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**PILOT ROLL OUT OF VEGETABLE WHOLESALE PRIVATIZATION AND  
RESTRUCTURING PROJECT**

~~Final Report to GKI and USAID Project Office in Moscow~~

prepared by

**The Boston Consulting Group**

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**THE BOSTON CONSULTING GROUP**

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## I INTRODUCTION

The Boston Consulting Group (BCG) has completed the pilot roll out of the vegetable wholesale privatization and restructuring project. The objective of this project was to enhance the effectiveness of the vegetable wholesalers in major cities throughout Russia. The methodology developed during the pilot project in Perm was further developed and refined to account for geographic and political specifics of the regions where the project took place. During the project BCG has worked in four regions (Arkhangelsk, Rostov, Petrozavodsk, and Tver) where it realized the following objectives:

- carried out the privatization and restructuring of wholesalers,
- advised MKIs and wholesalers on methodology for privatization of wholesalers,
- established "demonstration enterprises" in each region,
- trained local consultants to carry out this project on their own so that the project could be continued in other regions economically,
- used written materials, mass media, seminars (both on regional and national level), and other means to communicate the project to MKIs, city councils, city and regional administrations, and wholesalers.

In addition to realizing the above objectives, The Boston Consulting Group has also addressed two problems which were beyond the initial project scope, namely low degree of inter-regional trade and high incidence of monopoly wholesalers in many northern cities. To address those problems in the regions where the project was being conducted, BCG has designed and initiated two pilot projects:

- the establishment of inter-regional trade links between the wholesalers in Perm, Rostov, and Arkhangelsk and
- the creation of a vegetable wholesale market in Arkhangelsk to create competition.

Both pilot projects are currently underway. At the time of writing of this report the following results have already been achieved for the inter-regional trade project:

- memorandum on co-operation signed,
- trade links established,
- exchange of market information initiated,
- first orders from other regions (based on the exchanged market information) were placed,
- joint import orders have been made.

The next step is the expansion of this trading consortia to include wholesalers in other regions. Wholesalers in Petrozavodsk, Tver, and Tashkent as well as several trading companies in Moscow have already expressed interest in joining.

The project to create a wholesale market is also underway. Up to this date the following have taken place:

- wholesale market concept is finalized and accepted by all parties,
- co-operation agreement between the municipal authorities and facilities management company has been finalized,
- the public relations campaign to attract parties interested in entering wholesale business is underway.

The next step is the auctioning of warehouse space and the implementation of control mechanisms to regulate trade and settle disputes.

The privatization of wholesalers in four regions is underway. Six wholesalers have already been privatized with the remaining scheduled to be privatized by the end of June. The following table summarizes the privatization status of the wholesalers in four regions:

Region	Enterprise	Subdivision	Application	Commission	Priv. Option	Tender
Rostov	Baza 1		√	√	JSC 1	N/A
	Baza 2		√	√	JSC 3	N/A
	Baza 3		√	√	CT	√
	Baza 4 1	√	√	√	CT	26 5 94
	Baza 4 2	√	√	√	CT	26 5 94
	Baza 4 3	√	√	√	JSC 2	N/A
	Plodokombinat		√	√	CT	23 5 94
	Spartak		√	√	CT	23 5 94
	Auta		√	May 94	CT	June 94
	Gvozdika		√	May '94	CT	June 94
	Ovoshchi		√	May 94	CT	June 94
Arkhangelsk	Arkhangelskaya	√	√	√	CT	√
	Belomorskaya	√	√	√	CT	√
Petrozavodsk	Tsentrlnaya	√	√	√	CT	18 5 94
	Tomichi	√	√	√	CT	June 94
Tver	GORO	√	√	√	CT	May 94

The contents of this report are written in the form of a "cook book" The main purpose of this report is to serve as a guide to privatization and restructuring of vegetable wholesalers, development of inter-regional trade, and the creation of wholesale markets The information contained in this report is intended to help a novice to duplicate the project in other regions

The second chapter of this report deals with the issues of region selection and selling of the project to the local authorities The third chapter explains how to set up an efficient operating base and how to enlist the support of local decision makers Chapter four provides two case examples of how to conduct a short diagnostic phase to assess regional specifics and to earn credibility with local authorities Privatization process, privatization arguments, pros and cons of various privatization options, potential problems and obstacles to privatization, and case examples are covered in chapter five Chapter six provides an example of wholesaler financial restructuring and answers what to look for, whom to work with, and how to develop and implement a solution The last two chapters describe how to set up and implement inter-regional trade and create a wholesale market.

The accompanying slide book is intended to be used as an appendix to the written report It contains all necessary documents needed to replicate this project The documents include

- questionnaires,
- sample presentations (sell-in, diagnostic, and restructuring),
- privatization arguments,
- wholesale market concept,
- inter-regional trade concept,
- case studies,
- miscellaneous privatization forms and
- supporting legal documents

## II Region selection and sell-in

### *Region selection*

Careful regional selection can prevent the unnecessary waste of efforts. Prior to visiting regions try to gather as much information about the vegetable wholesalers as possible over the phone. The best sources of such information are the municipal GKI, agriculture, and trade departments.

Agriculture and trade departments will provide you with information regarding the number of vegetable wholesalers in the region, their location, and their trading volumes. The trade department can also give you some indications of regional specifics, for example whether or not the region is a net importer or exporter of agricultural production. The municipal GKI department will additionally provide you with the information regarding the privatization status of vegetable wholesalers in the region.

After the completion of phone interviews a list of potential regions should be compiled. The desirability of a region depends on the goals of your project. If the goal is privatization and restructuring, as was ours, then only the regions with unprivatized or partially privatized wholesalers should be considered. If the goal is only restructuring of vegetable wholesalers<sup>1</sup>, then the regions where wholesalers have been privatized should be considered. Wholesalers which were privatized via the commercial tender, JSC3, or JSC1 are the preferred candidates for the restructuring projects.

The success of the project will largely depend on the goodwill of local authorities towards privatization and market reform. To further narrow down the list of potential regions we recommend to have the list reviewed by central GKI in Moscow. Based on their knowledge of the political climate in the regions, they could help narrow down the list of selected regions to the regions where the project would not go to waste.

The next step is to visit the regions on the short list to personally assess the situation. For that, BCG has devised a survey questionnaire (see appendix) that aims to get additional information about the region. Prior to the initial visit, interviews with the city, GKI, trade, and agricultural department heads should be prearranged. At the same time a visit to one or more wholesalers in the area is also highly recommended. While it would be ideal to cover all regions, due to limited resources help should be first offered to those who want it.

After visiting all regions on the short list, use the information gained from interviews to select the final group of regions in which you feel the project will have the most opportunity for success.

### *Selling the project in the regions*

Once the regions have been selected, the next step is to visit them to "sell-in" the project to local authorities and wholesalers. The most important aspects of "selling" the project successfully in the region are:

- identification of decision makers in the region and
- addressing their concerns in the "sell-in" presentation

The decision makers in the case of privatization and restructuring of vegetable wholesalers who should be contacted and invited to the "sell-in" presentation are (in order of importance)

- mayor or the deputy mayor in charge of trade,
- chairman of the municipal GKI,
- head of the agricultural department,
- head of the trade department,
- head of the anti-monopoly committee (AMC)

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<sup>1</sup> According to our information most regions in the European part of Russia have already privatized their wholesalers. In those regions a post privatization restructuring would be the best choice for the project.

During the presentation you should aim to outline the project's benefits to all constituencies that are present at the "sell-in" presentation. The table below lists major benefits to the above decision makers.

<b>Constituency</b>	<b>Benefits</b>
City Administration	Privatization and restructuring will result in increased efficiency of wholesalers which will lower their dependence on city budget, increased efficiency of wholesalers will improve their profitability which will positively reflect on city's tax revenues, potentially large proceeds from the sale of wholesale facilities to relieve city's financial condition, privatization of wholesalers will increase competition which will lead to improved quality and larger selection of fruits and vegetables to the population.
Municipal GKI	Privatization of an important segment of municipal economy.
Agricultural Dept	Increased efficiency will lead to reduced losses, inter-regional trade will open export opportunities for local farms (especially important for the agricultural surplus regions).
Trade Dept	Inter-regional trade development project would significantly improve regions trade links with other regions, improve variety of available products, open opportunities to export local production to other regions.
AMC	In case where there is only one wholesaler, the creation of a wholesale market could be the answer, a wholesale market would introduce new players to the market and create competition.

### **III PROJECT START-UP**

#### **a Forming a steering committee**

To assure the continued support for your project by the key decision makers and to give them a feeling of ownership of the project, you need to integrate them into the project. Based on our experience the best way to do that is to set up a steering committee which meets once a week to review the progress of the project and to address the problems that may arise. The steering committee should consist of the representatives of

- city administration,
- GKI,
- trade department,
- agricultural department,
- property fund,
- AMC,
- "demonstration" wholesaler

It is of paramount importance that the representatives of those departments are empowered to make decisions on the behalf of their departments with respect to the project. Having people who have no decision power will defeat the purpose of a steering committee.

In order to assure that the people from those departments are relevant to the project we suggest the following procedure:

- 1 Meet with the head of each of the above constituencies (ex mayor for the city administration)
- 2 Invite them to join the steering committee. They will most likely refuse and will offer their deputy instead.
- 3 Accept the offer and request then that the deputy be given the responsibility to make decisions pertaining to the project on his/her behalf. That will ensure that the deputy will keep his boss continuously informed.

The steering committee should number 5-7 people in order to assure an efficient working environment.

#### **b Setting up operations base**

Although the circumstances vary by city, it is best not to rely too heavily on the business infrastructure of the project location. It is therefore important to set up an efficient operating base as quickly as possible. During our work, the consultants in each region chose to get apartments instead of staying in hotels. The apartments function as an office and communications center. Although all team meetings can be held in the 'office', none of our project teams had necessity to hold any client meetings there.

This issue of communication is more difficult as the primitive Russian telephone system continues to deteriorate. It is possible to contact Moscow, but most communication had to wait until the weekend when the teams would meet in Moscow to update each other, write presentations, and meet with lawyers or Federal officials.

## I Before leaving Moscow

- Settle staff issues
  - It is better to hire staff in Moscow
    - local staff will be biased about the situation
    - local staff will have too many contacts/relationships
    - local staff will have first loyalties to other people in town
  - Hiring good staff can be difficult, it requires about two weeks
- Get supplies
  - (i.e. computer, printer w/extra ink cartridges, paper, basic office supplies, especially pens, map of oblast and city (several copies), if available)
- Get contacts established
  - Call to get names of officials at GKI, MPF, Trade department, AMC
  - Keep a contact list of all people you meet, including address and phone
    - also keep useful numbers, such as hotels, airport, etc
  - Include in contact list the phone and emergency contact of all project staff
- Get travel schedules
  - Find all possible direct connections to Moscow (train, plane, car)
  - If direct connections are few, investigate connections through other cities
  - Make hotel reservations for first week

## II First week on location

- Accommodation
  - Finding an apartment/office is a top priority at the beginning
    - Check newspaper for advertisements
    - Ask taxi drivers, give them hotel contact number if they hear of something
  - Try to get apartment near town center, and get team all living in same area
- Transport
  - Find a permanent driver by asking each taxi if they are interested in the job
  - driver must have telephone at home
- Local support
  - Get address, phone, and eventually reliable contact person at some local services
    - Railroad station, airport, Aeroflot office
    - Business center for photocopy and fax
    - Good restaurants (for team and for lunch/dinner meetings)

## IV DIAGNOSTIC PROCESS

### a Case example Arkhangelsk

#### 1 Questionnaire

To diagnose the status of the fruit and vegetable supply system within a city it is necessary to gain an understanding of the current structure. Interviewing key components of this supply system is the easiest and most effective means of understanding the system. Typically the key components of the supply system are

- governmental structures
  - trade department
  - privatization committee
  - municipal administration
  - oblast administration (not needed in Arkhangelsk)
- farms
- wholesalers
- retailers
- consumers

Before interviewing these governmental structures and enterprises, the first step is to develop an interview questionnaire that acts as a "guide". Developing this questionnaire will ensure that all relevant information is obtained and it will also help structure the interview and keep the conversation flowing. The questionnaire should be structured so that it flows from general information into specific information. The actual interview questionnaires we used are located in the slide book accompanying this report. The interview questionnaires should at minimum include the following information

#### *Trade department*

- What is the structure of the fruit and vegetable supply system? Is it an association of enterprises (torg) or are the enterprises independent?
- How many farms, wholesalers and retailers are there in the city involved in fruit and vegetable distribution and what are their names (hopefully they will have a list)?
- What level of control does the city exert on the wholesalers? Does the city dictate storage volumes, pricing policies, assortment, who to buy from, who to sell to?
- What types of subsidies, loans, or credits are provided to the fruit and vegetable supply chain? Who gets these subsidies?

#### *Municipal GKI*

- What is the status of privatization of farms, wholesalers, and retailers in the fruit and vegetable supply chain?
- Do you favor privatization of this market segment? Why?
- What are the main obstacles to speeding up the privatization of this market segment?
- What method of privatization is preferable for fruit and vegetable wholesalers? Why?

#### *City administration*

- Is there enough food in the city? If not, why?
- What are the main problems with the food supply in the city?
- What measures are used to determine the extent of these problems?
- What measures should be taken to resolve these problems?

#### *Farms*

- What types of products do you produce and what are the volumes?
- To whom do you sell your products (%)? Do you sell them to local wholesalers, retailers, and consumers or do you export them to other regions?
- How do you obtain customers? Do you seek them, do they seek you, or do you receive assistance from the trade department?
- What are the major problems you have in selling your products? Are your prices too high, is there competition from other regions, or is demand falling?

- Are you profitable? What are your profits (losses)?
- Are you subsidized by the government? What type and how much?

#### *Wholesalers*

- Where do you buy your products? Do you import them or buy them locally?
- What are your storage losses? Why do these losses occur and what do you think you could do to improve this situation?
- To whom do you sell your products? Are they retailers, social institutions, trade firms, etc
- Who do you see as your major sources of competition? Are they street vendors, other wholesalers, or bypassing by farms?
- How do you find your customers? Do you have an aggressive sales policy that rewards salesmen for finding new customers and increasing sales to existing customers?
- What is your debt level? Are you having trouble paying off your loans?
- Does the city government help fund your business through subsidized loans, credits, or other types of financial assistance?

#### *Retailers*

- Who are your major suppliers (%)? Are they local wholesalers, local farms, wholesalers from other regions, farms from other regions, or street vendors and traders?
- What criteria do you use to choose suppliers? Is it price, quality, service, availability?
- What could the wholesalers do better to get more business?
- What do the wholesalers do well?
- Are you subsidized by the government? What type and how much?

#### *Consumers*

- Where do you obtain your vegetables (%)? Do you grow them, do your friends grow them, buy them from retailers, or do you buy them from street vendors?
- What criteria do you use to choose a supplier? Is it price, quality, availability, or service?
- What are your chief complaints about the fruit and vegetable supply system?

