the Soviet Union (1985-1991) some modest attempts to promote the development of non-state forms of property were made. The so called individual labor activity (family businesses which were not permitted to hire outside laborers) and new producers' co-ops first began in 1986. They employed some 6 million people (full-time as well as part-time) by 1991. Enterprises leased from the state by work collectives accounted by mid-1991 for about 14% of total industrial output, 20-30% of trade, public catering and personal services, 20% of construction and a considerable portion of auto transportation. Some 50,000 independent farms existed by the end of 1991, but their share in agricultural output fell far lower than 1%. Another 3000 joint ventures with foreign partners also came about during 1987 to 1991. This, however, produced less than 1% of total output.

The share of new non-state entities remained small until the dissolution of the USSR. They also operated within the framework of the centrally planned economy and were subject to numerous restrictions in terms of marketing their output, supplies, prices, investment, etc. Not until after the breakdown of the Soviet Union in December 1991 did Russia, now an independent country, launch its own radical privatization program. The success of the program was reflected in terms of speed. In two years, by the spring of 1994, over half of Russia's 70 million workers were employed at private enterprises or at those in the process of transformation into private enterprises. (See Exhibit 1)

This report collects the experiences of small-scale enterprises operating in Russia in the spring of 1994. These successes and difficulties illustrate the growing pains of a market economy and accomplishments of private sector development efforts in the former Soviet Union.

Nizhny Novgorod

The region (*oblast*) of Nizhny Novgorod (formerly called Gorky), in many aspects, was a typical Russian region. Nizhny was located where the Oka River joined the Volga River Basin. The city of Nizhny stood on the elevated south bank of the Volga River and was beautifully divided by the Oka into two parts. The east bank was the historical center of the city and included three principal "rayons"¹: Nizhegorodsky, Sovetsky and Prioksky. The west bank of the Oka was separated into five commercial regions. The trade fair, railway station and the major industrial plants were all located there. Yet, the population of the Nizhny Novgorod region of about 3.7

¹ A subdivision of a city.

This case was written by Humberto Esteve, Vladimir Popov and Ifim Life of CARANA Corporation, under the supervision of the International Privatization Group of Price Waterhouse as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. The authors wish to thank the owners and management of the businesses interviewed. The case study was undertaken through the Privatization and Development Project (PAD) funded by the United States Agency for International Development (USAID). September 1994.

million people (including the city itself at 1.4 million), was almost double the population of the average Russian region, at roughly 2 million inhabitants. The city of Nizhny itself was third population wise after Moscow and St. Petersburg, the two most populous Russian cities.

Nizhny Novgorod emerged in early 1992 as one of the leading centers of economic reform in Russia. Further, Nizhny Novgorod became the pioneer of small-scale privatization through auctions (the first auction in Nizhny was held on March 21, 1992). At the time, a well-known reformer and creator of the "500 days program"², Mr. Grigory Yavlinsky, together with his friend Boris Nemstov (the governor of the region), joined to form a team to carry out economic reforms at the regional level. Their programs were to a large extent implemented first in the city of Nizhny Novgorod.

Of the twenty-six Russian cities in which the International Finance Corporation had provided technical assistance to local administrations for small-scale enterprise privatization efforts, Nizhny Novgorod had been by far the most important one. By the end of 1993, out of a total of 5,000 privatized objects³ in the twenty-six cities where these programs had been implemented, roughly 1,000 had been privatized in Nizhny⁴. Nizhny was also the city of other "firsts." For instance, the first bankruptcy in Russia (the Vacksky Rayon Co.) occurred in the Nizhny region. Nizhny was also the site of the first privatization of collective and state farms initiated in the fall of 1993.

History

Nizhny Novgorod was founded in 1221, only 73 years after Moscow and just two decades before the Tartars (Mongols) invaded Russia. From the latter part of the 14th century, it became part of the Moscow principality and an important military forepost in the war with the Tartar-Kazan State. It was not until the mid-1500s, when Ivan the Terrible conquered Kazan and the border of the Russian state moved further east, that Nizhny lost its military significance. In the early stages of the 17th century, in a period of great internal disarray in Russia between two contending dynasties, Nizhny became the center of the resistance to the Polish occupation of Russia as well as the center of trade for the entire Volga River basin.

In the 19th century, Nizhny witnessed several developments: the all-Russian trade fair was moved to Nizhny in 1817, a railroad connected Nizhny to Moscow in 1862, and the Volga River became an important transportation route with the development of steam ships. The Sormovo shipbuilding plant in Nizhny started to operate in 1849 and the number of ships cruising the Volga increased from 15 in 1854 to over 1,000 by 1890. Still, by 1916 the population of Nizhny was only 110,000.

²A well known attempt at transforming the Soviet economy in a short period of time.

³Usually an "enterprise" or a group of assets associated with a location or with a specific activity.

⁴Small-Scale Privatization in Russia, *IFC Operational Report*, November 1993.

During the Soviet era, Nizhny experienced rapid economic expansion which was commonly attributed to the development of the machine building and defense-oriented industry in the region.⁵ The population of the city of Nizhny increased to 644,000 by 1939, to 941,000 by 1959, to 1.2 million by 1971 and to 1.4 million as of 1993. GAZ (Gorky Auto Plant), a car and truck manufacturer, was the largest employer in the city, with over 100,000 workers and employees. Other large employers included the aviation plant and the shipbuilding facility "Krasnoye Sormovo," as well as several other machinery and machine tools plants in the city. In Arzamas-16, a "closed city"⁶ in the Nizhny Novgorod region, there existed a federal nuclear center. Modern Nizhny Novgorod was the center of a vast metropolitan area strung out along the Volga and lower Oka rivers.

The Economy

Nizhny's per capita income in 1994 was roughly 70% of the Russian average. Moreover, sales of goods and services per capita totaled around 70% of the national average (see Exhibit 2). Lower than average living standards were typical for the Russian non-resource regions, based on machine building and defense production. Until 1994 when the subsidies stopped, Nizhny's industry was doing better than Russian industry as a whole, reflecting State subsidies to defense and machine building plants.

Foreign direct investment in Russia occurred mostly in the form of joint-ventures. It was very low (as of April 1994, approximately US\$3 billion) compared to Hungary, the Czech Republic, Poland (each with US\$3-7 billion), and China at over US\$50 billion in foreign investments. In Nizhny Novgorod, the level of foreign investment was at only 0.3% of the Russian total (whereas the population of Nizhny was roughly 2.5% of the total population of Russia).⁷

Glancing at the various structures and the overall surroundings of Nizhny, the visitor got an impression of relative decay and a slow pace of development, compared to Moscow and St. Petersburg. Though the consumer goods market seemed well supplied, the selection of goods was more sparse than in the capital. There were fewer cars in the streets, nearly all buildings appeared unkept on the outside and in need of urgent repair. Most of the city roads were in disrepair and the pace of renovation and maintenance proceeded slowly. In 1994 there were yet no "western class" hotels in the city and just a few western-style shops and restaurants.

The Nizhny Model for Small-Scale Enterprise Privatization

The most important feature of the Nizhny privatization model was the manner in which municipal property was privatized. Different from other models of privatizations used in Russia, in which

⁵This was stimulated in World Wars I and II by the destruction of plants to the west.

⁶ The term "closed city" during the Soviet period referred to a city not open to foreign visitors.

⁷See Exhibit 2.

acquisition usually took the form of outright "buy-outs" of property by the workers' collectives, the Nizhny model allowed for auctions and other forms of competition in privatization efforts.

In Moscow, for instance, over 90% of small shops, restaurants, cafes, repair shops, barber shops, etc. were leased to workers' collectives. This method allowed for the collective to gradually "buy out" the business at a significantly discounted price. At first, the concept of small-scale privatization used in Moscow did not receive support from the GKI (the State Committee on Property) and was said to have been deemed illegal by the Committee. However, this concept later became a sort of *fait accompli* in Moscow.

Nizhny's small-scale privatization efforts focussed less on leasing to workers' collectives as was the case in Moscow. From March 1992, when small-scale privatization started, to mid-1994 as it came to an end, only 12 out of 1,132 privatized objects were leased to workers' collectives with provisions for subsequent "buy-outs," while the rest were sold at auctions, commercial competition, tenders, investment competitions or (for large- and -medium size enterprises) converted into "joint-stock" companies.⁸ Exhibit 3 shows how some methods used for the privatization of small scale enterprises in Nizhny Novgorod differed from those used in the rest of the Russian Federation.

Specific rules and regulations for privatizing small business in Nizhny included the following:

1. Lease vs. Sale: Space was usually leased (most often for 15 years), not sold, to the new owner. The decision to lease rather than to sell space to private companies, came out of necessity, since it proved virtually impossible to quickly separate federal property (apartment houses) from municipal property (ground floors and basements of these apartment houses, where shops and other enterprises were located).

Out of over 1,000 objects privatized by June 30, 1994 in the city of Nizhny, about eight hundred were leased for 15 years, three for 5 years, one for 3 years, one for 1 year, and in about 200 cases the property was actually "sold." Until mid-1994 rent payments for leased space were low (50 rubles or 2.5 US cents a month per square meter), but as of July 1, 1994, city authorities had increased the rent to 4000 rubles (approximately US\$2) a month per square meter. They had also introduced rent coefficients - 1 to 10 - to

⁸At *auctions* price matters above everything else. At *commercial competitions* (the most popular form) the buyer makes commitments to preserve the profile of the enterprise, the volume of sales and the variety of goods, employment, working hours, etc. At *closed tenders* there is a limited number of bidders selected by authorities (usually with an aim to preserve existing technological ties). At *investment competition* the bidders suggest investment programs to restructure the business. As the name indicates, *buy-outs of leased property* is the sale of the leased property to the collective operating the business.

account for the advantages of good location.⁹

Theoretically, privatized enterprises that leased space had the right to buy it out at a price equivalent of only 2 or 3 monthly rental fees. To get this right to purchase, privatized enterprises had to demonstrate "good performance" (renovation of space, increase in the volume and variety of sales, etc.). In the region of Nizhny Novgorod (outside the city), property rights rather than rights to lease were sold to new owners in most cases.

2. Preference to Workers' Collectives: Workers' collectives of former state companies could start their own businesses (usually partnerships) by bidding at the auction together with other participants. Some moderate concessions given to workers' collectives included: a 30% price discount, a 3 month grace period to start payments and a 6 month "moratorium" to pay back loans from banks, if any existed.

3. Profile of the Enterprise: Overall, by mid-1994, the region of Nizhny Novgorod had privatized about 2,400 small objects¹⁰ (1,100 in the city of Nizhny and 1,300 in the region) out of 2,700 scheduled for privatization and 3,700 in existence (see Exhibit 4). Commercial competition dominated as the preferred method of sale of most objects, where the bidders competed on prices, but had to also make certain commitments related to future operations of the business. The most important one stated that no less than 70% of the space would be devoted to the previous profile of the enterprise.

The number of closed tender transactions grew sharply in 1993 and 1994 at the expense of commercial competition transactions, resulting partly from social concerns. Despite all commitments to preserve the profile, newly-privatized businesses found different ways to cut unprofitable services. At the same time, symptoms of collectives' concerns emerged over their possible loss of business opportunities if private investors purchased their enterprises. As Annex 1 suggests, closed tenders became popular in the privatization of the personal services enterprises, cinemas and utilities. The new mayor of Nizhny, Mr. Sklyarov, who was replaced by Mr. Bednyakov in March 1994, appeared even more inclined to use tenders and investment competitions than his predecessor.

Results: Overview

The ratio of final price of auctioned small-scale privatized objects to the initial price (the initial price was computed on the basis of the balance sheet in "old prices") varied greatly from one Russian region to another. In Moscow and Sakha (Yakutiya), the selling price most often equalled the initial price, while in 27 regions the selling price averaged between 1 and 5 times

⁹Rents are determined by coefficients (1 being the lowest rent district and 10 being the highest). For instance, a building located in the Avtozavosky region has a rent coefficient of 6 while the neighboring Maikovsky region has a rent coefficient of 3. Therefore, the rent in the latter region is one half as expensive.

¹⁰ Enterprises employing less than 200 workers.

the initial price. Moreover, some 17 regions posted 5- to 10- fold increases, and other regions evidenced even higher differentials (15 regions 10- to 20- fold, and 17 regions over 20-fold differentials).¹¹ Both the city and region of Nizhny Novgorod ranked at the very top of the list with the smallest differentials, having an average ratio of only 2 to 3 times the initial price (see Exhibit 4).

Prices of privatized property and the ratio of final to initial price varied across regions (*rayons*) within the city of Nizhny itself. While the final to initial price ratio in the central regions¹² fluctuated from 3 to 5 times, in the industrial regions it was only 2 to 3. The central regions were somewhat poorer than the outlying ones, yet they sustained higher property prices than in the industrial regions. For instance, the "richest" region, Avtozavosky- with the highest per capita income, had a low ratio of final to initial price of only 2.3 (see Exhibit 5)

At least three major factors affected the ratio of final to initial price in Nizhny. The first one came from the supply side: the attractiveness and size of the assets offered for sale. In Nizhny, the most attractive assets were offered early for sale were.¹³ But by 1993 the more attractive enterprises had been sold. The second factor was on the demand side: investors had little capital. The third one measured how fair the selling price was and how close it came to market clearing price. In Moscow, where there were no auctions nor commercial competitions, price equilibrium did not exist at all. In Nizhny, where a much greater proportion of sales were through an auction, the process compared more similarly to a free market operation than elsewhere.