## 11 Interviews

The purpose of the interview is to obtain the information that has been detailed in the interview questionnaire. If at any point during the interview you don't understand a response, it is imperative that you ask for clarification. Don't be afraid to ask why. In Arkhangelsk we interviewed the following components of the fruit and vegetable supply chain

- Municipal trade department
- Municipal GKI
- Oblast GKI
- Mayor
- Oblast agricultural department
- All four local farms
- All six wholesale type enterprises
- Twenty retailers
- Seventy five consumers

Listed below is the specific information we obtained in Arkhangelsk from each component of the supply chain

#### *Municipal trade department*

- Developed an understanding of the supply chain's basic structure and key players
  - deficit region (limited local production)
  - two large dominant wholesalers
  - over 100 retail stores
- Trade department has little involvement in the fruit and vegetable supply chain, it is primarily market driven
- The city grants subsidized loans to wholesalers for the storage of vegetables through the winter

### *Municipal GKI*

- The two dominant wholesalers are not privatized
- The city GKI was hesitant to privatize the two wholesalers because it feared a disruption in the fruit and vegetable supply to the city
- If they privatized the wholesalers, they would favor a commercial tender

### *Oblast GKI*

- The oblast GKI had little involvement in the privatization of vegetable wholesalers. All enterprises we were interested in were controlled by the city GKI

### *Mayor*

- The main reason for talking with the mayor was to determine if we would have a political sponsor in the event our project met with local resistance
- We also wanted to know his specific concerns about the food supply in the city so that we could make sure we incorporated his concerns into the project. This was politically expedient and created a sense of ownership in the mayor towards the project

### *Oblast agricultural department*

- The main purpose of talking with the oblast agricultural department was to gain further confirmation that the region imported most of its products from other oblasts. The agricultural department confirmed this
- They also informed us that a large portion of the population engaged in their own private production, known as "dacha farming". It was important to determine how wide spread this method of production was so that we could determine the relevant market for wholesalers

### *Local farms*

- The main information we gained from local farms was that they were having trouble selling their product locally because their production costs were too high. Wholesalers and retailers were importing product from other regions because they could import cheaper than they could buy locally
- The main products they produced were potatoes, cabbage, beets, and carrots. There was some greenhouse production of tomatoes and cucumbers

### *Wholesalers*

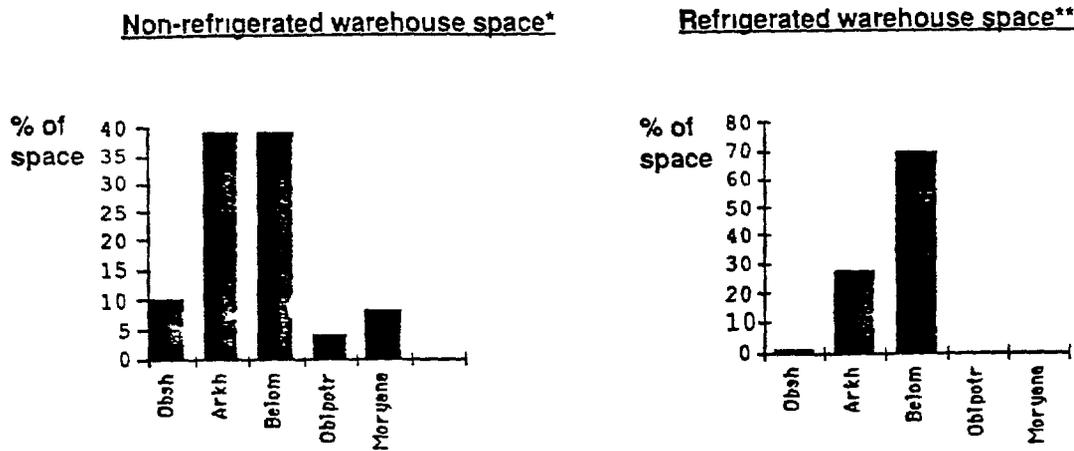
- The two large wholesalers' respective names were Belomorskaya and Arkhangelskaya
- Belomorskaya was the largest most modern wholesaler in the region and controlled 82% of the refrigerated space in the city (see figure 4.1). Arkhangelskaya had a relatively modern portion, but most of its space was old and in disrepair
- Belomorskaya had yearly sales of 1.5 billion roubles and Arkhangelskaya had sales of 1.2 billion roubles
- Arkhangelskaya was concentrating primarily on fruits and vegetables while Belomorskaya was concentrating on fruits, liquors, canned and tinned products, and other quick turnover products (see figure 4.2)
- Both wholesalers were deeply in debt to local banks. Belomorskaya owed 900 million roubles and Arkhangelskaya owed 1.2 billion roubles
- Both wholesalers imported product from outside the oblast because local farm production was expensive and the quality of locally produced products was inferior to imports
- Potato, cabbage, carrots, and beet losses in storage were high. Belomorskaya's losses were 25% and Arkhangelskaya's losses were 35%. We defined losses as spoilage plus fodder sales
- Storage space was only utilized 60% during peak capacity at both wholesalers
- We learned that the two large wholesalers were very eager to privatize, but that they had tried several previous times and had been denied by the local administration
- Wholesalers indicated that the local administration had promised to repay interest expense on loans used for long term storage, but as yet the government had not paid and the wholesalers believed they would not pay

### *Retailers*

- Retailers purchased only 20% of their products from wholesalers. The rest they bought directly from farms and importers from other regions

## 82% OF REFRIGERATED SPACE IS CONCENTRATED AT BELOMORSKAYA BAZA

- Non-refrigerated space is equally distributed



\* 100% all non-refrigerated vegetable warehouse facilities in Arkhangelsk  
 \*\* 100% all refrigerated vegetable warehouse facilities in Arkhangelsk

Source: BCG Analysis

Figure 4 1

## ARKHANGELSKAYAS' SPACE UTILISATION FOR FRUIT AND VEGETABLES IS 76% COMPARED TO 16% AT BELOMORSKAYA

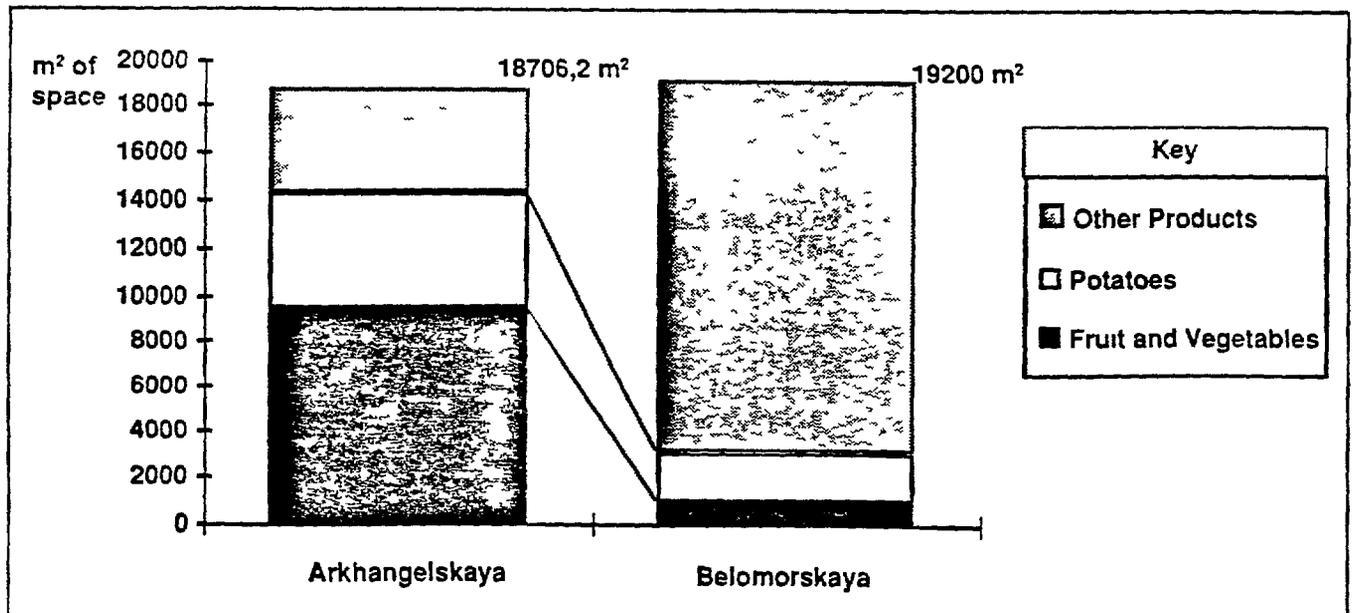


Figure 4 2

- The major criteria they used to select suppliers were price and quality. Their opinion was that local wholesalers were too expensive and that their quality was inconsistent.
- Retailers indicated that if the wholesalers would increase their quality, lower the price, and add more variety to their product line, they would buy more products.

#### *Consumers*

- Consumers indicated that they grew 35% of their own products. Another major source of product purchasing was from the city market and from street vendors. In total they purchased only 30% of their product through the traditional retail channel.
- Consumers said the primary criteria they use to select a supplier are price and quality. They indicated that if the wholesalers would set up vegetable stands or "consumer days" in the baza, they would be interested in buying directly from the wholesaler.

Other key sources of information were the municipal and oblast statistical departments. From the statistical departments we obtained information on the local consumption and production of vegetables.

### **iii Analysis**

Based on our interviews we were able to draw the following conclusions:

- Local production was decreasing, thus increasing the region's reliance on imports (see figures 4.3 and 4.4). Local production was also not profitable, so the wholesalers must develop sophisticated trading operations to compete against traders from other regions and street vendors.
- Local consumption of vegetables had decreased 50% with the exception of potatoes which had remained stable (see figure 4.5). This information revealed that demand was falling as price increased. If wholesalers could become more efficient in providing product, there was significant opportunity to increase sales.
- A study of the supply chain showed that there was significant bypassing of the wholesaler. 80% of the product retailers purchased bypassed the wholesaler (see figure 4.6). In addition, people were bypassing the traditional retail market channel by growing their own products, buying them from street vendors, or shopping in the city markets (see figure 4.7 and 4.8). This phenomena was reversed however in the winter, when consumers bought primarily from retailers. This period of time was the only one where wholesalers enjoyed a distinct competitive advantage because they had proper storage facilities and at this time they could charge a premium for their products.
- Wholesalers did not anticipate the decrease in demand, and as a result they purchased products using the previous year's level as a guide. This excessive purchasing resulted in large loans, large losses, and high debt for the wholesalers because they were unable to find customers for their products.
- Belomorskaya's management appeared to have more forward thinking than Arkhangelskaya's because they had already begun to diversify their product line away from purely vegetables and into other products such as liquors, and canned and tinned products.
- Privatization was absolutely essential because the high debt levels threatened the very survival of the enterprises. Only the stimulus of private ownership would be able to overcome this financial crisis.

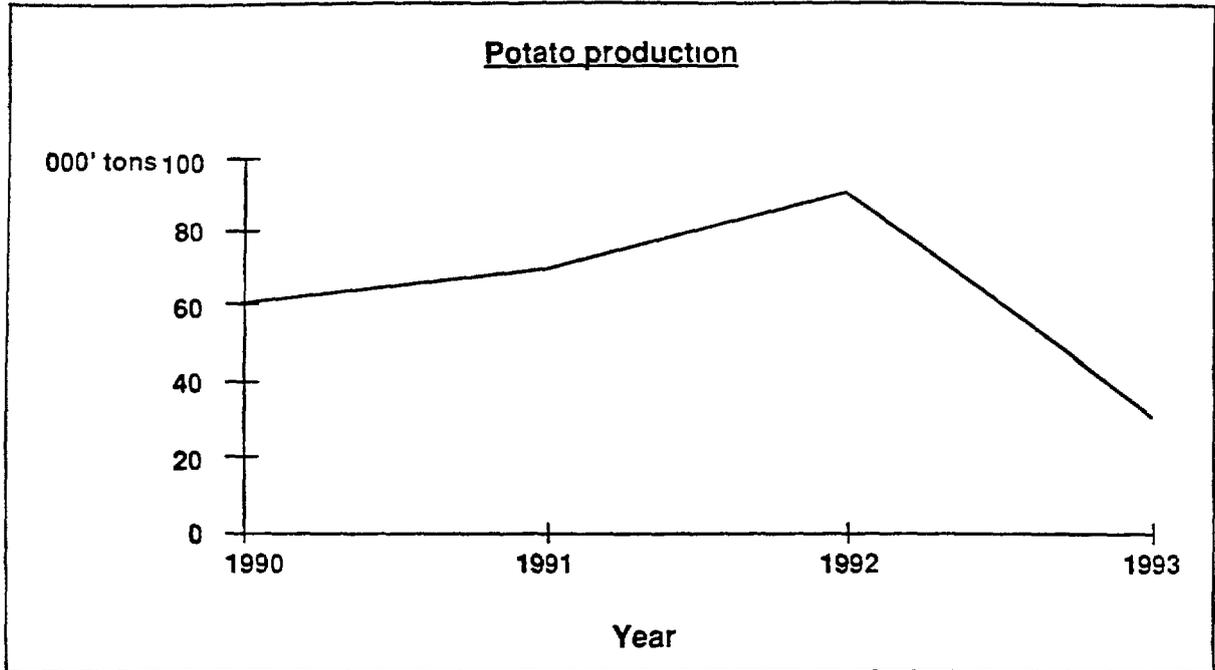
### **iv Presentation**

We had two goals for the diagnostic presentation, first we wanted to show that we understood the current situation and second we wanted to create a sense of urgency on the part of the city administration to privatize these wholesalers so that the needed restructuring could occur. By showing the supply chain configuration, the status of local production and consumption, and the key causes of supply failure, we convinced the steering committee that we thoroughly understood the fruit and vegetable distribution structure within Arkhangelsk. This established our credibility.

The next step was to illustrate that we knew how to improve the current situation. By illustrating the high debt and high degree of consumer bypassing, we were able to convince the steering committee that something must be done to ensure the survival of wholesalers. We illustrated that