In the historical center of the city of Nizhny, the number of privatized objects was lower than in the industrial part. Presumably difficulties in approving the development of the historical central region contributed to the low results.

Data indicated the workers' collectives became owners of the small enterprises in Nizhny almost as often as outsiders did. But the more expensive the objects at auction (in terms of change in initial to final price ratio), the less likely they were to have been bought by the collectives, since the workers' collective at that point may not have been able to gather enough money to win at the auction or competition. In addition, there were cases in Nizhny when a company initially bought by a workers' collective at auction was later sold to an outsider who was able to provide funds for its restructuring.

The share of enterprises purchased by the workers' collectives in the region of Nizhny Novgorod increased from 49% in 1992 to 63% in 1993, falling slightly to 62% by 1994. In the 1993-94 time period, when the average ratio of final to initial price fell, there evidenced a slight increase

¹¹ Socio-Economic State of Russia, January-May 1994. Goskomstat monthly report. June 1994, p. 127-28.

¹²For example, the right bank of the Oka river and the Kanavinsky region. See map.

¹³In 1992 the ratio of 10 to 1 clearly indicated this phenomenon.

in the percentage of ownership by workers' collectives.

Outcomes and problems of Nizhny's small-scale privatization

Though no statistics would allow for an overall direct comparison of the performance of state-owned versus privatized enterprises, some generalizations are possible, evidenced by the seven cases later presented in this report.

Privatization in most cases (even if it was only a 15-year lease) led to renovation. In contrast to the run-down exterior appearance of most privatized objects, the interiors of privatized shops, restaurants, and other service enterprises were almost always refurbished. Moreover, the privatized shops were much better decorated and "furnished" than the ones still owned by the state.

The real value of sales (adjusted for inflation) increased significantly in most cases, as also did the volume of goods sold. As available statistics for the city of Nizhny indicated, in the first quarter of 1994 compared to the first quarter of 1993, sales of bologna (in tons) increased by 0.3%, fish - 10%, butter - 32%, oil - 22%, and cheese - 84%. However sales of meat and poultry decreased by 11% and sugar by 34%. Because many privatized shops did report their sales as "accurately" as state-owned shops used to do, the actual numbers for values and volumes of sales could have been considerably higher.

Employment also grew in most privatized enterprises. It was difficult, however, to judge the impact of privatization on labor productivity since privatized businesses usually provided a greater variety of goods and services as well as an improved quality of the services.

Capital productivity increased enormously, as well as an increased intensive use of space in the privatized shops. As estimated by Mr. Borodin, an official of the Committee for the Management of State Property, "in the region of Nizhny, space in privatized shops is used 3 to 4 times more efficiently after privatization."

Newly-privatized small businesses nonetheless, faced a number of problems. Among others the following stood out:

1. Leases on property rather than full ownership, inhibited investment in physical improvements of the business premises. This resulted from a sort of vicious circle: the owners refused to invest until they could become proprietors, while the city authorities proved unwilling to allow them to buy-out the leased property until they made capital improvements. In turn the leaseholders refused to do this until they gained title to the property and so on. It was noteworthy that local officials admitted that newly privatized companies in the Nizhny Novgorod region, where property was mostly owned, not rented, were investing more into restructuring than their counterparts in the city of Nizhny.

2. "Social infrastructure objects," personal services like laundry and dry cleaning, shoe and watch repair shops, drug stores, hairdressers, children's food stores, etc., generally deteriorated after privatization. They either started to use part of their space to trade imported goods, or charge very high prices for their mainstream services. Previously, these facilities were subsidized by the city government, but subsidies were later discontinued. The government did attempt to help these enterprises by, for example, excluding personal services enterprises in some rent payments.

The Moscow experience with small-scale privatization of personal services was very much the same. In Moscow these enterprises were also previously subsidized by city authorities (both directly and indirectly, by charging lower utility rates and not requiring rent payments), but after privatization and numerous price increases the major part of the subsidies evaporated. Prices for personal services increased much faster than the CPI and the "volume" of personal services decreased by over 75% in the 1990-93 period. Dry cleaners, for instance, processed only 3.5 million articles of clothing in 1993 compared to 27 million in 1990. In January 1994, Moscow city authorities had given some concessions to the personal services enterprises (lower rent rates). However, enterprises providing personal services continued to cut output and lease their space to trading and other more likely to succeed enterprises.

3. The success of a privatized business did not depend on whether it was bought by a workers' collective or by outsiders. What really mattered were the "connections" of the new owners. The latter often came from the former nomenclature cadres, for instance, from the Komsomol, the Young Communist League, or from the less formal ex-elite (managers of the Soviet trade system or the auto service centers, etc.).

Sometimes the decision to buy an object at an auction precluded other bidders from participating (because threats or indirect warnings to the latter), so that the price at auction did not rise to equilibrium (the initial price was computed in "old prices", so it was much lower than the book value of assets in current prices; the initial price also did not take the location into account).

4. The demand for property offered for sale became weaker and weaker. The ratio of final to initial price in 1992-94 declined and by mid-1994 was only 2 times higher than the initial price. According to administration officials in the city of Nizhny, some objects were so unattractive that auctions or commercial competitions could not have been held since there were no applications at all.

This problem was by no means unique to Nizhny. All over the country there existed a lack of domestic and foreign capital for investment. The domestic savings rate was high (especially in the form of the increase of cash holdings), but the government budget deficit absorbed them, leaving limited funds to finance private investment. Economic instability (high inflation) and political uncertainty discouraged foreign investors causing low foreign investment.

Bank credits lasted for periods of 3-6 months, and only 4% of credits were long-term (over 1 year). Private investors under these conditions could obtain credits at reasonable rates to privatize or to restructure their businesses.

Overall, the book to market ratio (the ratio of the book value of assets in current prices to market value of companies' shares or market value of businesses) was extremely high because of low demand, somewhere between 50 and 100. Privatized property was, thus, sold at a 98-99% discount in real prices, or at 1-2% of its current book value.

The current sluggish demand for assets, however, could increase once inflation was brought under control, the government budget deficit reduced (so more private savings are left for investment), and the investment climate improved.

5. In Nizhny, the focus of the privatization program shifted from privatizing enterprises to providing assistance (technical and financial) to help newly privatized enterprises restructure and adjust to market demands. The recent decision to create 10 privatization centers all across Russia aimed at providing this kind of assistance. One of the centers would be created in Nizhny Novgorod with a mandate to service a number of regions, including the Nizhny region itself.

6. The whole issue of taxes (see Annex IV for a listing of all applicable Federal and Local Taxes) and permits veritably constituted a discouraging burden that was almost impossible to carry by small scale enterprises, if strictly adhered to.

Exhibit 1
Privatization Dynamics, 1992-94
Russia Wide

Number of Enterprises (thousands)	as of 4/01/92	as of 01/01/93	as of 01/01/94	as of 06/01/94
1. Number of state owned enterprises*	139.9	204.9	156.6	145.6
2. Number of applications for privatization	18.4	102.3	125.5	135.7
3. Number of processed and approved applications (number of privatized enterprises)	5.0	46.8	85.6	101.6
4. Number of state enterprises converted into public joint-stock companies	0.06	2.4	14.1	19.0
5. Share of privatized enterprises in the total number of state owned and private enterprises (3) : [(1) + (3)]	3.5	18.6	35.3	41.1

Source: Russian Economy Developments in May 1994. Institute for the Economy in Transition. Moscow, June 1994, p. 7.

* To be privatized.

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Exhibit 2
Some Indicators for Nizhny Novgorod Region and City

Population, January 1, 1993, thousand	
Region - 3697	
Urban - 2872	Rural - 825
Nizhny - 1433	Other - 1439

As a % of National Average:	
Population (January 1994)	- 2.5
Personal income per capita (April 1994)	- 70
Average wage (March 1994)	- 86
Number of unemployed (March 1994)	- 2.6% of all Russian unemployed

Index of Industrial Output, 1985 = 100%

	1986	1990	1991	1992	1993	1994*
Russia	104	114	105	86	72	53
Nizhny Novgorod Region	104	110	110	113	100	67

* Estimate

Number of joint-ventures - 37 (1.2% of total number of joint ventures in Russia)
Foreign direct investment by April 1, - \$7.5 mln. (0.3% of total FDI in Russia)

Source: Goskomstat

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Exhibit 3

In 1993, Russian enterprises as a whole in comparison to Nizhny Novgorod small-scale enterprises were sold in the following ways (% of total):

Privatization Sales Mode	All Russia	Nizhny Novgorod
Auctions	9.2	8.3
Commercial Competition	44.0	70.0
Investment Competition	1.9	-
Closed Tender	-	20.6
Buy-outs of leased property	42.8	1.0
Direct Sale (non-competitive)	1.5	0.1
Sale of Assets of liquidated enterprises(nc)	0.6	-

Exhibit 4

Some Major Results of Privatization in Nizhny Novgorod Region by July 8, 1994

Region/Industry	All enterprises in municipal property	To be privatized enterprises (according to a plan)	Privatized enterprises as of July 8, 1994
City of Nizhny Novgorod	1505	1090	1090
Region of Nizhny Novgorod	2233	1372	1311
TOTAL	3738	2696	2401*
Trade			1402*
Public Catering			279*
Personal Services			610*
Other			8*

* The sum does not add up to the total in the source.

Region/Industry	Ratio of selling price to the initial price at the 1994 auctions, %	Share of enterprises purchased by worker collectives, %
City of Nizhny Novgorod	225	46.3
Region of Nizhny Novgorod	313	62.6
TOTAL	242	55.0
Trade	242	55.6
Public Catering	340	44.5
Personal Services	186	50.2
Other	226	100.0

Source: Statistical material of the Committee to Manage the State Property in Nizhny Novgorod Region.

Exhibit 5

Some Indicators of Privatization by Region (rayons) of the City of Nizhny

Region of the City of Nizhny	Population as of 01/94, thousand	Average per capita income in 1993, rubles	Ratio of final to initial price of privatized objects, %	Number of privatized objects, a % of a plan
Nizhegorodskiy	134.6	55768	334	48
Sovetskiy	172.3	47610	331	66
Priokskiy	104.1	55262	451	61
Kanavinskiy	169.9	52115	448	70
Avtozavodakiy	341.9	75236	232	67
Leninskiy	167.4	55629	206	71
Moskovskiy	148.0	40328	249	94
Sormovskiy	186.4	50319	213	72
All regions	1424.6	59330	281	67

Source: City of Nizhny Novgorod Committee to Manage the State Property.

Part II
Case Studies of Individual Enterprises
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*The companies were selected for study at random.

Case #1 Konsum Food Shop

The Partnership

In December of 1992 the Konsum partnership was organized by two equal partners, Igor Ponomorev and Lydia Yevseeva. The partnership was formed with plans to participate in an auction in order to acquire a food store. In January of 1993, the Konsum partnership received rights at auction, to rent a local food store in the Maikovsky region of Nizhny Novgorod, catering to 15-20 surrounding apartment complexes occupied by veterans of war and elderly citizens. The store had an initial total space of about 74 square meters with a product space of 68 square meters.¹⁴

The store was acquired without any previous debt, nevertheless, the contract included several of the usual obligations, among which was to partially (30% of total space) keep the specialty products for diabetics character.¹⁵ Konsum had to make also capital improvements (not less than 200,000 rubles) within two years after the auction. The last requirement included the preservation of the number of jobs in the profiled activity.

Raising Capital

Konsum borrowed 9,000,000 rubles from Leninsky Commercial Bank at an interest rate of 110% per annum, with which it used to pay the final auction price of 6,600,000 rubles for the right to rent the store for 15 years.¹⁶ The remainder of the loan was used to purchase two trucks (2,400,000 rubles). In addition to the loan, the partnership invested 2,000,000 rubles of their own savings in the start-up phase of the operation, in the purchase of equipment (display counters, refrigerators, etc.) and other general improvements (1,000,000 rubles), and for the first few months of rent.

Since initially acquiring the food shop, Konsum had been forced to borrow twice more to help finance its operations. The first of the two loans was taken in April of 1993, the second for 15,000,000 rubles was taken in February of 1994 at a subsidized interest rate of 90% per

¹⁴Small alterations were taking place in 1994 to "create" additional space.

¹⁵The "profile" of this store included special foods and medicines for diabetics as well as regular food stuffs. The diabetic line of products occupied 30% of total space while the regular food stuffs occupied the rest. Konsum had the obligation not to reduce the space allocated to the diabetics line.

¹⁶ In the initial rounds of privatization auctions in the city of Nizhny Novgorod the "objects" sold were typically 15-year leases on pre-existing "enterprises."

annum¹⁷ to help pay for capital improvements that were still well in progress as of July 1994. By July 1994, all loans had been repaid.¹⁸ Panomarev and Yevseeva (both equal decision-makers) commented that the February 1994 loan had compromised the store's profits for 1994, but that it had been well worth it, since the capital improvements (once completed) would attract more business.

Changes of "Profile"

The store went through a series of transformations since it was first built in 1980. It began as a bread shop and later became a store that sold food and other products for diabetics. It was the latter "profile" that Konsum was required to preserve. As a result, the store devoted 30% of total space to food stuffs such as sugar-free confections and various other types of goods, such as medication, that diabetics from across the entire Maikovsky region of the city came to buy.

From Privatization to the Present

Employment

Before privatization the store employed 4 workers (1 accountant, 1 director and 2 sales persons). Konsum kept two of these four employees after the store was leased at auction, and 4 new workers had been hired. After several turnovers in staff, the store operated with 8 employees (6 plus the two owners who were also on the payroll) by July 1994.

The number of employees did not increase proportionately to the increase in sales. Panomarev explained that the workload for each employee had increased dramatically and this caused the constant turnover in staff. He added, "When we first acquired the store, the workers were practically falling to their knees as a result of the increase in workload¹⁹...in fact, two workers recently quit because the workload was simply too much for them to handle."

*Product Differentiation*²⁰

Since privatization, Konsum had effectively increased the diversity of its product line. By the

¹⁷ In February of 1994 the going interest rate was roughly 200% per annum.

¹⁸The February 1994 loan has been repaid partially with profits from the Konsum operation and the rest was paid out-of-pocket (by the two partners).

¹⁹ Implied was the increase in the volume of goods handled, the increased requirements for maintenance, promptness of customer handling and others, to improve in the use of very limited space.

²⁰For the distribution of sales by product type please see Exhibit 1.

summer of 1994, the revised product line offered different meat products (35% of total sales), from sausages and hams to frozen chickens. The selection of vegetables increased and as a result, sales also increased in absolute and relative terms. In June 1994, vegetable sales accounted for 13% of total revenues compared to 4% before privatization. Candies (7%), and fish products (11%) were entirely new additions to the product line. The owners reported that the new array of dairy (14%) and bread products (20%) had increased their client base as well as sales, "...if a customer is able to buy milk and bread in one location in addition to other day-to-day staples, he will definitely shop in that kind of store as opposed to going to three or four kinds of specialty stores (bread store, dairy store, meat store, etc.), which was the standard procedure before retail outlets were privatized.²¹ That is why we have increased our product line, and as a result, we have more customers."

Cigarettes and alcohol had not been added because of the type of clientele (mostly the elderly) that frequented the store. Moreover, the partners both agreed that the sale of tobacco and liquor products would attract the "wrong type of crowd."

Innovation

Several months after acquiring the store, Konsum used the 2,400,000 rubles left over from its original loan to purchase two trucks. Panomarev commented that this addition not only helped the store receive supplies without paying "exorbitant" delivery fees, but could also be used for other purposes.

One way that Konsum expanded the business was by participating in "street sales." Using one truck for this purpose, each morning Konsum delivered food stuffs to a neighboring region and sold them on the street right out of the truck. This was a common way for food stores to get rid of inventories of unsold goods or to simply generate more sales.

Sales and Expenditures

The sales volume increased tremendously since privatization. Prior to privatization in 1992, the store focused exclusively on products for diabetics. Sales averaged about 600,000 rubles per month. For 1994, sales averaged 60,000,000 rubles per month, an increase of almost 7 times in constant prices.²²

Since the store was located in a community that was home to low-income citizens (mainly pensioners), margins were kept as low as 9%-10% (maximum allowed by law is 25%). In fact, Yevseeva mentioned that on a local radio program broadcast, Konsum was credited as being the food store with the lowest prices in all of Nizhny Novgorod. Of the roughly 6,000,000 rubles

²¹ It should also be noted that rent rates for stores that sell bread and milk are lower than otherwise.

²² The CPI has registered a fifteen-fold increase from December of 1992 to June of 1994 (18 month period).

per month gross income (margin), Konsum spent nearly 5.2 million to operate it.²³

Although Konsum did not pay high salaries to its workers, wages nevertheless exemplified the highest of the expenditures (30% of margin) at 2,000,000 rubles per month²⁴ (500,000 of which goes to wage tax). The next highest expenditure was the security system against theft which cost 1,000,000 rubles (15% of margin) per month. This expenditure was considered a necessity, as they had been burglarized several times before. Rent (100,000 rubles) and utilities (400,000 rubles) were relatively much less expensive at only 500,000 rubles (7.5% of margin and only half of the cost of security) per month. The rest of the expenditures added up to another 1,700,000 rubles and included: taxes, bank fees, licensing fees, distributor's commissions, gas and miscellaneous expenses. After paying for all expenditures, Konsum received a monthly profit of around 800,000 rubles before profit taxes. However the two partners declared, somewhat in contradiction with earlier statements, that "if they were not earning a salary, they would not have enough to live on from profits alone."

A Closer Look

The store was rather small and cramped. Most of the time the customers had to wait in line since the number of employees available could not effectively manage serving more than five customers at a time. Since the elderly made up most of the store's clientele, the purchases per customer were often small. There were normally 6-10 customers in the store at any time, making for a busy day.

Moreover, the equipment was old and at times broke down. Panomarev complained that, "each time that the refrigeration equipment in the display counters stopped working, it costs us a lot of money to fix it. Yet the store is not now making enough profit to be able to purchase new equipment."²⁵

Suppliers

Most of the products sold in the Konsum food store were of domestic origin bought through local distributors. However, some products sold were imports, also available through local channels. Most of the purchases were cash and delivered either two or three times a week depending on the type of merchandise. The exception was milk which was delivered fresh every day. Meat products and some dairy products were ordered to be supplied three times a week, while vegetables and bread were supplied twice a week. All non-perishables were reordered as supplies ran out (there was very little inventory of these or any other goods kept in the small

²³For a graph of the distribution of expenditures see Exhibit 2.

²⁴Figure includes wage tax/social security.

²⁵Their ability to have promptly repaid the loans seems to contradict this assertion.

quarters of this store).

Outlook

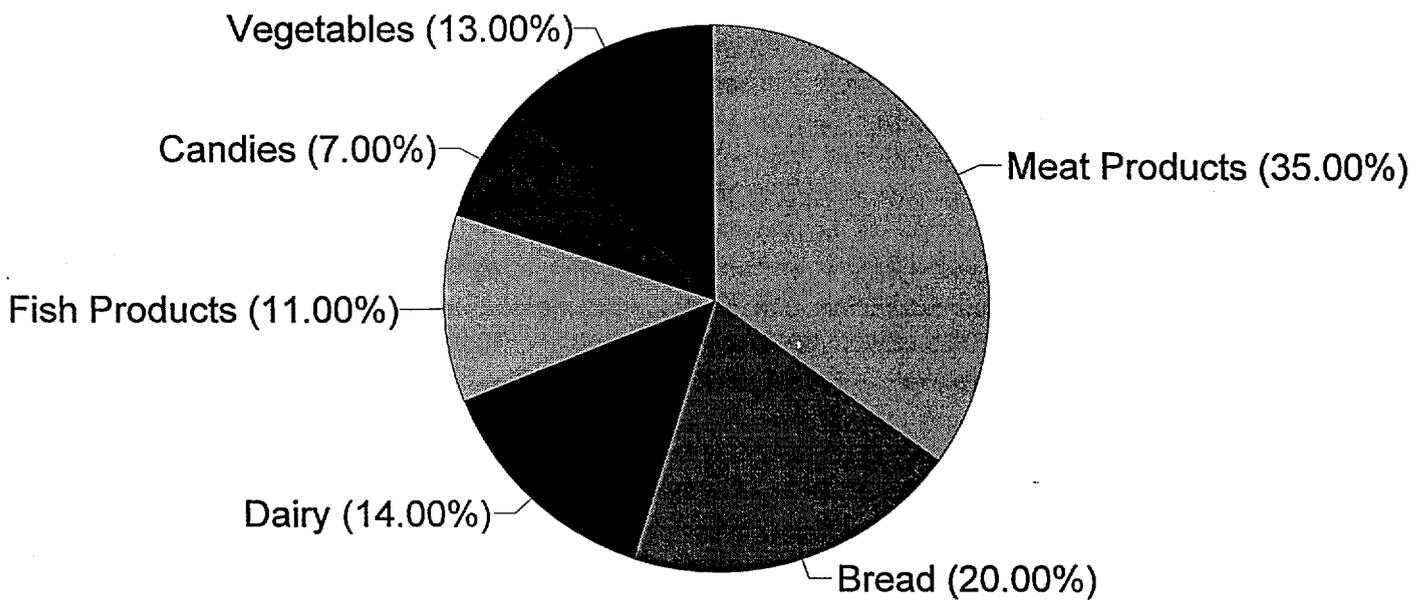
Problems and Challenges

Panomarev and Yevseeva's grievances were common among many small-scale newly privatized enterprises. The main problem, according to them, was taxes. Panomarev commented, "I understand that hospitals, schools, road projects and other social costs need to be paid, it's like that all over the world, but these taxes that the government charges us are unreasonable - they strangle us!" The rising cost of rent and utilities demonstrated their next concern. Although the partners felt as though the rent they paid was a fair price, they expressed concern for the announced rent and utilities hikes.

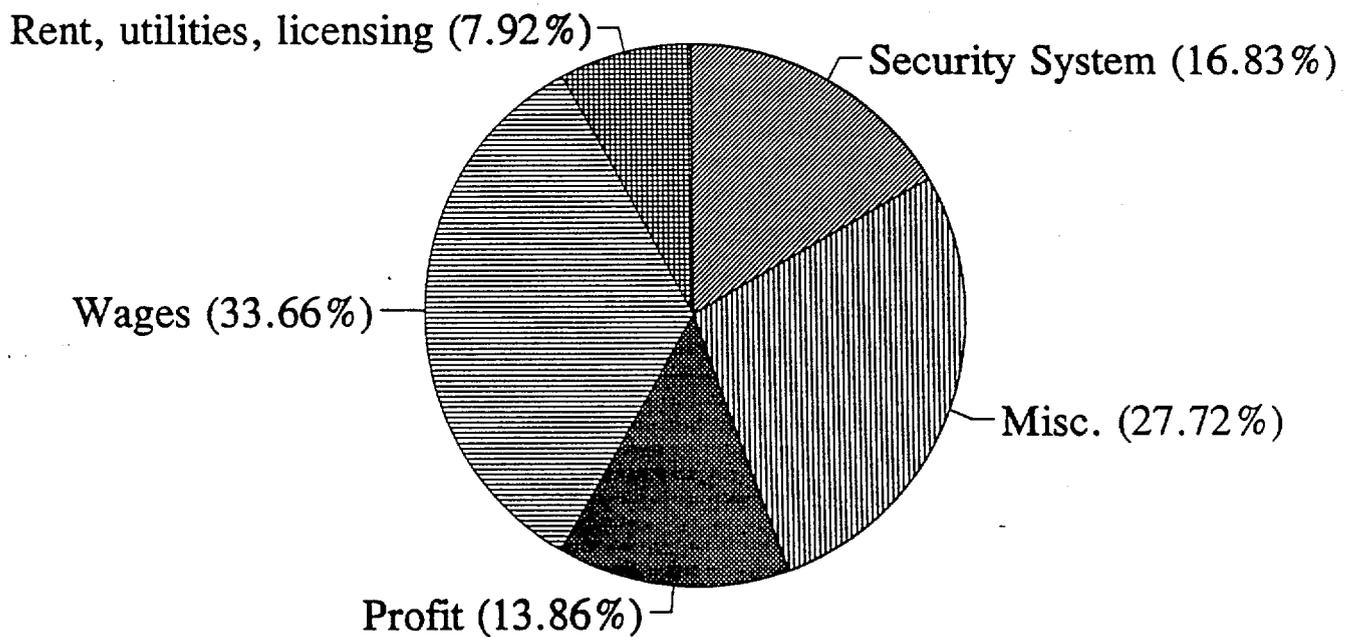
The partners had set several goals for the store. They longed to achieve the purchase of new equipment. If they were sure that the equipment would function properly they would have been able to stock more products without spoilage. Next, since they first leased the store, they contemplated whether or not they would ever own it. In January of 1994, the Konsum partnership applied to GKI (the State Committee on Property) requesting the right to purchase the building. Upon visiting the store, a State Committee field team assessed that the store did not demonstrate success and good upkeep and was therefore not eligible for purchase. Since the visit by the GKI team, the partners had been hard at work, sacrificing profit and personal savings, to further renovate the store in order to fulfill their goal of actually "owning" it.