# POTATO PRODUCTION HAS DECREASED 66% THIS YEAR

- Reasons include bad weather and an increase in competition

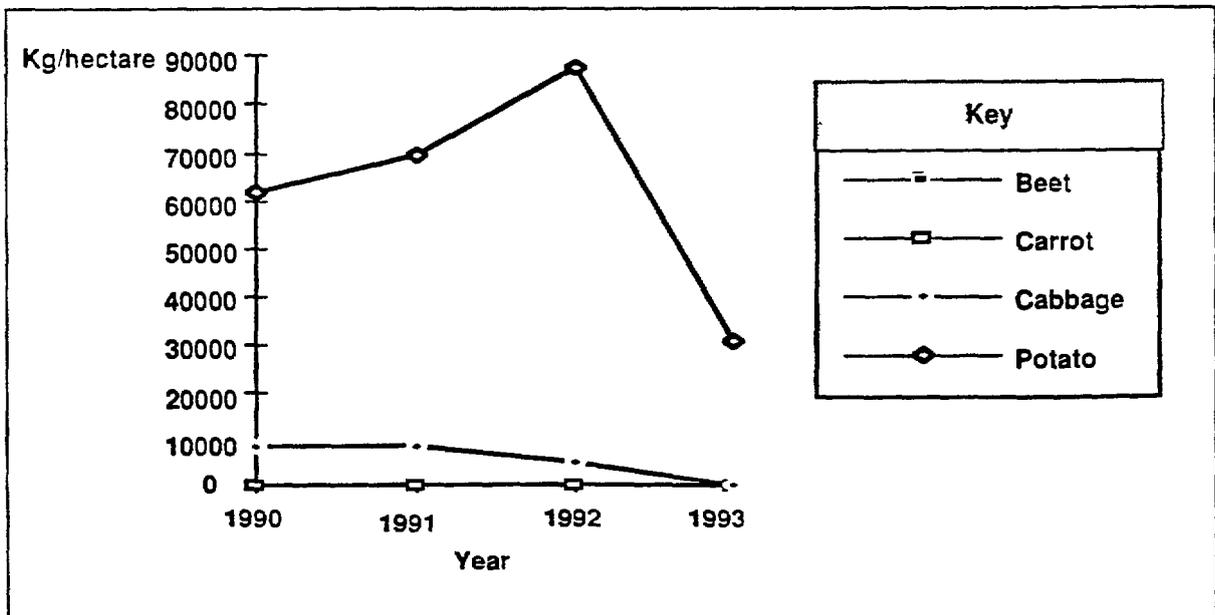


Source: Government statistics

Figure 4 3

# PRODUCTION OF CABBAGE, CARROTS, AND BEETS HAS ALSO DECLINED

- Arkhangelsk produces very little beets and carrots

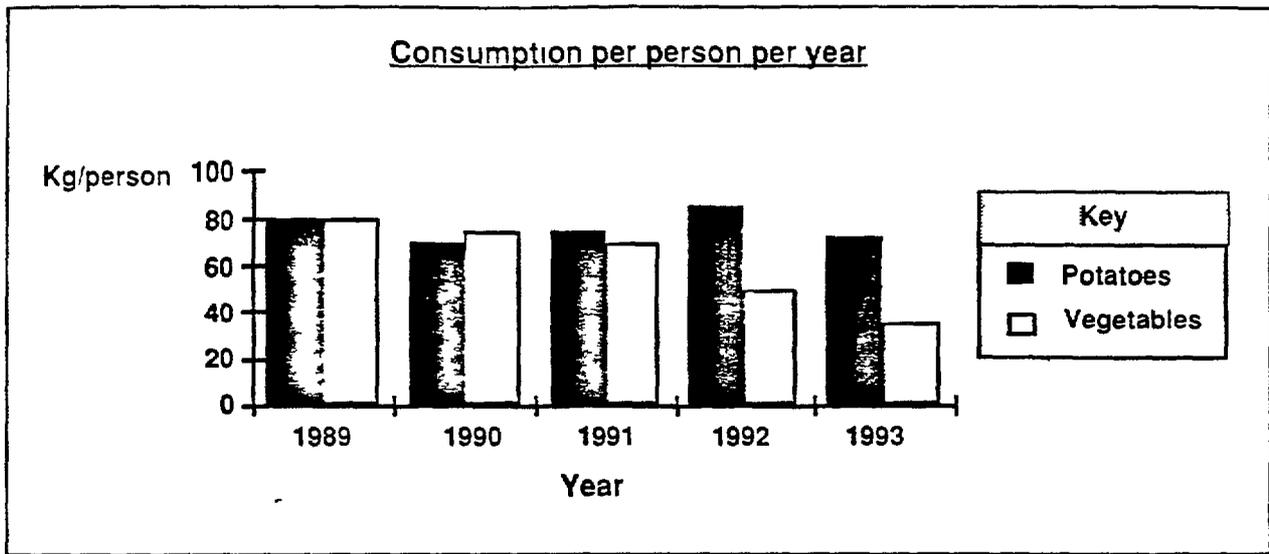


Source: Government statistics

Figure 4 4

**SINCE PRICE CONTROLS WERE LIFTED\* CONSUMPTION OF CABBAGE, CARROTS, AND BEETS HAS DECREASED BY 50%**

- Potato consumption has remained stable:
  - individuals grow and store their own
  - "the second bread" in Russia



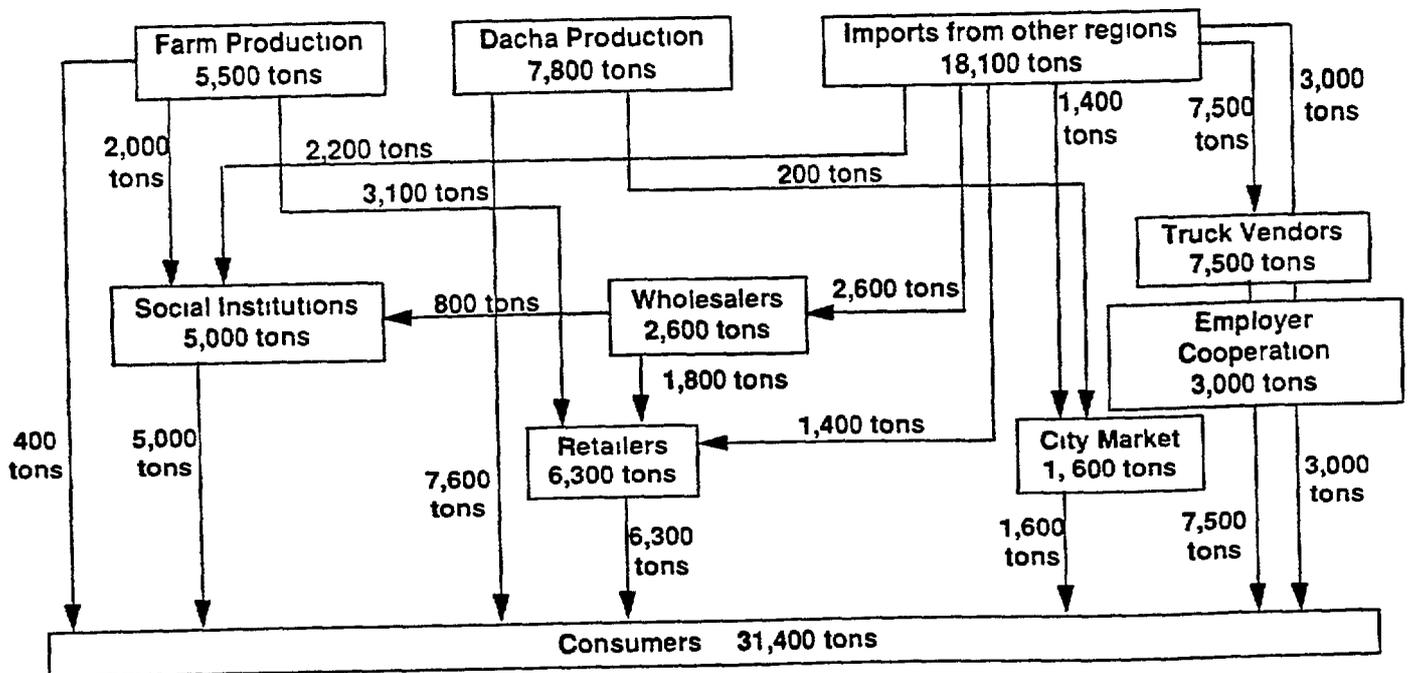
Price released November 1991

Source: Government statistics

Figure 4 5

**IMPORTS ACCOUNT FOR 60 % OF ALL POTATOES CONSUMED IN ARKHANGELSK**

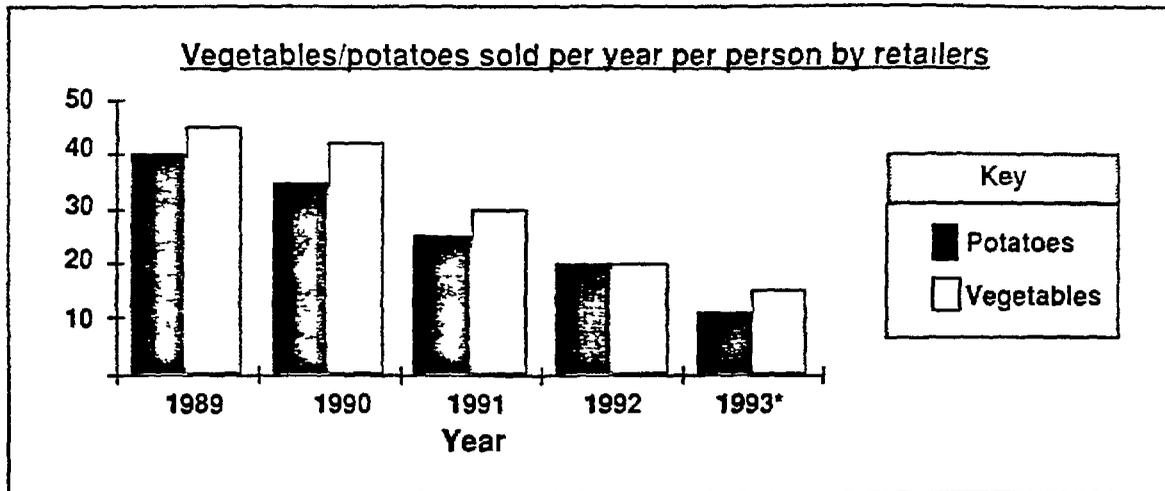
- The proportion is higher for other products



Source: Government Statistics, BCG Interviewers: BCG Analysis

Figure 4 6

**DURING THIS TIME, THE QUANTITY OF VEGETABLES AND POTATOES SOLD THROUGH NORMAL RETAILER OUTLETS HAS DROPPED BY 60%**



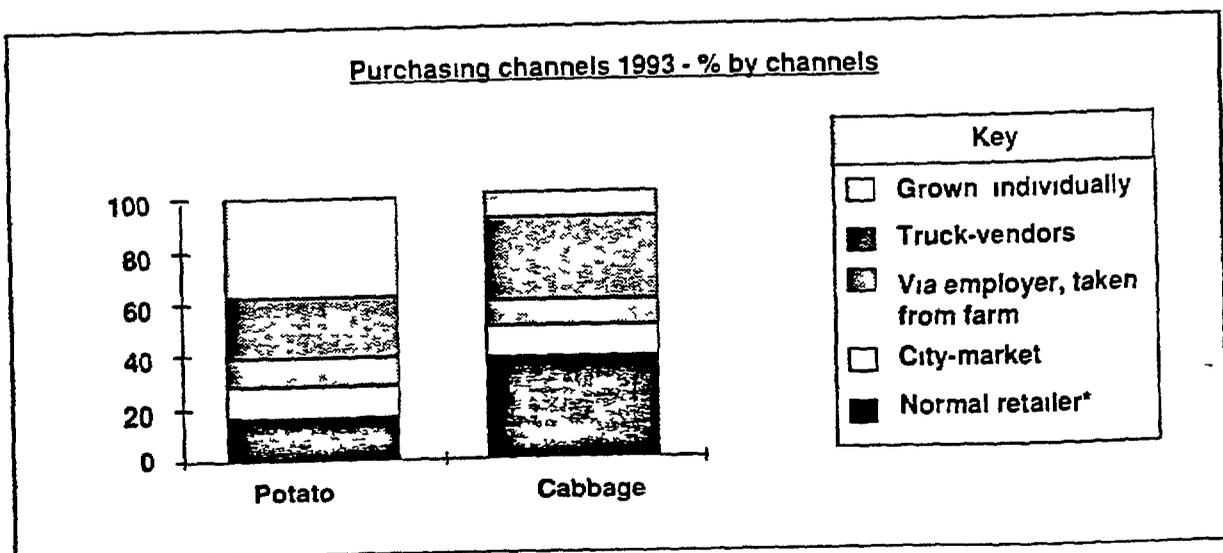
\*Forecast based on information Jan-Oct '93 Sales/Jan-Oct '92 sales = 43% for potatoes 65% for vegetables

Source: Government Statistics

Figure 4 7

**NEW DISTRIBUTION CHANNELS HAVE EMERGED AS CONSUMER SEEK CHEAPER SOURCES OF PRODUCT**

- Truck vendors, dacha farming, employer co-operation



80% of potato sold via "normal retailers" occurs after the harvest season  
Notes: Social institutions were not included

Source: BCG Consumer Interviews. Sample Size 35. Interviews in city-market

Figure 4 8

losses were high sales were falling, and motivation was low. The only way these enterprises could be saved was by massive restructuring. We illustrated that restructuring could only occur when accompanied by privatization. Restructuring without privatization was doomed to fail.

They agreed with us on all of these points and as a result they agreed that privatization and restructuring must be the goal of our project.

## **b Case example Petrozavodsk**

After the city officials agreed to the goals of the project and requested our assistance, we began work with a 'diagnostic phase' with the following goals:

- to understand the vegetable supply situation in the city
- to understand the current situation of the baza
- to understand the interests of all parties involved in the project
- to build credibility for ourselves and our recommendations

The diagnostic phase in Petrozavodsk took 3 weeks and involved 5 steps:

- Data Collection
- Questionnaires/Audits
- Interviews
- Analysis
- Presentation

### **1 Data Collection**

Unfortunately, there is very little reliable data available for aggregate vegetable production, transportation, storage or consumption. Most data that is available is either out-dated, incomplete, inconsistent, or politically biased.

However, the data should still be collected since lack of 'official' sources will be viewed sceptically by opponents to the project. These sources include:

- City Trade Department
- Oblast/Regional Department of Statistics
- Oblast/Regional Ministry of Agriculture

### **11 Questionnaires/Audits**

The best and most relevant factual data is collected through a series of 'audits'. The most important of these are consumer, retailer, baza and competitor audits. Copies of questionnaires are included in the slide book appendix.

#### *Consumers*

Using your Russian staff or hiring a local student for a day, it is very easy to get a snapshot of the local attitude to the vegetable supply. This data makes a strong impression on local authorities and can be effectively used to support your recommendations. It is appropriate to survey 60-70 consumers in several different city districts.

#### *Retailers*

In Petrozavodsk, with about 40 vegetable retailers, we surveyed them all. Even in a larger city, this may be necessary to build proper credibility and avoid petty arguments. In each case, it is important to speak with a director or deputy director of the retailer. We did this by visiting the stores with no appointment and had no difficulty. In some cities it may be helpful to have a letter from the mayor/trade department encouraging co-operation with the project. Visiting the retailers also allows an assessment of the store itself and an audit of prices.

An alternative to visiting all the stores is to arrange a meeting of retail directors. We have not tried this method.

#### *Bazas*

It is important to get a complete and detailed audit of each baza that is part of the project. The Wholesaler Audit in the appendix provides a basis, but individual circumstances will vary.

widely For many reasons, baza directors and management will hide details about facilities, inventories, and financial condition To get more complete information, interview each member of the management team separately As part of the audit it is important to get copies of several original documents (see appendix for samples)

- Balance sheets for last several quarters
- Inventory lists, with purchase price and date
- Lists of loans with details of purpose and payment schedule
- List of employees with positions and salaries
- Accounts payable and receivable with dates, creditor/debtor and penalties
- Map of facilities, including assets on other sites
- List of physical assets, especially trucks and major equipment
- List of major suppliers and business partners
- List of major customers, including volumes, payment terms, and relationship

### *Competitors*

- There are several types of competitors and it is important to understand their relative strength in the market, their future plans regarding vegetable supply, and their possible impact on the project
- Importing/trading companies
- Other non-municipal bazas (such as school system, military, railroad, port, etc )
- Direct imports on trucks
- Local private/collective/state farms
- Strong retailers with active contacts with suppliers

## III Interviews

Direct, private interviews are necessary with all important participants in the project These interviews serve the following purposes

- To explain the project/answer specific questions
- To gain acceptance and support for the project
- To understand and address specific concerns/goals/interest of specific parties
- To learn the status of privatization and local peculiarities in the process
- To gather some more information about the vegetable supply of the city
- To avoid surprises later in the project

The interviews should include a broad range of important people, including

- Mayor (or representative)
- Local GKI
  - Director
  - Director of Privatization Department
  - Director of Economics (if applicable)
- Municipal Property Fund Director
- City Administration, Trade Department
  - Director
  - Specialist in Vegetable/Food Supply
- Anti-Monopoly Committee Director (or representative)
- Municipal/Regional Department of Agriculture Director
- Regional GKI Director
- City Market Director

## IV Analysis

The analysis of the vegetable supply is not complex The basic and most important element of understanding is the "Vegetable Supply Chain" (see appendix) which includes all the important participants from producers to consumers The volumes that pass through these channels are difficult to measure since they are either inexact or unavailable Some can be calculated using gross estimates and others can be calculated based on residual values from other parts of the supply chain

Most other analyses regarding vegetable supply involve a specific aspect of the chain

- sources of vegetables sold at retailers (from retailer audit)
- preferred sources of vegetables for consumers (from consumer audit)
- losses at various points in the chain (several sources, including baza data)
- change in sources of vegetables (producer, retailer, baza audits, interviews)

## v Presentation

The result of the diagnostic phase is a recommendation about improvement of vegetable supply for the city. This recommendation will almost certainly include some element of privatization of the wholesalers and perhaps other parts of the supply chain. There is likely to be some resistance to any changes, so the presentation must achieve the following goals:

- Show an understanding of the goals and interests of all parties affected
- Establish your information as the most current and most relevant
- Establish yourself as an expert in vegetable supply problems in the city
- Present a detailed solution and explain how it solves the various problems
- Gain commitment to a timeline and assign responsibilities to implement the solution

To achieve these goals, it is important to find the correct balance between presenting data, analysis, interpretation and recommendations. Data, especially in Russia, can always be disputed, which undermines the foundation of the entire presentation. Therefore, although it must be presented to establish credibility, it is best to keep it to a minimum. For example, in Petrozavodsk we presented the vegetable supply chain without showing our detailed volume calculations in order to focus on the chain itself and avoid inevitable arguments about the volumes.

Analysis and interpretation should be discussed before the presentation with the most important and influential people. Most likely, this means you should review a draft of the presentation a day or two beforehand with the Director of GKI and the directors of relevant bazas.

Recommendations should of course be reviewed before the meeting with the ultimate decision makers on the Steering Committee. In essence, the presentation is a formalization of the results. It is not a place for surprises or discussion of the information.

If the work is done well and the presentation achieves its objectives, the only serious discussion will be about implementation of the plan. The group should therefore include all people responsible for parts of implementation and these responsibilities and their deadlines should be clearly defined in front of the group.

A summary of the presentation and its results should be written by you and distributed to all participants the next day. This summary should focus on the next steps for implementation of the plan.

## V PRIVATIZATION PROCESS

### a Summary of Required Documents

The privatization process, although theoretically standardized throughout Russia, should be discussed in detail with staff of GKI, the baza, and the MPF. The timeline and responsibilities should be agreed in detail. Some steps, such as AMC approval, can be done in parallel to save time.

#### SUMMARY OF PRIVATIZATION STEPS

#	Steps	Time
1	Enterprise gives documents to GKI	2 weeks
2	AMC approval	1 month
3	GKI issues order	1 week
4	If separation required see Section V c	5 weeks
5	GKI prepares privatization plan profile supplement and all acts	1 week
6	Commission plan signed by all members	1 day
7	GKI issues all necessary documents (see list)	1 day
8	Transfer documents to Property Fund	1 day
9	Working collective meeting discussion of privatization plan minutes to GKI	within 2 weeks
10	Advertising by MPF	2 weeks
11	Tender	1 day

The baza management will have to prepare a variety of documents for the GKI. For some well-organized enterprises this will be a simple task, but for vegetable wholesalers the data is unavailable, disorganized and inconsistent. The project team should avoid becoming too involved in details, but it may be necessary to closely manage the process in order to assure timely and acceptable completion.

## DOCUMENTS PROVIDED TO GKI BY BAZA MANAGEMENT

#	Document	Information	Notes
1	Application		See sample in appendix
2	Balance Sheet 1		Prices before 1 1 92
3	Balance Sheet 2		Prices before 1 1 94
4	List of assets and equipment (inventory list)	Object inv #, # of items price year of entry into operation	Prices before reappraisal 1 1 92 made on date of balance sheets provided
5	List of fixed assets	Object, location, inv #, price year of entry into operation, % deprec , residual value	Prices before 1 1 92 made on date of balance sheets provided
6	List of employees	#, name, position	
7	List of incomplete construction and uninstalled equipment	Facility location, year building started, est work, actual work handled	If applicable
8	List of long-term financial investment	Item, balance sheet value	If foreign currency provide separately
9	List of intangible assets	Value of assets, depreciated, value depreciated	If applicable
10	List of foreign currency funds	Currency, Banks & accounts sum in foreign currency	If applicable
11	List of loans	Source date # amount interest rate penalties, terms pledge purpose	If enterprise is being split current data is necessary
12	Other payables	Creditor amount product date penalties terms	If enterprise is being split current data is necessary
13	Receivables	Debtor, amount product date penalties terms	If enterprise is being split current data is necessary
14	Inventories	Product amount initial price current wholesale price location % spoilage	If enterprise is being split current data is necessary
15	Copies of technical passports for facilities		
16	Copy of technical passport for land		

The GKI, after receiving information from the baza management, must write the privatization plan and accompanying acts. Primarily, this is a restating of the same information. As with the wholesalers, the effort required to do this will very greatly depend on the quality and sophistication of the local GKI. It also depends on the information received from the baza. Preparation of the documents can begin before everything is received from the baza since the items are mostly distinct.

## DOCUMENTS PROVIDED TO MPF BY GKI

#	Document	Responsible
1	Privatization Plan	GKI
2	Mayor's approval of Plan	Mayor
3	Act 1	GKI
4	Act 2	GKI
5	Act 3	GKI
6	Act 4	GKI
7	Act 5	GKI
8	Act 6	GKI
9	Act 7	GKI
10	Act 8	GKI
11	Act 9	GKI
12	Supplement about profile	GKI, Trade dept
13	Certificate of property	GKI
14	Act of transferring property	GKI
15	Information advertisement	GKI
16	2 balance sheets	Baza
17	Inventory list	Baza
18	List of employees	Baza
19	Copies of tech passports for facilities	Baza
20	Copy of tech passport for land	Baza

The MPF must also prepare some documents in order to prepare for the privatization. Their most important task, however, is to advertise the upcoming sale of the enterprise. In order to ensure enough interested bidders and to be sure that the legal minimum advertising period of two weeks is satisfied, it is important to review the advertising plan with the staff of MPF. If there is doubt about finding interested bidders, individual contacts with prospective buyers can also be initiated. If this is done, it should be on a large scale so as to be considered impartial.

## DOCUMENTS TO BE ISSUED BY PROPERTY FUND

#	Document
1	Letter to a buyer
2	Agreement of selling/buying
3	Certificate on property

### b Privatization Options Pros and Cons

#### Privatization Options

According to the Russian privatization law, enterprises can be privatized via one of the following options: sold as one piece via auction, commercial tender, and investment tender, or converted into a joint stock company (JSC) with the subsequent sale of shares via one of the above methods.

When an enterprise is converted into a joint stock company its employees vote on one of the three possible variants of employees' benefits. Therefore there are three ways to privatize a joint stock company: JSC 1, JSC 2, and JSC 3. The choice depends on the employees' benefits scheme.

Additionally, privatization can occur via the liquidation of an enterprise and sale of its assets.

Small enterprises (<1M Rb book value on 1 01 92) can not be converted into JSCs. Large enterprises (>10M Rb book value on 1 01 92) must be converted into JSCs. Medium size

enterprises can be converted into JSC during privatization at the discretion of privatization commissions that approve privatization plans for these enterprises

### **Auction**

An enterprise is sold to the highest bidder. No privatization conditions are allowed.

### **Commercial Tender**

An enterprise is sold to the highest bidder. All bidders agree to fulfill privatization conditions.

### **Investment Tender**

The winner is determined by the Commission based on the best investment program.

### **JSC 1**

25% of equity is allocated to employees free of charge in the form of a non-voting stock. 10% is distributed among employees via the closed subscription at a nominal price. 5% is distributed among management at a nominal price. 60% is sold by the Property Fund via auctions, commercial or investment tenders.

### **JSC 2**

51% of the voting stock is allocated via closed subscription at a nominal price among employees. The rest is sold by the Property Fund via the commercial or investment tenders.

### **JSC 3**

30% of the stock is allocated at a nominal price to the "buyout group" that obtains consent of the majority of employees, fulfills the privatization plan and prevents bankruptcy during the transition period. Transition period can not be more than 1 year. 30% is allocated via the closed subscription among employees. 50% is sold by Property Fund via the commercial or investment tenders.

### **Interests of Constituencies Influencing Selection of Privatization Option**

To ensure acceptability of recommended privatization options it is imperative to closely examine the interests of constituencies that can influence the selection of privatization options. The relevant constituencies in the privatization of vegetable wholesalers include:

- local administration (trade department, sometimes department of agriculture)
- local Committee on Property Management (MKI)
- management of wholesalers

#### *Local Administration*

The social function that vegetable wholesalers perform in supplying the population with vital products makes local administrations extremely interested in controlling the privatization process.

The interests of local administrations boil down to the following key issues:

- ensure minimum guaranteed supply of basic vegetables to the city's population,
- reduce or eliminate subsidies to wholesalers,
- guarantee supply to social institutions,
- increase budget revenues

Additionally, municipal administrators sometimes demonstrate a desire to keep control over privatized entities for the sake of control. The interest in direct control also stems from the limited experience in using monetary and fiscal regulatory means.

### *Local Committee on Management of State Property (MKI)*

MKIs more than other constituencies are interested in the process of privatization. Therefore, the following criteria are of key importance to MKI

- transparency of the process,
- compliance with all regulations and formalities,
- speed,
- simplicity

MKIs have a vested interest in the positive image of privatization as it forms the public opinion about their work. MKIs' desire to ensure positive image sometimes creates conflicting objectives. For example, the long term viability and efficiency of privatized wholesalers is often incompatible with desire of workers collective to keep the majority share.

Additionally, MKIs also have a direct interest in maximizing the proceeds from privatization.

### *Management*

Management favors the safest privatization options that minimize the risk of losing their enterprise to outsiders. The options that they prefer are the ones that give insiders preferential treatment.

Also managers are interested in obtaining the full control over operations and property after the privatization. Therefore, the management prefers options that allow them to obtain the controlling share and resist privatization conditions.

Finally, the management also is interested in paying as little as possible for the enterprise.

### **Criteria for Evaluation of Options**

The privatization options are evaluated from two main perspectives: impact and feasibility. An option has a high impact if it ensures the efficiency and profitability of a privatized enterprise. An option is feasible if it ensures a quick and transparent privatization process that is acceptable to the above mentioned constituencies.

### **Impact of the Privatization Option**

The impact of the privatization option can be decomposed into two components: a concentration of ownership and revenues from sale.

#### *Concentration of Ownership*

As will be discussed below, the majority of vegetable wholesalers are financially distressed and operationally inefficient. They need business and financial restructuring. Therefore, the efficiency of a privatized enterprise greatly depends on its ability to undergo radical restructuring within a relatively short time.

Radical restructuring requires concentration of ownership within a relatively small group of competent investors. If the ownership of an enterprise is diluted among numerous people, the restructuring will be virtually impossible, at least in the short term. Therefore, the privatization option that facilitates concentration of ownership will be preferred.

#### *Revenues from Sale*

Revenues from the sale of a wholesaler, aside from a straight forward positive effect on the budget, can also be used as a measure of future business competence of new owners. The high price paid for an enterprise is an indicator of a competitive sale that ensures the transfer of the enterprise to a user who would assure the most profitable use of the assets.

The privatization option that imposes no restrictions on bidders, no conditions on the enterprise and does not favor any particular group of buyers facilitates a competitive sale and brings the highest revenue

## **Feasibility of Privatization Options**

The feasibility of privatization options is determined by simplicity and transparency of the privatization process as well as acceptability of options to the above mentioned constituencies

### *Simplicity of Privatization Process*

If the privatization process is overcomplicated, then there is a high probability that it will not be followed by the constituencies involved. Also, a complicated process would generate lengthy delays that, in view of the critical state of many wholesalers, can lead to the collapse during the transition period. Finally, a complicated process creates grounds for abuse and, hence, can negatively affect the image of privatization.

### *Transparency of the Privatization Process*

The process's transparency ensures a positive privatization image, creates a better environment for an open competitive sale, and increases the chances of privatization success.

### *Acceptability*

The acceptability of privatization options for the local administration, MKI, and management eventually determines the feasibility of the recommended privatization option. An option will have a high acceptability if it meets a majority of the interests of the local administration, MKI, and wholesaler management.

## **Evaluation of Privatization Options**

Privatization options are evaluated by assigning scores to the above criteria. The highest score is 10, the lowest is 0. The criteria are assigned the following weights:

### *Impact*

- concentration of ownership - 60%
- revenues from sale - 40%

### *Feasibility*

- acceptability - 50%
- transparency - 25%
- simplicity - 25%

The Tables 5.1 and 5.2 show the scores of the privatization options along the impact and feasibility dimensions. Commercial tender is the best option on the combined impact-feasibility scale.

The major reasoning behind the score assignment is explained below.

### *Impact Scores*

- concentration of ownership is the highest in all "non joint stock company" cases, when an enterprise is sold as one piece,
- JSC 2 causes the highest dilution of ownership since it distributes the largest portion of the stock among employees and impedes a quick accumulation of the controlling share,
- the highest revenues are generated via the auction sale because it does not allow for any form of conditions to be imposed on the privatized enterprise,

- commercial tender has the lower revenue score since the privatization conditions lower the sale price,
- JSC 1,2, and 3 distribute significant amount of shares at a nominal price, JSC 2 allocates the largest portion of shares via closed subscription at a nominal price

**Table 5 1**

**AUCTION HAS THE HIGHEST IMPACT RANK AMONG PRIVATIZATION OPTIONS**

- **Commercial Tender is the second best option**

	Concentration of ownership	Weight	Weighted score	Revenues	Weight	Weighted score	Total score
Auction	10	0,6	6	10	0,4	4	10
Commercial tender	10	0,6	6	8	0,4	3,2	9,2
Investment tender	10	0,6	6	3	0,4	1,2	7,2
JSC 1	4	0,6	2,4	5	0,4	2	4,4
JSC 2	1	0,6	0,6	2	0,4	0,8	1,4
JSC 3	7	0,6	4,2	4	0,4	1,6	5,8

*Feasibility Scores*

- investment tender has high acceptability score since MKI's and local administrators prefer the option that gives them the most discretion in determining who gets the enterprise,
- JSC 2 is popular among managers and employees since it allocates the majority of shares to them via the closed subscription,
- auction is the least acceptable option since it does not allow to impose conditions and, hence, generates concerns of local administrators about a possibility of interruption of the vegetable supply, auction is not popular with wholesalers' management as it carries a higher risk of losing the enterprise to outsiders,
- JSC 1 has low acceptability mainly because it gives only a minor share to company's insiders and does not allow to impose privatization conditions,
- transparency and simplicity scores are higher when an option leaves less discretion on how a new owner is determined, investment tender has the lowest score since the process of investment program selection is the most complex and discretionary,
- transparency scoring is lower when the privatization option gives insiders a preferential treatment,
- JSC options have lower simplicity scores than auction and commercial tender because they imply a complex process of corporatisation and sale of multiple shares

**Table 5 2**

**COMMERCIAL TENDER IS THE MOST FEASIBLE OPTION**

	Acceptability	Weight	Weighted score	Transparency	Weight	Weighted score	Simplicity	Weight	Weighted score	Total scores
Auction	1	0,5	0,5	10	0,25	2,5	10	0,25	2,5	5,5
Commercial tender	6	0,5	3	8	0,25	2	8	0,25	2	
Investment tender	7	0,5	3,5	2	0,25	0,5	2	0,25	0,5	4,5
JSC 1	2	0,5	1	6	0,25	1,5	3	0,25	0,75	3,25
JSC 2	7	0,5	3,5	4	0,25	1	3	0,25	0,75	5,25
JSC 3	3	0,5	1,5	6	0,25	1,5	3	0,25	0,75	3,75

**Recommendation**

As the Figure 5 3 shows a commercial tender has the best combination of impact and feasibility

Commercial tender is recommended as the preferred privatization option for vegetable wholesalers

Due to its high impact, auction is recommended as the second best option, especially if it appears feasible

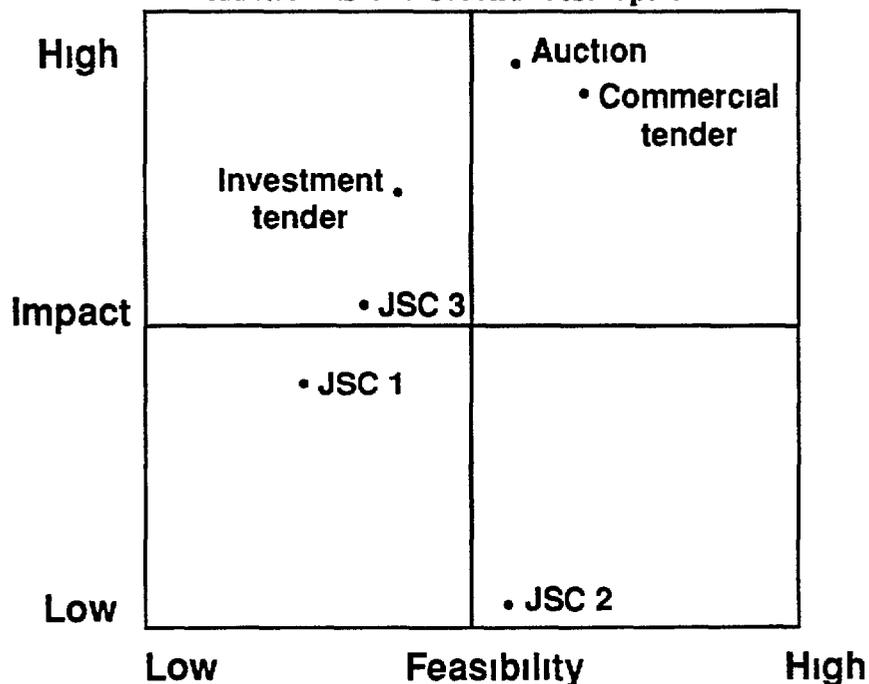
JSC 3 should be chosen if corporatisation is required

JSC 2 clearly has the worst impact and should be avoided

**Figure 5 3**

**COMMERCIAL TENDER HAS THE BEST COMBINATION OF IMPACT AND FEASIBILITY**

• Auction is the second best option



### c Splitting an Enterprise

The difficulty of separation is directly related to co-operation and relative power of the current enterprise director, the city authorities, and the director(s) of the separated enterprise(s). The difficulty is also related to the amount of interdependence between the enterprises to be separated. In general, it is possible to finish the process completely in five weeks.