EXHIBIT 1

Distribution of Sales by Product Type Konsum Food Shop



Monthly Distribution of Margin Konsum Food Shop



Case #2 Simbirski Food Store

The Simbirski Store

For seventeen years prior to privatization the enterprise now called "Simbirski Food Store" had supplied food products to a densely populated area of the GAZ auto plant region of Nizhny Novgorod. Towards the end of October 1993, after outbidding two other companies, the Nizhny Novgorod Auto Ltd. company bought the lease rights for the food shop for 15 years at a final price of 40,000,000 rubles. Total shop space measured roughly 1,201 square meters and product space measured nearly 800 square meters, fully occupying a semi-attached dedicated building adjoining an apartment complex.

The initial rent for the property was set at 3,497 rubles per square meter (4.2 million) per month. In addition to the lease rights acquired at auction, the Nizhny Novgorod Auto partnership also purchased the existing equipment to be used in the future operations of the store at an additional price of only 514,000 rubles. Although the store was bought "free and clear" of all debts that the old operation had incurred, the store did not come without obligations. At time of purchase, the new owners made a commitment to retain the store's "profile" for the first five years of the lease. In addition, the store was made responsible for the maintenance and repair (i.e. the plumbing, sewage, electrical equipment, etc.) of the adjacent (semi-attached) apartment building.

GKI, the State Committee on Property, had enacted a rule that entitled the current leaseholder to purchase²⁶ the leased building for a sum equivalent to three months of rent, under the condition that the enterprise be successful. In May 1994, after the store demonstrated it was well run and successful, the government permitted the partnership to purchase the building for 7,200,000 rubles. After the purchase, not only were the rights to the property secured for 49 years, but also the new owners were relieved of rent payments for the same period. According to the owners, this event has made them more confident and thus more committed to the further development and capital improvement of the store.

The New Owners: Nizhny Novgorod Auto Ltd.

Nizhny Novgorod Auto Ltd. (NNA) was organized in September 1992. At the time of initiation of operations, the company was strictly an auto repair shop specializing in the repair of Mercedes Benz cars and employing roughly 140 people. Soon thereafter, the company grew to become a used car dealership with its own sales lot located in the GAZ auto plant region. In addition,

²⁶ By "purchase" we mean the rights to the property for 49 years. Complete land privatization had not yet been attempted in Russia. Initial efforts at farm privatizations were being carried out precisely in the region of Nizhny Novgorod.

it also served as a dealer in the city for GAZ vehicles. The partnership consisted of four equal principal owners, one of which was Gennadi Kolochkov. Since Kolochkov was the one that headed the acquisition of the Simbirski Food Shop, he was made the General Manager and Chief Operating Officer of the newly purchased store. Kolochkov's previous position was Repair Shop Manager and Technical Specialist at the Togliati automobile manufacturing plant.

Capital from the Nizhny Novgorod Auto Ltd. and loans from Nizhstroy Bank, a local financial institution, helped finance both the original lease and the eventual purchase of the Simbirski store. The initial 40,000,000 rubles used to acquire the store at auction, was almost all borrowed at a subsidized interest rate.²⁷ The Simbirski store managed to repay the debt by the end of the first quarter in 1994. After paying off the loan, the partnership felt confident enough financially to invest the 7,200,000 rubles needed to purchase the building in May 1994.

From Privatization to the Present

Before privatization, the store employed 18 workers and maintained a modest variety of food products. The inside of the store was poorly maintained and badly worn down. The volume of sales averaged roughly 20,000,000 rubles per month by mid-1993 and the turnover of goods was rather slow, evidenced by the spoilage rate.

As Kolochkov reflected upon the past year of the store's operation and new management, he felt very satisfied with the progress. Sales had increased tenfold to about 210,000,000 rubles per month (as of June 1994) in current prices.²⁸ Over the same period of time, the work force had expanded to 90 people. Given this degree of progress, Kolochkov could afford to complete many capital improvements to the store, in addition to the replacement of all of the old operating equipment (such as display counters, cash registers, shelves, etc.). The inner appearance of the shop was now truly remarkable, furnished with new Italian-made display counters, and decorated with mirrored ceilings and marble-lined floor and walls.

Required to keep 70% (of total space) of the old "profile" of the store (food shop), there remained some room left to expand and differentiate the product line. However, most of the newly-introduced activities still dealt with food and beverage products. Though the product lines remained focused, the "final" product's orientation became more diverse.

²⁷The Nizhny Novgorod Auto company received a government subsidy in partial abatement of the interest rate charged by the private lending institution for the loan.

²⁸ This sales volume was truly remarkable for a store of this size. Gennadi gave an example to prove this fact. According to him, there was a store two blocks away of the same size which had a sales volume of only 100,000,000 rubles per month.

The Business

Meeting Market Demand - Product Differentiation

Responding to the demand of the clientele, the Simbirski Food Store expanded the variety of products available. The main additions included liquor and tobacco products in February 1994. By adding these goods, the store increased the sales volume by nearly 30%. Under new ownership, the selection grew from the limited number of items previously sold such as vegetables, eggs, bread, several types of sausages and hams, some fish products, three types of cheese and some fruits. Simbirski now sold 30 kinds of meat products (bologna, salami, hams, veal hot dogs, etc.) compared to only 7 kinds prior to privatization. New dairy products were also added to the selection. Imported cheeses, two types of milk (low-fat and regular), cottage (farmer's) cheese, yogurt and buttermilk were among the new arrivals. Further, candies, "exotic" (tropical) fruits, and an assortment of dried and smoked fish (both domestic and imported) were also added.

Kolochkov explained that he had and always would, look to sell new products to meet the changes in demand and competitive conditions. Surveys and questionnaires filled out by clients assisted in assessing these changes. Once new demands were identified, the new products were quickly placed on the shelves.

The store managed to not only maintain this new variety of products, but has also managed to keep the turnaround time to a minimum under new management. Simbirski had been able to sell all of its inventory within two days of delivery, thus keeping all of the food stuffs fresh. For instance, all milk and meat products were sold within one day of delivery and fruits and vegetables within two. This type of quick sale of products that were vulnerable to spoilage, coupled with the liberal return and exchange policy had earned the store a good reputation among clients. Thus, Simbirski expanded its client base from just local, before privatization, to a point where customers were travelling as far as 20 kilometers to visit the store.

Innovations

In addition to product differentiation, the Simbirski store had purchased several trucks and automobiles to facilitate transportation of the varied produce that it purchased from local distributors. In total the store owned five trucks, two cars and one mini-van. Although it leased the trucks on occasion, or at times contracted out to various distributors for shipping purposes (in these instances one truck always remained to service transportation needs of the store), most of the time they served the shop exclusively. Kolochkov felt certain that the addition of this fleet of trucks helped cut his transportation costs in half.

Prior to purchasing the building in May, plans were made to build a bar and grill in space previously used for storage. The bar and grill were in operation with future plans to build a patio section outside of the building to accommodate more customers. Also, the Simbirski operation sought to expand by buying out a nearby food store. The legal paperwork for the

acquisition had already been submitted. The plan called for the GKI to retain a share of 50% of profits in this new venture.

Other innovations included a complimentary grocery delivery service for the elderly and handicapped²⁹, setting-up a booth at the *rinok* (the local market), contests for customers to win food parcels, and other marketing devices to attract and expand its customer base.

Suppliers

Suppliers used by the Simbirski Food Shop consisted mainly of privatized companies. Roughly 70% of all products sold were domestic and the rest were imported. The store purchased imported products from two importing distributors: Maxio of Holland (fruits and candies), and Ruges of Finland (cheeses, meat products, candies, wines and other liquors). All of the domestic products were purchased directly from the producers with the exception of some vegetables which were still bought through distributors that delivered the merchandise to the shop every other day.

The payment system for purchases from suppliers was structured in a way that protected the shop from paying in advance for bad produce. All new suppliers had to extend up to 10 days credit to the Simbirski store. Deliveries³⁰ during the week were paid as follows: 1) Monday and Tuesday deliveries were paid for on the following Friday; 2) Wednesday and Thursday deliveries were settled on the following Tuesday. On the other hand, established vendors received payments in cash. Occasionally, when testing a new product, both new and established suppliers extended credit. Simbirski used this strategy in order to minimize the risks and costs of introducing new products that might not have sold well.

*Sales and Expenditures*³¹

All sales transactions of the store were paid for in cash. The store's sales volume continued to increase with the various additions and innovations in the operation (i.e. addition of liquor and tobacco products, bar and grill, etc.). In 1994, the store grossed on average 210,000,000 rubles per month (sales decreased in the summer months). With the exception of the products sold through the bar and grill, all goods were marked-up only 20% (25% is the limit by law). Other than the cost of goods, wages absorbed roughly 48% of the margin.³² Rent, utilities and licensing

²⁹This service had been introduced to increase business as well as show local officials that the store contributes to the needs of the community.

³⁰By "deliveries" we mean two things: 1) actual deliveries to the store of imported goods, 2) since most of the domestic products are picked-up by the store's trucks, "deliveries" refer to the date of pick-up.

³¹For the distribution of expenditures see Exhibit 3.

³² Figure includes wage tax / social security.

followed next, by value, in the expense column averaging 20% of total margin. Value Added Tax plus Excise Tax were equivalent to another 23% of margin. Transportation and miscellaneous expenses added up to 5%. The 4% left over was profit before taxes.³³

Outlook

Problems and Challenges

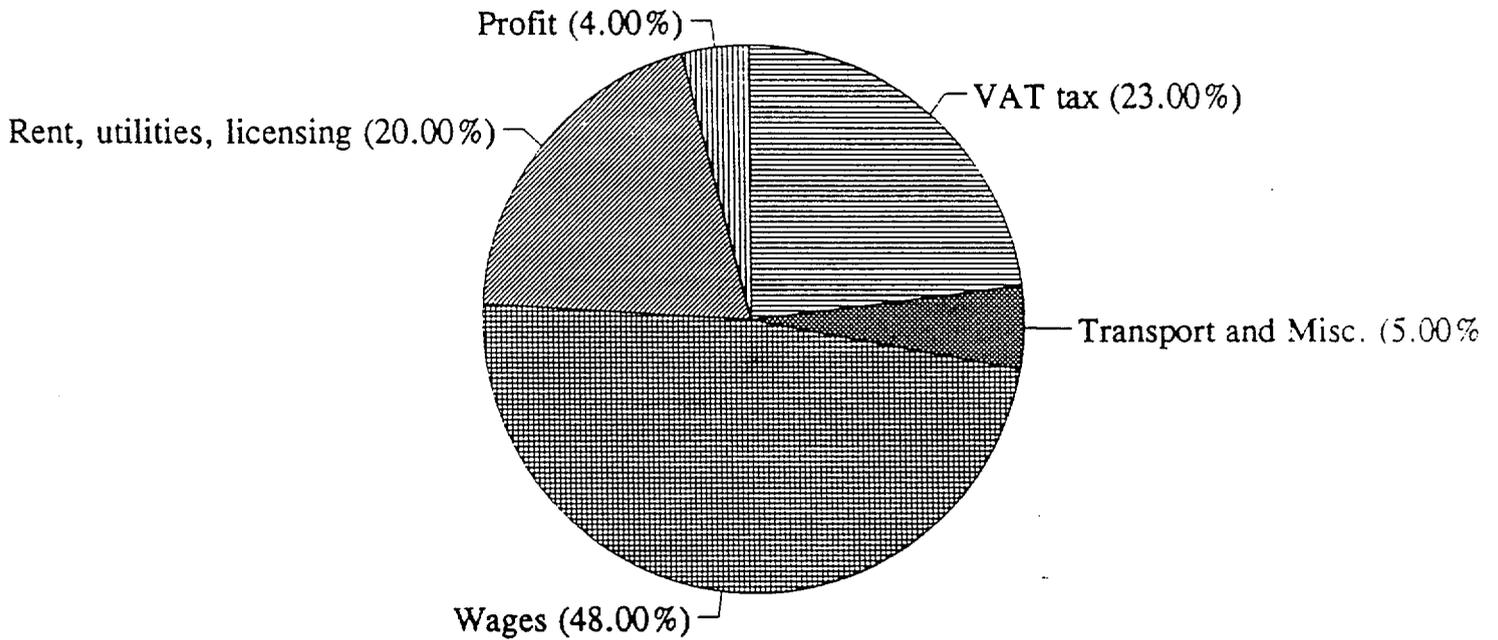
The new owners believed that the principal problem was taxation. Next, the issue of licensing fees associated with the various operations, which increased every quarter, became also a major concern for Kolochkov. He expected, however, that these problems would ease as the local government gradually reformed its tax and fee structure.

Kolochkov commented that one of the most critical challenges that laid ahead for the Simbirski Food Store was increasing efficiency. Minimizing costs with respect to spoilage, utilities and the overall cost of goods, increasing productivity of the workers,³⁴ looking for new suppliers that would provide more favorable terms, installing a refrigerated warehouse to increase "per order" size, and advertising to increase the client base, were goals that keep Kolochkov's business agenda full.

³³ Although the Profit Tax was 35% in Nizhny Novgorod, Gennadi commented that the store was left with roughly 2% of margin as net profit.

³⁴ Simbirski has done much to maximize worker productivity. In addition to raising salaries to 150,000 rubles per month per worker, it has developed a nice benefits package which includes paid holidays and cruises on the company river boat. Also, Gennadi is thinking of devising a profit-sharing arrangement for the workers.