- Week 1 Plan for splitting is approved by GKI, AMC, City Trade
- Week 2 Workers separation, new director
- Week 3 Splitting of assets, inventories, payables, receivables, workers
- Week 4 Approval of separation agreements, arbitration if necessary
- Week 5 Transfer of assets and inventories

Note: In order to accomplish separation more quickly, it is possible to separate only physical assets without creating another enterprise. They are then sold to another already existing enterprise.

The most important step is to find a capable director for the new enterprise. This should be done as quickly as possible to provide an offsetting power to the director of the core/central enterprise.

#	Measures	Time	Documents	Responsible
1	Present splitting plan to working collective	1 day	GKI order	Management
2	Separation of workers	1 week	New lists of workers, Order of separation	Management
3	Meetings of new working collectives	1 day	Standard Articles, Order about new enterprise creation, Order about new director appointment	GKI
4	New director(s) contract	1 day	Order of GKI	New director
5	Registration of new enterprise	1 week	Standard Articles, Minutes of working collective meeting, Order of GKI	New director
6	Opening of new bank account	1 day	Order of GKI about enterprise registration, AMC conclusion	New director
7	Order of splitting	1 week	Separation agreement signed by directors -assets -inventories -payables -receivables -working collective -loans -capitalized losses -other	GKI
8	Decision of privatization	1 week	Application	Commission

### d Privatization case example Petrozavodsk

#### 1 Sell-in

As with the other regions, the sell-in process required two visits to the city. The first time was primarily a diagnostic visit to see if the region 'qualified' for the project. This involved determining the number and privatization status of vegetable wholesalers, as well as understanding the attitude of important local officials and baza management to privatization.

The purpose of the second visit was to establish an agreement to conduct the project in the city. It is important to clearly discuss the objectives, the process, the timelines, the responsibilities of all involved parties, and to manage the overall expectations. City officials and baza management should very clearly understand that they will have to make substantial effort to complete the privatization plans and implement restructuring at the baza.

During each visit, it is important that the Directors of GKI, MPF, AMC, City Trade, and the important bazas are involved in the meetings. Also, it is advisable to tour the bazas to see their condition, and to visit some retailers to get an impression of the current vegetable supply. The meetings should be scheduled about 5 days before arriving in the city. The visit takes 1-2 days.

## **ii. Steering Committee**

The steering committee in Petrozavodsk was the same as the Privatization Commission. Informally, it also included the director of the one large baza, GORO. Having the members of the commission on the steering committee is an essential minimum, as all their signatures are required to approve the privatization plan. If a member of the steering committee is unavailable for a meeting, another representative should always attend.

The formal presentations should involve a broader circle than the actual steering committee. It is important to include the people who are responsible for implementing the proposed solutions. This includes various staff from GKI, Trade department and baza management.

The steering committee should meet formally about every three weeks when there is a major decision to be made. Of course, on an informal or immediate basis there will be many individual meetings with steering committee members on various details.

Formal presentations are important to control the direction of the project, gain implied consensus, and publicly assign deadlines and responsibilities. However, they also provide opponents a chance to discredit the project and take significant effort to prepare, so it is best to keep them to a minimum. In Petrozavodsk we had two formal presentations:

- first to present the diagnosis and agree on a plan of action
- second to approve the privatization plan and begin restructuring

## **iii Politics involved**

This is an extremely important issue and will vary widely between regions. Although it is not possible to know all the hidden agendas of people associated with the project, it is important to try to understand their motives.

The GKI and MPF are generally in favor of privatization, especially since they receive a share of all proceeds. However, the privatization plans involve significant effort to complete and, although the Director of GKI may support the plan, getting it finished may be difficult. The stronger the support from the top, the more effort will come from the staff.

The AMC is generally powerless to help the privatization process. Its only power is to block it, and so their approval is needed, but enthusiastic support is not necessary.

The City Trade Department is more difficult. Their influence varies greatly between regions. They will express concern for the vegetable supply, especially availability, prices, and quality. Sometimes this is genuine, and sometimes it is an effort to gain other objectives. It is important to understand their relationships with the wholesalers, local producers, and retailers.

The mayor must support the project. The mayor must sign the privatization plan and any separation documents. Also, in any disagreements, the mayor will be the final arbitrator.

In general, only municipal authorities will be actively involved, or even interested, in the project. However, in Petrozavodsk, the Ministry of Agriculture became interested in the modern vegetable storage facility and eventually decided to block the privatization so they could gain

possession This action was initiated and supported by local vegetable producers who were worried that they could not sell their products to a privatized baza Such an unexpected action underlines the difficulty and importance of following the politics surrounding the project.

A final note on 'politics' It is not uncommon for a someone to look for direct, immediate personal benefit from the privatization transaction This can take the form of a direct cash payment Staff of GKI, MPF or baza management may look for payments from prospective investors or even from the privatization project itself It is important to be aware of such situations and not allow them to delay or block the progress of the work

#### **iv Privatization option selection**

In Petrozavodsk, as in other regions, the baza management initially favored the Joint Stock Company option They expected it to be cheaper and to guarantee that they obtained ownership for themselves

The commercial tender was chosen and presented as being in the best interests of all parties involved

- Baza management actually can get cheaper price and risk of losing is equal to JSC
- City has some assurance of continued supply by creating sales profile
- MPF and GKI realize more revenue

#### **v Managing the privatization process**

The privatization plan is a bureaucratic and detailed set of documents that takes much effort to prepare Usually the GKI staff will know how it is done and handle it, in co-operation with baza staff (especially accounting and facilities/technical) In Petrozavodsk we provided extensive support in preparing the plan for three reasons

- the GKI staff did not know all the steps and required information
- the motivation of GKI staff and baza staff was very low
- the schedule was very tight and it should all be completed quickly
- the privatization plans and the separation of enterprises was done simultaneously, which greatly increased the complexity and confusion involved

The privatization plan must then be approved by the commission, but this step should be only a formality since the members of this commission are very involved in preparing and approving the information in the plan

## VI FINANCIAL RESTRUCTURING OF A WHOLESALER CASE EXAMPLE - BAZA BELOMORSKAYA IN ARKHANGELSK

### a What to look for

The most important aspect of restructuring a wholesaler is to improve their financial situation. Under the former system, wholesalers were not required to be profitable because they were subsidized by the state, and any losses they incurred were covered by the government. This has all changed and many wholesalers have had trouble adapting to this new environment. Wholesalers in the Russian Federation are now characterized by high debts and poor financial management. All other restructuring efforts will be futile if the enterprise goes bankrupt.

The first priority for restructuring wholesalers is to determine their current financial situation. The most pressing issue is usually the amount of debt the wholesaler has taken and their ability to pay it back.

#### Determination of allowable debt levels

There are two techniques for determining the allowable debt level.

- 1) The first technique uses the ratio

$$\frac{\text{profit before interest}}{\text{interest payment}}$$

This ratio should be greater than 2. If it is less than two it signifies a debt condition that may not be serviceable. Belomorskaya's ratio was 2.1, which indicated that current debt exceeded recommended debt level by 89% (see figure 6.1).

- 2) The second technique uses another ratio

$$\frac{\text{Current assets}}{\text{Current liabilities}}$$

This ratio should be greater than 1. Belomorskaya's ratio was a dismal 0.4.

If the wholesaler has a debt problem, the next step is to determine what are the root causes. Typical causes include:

- high inventory levels
- improper pricing strategies
- long payment delays from customers
- lenient customer credit

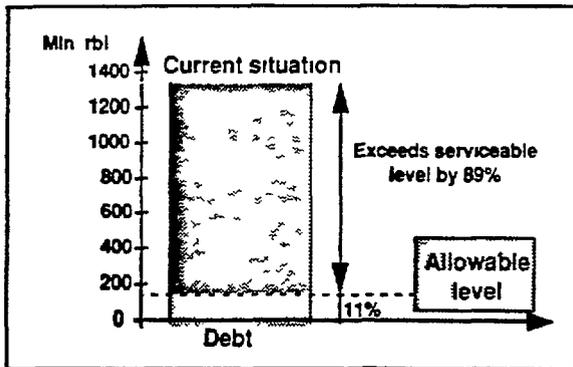
#### Excessive inventory

A debt crisis is almost always accompanied by high inventory levels. If the wholesaler is deeply in debt and has no inventory, survival may not be an option. At the beginning of December, Belomorskaya had five months worth of inventory in stock (see figure 6.2). High inventory levels are especially disastrous in a highly inflationary environment if inventory value can not keep up with inflation. This was the case with Belomorskaya. They had taken loans with an interest rate of 20% per month, but the market would only support price increases of 8% per month on their products. Consequently, every day they held their inventory they lost money.

#### Improper pricing strategies

A typical error made by wholesalers is a failure to take interest expense into account when they set a pricing policy for their products. In order to determine product profitability it is necessary to allocate all relevant costs to the product, and then compare total cost with revenue. Wholesalers typically judge product profitability by comparing purchase cost plus some arbitrary mark-up (20% in Belomorskaya's case) to sales cost. At Belomorskaya we divided their product

# CURRENT DEBT LEVEL CONSIDERABLY EXCEEDS THE ALLOWABLE LEVEL



- Factors that determine allowable level**
- Desirable ratio Profit\*/Interest payment = 2/1
    - Average margin = 20%
  - Average monthly turnover = 284,6 mln (Nov 93 - Jan 94)
  - Current bank interest rate = 240%



**Allowable debt level 142 mln (current debt exceeds this level by 89%)**

The unfavourable debt ratio qualifies Belomorskaya as a "heavily indebted" enterprise under the laws of the Russian Federation

The reference is to the ratio profit before interest is paid/ debt interest payment

Figure 6 1

## BELOMORSKAYA'S HIGH INVENTORY LEVELS CREATE THE NEED TO FINANCE PURCHASES

- In Nov-Dec 1993 Belomorskaya had stock of products worth fourfold - fivefold monthly turnover
- This "freezes" the working capital

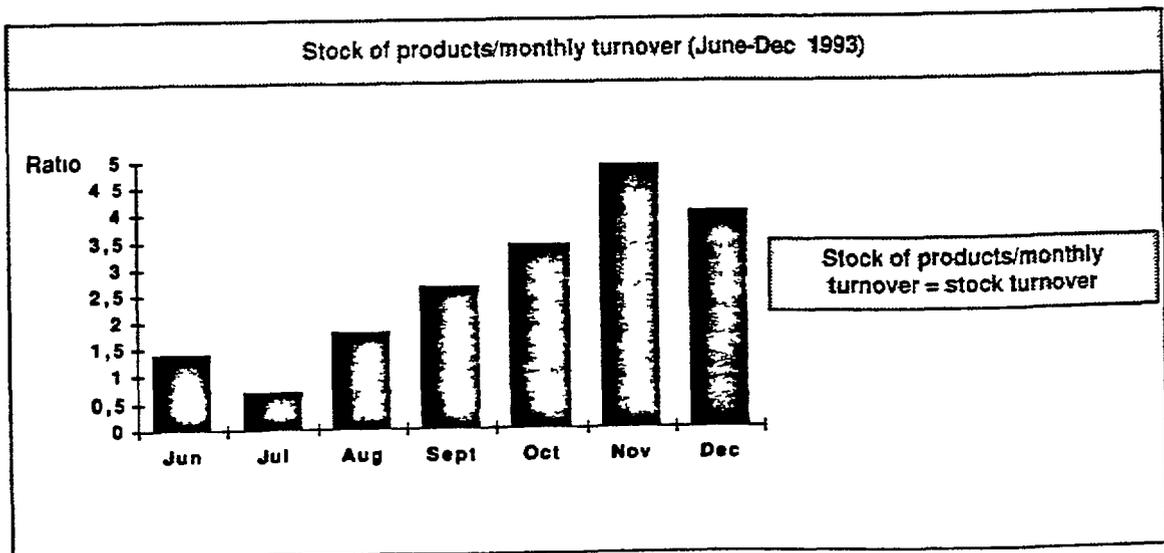


Figure 6 2

base into two segments. The first segment consisted of quick turnover products such as fruit, canned and tinned meat, and chocolate. The second segment consisted of long term storage products such as potatoes and vegetables.

After allocating all relevant costs to each product segment, we discovered that the high turnover products were profitable (see figure 6.3) and long term storage products were unprofitable (see figure 6.4). This analysis further supported our findings regarding inventory levels. Interest cost is extremely dangerous for long term storage products. If a product is to remain profitable, its value must increase each month by at least the interest rate used to finance the purchase.

A common misconception among vegetable wholesalers is that if they have their own working capital, they do not regard the cost of capital as a real expense. When performing this analysis for a client that is self financing, the consultant should use the bank interest rate as the cost of capital because this is the return the wholesaler could achieve if the money was invested in a bank instead of buying vegetables. This is a difficult concept to explain to wholesalers and for a more in-depth discussion of opportunity costs or the cost of capital see any standard finance or accounting textbook.

### **Long payment delays from customers**

In a highly inflationary environment, reducing the amount of time it takes a customer to pay his bill is key to preserving the value of the payment. For example, if the monthly interest rate is 20% and it takes an average of 30 days to collect payment from a customer, the wholesaler really only received 83% of the value for his sale. This translates to loss in value of 17% for every transaction the wholesaler makes.

When we analyzed Belomorskaya's receivable cycle that is exactly what we found. From July to December, receivables adjusted for inflation had increased 1,100%, the payment cycle was 31 days, and the average monthly value of receivables was 280 million roubles. This resulted in a value erosion of 670 million roubles per year. Of this 31 day payment cycle, 21 days were caused by internal inefficiencies, which resulted in 454 million roubles worth of value loss.

### **Lenient customer credit**

Lenient credit terms significantly contributes to high levels of receivables. In a highly inflationary environment it is essential to restrict credit access in order to decrease receivables. If the wholesaler has no credit sales, he will have no receivables, and thus no value erosion.

If a wholesaler's sales are greater than 40% on credit, there could be a problem with credit leniency. In the case of Belomorskaya, 70% of their sales were on credit. In addition to a large number of sales on credit, Belomorskaya's sales department continued to sell product to customers on credit, even though those customers had not paid their outstanding balance for months.

### **b Whom to work with**

In financial restructuring it is extremely important that the director of the enterprise understands that you are working to help him improve his operation because he controls all of the financial information that you will require. He is also the person who decides to take loans, makes pricing decisions, and enforces credit requirements. Once you have gained the trust/approval of the director, you will need to work with the chief accountant, chief economist, and possibly the deputy director. Whoever is directly responsible for finances will be the person you need to work with.

### **Determination of debt level**

In order to determine the debt level, you will need copies of all loan papers, including payment schedules, loan amounts, and the interest rates. You will need copies of the income statement so that you can determine profit for the profit/interest payment ratio, and it will be necessary to

# HIGH TURNOVER PRODUCTS ARE CURRENTLY PROFITABLE <sup>1)</sup>

• Example oranges

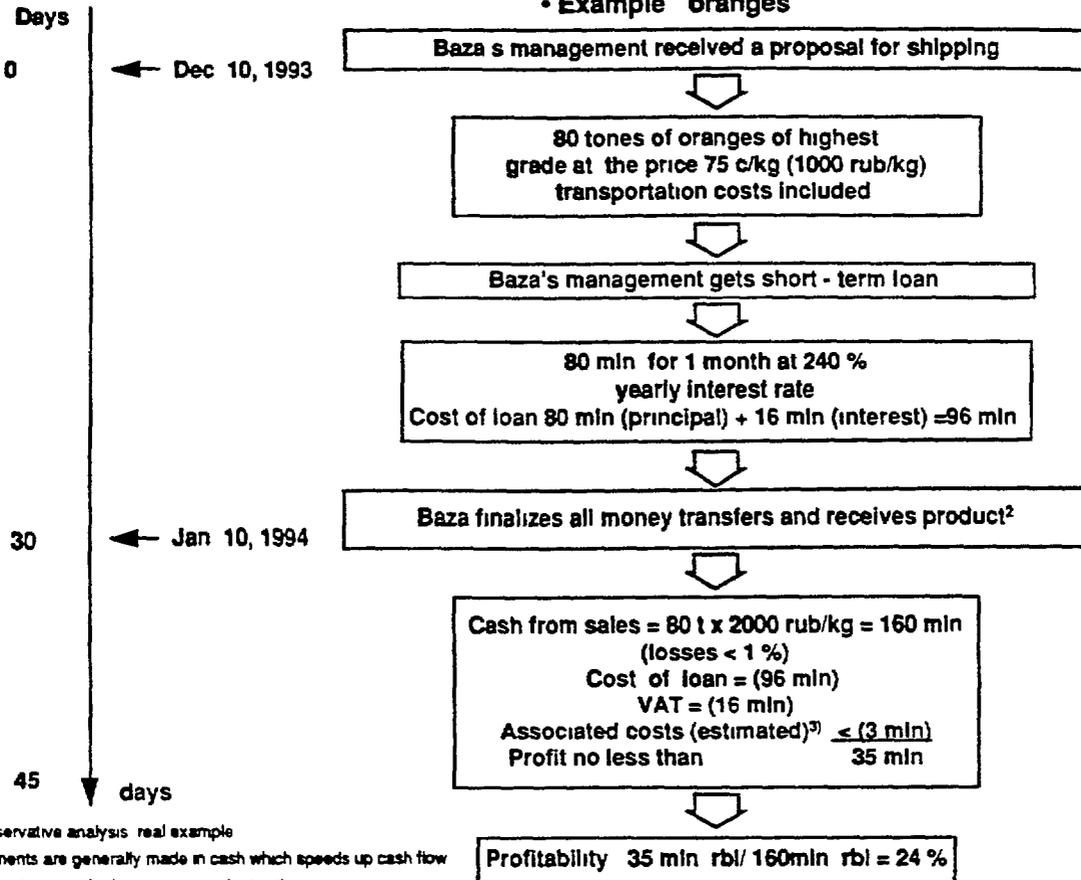
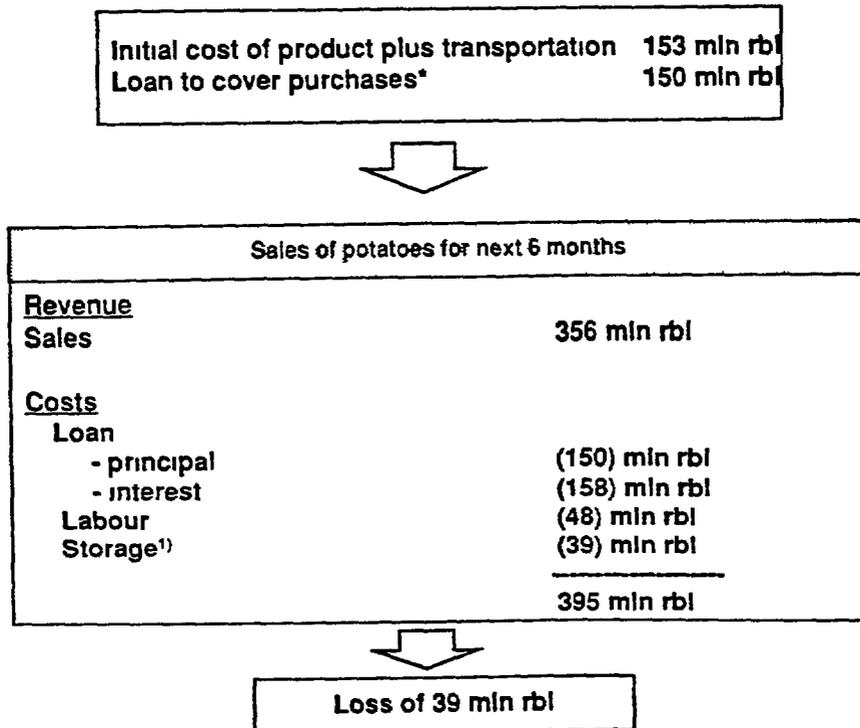


Figure 6 3

# LONG TERM STORAGE PRODUCTS ARE CURRENTLY UNPROFITABLE

• Belomorskaya does not recover interest and storage costs  
• Example potatoes



Interest rate 210%/yr  
<sup>1)</sup>Utilities depreciation

Figure 6 4

obtain a copy of the balance sheet in order to make the calculation of current assets/current liabilities

### **Excessive inventory**

To determine the inventory value, it will be necessary to obtain a current version of the inventory valuation. This should be inventory valued at the market projected value.

### **Improper pricing strategies**

To develop a complete cost model for a product it is necessary to have the following information:

- Purchase cost
- Transportation cost
- Principal loan cost
- Interest loan cost (varies by loan term)
- Allocated labor cost
- Allocated storage cost (including utilities, rent, depreciation)
- Storage and transportation losses (if any)

The above costs should be added and then compared to sales price in order to determine product profitability. Allocation bases for labor and storage cost can be space used or tons processed.

### **Long payment delays**

It will be necessary to sample invoices from many separate weeks in order to determine payment cycle. Information that is required from the invoice is as follows:

- Product receipt date
- Date invoice is issued
- Date customer receives invoice
- Date customer transfers money
- Date wholesaler receives money

To get a fair measure of accuracy, you should sample 20 invoices a week from the previous eight weeks. The total elapsed time between the product receipt date and day the wholesaler receives the money is the complete order payment cycle. The internal order payment cycle is the time from product receipt until the customer receives the invoice.

### **Lenient customer credit**

You should speak with the director, the head of the sales department, and possibly the head of the accounting department in order to ascertain exactly what are the credit criteria. Most often there will not be a formal credit policy and this is always bad news. A helpful suggestion is to examine several customer's records and ask why is this customer receiving credit or why is this customer **not** receiving credit.

## **c Developing a solution**

### **Debt reduction, excessive inventory levels, and proper pricing**

Debt reduction, excessive inventory levels, and proper pricing strategies go hand in hand. At this point it has been ascertained whether the product has been priced adequately. The first step is to determine at what price should all product be sold (see figure 6.5). If the product can not be sold profitably, all attempts should be made to liquidate it immediately to avoid interest expense continuing to erode product value.

**A word of caution:** flooding the market with product could lower price, so be careful to release product at such a rate to preserve existing product value.

In Belomorskaya's case, accelerated inventory sales would reduce debt by only 60%, leaving 40% of unserviceable debt (see figure 6.6). This illustrates that when they took loans they

# A PRICE CALCULATION MECHANISM WILL HELP BELOMORSKAYA DETERMINE THE PROPER PRICE FOR EACH PRODUCT

- Should be performed every month

Product price calculation matrix	
Product purchase price	_____ rbl/kg
Transportation cost	_____ rbl/kg
Principal loan cost	_____ rbl/kg
Interest loan cost	_____ rbl/kg
Labour cost	_____ rbl/kg
Storage cost <sup>1)</sup>	_____ rbl/kg
Total cost	_____ rbl/kg
Profit margin (15%)	_____ rbl/kg
Target price	_____ rbl/kg

1) Unless depreciation

Figure 6 5

## ACCELERATED SALES OF EXCESSIVE INVENTORY WILL ELIMINATE A PORTION OF THE CURRENT DEBT

- Current inventory levels are only 60% of debt value

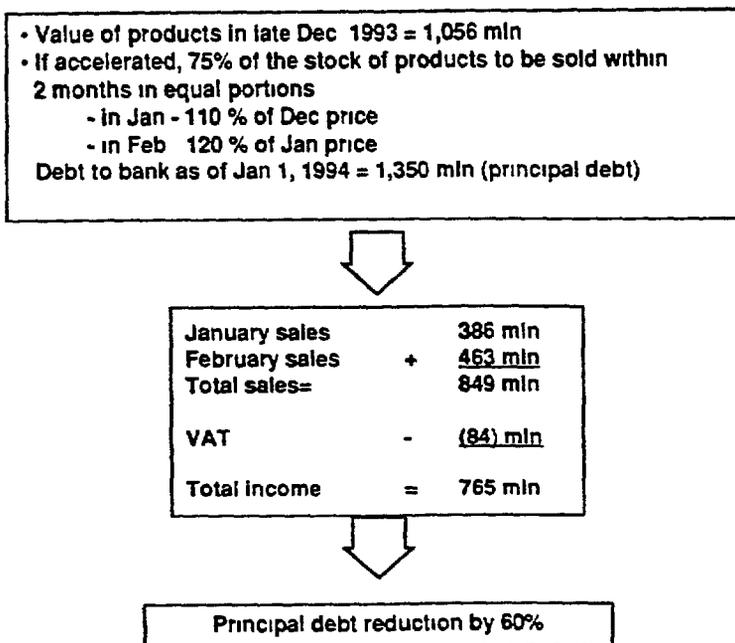


Figure 6 6

bought product whose value did not keep pace with inflation and as a result they now owe 550 million roubles for taking the loans. In other words, the wholesaler would be in a better cash position if he had never taken the loans.

This illustrates a new paradigm that must be adopted if vegetable wholesalers are to remain a viable business opportunity. As has been stated before, in the past wholesalers did not have to worry about paying back loans, the state covered all shortfalls. Now, the wholesalers have to pay back the loans, so they have to learn when to take loans, what products to buy with those loans, and how to pay the loans back. A strategy we developed at Belomorskaya was to take "target" loans. Target loans are taken for a specific product, for a specific amount of time, and paid back with the proceeds from the sale of those products. The proceeds of these sales are not to be used to buy new products, they are to be used to pay back the loan. Profits from the sale of these products can be used to buy new products, but only after all loan expenses have been paid. By reinvesting profits the wholesaler begins to develop his own working capital.

At any one time the wholesaler may have several target loans. This is acceptable as long as cross subsidization of loan repayment does not begin to occur with sales proceeds. This strategy will force the wholesaler to rigorously analyze his loan needs, control his borrowing practices, ensure loans are paid back, and grow his own working capital. We developed a simple forecasting sheet to help Belomorskaya forecast their cash needs (see figure 6.7).

A word of caution: the wholesaler should always treat his own working capital as if it were borrowed, then make sure he pays it back to himself with interest and earns a profit.

### **Long payment delays and customer credit**

At Belomorskaya we discovered that 21 days of their payment cycle occurred because of internal inefficiencies. It took 21 days after the customer had received the product to deliver the invoice to him. The most effective means of reducing this cycle is to deliver the invoice when the product is delivered. This may involve hiring an extra clerk, but the savings obtained from reducing the payment cycle more than makes up for this expenditure (see figure 6.8).

The ultimate goal should be to avoid receivables all together, but since this will never happen, we must be content to reduce receivables. The easiest way to reduce receivables is to reduce credit access. To reduce credit access it is imperative that a firm credit policy be developed and distinct credit criteria be established in order to determine a customer's credit worthiness. At Belomorskaya we found that no firm policy existed, so we worked with the management to establish this policy and the necessary guidelines. The result was a new credit policy (see figure 6.9).

Internal communication about the status of debtors was also a major problem at Belomorskaya. The accounting department would know that a customer had not paid their bill, but would not communicate this information to the sales department, who would then proceed to sell product to the customer on credit. We worked with both the sales and accounting departments to develop a debtor communication system.

The concept was simple and involved the use of a manual catalogue system (see figure 6.10). When a customer missed a scheduled payment, the accounting department would send an index card to the sales department stating that the customer had not paid his bill. Then when the customer called to place an order, the sales department was able to inform the customer that because the previous bill had not been paid, he could have no more products on credit until the bill was paid. When a customer paid the bill the same system was used. An index card was sent from the accounting department to the sales department stating that the customer had paid the bill and that it was now acceptable to continue credit sales to that customer.

The catalogue holder was a drawer in which all index cards were placed alphabetically. This solution is simple, yet highly practical and easily implementable.

**TO AVOID FUTURE FINANCING PROBLEMS, BELOMORSKAYA SHOULD FORECAST THEIR CASH FLOW TO DETERMINE THEIR FINANCING NEEDS**

• Simple tool for analysis

	Jan	Feb	Mar	Apr
<b>Cash flow from operations</b>				
<b>Inflow</b>				
Cash from sales				
Returns from suppliers				
Cash from other activities				
<b>Total inflow</b>				
<b>Outflow</b>				
Purchases				
Transportation				
Labour				
Utilities				
Returns to customers				
Other (eg replacement reserves)				
<b>Total outflow</b>				
<b>Net cash from operations</b>				
<b>Cash flow from financing</b>				
<b>Inflow</b>				
Interest received				
Loans received				
<b>Total inflow</b>				
<b>Outflow</b>				
Interest paid				
Loans paid				
<b>Total outflow</b>				
<b>Net cash from financing</b>				
<b>Cash flow from investments</b>				
Inflow disposition of assets				
Outflow acquisition of assets				
<b>Net cash from investments</b>				
<b>Total cash flow</b>				

Major indicators

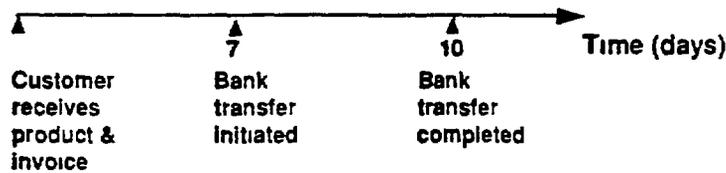
- Positive net cash flow from operations shows that company is generally healthy and can grow using internally generated funds
- Growing company may have negative cash flow from investments
- Cash from financing should be a function of target growth and cash from operations
- Financing provides cash that is needed for growth if operational cash flow is insufficient

Figure 6 7

**TO ADDRESS THE ROOT CAUSE OF PAYMENT DELAY, BELOMORSKAYA SHOULD DELIVER INVOICES SIMULTANEOUSLY WITH PRODUCTS**

• Savings of over 450 mln rbl/yr

Average payment cycle with suggested improvements



Benefit		Cost
• Reduce payment delay by 21 days -	450,000,000 Rbl/yr	• 1 clerk to create invoices - 480,000 Rbl/yr
• Reduce special department by 3 people -	1,440,000 Rbl/yr	
• Reduce expense to deliver product -	1,000,000 Rbl/yr	
<b>Total benefit</b>	<b>452,440,000 Rbl/yr</b>	<b>Total cost 480,000 Rbl/yr</b>