Monthly Distribution of Expenditures Simbirski Food Store



Note: Gross income = 210,000,000 rubles per month

Case # 3 Alyona Vegetable Shop

The Partnership

On December 12, 1992, Tatiana and Olga, two friends since middle school, entered into a partnership to purchase a vegetable shop in the city of Nizhny Novgorod, located closely to the GAZ auto manufacturing plant. They acquired a 15-year lease at auction at a price of 22,000,000 rubles for 536 square meters in total area with about 257 meters product space. The terms of the lease included a rent clause requiring payment of 4,000 rubles per square meter of ground level space each month, and 2,000 rubles per square meter for the cellar per month.³⁵

Insiders' Benefits

Common in cases of privatizations all across Nizhny Novgorod, as in the case of Alyona, was an important variable of connections. Tatiana was once a prominent figure in the local Komsomol as well as a high ranking official of the Communist Party. These former positions had most probably played a key role in Tatiana's early access to new business opportunities.

From Privatization to the Present

Prior to privatization the shop was a workers' collective with 12 employees. By the end of 1992, the store had accumulated a debt to its suppliers of 5,000,000 rubles before being driven into bankruptcy. The standard policy for small-scale enterprise privatizations in Nizhny Novgorod stipulated at the time that upon the sale of an enterprise at auction, the city would absorb all debt. The vegetable shop was presumed "free and clear" of this relatively large deficit. Tatiana and Olga were quite surprised when asked to pay the collective's outstanding debt after having paid for the shop at auction.

Since privatization, the shop had achieved unprecedented levels of sales and financial success. As of July 1994, sales ran between 50 and 60 million rubles per month compared to 2.5 million before privatization. In constant prices as well, the shop had increased sales roughly 3 times over previous levels. The number of employees had also nearly tripled to 35 workers. With the ability to choose suppliers other than state monopolies, the cost of goods sold were kept within competitive levels resulting in lower prices and improved quality, allowing for expanded sales and profits.

³⁵Based on our findings, the rents to be paid for most small-scale privatization objects, including the vegetable shop, would rise proportionately with inflation.

The Business

The shop's overall appearance did not particularly appeal to the eye: the sidewalk and the building itself were poorly maintained, and the windows and signs did not offer much for the "passer by" to see. In contrast, the inside of the store appeared well organized, clean and well kept. Although the State Committee put pressure on the shop to refurbish the locale and area just outside the store, the partners were reluctant to invest monies for property that did not actually belong to them. Therefore, the shop remained neat and tidy on the inside and unattractive on the outside.³⁶

The shop was located next to three large buildings housing war veterans and pensioners. As a result, the "authorities" expected that prices on the fruits and vegetables to be kept low. Any shop that sold food products in the city had to keep profit margins below 25 percent. The Alyona store was "forced" to limit its margins to a range of 10%-15% because the clients simply could afford the higher prices. Yet the shop managed to thrive regardless of the lower sales margins. Net profits ranged anywhere from 6% to 8% of gross sales. These figures represented monies left after covering maintenance and operational costs in the shop.

Product Differentiation

Adding product lines vastly different to the main line of products was a fairly common occurrence in many newly privatized small-scale enterprises. Expansion efforts in the product line and the introduction of new products and entirely new lines were important indicators of entrepreneurial skills that the new owners demonstrated. As of June 1994, the store was selling 12 to 15 types of fruits year-round, mostly imported, and 10 types of vegetables, purchased from local suppliers. Tatiana and Olga had further diversified their shop by adding garments to their line of products for sale. Although the conditions of sale at auction required the shop to keep its "profile", this condition (specifically referring to the allocation of space within the premises) was capped at 70 percent of total space. Taking advantage of that opportunity, the two partners used roughly 20 percent of their store space to sell clothes.

Innovations

The partners had recently set their minds on the purchase of additional space in the adjacent building. They planned to introduce again different products in this new space, although they had not yet decided what these new products would be. In summary, increased sales, product diversification and the planned expansion are signs of a viable and flourishing operation.

In order to cut costs, Tatiana and Olga decided to rent trucks and drive them out to the farms

³⁶ This phenomenon, almost universally observed in this city, invited speculation as to its cause and purpose. Was it "cultural", the lack of resources, deliberate camouflage? These were some of the questions prompted by the many times appalling contrast between outside and insides.

to buy directly. They strongly believed that this tactic would help them to cut costs and acquire better quality goods in the long run. In addition, by buying direct, Alyona could return (for refund or credit) all damaged or spoiled merchandise. Distributors (wholesalers, intermediaries), on the other hand, proved less willing to give such return concessions.

Suppliers

Alyona used various suppliers for its produce, with the majority of the fruits and vegetables purchased from intermediaries at distribution points. Fruits were imported from Moldova, but mostly from a Finnish warehousing company (called "Exotic Fruits") that distributed imported products, such as bananas from Costa Rica and Ecuador. Vegetables were also purchased through intermediaries, which were small companies that acted as brokers for local producers. Most of them delivered the produce right to the shop. Almost all purchases were paid for in cash.³⁷ If terms were used, however, they normally netted 10 days.

Sales and Expenditures

The shop grossed anywhere between 50 and 60 million rubles per month.³⁸ Cost of goods sold represented, on average, 75% of sales revenue. Wages represented roughly 30% of margin. Next on the expenditure list were rent, utilities, and maintenance, which roughly equaled another 25% of margin. Miscellaneous expenses such as transportation costs, capital repairs, licensing and other costs ran approximately 10% of margin. The value added tax of 23% was also based on margin. Other unspecified expenses accounted for 6% of margin. The remaining 6% of margin was the net profit before taxes.

Outlook

Problems and Challenges

The most difficult barrier that the Alyona vegetable shop had to overcome was competition with state-owned shops in the same line of products. While the state-owned shops continued receiving subsidies of various types, such as low utility payments and lower cost of goods purchased through state-operated suppliers, Alyona paid market prices in both instances. Nevertheless, that competitive edge was regained as state-owned shops began to go further into debt, received less and less subsidies, suffered from limited supplies and sources, and an overall lower quality of products. Moreover, state-owned retail shops were also limited in the sourcing of their products, buying almost exclusively from state-owned enterprises and not having access to attractive imported lines.

³⁷By "cash" we mean actual monies. In Russia, there is yet no operating check system.

³⁸ For the distribution of expenditures see Exhibit 4.

One of the main goals that the owners of Alyona had (which seemed to be a common goal with all the new private owners of small scale enterprises) was to actually purchase the property that the store sat on.³⁹ By "owning" the building/space, Tatiana and Olga expected to gain the security which would permit them to undertake various expansions restricted by the lease agreement, for instance, the keeping of the profile (on the use of space) within strict limits.⁴⁰ In addition, they reported a willingness to undertake much needed capital repairs and new capital investments with security of ownership.

The paramount problem faced by the vegetable shop was the one of taxes, viewed as a hindrance to more rapid expansion. Nevertheless, the general outlook for the business was favorable, as the partners a reduction in taxes in the near future.

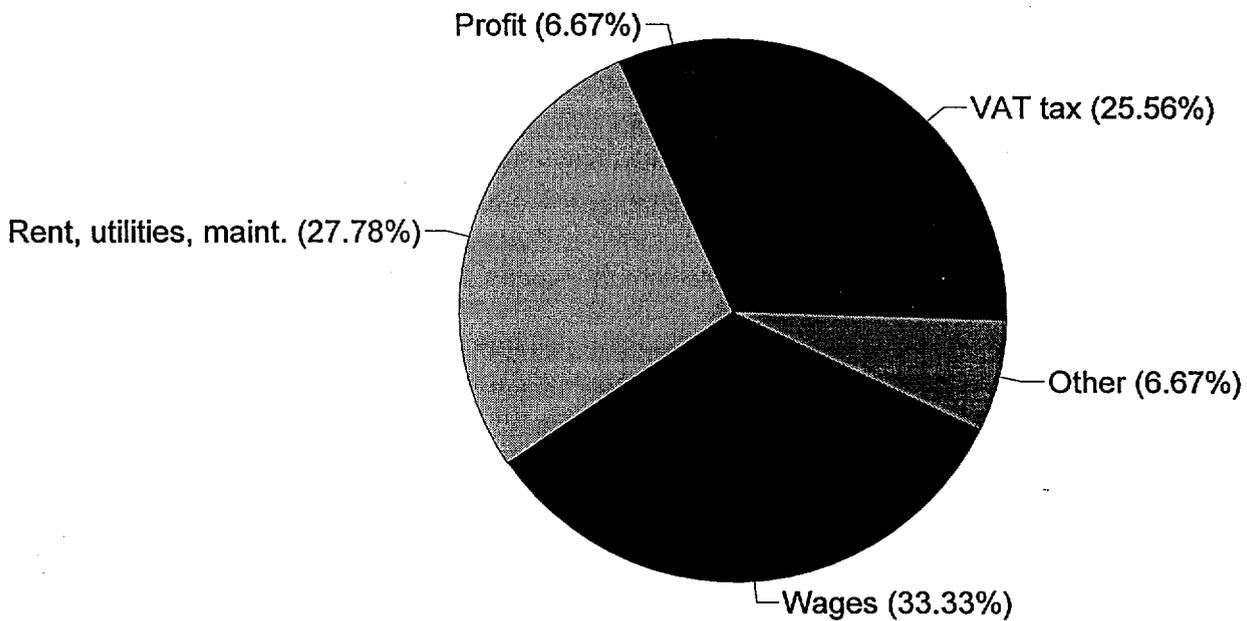
³⁹ Reportedly the purchase price of the "objects" is the equivalent of only 2-3 monthly rental payments.

⁴⁰ Apparently the promise of the sale of the property was one of the persuasive arguments the authorities used to keep the privatized enterprises adhering to privatization requirements.

Exhibit 4

Monthly Distribution of Margin *

Alyona Vegetable Shop



* 1) Total average sales are between 50 and 60 million rubles per month.

2) Margin = up to 25%

Note: Miscellaneous expenditures include transportation, licensing and capital repairs.

Case #4 Tatiana's Cultural and Business Center

The Partnership

In 1974, the state-owned auto manufacturing plant GAZ developed a cultural center for youths. The Center was the only one of its kind serving the GAZ plant region, which was a "city within a city." Home to 350,000 residents, the GAZ plant region was a self-sustaining and functioning part of Nizhny Novgorod. For this reason, many residents rarely travelled to other parts of the city since all that they needed was in the proximate vicinity. This helped with business since there was a constant local client base. The clientele visiting the Center ranged from young school children attending the "Sunday School" and various studios to adults coming to the restaurant and bar. Nevertheless, the Center retained the title of "Cultural Center for Youths."

Tatiana and Olga, the partners in the Alyona vegetable shop operation, were also active in other business dealings in Nizhny Novgorod. Later, while working for the auto plant, Tatiana served as the Interim Director of the Center. This was the precedent that set the stage for her current "ownership" of the Cultural Center for Youths. In December of 1991, she struck a deal with GAZ to lease the property. With the help of two partners (each holding 20% of the business), Tatiana⁴¹ (60% holder) developed the Center to one now containing 10 different, mostly self-sustaining, business operations. In addition to the businesses in the Center, Tatiana's "partnership" also operated a parking garage with 160 spaces and 3 kiosks, profits from which helped her with the operating expenses of the Center.

The building itself remained the property of the GAZ auto plant, and the exterior was still "run" by the city administration. The building was valued at approximately 515 million rubles and could be bought at any time for that amount. The lease was signed for a period of 5 years with an option to buy. Upon purchase of the building, however, Tatiana's partnership could deduct all the monies spent on capital improvements and depreciation (equivalent to roughly 200 million rubles) from the purchase price, putting them at a considerable advantage over other potential buyers of this property. The total area of the Center measured roughly 3,000 square meters and the rent was 3,000 rubles per square meter per month (adjustable for inflation).

From Privatization to the Present

Employment

Prior to privatization the Center was losing money and was receiving direct and indirect (through GAZ) subsidies from the government, which helped it to continue operations. Previously, the

⁴¹Olga, although not a shareholder, seemed to be an active partner in the various businesses within the Center.

Center employed 20-25 persons operating four activities: the Sunday school, art studio, dance studio and a children's center. The Center's operational capacity increased following privatization to employ 116 workers during its "peak" operating season⁴² (winter, spring and fall) and 84 employees in the "off" summer season. This large increase in the number of workers attributed to the expansion and diversification of activities.

*Sales and Expenditures*⁴³

The Center's margins were not controlled as in the vegetable shop (25% maximum). The restaurant and bar, for example, had mark-ups anywhere between 100%-150%. Sales ran in the range of 100-150 million rubles per month during the "peak" season, dropping to 50-80 million during the summer. Overall, sales in current prices jumped 20 times over previous levels.⁴⁴ Tatiana attempted recently to put together some other businesses in order to further increase sales in the coming season.