Return on investment = 1,000,000 %/yr

Figure 6 8

## DISTINCT CRITERIA MUST BE USED TO DETERMINE A CUSTOMER'S CREDIT WORTHINESS

- Restrict access of customer credit

Criteria	100% prepayment	50% prepayment	100% credit
Customer's solvency	Insolvent	Solvent	Solvent
Payer's reliability	Unreliable	Unreliable	Reliable
Volume of order	Regardless of order's volume	>500,000 Rbl	Regardless of order's volume

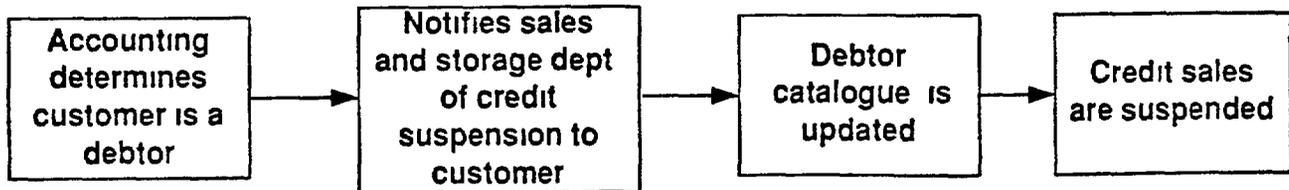
Restricting credit is an important factor in stabilising Belomorskaya's financial condition

Figure 6 9

## CUSTOMER INFORMATION WILL BE TRANSFERRED FROM ACCOUNTING TO THE SALES DEPARTMENT

- Ensure products are not sold to debtors on credit

### Enterprises on credit suspension



### Enterprises off credit suspension

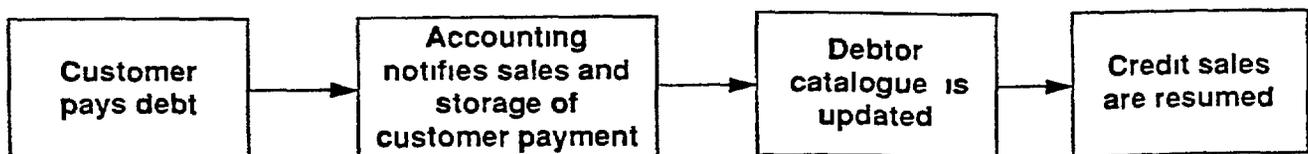


Figure 6 10

## **Implementation**

Implementation is the hardest point in financial restructuring. In order to succeed, it is necessary that management has thoroughly understood all recommendations you have made. The optimal situation is when the solution was developed in conjunction with the management and they feel that they have some ownership in it. The best way to ensure implementation is to illustrate the financial effect these solutions can have on the business. It also helps if the consultant spends time with the management working together with them to implement the solution. There is no black box that will implement this solution, the management must understand it and be committed to improving their operations. The best way to facilitate the financial restructuring is to privatize the enterprise. At that point the money becomes real to the management because they now own the company.

## VII DEVELOPING INTER-REGIONAL TRADE (IRT)

Inter-regional trade (IRT) collapsed with the disintegration of the centralized distribution system. Inter-regional transactions used to be administered from the center and individual wholesalers used to receive the fixed plan figures that prescribed to them where and what should be purchased and sold.

In a market economy fruit and vegetable wholesalers generate most of their earnings from IRT. Since most Russian wholesalers source and sell their products locally, they do not provide adequate value added in the supply chain and therefore are increasingly bypassed by farmers and retailers (see Figure 7.1). Additionally, in the southern regions, wholesalers face increasing competition from the city markets. As a result, wholesalers face increasing financial difficulties. Development of inter-regional trade is the key component of improving the vegetable supply and financial position of wholesalers in the emerging market economy.

### Problems of IRT

Most fruits and vegetables are grown locally and stored for a period of up to eight months (potatoes, beets, carrots, cabbages) or imported from abroad by Moscow or St. Petersburg trade firms (bananas, oranges, lemons, kiwis). A small volume of supplies comes from one CIS region to another or is imported directly to the regions from abroad. 50-60% of all "non-local" products come to the regions via Moscow or St. Petersburg.

The main problems impeding IRT are as follows:

- high default risk / non-payment crisis,
- lack of market information,
- high transportation costs,
- lack of scale for imports.

#### *High Default Risk / Non-payment Crisis*

Inability to differentiate the business reputation and credit standing of different buyers/sellers drives demand for prepayment. The lack of working capital precludes most buyers from placing more orders on a prepayment basis. As a result, the demand declines altogether with the profitability along the chain.

#### *Lack of Market Information*

The information vacuum caused by the collapse of the centralized system was not filled by newly created private small companies for several reasons. First, the new trading companies which include vegetable wholesalers lack capacity to engage in a cross-regional market research. Some 90% of them are small with annual sales of less than 1 million dollars. Second, the majority of wholesalers lack product expertise since they do not specialize and trade a very wide range of products. About 85-90% of new private wholesalers are "trade everything" companies.

#### *High Costs of Transportation*

Transportation constitutes a much higher proportion of the total cost than comparable transportation in the West. Cost of truck transportation runs up to 25% of the total cost in Russia compared to the cost of similar truck transportation in the US that will be around 6% of total the product cost. Lack of back-hauling and truck brokerage is one of the causes of high trucking costs. Railway transportation lacks reliability and temperature control that makes it unattractive for fresh fruit and vegetable trade.

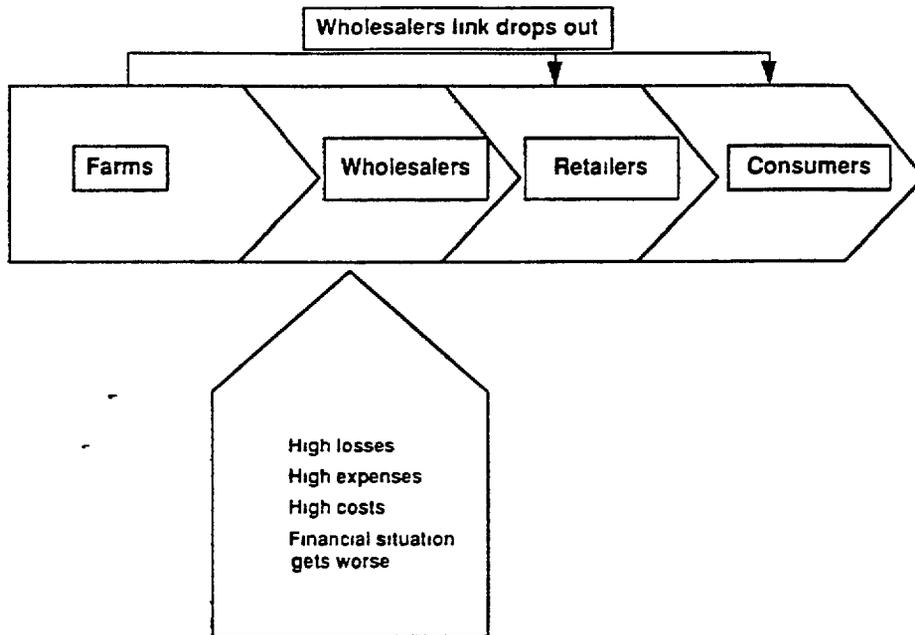
#### *Lack of Scale for Imports*

Insufficient scale causes several problems with imports from abroad:

- unfeasibility of transportation, i.e. order sizes are too large (e.g. one wholesaler had to decline shipments of fruits because it lacked the resources to buy a full ship),
- higher purchase price, since there are no quantity discounts,
- higher handling costs, since there are limited mechanization opportunities,
- slower delivery, since smaller orders get lower priority.

**Figure 7 1**

**INCREASED BYPASSING FORCES WHOLESALERS TO SEARCH FOR NEW SOURCES OF VALUE ADDED**



## IRT Development Concept

The concept of IRT development is designed to address the above problems. The objective is to develop selected wholesalers in different regions into cross regional traders. The wholesalers and their associations will then play a role of an IRT vehicle by performing the following functions:

- solvency check on suppliers/buyers in their regions to reduce a default risk,
- market research and exchange of market information to fill in the information vacuum,
- truck brokerage/back hauling to reduce transportation costs,
- pooling multi-regional import orders to increase the scale of import orders

### *Wholesaler Selection*

The starting point is a selection of wholesalers who would be able to carry out IRT functions. The selection criteria are the quality of management, existing trade contacts, and a sufficient storage capacity. The quality of management is by far the most important criterion. The management should be evaluated based on the following abilities:

- ability to understand the need for IRT and the opportunities that IRT provides a wholesaler,
- willingness to travel out of their regions and work in an unfamiliar environment,
- ability to establish and maintain trade contacts,
- ability to generate credibility and trust

### *Establishment of Marketing Links*

When the first two or three wholesalers are selected, they need to establish marketing links among themselves. It is important at this point not to force formalization of relationship between wholesalers since it can scare new partners away. The objective is to establish a good working relationship and develop mutual trust.

The wholesalers should hold an introductory conference where they:

- introduce themselves,
- exchange information about their companies,
- discuss the IRT development concept
- sign an agreement of co-operation (see Memorandum on Co-operation in Appendix)
- agree on schedules and formats of the market information exchange

After establishing initial contacts the wholesalers will start regular exchanges of marketing information by sending each other lists of offers and purchase inquiries. The offer form should specify at least the following:

- product type,
- quality grade,
- price,
- volume (min/max),
- payment terms,
- shipment terms,
- packaging

The wholesalers should be shown that there are *multiple benefits* from providing as many offers as possible including brokerage offers of goods owned by other companies. These benefits include profits from selling their own merchandise, brokerage commission for offering goods of other regional suppliers, and an opportunity to make money on reciprocal offers from other wholesalers.

When a wholesaler acts as a broker offering others' products, the offer should state the final price that already includes the broker's fee and will not be marked up afterwards.

### *Solvency Check*

The solvency check can be initially informal and limited to a telephone inquiry about particular businesses in the counterpart's region. The main value added is that it is much easier for a wholesaler to check the reputation of businesses located in its home region than in a remote one.

It should be understood that the wholesaler that provides information on the business reputation of buyers/sellers in its region can not be held liable if the information turns out incorrect

The solvency check data should be systematized and accumulated in a data base that later can be marketed to outside users

The data base format (see Appendix) should allow the buyer/seller to make a clear judgement about the credit risk, that in turn allows them to define acceptable payment terms

The differentiation between low and high credit risk will allow low risk buyers to receive more lenient payment terms. Better payment terms lead to a significant increase of these buyers' purchases since the demand appears to be highly elastic with respect to payment terms. Some 80% of interviewed buyers indicated payment terms as the key determinant of suppliers' attractiveness

The process of market information exchange and solvency checks is outlined in Figures 7.2 and 7.3

#### *Truck Brokerage*

The wholesalers should be encouraged to organize mutual truck back hauling from their home regions since it will significantly decrease costs of transportation and increase the turnover. The interviews with trucking companies indicated that trucks had no return cargo on 50-60% of trips. The primary reason is a lack of knowledge of possible product deliveries from the destination region to the home region.

The wholesalers will assist trucking companies delivering products from their counterparts to find the return cargo in their home regions. They also will supervise the logistics and make arrangements in advance to prevent delays in cargo shipments. The wholesalers will charge a truck brokerage fee for their services. As was indicated earlier, trucking costs run up to 25% of total costs and hence truck brokerage can provide a significant value added to IRT.

#### *Combined Purchasing*

Combined purchasing allows the wholesalers to get additional quantity discounts, get a higher order priority and reduce handling costs. A combined purchasing will proceed along the following steps:

- combined order is placed by one of the wholesalers (ordering wholesaler), e.g. better located to receive the shipment,
- the payment is made by each wholesaler to the supplier's account to avoid additional transactions,
- the ordering wholesaler arranges customs clearance, pays import fees, etc.,
- shipments to co-ordering wholesalers are arranged by the ordering wholesalers,
- the ordering wholesaler is reimbursed for the time and expenses on a direct or prorated basis.

#### *Inter-regional Food Broker*

After the marketing links are established and the wholesalers make inter-regional transactions, a need for a separate company that will specialize in IRT brokerage can arise.

The major functions of the food broker would be similar to that of the US produce broker and may be outlined as follows:

- monitor demand for major product categories,
- monitor the supply dynamics and communicate to farmers likely demand shifts,
- put together offers and orders,
- arrange the logistics of shipments,
- control quality of products shipped.

It should be noted that broker is paid commissions based on physical product volume shipped and does not take possession of products.

Figure 7.2

MECHANISM OF INTERREGIONAL INFO EXCHANGE AND TRANSACTION (II)  
• Buyer's perspective

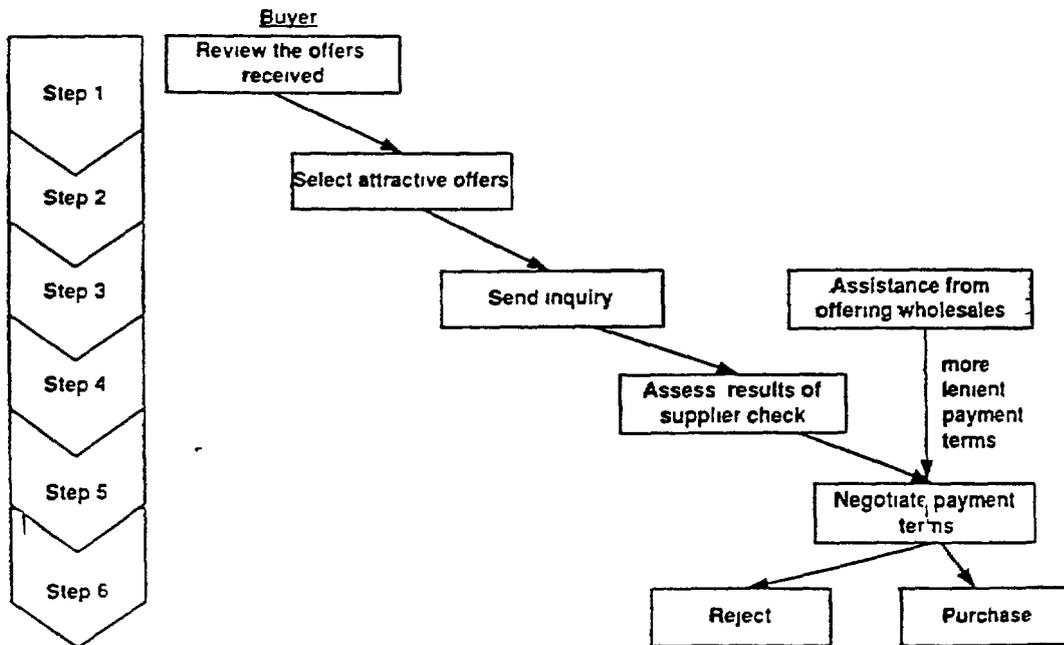
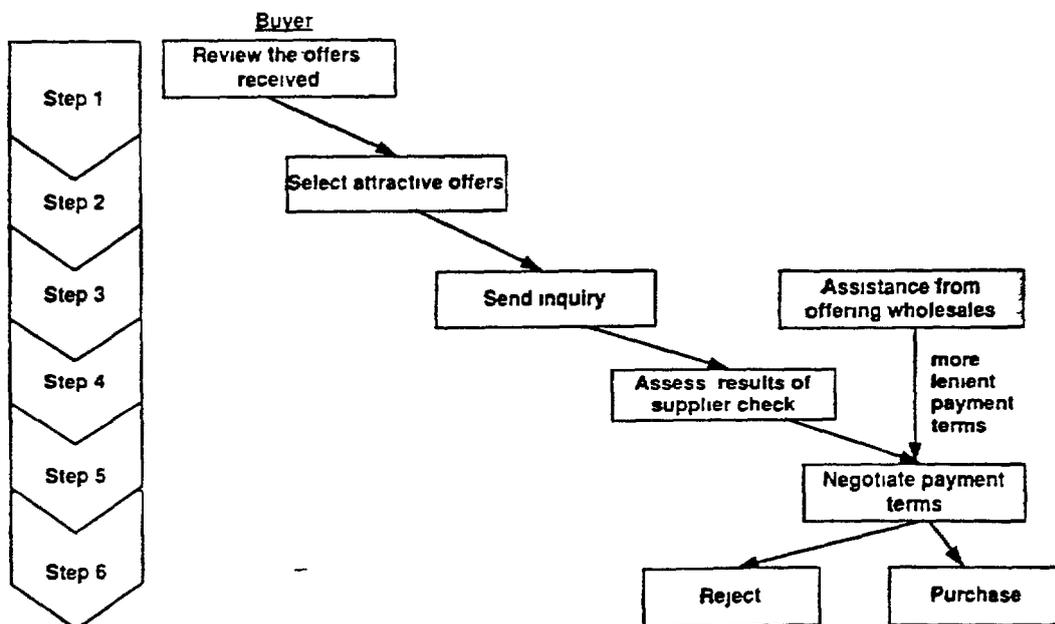


Figure 7.3

MECHANISM OF INTERREGIONAL INFO EXCHANGE AND TRANSACTION (II)  
• Buyer's perspective



The food broker may be better positioned to perform IRT transactions than wholesalers since they have to devote significant time to their local operations and tend to be more interested in the role of a distributor

## VIII CREATION OF A WHOLESALE MARKET

### Concept

The idea of creating wholesale markets in Russia was adapted from wholesale markets currently operational in America and other countries in western Europe

Wholesale markets are trading points that co-locate several wholesalers on the same premises. This concept is advantageous because it provides a central location where farmers can find buyers for their products and retailers can find products to buy. The wholesalers are incented to set-up operations in this market place because they will have access to customers that they would have been unable to otherwise reach. The facilities located on these premises are also typically better equipped than the premises the wholesalers would be able to lease (refrigeration, railroad access and large storage capacities). Because the wholesalers are co-located on the same premises, they are able to share inbound freight costs, product costs, as well as utility payments.