The major operating expense that the Center incurred came from wages. With employees making between 100,000 and 150,000 rubles per month (a good salary by Russian standards), almost 30% of revenues went to labor⁴⁵. Rent and utilities consumed about another 20%. Miscellaneous expenses such as transportation, maintenance/repairs and licensing added-up to about 15%. All expenses (29% of revenues were unaccounted for⁴⁶) plus taxes reportedly amounted to 94% of revenues. Gross profits averaged therefore approximately 6% of total revenue.

The Businesses

Among the most recent operations of the Center, there existed: a barber shop, a disco, an art studio for the visual arts, a Sunday school, an aerobics room, a dance school, self-defense classes, a restaurant and a bar, a "beauty" school, and even a psychologist in residence. When the Center was privatized, one of the provisions required that it remain a "cultural center." Tatiana and her partners achieved this by harboring the art studio, dance school, etc.

⁴²During the summer, many citizens inhabiting the immediate vicinity around the Center moved to the countryside for vacation. At this time, Tatiana cut back on employee help and other operations in order to minimize costs in this "off-season".

⁴³ For the distribution of expenditures see Exhibit 5.

⁴⁴ This may seem a bit deceiving since before privatization these cultural services were subsidized by the government and the Center was required to charge extremely low prices for these services. After price liberalization these requirements were lifted. Nevertheless, the increase in sales could also be justified by accounting for the addition of various activities that were not present before (i.e. restaurant and bar).

⁴⁵ Figure includes wage tax/social security.

⁴⁶This figure includes an undisclosed amount spent on goods sold in the restaurant, bar and kiosks.

Nevertheless, they managed to establish other more profitable additions to the Center.

The accounting department located in the center carried out all financial operations for the businesses. The Center employed 3 full-time accountants. Olga, Tatiana's partner in the vegetable shop worked in the accounting department as a financial advisor. It was commonplace to find partners in some of the businesses of a conglomeration working and listed on the payroll of other businesses within the "group" as opposed to only receiving dividends. This occurred primarily because taxes on profits and or dividends were higher than taxes on wages, both to the business and to the employee.

Distribution of Revenues⁴⁷

The bar and restaurant contributed to 25% of total revenues. The bar was a recent addition, and Tatiana felt that it had significantly helped to attract customers to the restaurant. To increase sales, Tatiana constantly tried to come up with new ideas for the restaurant, including hiring a band to play on Saturday nights and selected week nights. This was part of the Center that Tatiana depended mostly on for future profits, and therefore she continually invested money to improve it.

The "schools" (Sunday school, dance school, aerobics classes, self-defense school and the "beauty" school), all except the Sunday school, contributed about 3% each to total revenues. These schools existed for two reasons: 1) they helped to preserve the "profile" of the Center, and 2) it was Tatiana's way of contributing to society.

The Sunday school contributed roughly 15% of total revenues. It was originally built for girls only, but later admitted boys. Each student attended the school for two years. The available curriculum ranged from foreign languages to computer training. Tatiana worked on expanding the curriculum and expanding the scope of operations. This approach evidenced a strategy that Tatiana tried to employ throughout her conglomeration of businesses.

The barber shop specialized in haircuts for children and provided close to 7% of all revenues. Tatiana planned to diversify the shop's scope by hiring a manicurist and cosmetics specialist in the near future. The average hair cut ran about 6,000 rubles (equivalent of US\$3). The disco (5%), the art studio (3%), and the psychologist (5%) of revenues, were brand new additions and remained in a developmental stage. Tatiana expected the disco to be successful upon its completion.

Other businesses that were not located in the Center but were also part of the conglomerate included the parking garage and the 3 kiosks, representing a very important 28% of total revenues. Tatiana recently began to develop her parking business by signing a rental agreement for another lot to park cars elsewhere. This lot would provide 24-hour security and would offer

⁴⁷ See Exhibit 6.

75-100 parking spaces for daily or monthly rentals.

Suppliers

Tatiana relied on distributing companies to provide products for the restaurant/bar and kiosks. All of the products were delivered to the Center twice a week, with all accounts settled in cash.

Outlook

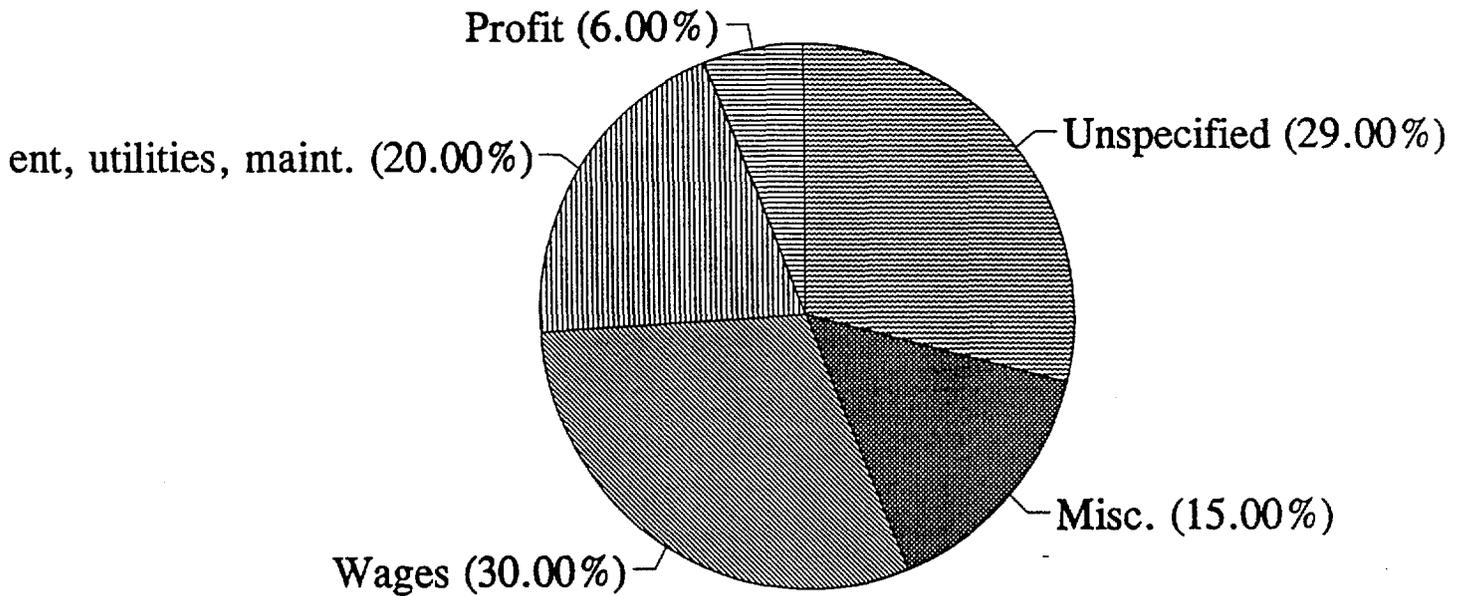
Problems and Challenges

Since initiation of operations, the Center faced various problems. First, there arose the controversy on who would eventually be allowed to own the building. After multiple negotiations with city officials and the GAZ auto plant, the Tatiana partnership received the first chance to buy the building. As in the case of the vegetable shop operation, Tatiana hoped to purchase the building on which the Center was located. She was confident that she could raise the needed 315,000,000 rubles to do so by the summer of 1995.

After this source of uncertainty was overcome, Tatiana began to expand the scope of operations of the Center. Next came a difficult challenge, one of start-up capital to finance these expansions. Through her connections, Tatiana was able to borrow money for that purpose. All of the debts had now been paid off. Lastly, and by far the most significant problems that Tatiana and the two partners experienced were taxes and capital improvement costs. The capital improvement was eventually financed and paid off. Through constant negotiations with city officials, Tatiana was also able to gain various tax concessions. With most operational questions solved (i.e. problems with high taxes, and future ownership questions), Tatiana's outlook for her center appeared quite optimistic.

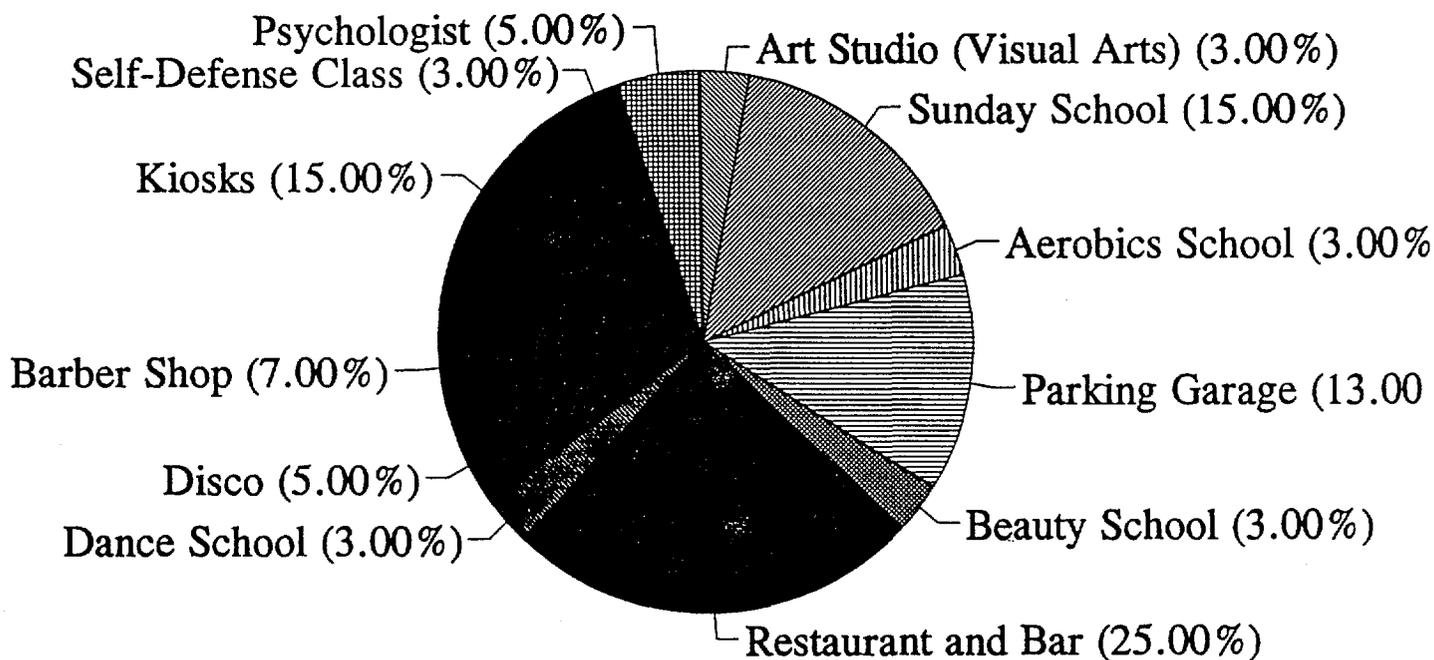
Monthly Distribution of Revenues *

Tatiana's Cultural and Business Center



* Total revenues are between 100 and 200 million rubles per month.

Break-Down of Total Revenue by Business Tatiana's Cultural and Business Center



Total revenue = 100%

PART III

The Emerging Conglomerates

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**Only two and a half years after small-scale enterprises were first privatized in Nizhny Novgorod and mostly acquired by the enterprises' workers' collectives, a subtle new change of ownership has and apparently continues to take place. Enterprising investors and successful owner-operators of privatized enterprises have utilized various schemes to expand and form budding conglomerations of businesses.*

Case #5
Novtek - An Incubator for New Businesses
"A Capital-Less Venture Company"

The Early Stages

The Affiliate

Novtek was founded in 1989, and soon thereafter, entered into an agreement with a Moscow-based company called Lavadov Information Technologies to later become the company's affiliate in the city of Nizhny Novgorod. The bilateral relationship consisted of Novtek creating a "software house" (a center for the development of computer software packages) and Lavadov providing the necessary start-up "know-how" (by sending a training team and a managing representative from the Moscow office) and some capital once the affiliate office was set up. Novtek became fully operational by the start of 1990, functioning in a rather focused way under close supervision and direction by Lavadov in Moscow.

The Joint-Venture

In 1991, after the fall of communism, Novtek applied for the "benefits" of a joint-venture development program which was set up by the new reform-minded government. By the end of 1991, after breaking all ties with Lavadov, Novtek entered into a joint-venture with a U.S.-based software company.⁴⁸ According to Vera Ivanovna Chadayeva (who was appointed Director), Novtek was fully developed and functioned independently from Lavadov at that time, and therefore the company had no problems in finding a joint-venture partner.

The joint-venture, however, had problems from the beginning and was short-lived. When a transfer of monies in the sum of US\$100,000 from the U.S. partner was frozen by a local bank for an undisclosed reason, the U.S. company quickly reacted by withdrawing from the joint-venture (giving up its initial US\$55,000 investment used for the development of the joint-venture with Novtek).

The monies originally invested by the U.S.-based partner, as per the joint-venture agreement, were used to purchase several computer systems and other office equipment. When privatization was initiated in 1992, Novtek used the remainder of the monies to purchase the rights to lease the building in which the office was located in and develop Novtek into "an incubator for new businesses" and an emerging conglomerate with both service and retail outlets.

⁴⁸ A joint-venture arrangement provided a relative tax shelter and the opportunity of attracting capital from a foreign partner.

The Emerging Novtek Conglomerate

Expanding Operations

As soon as the "tax holidays" given to the Novtek joint-venture expired⁴⁹, the company began to quickly diversify its operations. Within four to six months, in addition to maintaining the software division, Novtek had developed five new business activities. The most complex business structure developed was a T.V. cable system installation company. Almost immediately after its formation, the company received a contract to put in a cable system that would serve 12 buildings in a region of Nizhny Novgorod. Novtek used the proceeds of the initial contract (and only one to date) to purchase at auction the rights to lease an automobile repair shop, and to organize repair, sales, rental and lease service of Mercedes Benz automobiles. Describing the latter operation as the "turning point" for Novtek, Chadayeva attributed the fast-paced development of the firm to the rapid success of the Mercedes shop.

Several businesses were then acquired, or set up, almost immediately as part of the small-scale privatization process. The first was a computer servicing shop which provided technical and maintenance assistance to computer owners. The next one to be acquired was a food store located close to the main office building around which many of the businesses created by Novtek were situated. And lastly, Novtek established an accounting firm which contracted its services to various businesses (a hospital and several retail outlets) and became the accounting firm used by the newly formed businesses within the conglomerate.

Vera - "The Central Force"

Vera Ivanovna Chadayeva had always been well connected with government officials and local Party chiefs. Her prior experience ranged from serving as Director of a statistical department of the Bureau of Economics to a high-ranking position with the Department of Defense. Her expertise and connections, coupled with her inherent talent to adapt quickly to emerging circumstances, helped her play an effective role as "idea generator" in entrepreneurial efforts, earning her the position as Director of Novtek. In addition to forming and developing Novtek as a conglomerate, Chadayeva participated in a most unique and complex operation of helping new businesses get started. In most cases, this operation resulted in the establishment of long term mutually beneficial relationships.

Chadayeva was behind all innovations, development and growth of the Novtek conglomerate. Her responsibilities ranged from organization to the actual implementation of company policies of development and operation. In addition to heading Novtek, Chadayeva played an active role

⁴⁹ According to joint-venture regulations, newly formed companies were exempt from paying taxes for a five-year time period. Since the Novtek joint-venture abruptly ended with the "pull-out" of its US partner, the tax-exception was removed and Novtek was once again made tax liable.

in the Nizhny Novgorod business community. She occupied the main seat on the board of trustees of a loan program created by the NGO named Opportunity International⁵⁰, an organization funded by the U.S. government (USAID) and private companies. This position put her in contact with many new small-scale business effort. Chadayeva also directed a business consulting company that added a channel to her interaction with the local business community.

The Role of Novtek in the Formation of New Businesses

The Incubator

By serving as an "incubator",⁵¹ Novtek was able to retain shares in business ventures that would eventually function on their own. Chadayeva described many occasions when entrepreneurs came to her with ideas for new business ventures. If the idea was viable (this judgment was normally made by Chadayeva), Novtek entered into a contract promising to help the business achieve operational and self-sufficient status, by nurturing it with the needed financing⁵² and provision of various services. In exchange, Novtek received a future stake in the firm once it left the "incubator." The new companies generally remained divisions of Novtek for three to six months before separating. Novtek received benefits only if the company performed well and managed to stay in business.

A Closer Look at the Incubator Arrangement

Once a contract between Novtek and a new business was signed, the new company became a division of Novtek. Almost instantly, various mutual financial and operational networks were established.

Finance Network

The financial arrangements varied depending on the type of new business that was "incorporated"⁵³ and were usually determined prior to the signing of the agreement. Most of the time, Novtek provided the capital to initiate operations. In addition to start-up capital, all employees were placed on the Novtek payroll. While a division of Novtek, all proceeds of the new business were collected and distributed by Novtek in a way that was typical of a property-

⁵⁰ Opportunity International helped new businesses to get started by supplying the needed start-up capital.

⁵¹ Novtek helped a newly-forming business financially (by providing start-up capital) and also by giving the companies access to the office (actual office space) and services such as accounting (sometimes at no charge and other times at a nominal fee) that belonged to Novtek.

⁵²This financing came in forms of either start-up capital and/or salaries for employees (including the Director who was normally the inventor of the business venture).

⁵³ Although the conglomerate had initiated more new businesses that acquired existing ones, the Novtek "method" was equally applicable to start-ups and reorganizations.

management company. All expenses that Novtek charged to the account of the new business (i.e. rents, utilities, wages) were deducted from the incoming revenues generated. If expenses exceeded revenues, Novtek absorbed the costs.

The Operational Network

In addition to the intricate financial network, there existed a well developed operational link. Once the newly incorporated business became operational, it received and provided various services. For example, a management training operation that recently became part of Novtek provided its services, usually free of charge, to any of the Novtek divisions that required such. In return, it received and "paid for" the services of the company's accounting firm, consulting company and even Mercedes rentals from the automobile operation.

This network extended to the realm of employment as well, as many of the employees worked for different divisions of Novtek. At times, a Director of one operation within the "incubator" functioned as a manager of another. Chadayeva reported that this technique was sometimes used as a means of distributing profits and channeling monies in the form of wages between the divisions. This was primarily done in order to avoid paying a higher Profit Tax.⁵⁴ On many occasions the new businesses did not generate enough revenue to pay the salaries. In order to justify the expenditure on wages, some employees held several positions and received payment from the revenues of different companies.

Corresponding directors of each division made most of the day-to-day decisions. A board of directors⁵⁵ existed, however, which voted on the more important decisions to be made. Chadayeva was the Chairperson and could "veto" any of the decisions made by the Board.

Current Projects

The Vocational School

The conglomerate trend evident in Novtek's development tactics could be identified by examining the current agenda of projects in progress and those "on the drawing boards." Among the latest, Novtek entered into a partnership (partially sponsored by the World Bank) with the Department of Economics of the local university, to develop a vocational school in Nizhny Novgorod. This project collaborated with the Army's Academy of Engineers (Nizhny Novgorod's branch), which donated the space for the new school. A group of graduates from a teacher-training program

⁵⁴ As mentioned previously, the Profit Tax was at a higher rate than the Wage Tax, and therefore, profits would be distributed as wages in order to avoid paying the higher tax.

⁵⁵ This board of directors was composed of representatives from all of Novtek's companies, including the new businesses of the "incubator" operation.

that was previously administered by Novtek and then referred to the Department of Economics⁵⁶ provided instructional services. In this manner, Novtek established a business (the vocational school) that utilized (by hiring) one of its own divisions. Therefore, Novtek would benefit two ways from one venture.⁵⁷ This was the type of growth (referred to as "interlinking") that Chadayeva strived to achieve: one division of Novtek employing another.

The Television Channel

Novtek had never experimented with T.V.-related business dealings. The latest planned venture involved the development of a television channel for broadcast on the cable system. Chadayeva hoped to use this business not only to sell air time for local programming and advertising, but to also get exposure for the Novtek businesses. In addition to serving as a conduit for advertising the Novtek companies, Chadayeva looked upon the future of the cable channel as part of the "interlinking." Novtek sought recently a joint-venture partner to realize the project as an estimated cost of US\$1,000,000.

Outlook

Problems and Challenges

The major problem that Chadayeva complained of was taxes. Although rumors circulated in Nizhny Novgorod that the tax structure and overall system was on the verge of reform, Chadayeva was pessimistic of changes in the near future. "Under the current system", she remarked, "the only way of prospering is by avoidance of taxes through loopholes."

With many projects still in a developmental stage, Chadayeva remarked that Novtek was now actively seeking sources of financing. This major challenge, which she felt confident would be met by way of loans or joint-venture, was a major and most crucial "turning point" to the next step of evolution for the Novtek conglomerate.

⁵⁶ The teacher-training program was established under a previous partnership between Novtek and the Department of Economics. Presently, it operates as an instructional contractor company that provides teaching services by its own graduates. This company still functions within the Novtek conglomerate.

⁵⁷Novtek will be receiving proceeds from the vocational school as well as its instructional contractor company (as it still retains a "stake" in the company) that would be providing its teaching services within the school for a fee.

Case #6
Negotisian - An Acquisition Based Conglomerate
“A Case of centrally managed growth”

An Unusual Narrow Based Ownership

Negotisian stood out as a well-defined three person equal shares partnership--a partnership led by a young (under thirty years old) General Director and an equally young management team. Following an uncharacteristic approach, the partnership set out to compete in “closed tenders” and at auction with workers’ collectives and other potential investors, in order to buy a few targeted, choice locations on which to base their ambitious business plans.

The partnership and the management team that joined them had carefully analyzed the offerings under the mass privatization scheme and had developed a fairly comprehensive acquisition strategy. The strategy was one limited to how much money they were willing to invest to outbid other “contenders”, but one that included other considerations such as providing old age and veterans discounts in the businesses they set out to buy.

The Negotisian trading conglomerate grouped nine retail trade shops and three personal services businesses (one watch repair shop and two barber shops/beauty parlors). In addition, the partnership owned a former communal apartment which housed their management offices, ideally located in the emerging trading center of the old city close to several of their own stores. A twenty truck transportation fleet was also available for their own use and that of two other “friendly companies.”

The conglomerate employed 350 full-time and 150 part-time employees, working 3 shifts per day, 7 days per week by the summer of 1994. Of total sales valued at 500 million rubles per month, retail outlets generated 80% and the personal services businesses (including products used in these businesses) generated 20%.

Strong Centralized Management and Controls

The role and authority of “central management” over day to day operations of a very heterogeneous conglomeration of businesses, including numerous products, suppliers and customers proved unusual. The young General manager, Mr. Vadim Smirnov, evidenced intimate knowledge and a sense of purpose in direction each business was moving. A three-person accounting team handled, now with the aid of computers, all the multiple tax reporting requirements for the businesses. Given the existing cumbersome tax structure and multiple permits required of each and every business (sometimes differentiated by product category), the task of keeping account of hundreds of cash transactions, inventory records and tax and permit requirements appeared daunting for a fairly small central management team, even with the aid

of computers.

Sales of the various enterprises that formed the conglomerate were transacted in currency, and inventory turnover was remarkably fast compared to western standards. This led to the assumption that store managers and central management focussed primarily on daily (and even more frequently) inventory checks and cash balances. In any case, cash needed to be collected, deposited or stored away for safekeeping and used for purchases and most other payments. The bookkeeping and accounting functions provided "tax information" to the authorities and the principals of the firm.

The Complete Overhaul of Acquired Businesses

Negotsian was a conglomerate not only growing, but changing at a rapid pace, developing internal synergies where there appeared none before. The conglomerate began to successfully blend the growing market appetite for "higher quality" western goods and services with an improved offering of very basic products and services.

For example, Negotsian converted a former barbershop located on the ground floor of a building that housed high ranking officials (civilian as well as army), into a first rate German equipped "hair care salon", beauty parlor and "total body care" establishment. The more efficient use of space would allow Negotsian to also open a boutique for the newly affluent. The cosmetics line used in the salon and sold in the boutique was supplied by Wella of Germany, whom they represented with exclusivity in the oblast. Because a new city regulation would increase rent rates (in some cases as much as ten times) for all lease holders of businesses except for personal services enterprises, the salon-boutique would maintain its "barbershop" profile.

Another interesting example of Negotsian's entrepreneurial skills involved the transformation of a "bread and milk" store into a far more ambitious frozen yogurt establishment. Leased under a "low rent" provision because of their bread and milk store profile, the frozen yogurt production and distribution center based in the same premises, benefitted, too, from the low rent provision. Shrewdly they continued to sell bread and milk improving the quality (freshness) of the products and increasing the variety of the offering. At the same time, they kept margins and profits at a minimum earning considerable goodwill from the community and authorities. The investments going to modernizing the bread and milk side of the business facilitated both the increasing flow of customers to that part of the store and the vacating of considerable floor space for the yogurt business, both at the street level and in the cellar.

The Milkschreider Company of Germany supplied under exclusive rights the raw materials and tradename for yogurt products. As in the case of the hair salon, the German supplier provided the specialized equipment and specifications, both technical as well as the manner of display and sale of the products.

The External Connection - Imports and Distribution

Negotian set out deliberately and rapidly to become the local⁵⁸ distributor and retail outlet of imported goods that fit their acquired network. They had no intention, however, to become national distributors or to import from abroad directly. They set their horizons at least for the next few years on buying these imported goods from distributors and wholesalers in Moscow who dealt directly with the foreign supplier, with transportation into Russia, with customs and warehousing and with foreign currency payments. Negotian paid the "importer" 100% in advance and deliveries took 7-9 days; usually 7 days into Moscow and 2 days from Moscow into Nizhny.

A major unresolved problem involved the time and cost of these transactions due to the absence of adequate banking mechanisms. Negotian had to collect in cash the full value of the order and hand it over to the bank, which in turn took between 3 to 7 days to transfer it to the Moscow distributor, who then placed the order. The product arrived in Nizhny within 10 to 15 days after full disbursement of funds.

Given the increased affluence and pent-up consumer goods demand of many Russians, margins were attractive and these businesses showed every sign of being the wave of the near future. Negotian recently added a Reebok shoe franchise to its chain and was seeking to build-up a sporting goods store (or stores).

Outlook

Negotian had contemplated, among other ideas, to build a new restaurant in the "cellar" of their variety food shop located across from the now partially refurbished 19th century theater house. This new business would also include a liquor store and had the backing of a Swiss joint-venture partner. Other possibilities lingered in the area of importing liquor and food products directly from countries such as Bulgaria and circumventing Moscow and other more congested routes. Negotian's initial opportunistic horizontal strategy appeared, in hindsight, to have been only the first phase of a more ambitious long term strategy of building a broad base for a potential high rise vertical development.

⁵⁸Sometimes understood as city and region and sometimes understood as multi-regional.

Case #7
The Dmitriessky Group

The Dmitriessky Cheese Shop

Since opening for business in 1976, the Dmitriessky cheese shop had developed a very good reputation city wide and with city officials for the high quality of its cheese. This specialized cheese shop was the cornerstone of the growing Dmitriessky chain. It stood in the corner of possibly the busiest intersection at the heart of the "commercial sector" of the old city of Nizhny Novgorod.

By April 1992, cheese represented almost 100% of sales, while at present cheese sales of 30 tons/m represented only 40% of total sales. This also included processed meats (sausages, bologna, hams, etc.), wines and vodka and imported cookies and candies. Sales of the "cheese shop", as it was commonly known and Dmitriessky II, just around the corner, averaged 600 MM rubles per month. The cheese shop had reached at its peak a sales volume of 50 tons/m of varied kinds of cheeses by the summer of 1994. Sales of cheese at Dmitriessky II did not represent as high a percentage of total sales as was the case in the cheese shop.

A Different Ownership Structure

The Dmitriessky cheese shop was acquired at auction - a limited five year lease - in April 1992 by the workers' collective headed by the then municipal store Director. Of the 17 original members of the collective, only a few remained as shareholders while some outsiders purchased substantial numbers of shares. At the same time many of the 80 employees working for the cheese shop did not own shares and others only owned as little as 1%. Vera, the Shop Director, and Mr. Kanasmin, the two-shops' (Dmitriessky I and II) overall Director, each owned 17% of the cheese shop and each held smaller interests in other enterprises in the Dmitriessky "chain".

The "chain" at present was formed by one wholesale operation, one trucking operation⁵⁹ and nine reportedly similar retail shops. Each retail shop was a separate company with its own books and bank account. Each company was also privatized at a different time, not necessarily in the same manner. In addition, different individuals owned different shares of one or several of the companies.

With reported cheese sales by the two neighboring Dmitriessky (I & II) shops of 240 MM rubles/month and total cheese sales for the group of 1 billion rubles/month, the relative importance of the first two stores of the chain in the groups' development was apparent. This was backed by the fact that the cheese shop reinvested one-third of its profits developing its

⁵⁹ Four ten tons trucks and four four tons trucks.

facilities (for example new refrigerated storage) in order to serve as a purchase and distribution center for cheese and other dairy products for the "chain".

Vera - the shop's director and cheese expert

While lacking managerial sophistication, Vera's intimate knowledge of her shop's products, their source, quality, potential, salability, etc. was clearly evident. Her "authority" even over her nominal equal or superior, Mr. Kanasmin, was also evident. Her partners recognized her shrewdness in dealing with City authorities⁶⁰. She was very involved in the forthcoming delicate negotiations with the City's office of the historical patrimony (the office in charge of possible renovations of the stores exterior appearance) involving buying or obtaining a secured long-term lease on the "historical building" in which the Dmitriesky I and II shops were located.

As a "cheese oriented" person, Vera also successfully led a product diversification program resulting in significantly higher overall sales while helping to make cheese the principal item in several other of the "chain's" stores.

The Outlook - Opportunities and Constraints

The Dmitriesky Chain of stores developed and grew through replicating the model of the cheese shop. Moreover, the ownership pattern of each store differed in every case. Decision making, mostly left to the store managers or "directors", would also tend to differ and result in different products, sales and performance profiles for each store.

There remained, however, visibly strong "bonding" elements in the "chain" beyond common ownership by a few shareholders. These bonding elements were observed in the extended sale of cheeses in many stores, in the wholesale operation put in place to supply the stores in the Chain (and others) and in the trucking operation. Interestingly, financial exchanges among the stores if existing, did not appear as a significant bonding factor.

The Dmitriesky Chain in contrast to Negotsian was loosely managed. It lacked management at the center and compared more to the style of a franchise or a U.S. department store chain where every store was independently managed to respond to its own market demands.

⁶⁰ Vera's pictures standing next to Mrs. Thatcher, both with ample smiles exchanging glances, tell a great deal of these ladies personalities. The rest of the people in the pictures seem to fade in the background.

ANNEXES

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ANNEX I

Privatization Objects by Type at the City Level
Nizhny Novgorod Totals as of June 30th, 1994

Type of Activity	Number of Objects					TOTAL
	CC	CT	I	RB	A	
RETAIL SALES	528	132	1	3	50	714
of which:						
1 Food Stores	69	11	1	3	11	95
2 Bread Stores	61	40				101
3 Milk Stores	41	9				50
4 Book Stores	22	3				25
5 Children's Products	1				7	8
6 Commission Stores	9	1				10
7 Furniture, Hardware	29	2				31
8 Clothing Stores	172	42			9	223
9 Vegetable Stores	35	17				52
10 Sporting Goods	15	3				18
11 Fabrics	2	2				4
12 Flatware and China	14				2	16
13 Stock	7				16	23
14 Building Materials	1	1				2
15 Kiosks	46				3	49
16 Others	4	1			2	7
CATERING	112	13			16	141
of which:						
1 Cafes	86	5			9	100
2 Cafeterias	6	3			1	10
3 Restaurants	1	1				2
4 Ravioli Houses	3	1				4
5 Dumpling Bakeries	3					3
6 Beer Kiosks, Pubs	4				3	7
7 Bars	4					4
8 Catering Kitchens	1	1				2
9 Deli	4	2			1	7
10 Confectionaries					2	2
SERVICES	151	86		9	28	274
of which:						
1 Tailor (Repair)	29	21				50
2 Shoe Repair	19	8				27
3 Hair Apparel	1	1			7	9
4 Hair Dressers	36	20				56
5 Furniture Repair	2			9		11
6 General Rental Service	5	2				7
7 Photo Developers	19	12				31
8 Cleaners	5	5				10
9 Watch Repair	3	6			8	17
10 Tailor	3	2			11	16
11 RTA Repair	1	1				2
12 General Repair	25	3				28
13 SBT Repair	2	1			1	4
14 Transportation					1	1
15 Others	2	4				6
CULTURE		1				1
of which:						
1 Cinemas		1				1
PUBLIC		1				1
of which:						
1 Bath Houses		1				1
2 Others						
TOTALS	791	233	1	12	95	1132
CC = Commercial Competition	CT = Closed Tender	I = Investment	RB = Rent/Option to Buy	A = Auction		

Annex II Privatization of Studied Enterprises Transactions Summary

Object	Date of Privatization	Type of Privatization	Company that purchased the Object	Initial Price 000R'	Final Price 000R'	Price of Equipment 000R'	Total Space m ²	Total Space M ²	Product Space M ²	Special Notes
Alyona Vegetable Shop (Tatiana Kuzmina)	12/27/92	15 Year Lease	Partnership "Alyona"	1000	22000	22000	0	536.2	257.2	
Dimitrievski (Igor Kanashkin)	4/4/92	15 Year Lease	Partnership "Dmitsievsky Magazin"	62	4500	4500	1.7	310	70	
"Barrel" (Vadim Smignov) Wine Place & Reebok	9/29/92	15 Year Lease	Partnership "Negotsiant"	1500	72000	72000	0	748.9	402.8	
"Volshebnitsa" Barber Shop	6/15/93	15 Year Lease	Partnership "Negotsiant"	40000	65000	65000	58.4	527.8	322.2	
Simbirskiy (Marble Shop) Gennadi Kolochkov	10/28/93	15 Year Lease	Partnership "Nizhnegorodavto" Nizhny Novgorod Auto Ltd.	33600	40000	40000	51.4	1201.5	776.8	"Object" acquired on 5/20/94 for 7.2 millionR
Konsum Food Store Igor Panomarev Lydia Yevseeva	1/26/93	15 Year Lease	Partnership "Konsum"	150	6600	6600	0	73.8	67.9	

All Figures have been taken from the records of the city GKI; price figures are in current rubles.

Annex III

Required commitments by privatized firms

1. Preservation of the enterprise "profile" for 15 years.
2. Preservation of the minimum "value" of sales and/or production and the product mix.
3. Preservation of the number of jobs in the profiled activity.
4. Preservation of the number of hours (workers/hrs.). Reduction is only possible by the permission of the "authorities".
5. Enterprise can only be "closed for repairs" 3 months/year.
6. Capital repairs within two years after privatization can not be less than 200,000 rubles.
7. Information not available
8. Preservation of the commitment to civil defense requirements (cellars as bomb shelters . . .)

Note: These commitments or conditions to privatizations are selectively applied, although 1 and 8 have been applied in all cases.

Annex IV

Federal and Local Taxes

Federal:

- Value added tax (VAT) - 20% of value added
(10% of non-alcoholic food goods and children's goods)
- Special tax (for the financing of the most important industries) - 3% of value added
- Excise taxes - high for particular goods, such as alcohol and tobacco
- Profit tax - 13% of profit to the federal government (+ up to 25% of profit to the region; in Nizhny it is 22%)
- Tax on surplus wage fund - in excess of 6 minimum wages* by the number of employees - 35% of the surplus (i.e. wages, higher than 6 minimum wages, may not be included in costs and are treated as profits, that are subject to 35% tax
- Contributions to social insurance funds (as a % of wage fund):
 - to Pension Fund - 28%
 - to Social Insurance Fund - 5.4%
 - to Social Insurance Fund - 3.6%
 - to employment Fund - 2%

(There is a personal income tax that is paid by individuals, but 12% of wages and salaries are withheld as a source by the employer).

Regional:

- Profit tax (22% of profit)
- Development of education tax - 1% of the wage fund
- Maintenance of roads tax - 0.8% of total sales (VAT excluded)
- Maintenance of residential building - 1.5% of sales (VAT excluded)
- Ecology tax - 10% of the capacity of trucks, cars and other machinery multiplied by the coefficient (roughly 40,000 rubles per truck/bus a year and 20,000 rubles per car a year)
- Police maintenance tax - 3% of minimum wage multiplied by the number of employees;
- Public transport maintenance tax - 1% of total wage fund.

*Minimum wage is set by the government every quarter. From July 1, 1994 it was risen to 20,500 rubles a month, about 10% of the average wage.

Annex V
Information Sought from Interviews

- Q. When was business privatized - auctioned/other
- Q. "Who" bought - workers collective/other
- Q. How many of the former employees participated in the auction -how many are still with the firm - how many "control" the firm - how many new employees - (are they unionized?)
- Q. If the firm is controlled by outsiders - are these outsiders private people - other company - local/other Russian/foreign J.V.
Do "outsiders" control other similar firms in NN.
- Q. Who manages the firm - what percentage ownership - is this a multi-enterprise company - is each enterprise separately managed. Who/how are capital decisions made.
- Q. When the business was privatized - what were the assets purchased - were there any liabilities (recognized and unrecognized) included in transaction have these been paid off - are there significant liabilities in their balance sheet now.
- Q. What was the original profile of the business - how much change have/can they introduce
Who supervises "profile maintenance" - who authorizes change when/how.
- Q. What rent are they now paying Rubles/sq.m/month. Is it escalating? - how often? - by how much?
- Q. What improvements have they introduced?
Do they intend to buy the space (bldg.) if/when the "object" comes up for sale? Will they make capital improvements - inside?, outside?
- Q. What is/was their sales volume? Is it increasing in Rubles and/units - what is the outlook.
- Q. Who are their suppliers - % private - % state
What changes have been introduced
do suppliers deliver - do suppliers extend credit - general sales terms?
- Q. Does the business own vehicles - were these bought at auction?

Q. Who do they sell to - have there been changes - do they deliver - do they extend credit?

Q. What are their sales margins - are these regulated - controlled - how?

Could they describe A,B,C,D,E,:	Sales	100%
	Cost of goods sold	A%
	Salaries and wages	B%
	Rent and Utilities	C%
	Taxes	D%
	Other significant cost items	E%

Q. In which of the above line items could they introduce significant changes to improve the business long term profitability - or increase salaries and wages or personal income or "benefits"

Q. What are the most important problems they face?
What have been the most important problems to date?

Q. Have they set any goals 1 year → 5 years
What plans they have?

- space renovation
- capital improvements
- buy out space
- new product line
- other

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