These markets are also attractive for traders and wholesalers from other regions because it gives them a chance to lease facilities where they can store their products for a short period of time in suitable conditions.

The retailers like the concept of a wholesale market because it provides them with an opportunity to inspect quality, price, assortment, and service from several competing wholesalers. The retailers no longer need to visit multiple sites, they can meet all their needs at this one market. This idea is particularly attractive to retailers located in rural areas because this concept will allow them to choose between multiple wholesalers, where previously for economic reasons, they could only buy from the wholesaler that served their region.

Governmental bodies are interested in wholesale markets because through sheer volume and competition, product quality, availability and service will increase while competition holds down prices. Implementation of this concept will result in a more satisfied population and further strengthen the public's support for the government.

### How to select a site suitable for the market

The ideal site is one that is big enough for four to five wholesalers (typically 5,000 tons of capacity for each wholesaler). The utility systems should be separate, it should have refrigeration, rail access, truck access, river or sea access, and have locking mechanisms to ensure that theft is not a problem. There should also be adequate office space to house the administrative functions of several wholesalers. These facilities are not hard to find in most large Russian cities because under the planned economy system, municipal authorities believed in building one large relatively modern storage facility per city. Currently these facilities are severely under-utilized (typical utilization factors are <50%) and local authorities are now seeking ways to increase the facility's utilization.

In Arkhangelsk, the premises of Belomorskaya wholesaler met most of the above criteria. The main problem of Belomorskaya's premises was that the utility systems were inseparable. There was no cost effective way to separate the refrigeration system, the sewage system, the electrical system, or the water system. This was one of the obstacles that we would have to overcome when setting up this market.

### Ownership

Wholesale markets in the west are typically owned by the municipality and a third party property management firm is hired to oversee all operations. This scenario is currently a problem in Russia because while the state owns most of the property, there is a lack of qualified property managers and the city is no position to manage the property themselves. The only people who are incented to manage the property are the owners, so therefore some measure of private ownership must be introduced.

In Arkhangelsk, city authorities were reluctant to privatize the entire Belomorskaya site because it was the largest, most modern storage facility in the entire oblast. The authorities felt that if they privatized the entire site and the wholesale market concept collapsed, the fruit and vegetable supply to the city would be damaged. Belomorskaya's management was adamant that some measure of private ownership would have to be assured otherwise they would not allow their facility to be used for the market.

**Note** Belomorskaya's management had a fifteen year lease on the premises and the lease agreement was structured such that it could only be broken if Belomorskaya voluntarily broke the lease. The city could only break the lease if Belomorskaya defaulted on payment or damaged the facility.

The compromise solution that was agreed between Belomorskaya, the Municipal GKI, and the Boston Consulting Group was to privatize one half of the premises along with the common systems (utilities, property, roads, railroads, and support buildings) and leave the other half of the premises in municipal ownership (see figure 8.1). This solution allayed the city government's concerns that they would lose control over facility and it satisfied Belomorskaya's management because they were allowed to privatize a portion of the facility and the common systems (see figure 8.2). The privatization variant that was agreed was commercial tender accompanied with profile conditions.

There was a real debate over how to privatize the common systems. The city wanted to ensure that if the common systems were privatized, they would still be able to use the existing utilities rather than be forced to build new ones. One option we investigated was leaving the common systems in municipal ownership. This option was disposed of because it was felt that the city would not be interested in the maintenance of these systems and that they would be allowed to fall into disrepair. The solution that we agreed upon was to develop a Joint Activities Agreement between the winner of the commercial tender and the city administration. This agreement would allow the privatization of the common systems, but would also provide that the city would be able to access these systems (see figure 8.3). Both parties would agree to split the maintenance cost and that each party would pay a proportional amount of the utility payment based on square footage occupied. Acceptance of this agreement was also made part of the conditions concerning the commercial tender.

### **Facility management**

There is a need for one firm to be responsible for the management of the facility (see figure 8.4). This management includes maintenance of systems and premises as well as ensuring the cleanliness of the facility. It is also necessary to co-ordinate receipts, shipments, and utilization of common equipment such as unloaders, conveyors, and sorting machines.

At Belomorskaya we investigated three alternatives to determine who should manage the facility. The options were the owner of the privatized half, a third party property management firm, or the city (see figure 8.5). The main concern about having the owner of the privatized wholesaler act as property manager was that he might discriminate against the other wholesalers. Regarding the second option, as we have mentioned before, there is a lack of third party property managers in Russia and Arkhangelsk was no exception. The city had a property management division that could have fulfilled this role, but we were not sure of its competence. The final option was to have the city administration manage the property, but this was the worst option because the city had no time to manage the property nor the experience.

It was decided that the owner of the privatized half would manage the property because they owned a portion, they had knowledge and expertise resident, and they would be the single largest leaseholder. The concerns over discrimination were covered in the Joint Activities Agreement which gave legally binding assurances to the city that discrimination would not occur.

### **How to find wholesalers for the market**

Finding wholesalers for the market should not be very hard. The city administration probably knows several interested parties, and in the event that they do not know of any, it is fairly easy to

# PRACTICALLY, THE EASIEST WAY TO SUBDIVIDE IS ALONG THE RAILWAY LINE

Barrier between the public and private half

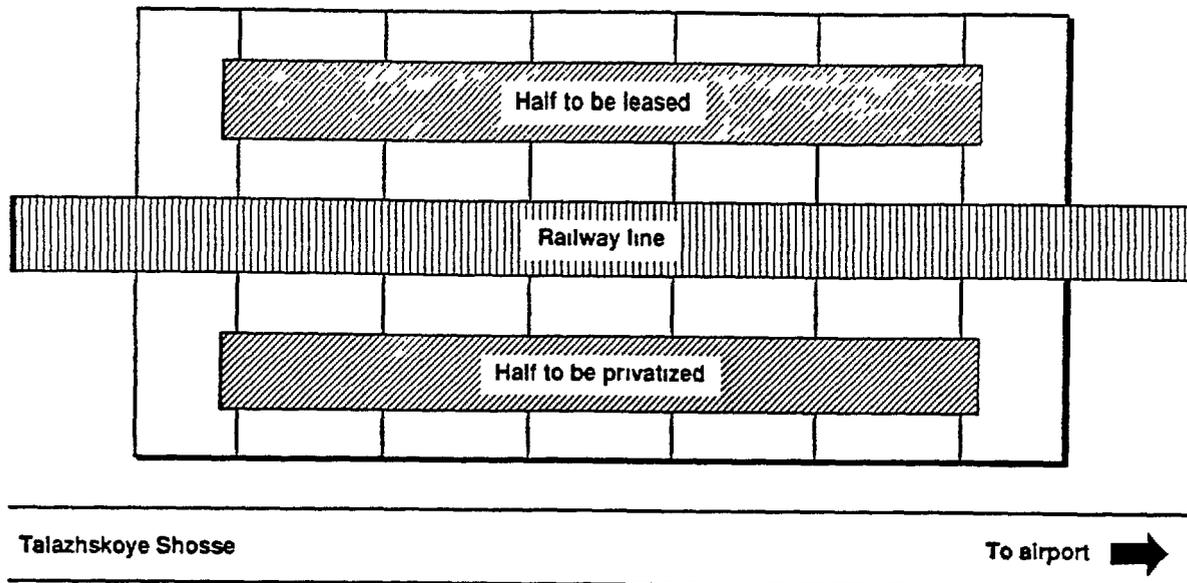


Figure 8 1

## ONE HALF OF THE FACILITY WILL BE PRIVATISED VIA COMMERCIAL TENDER

Best option for this vegetable wholesaler

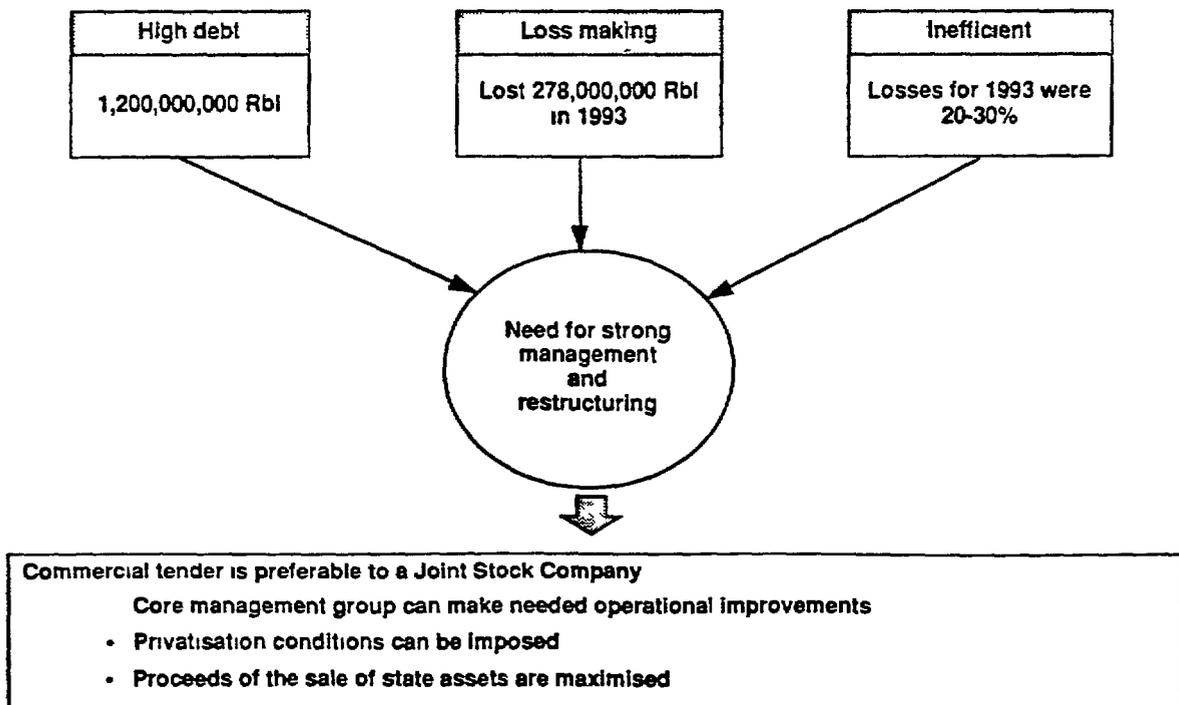


Figure 8 2

**TO ENSURE DISCRIMINATION DOES NOT OCCUR, A JOINT ACTIVITIES AGREEMENT WILL BE CONCLUDED BETWEEN THE CITY AND THE PRIVATE WHOLESALER**

Wholesaler will own the common systems, but city will have access

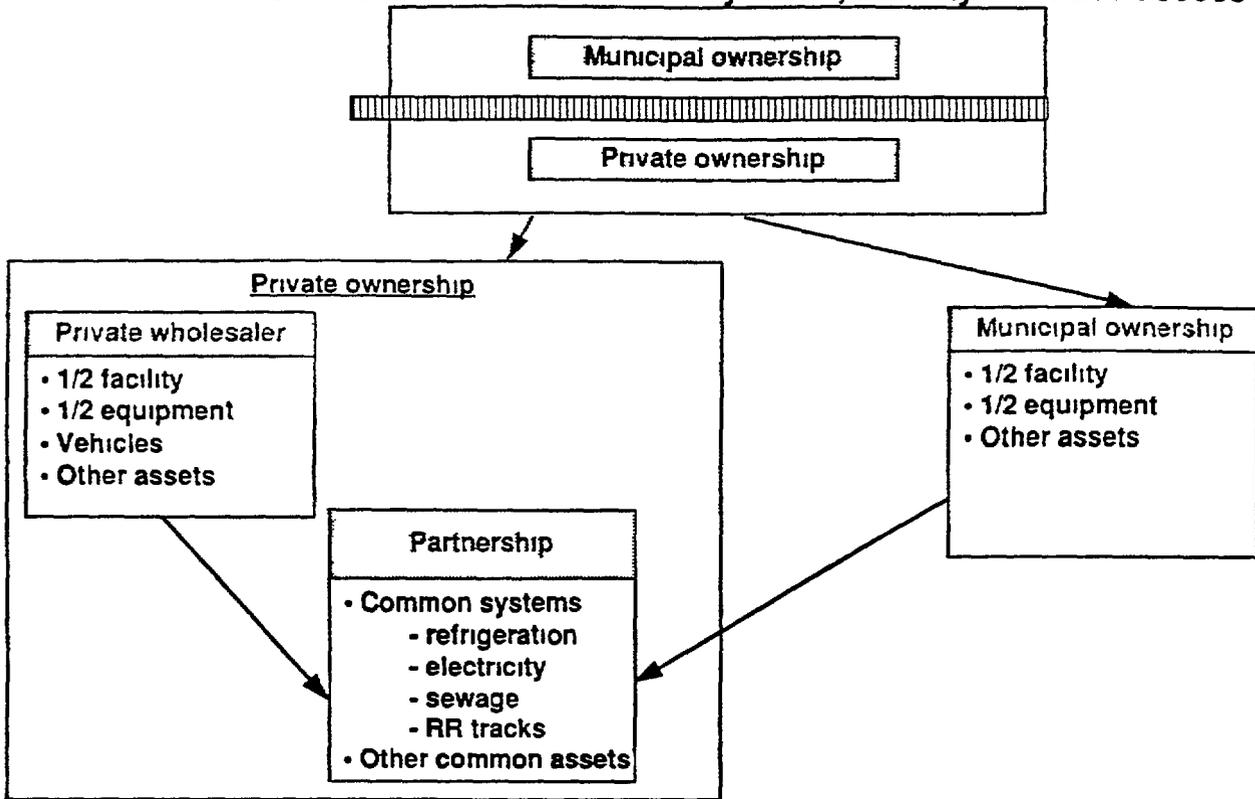
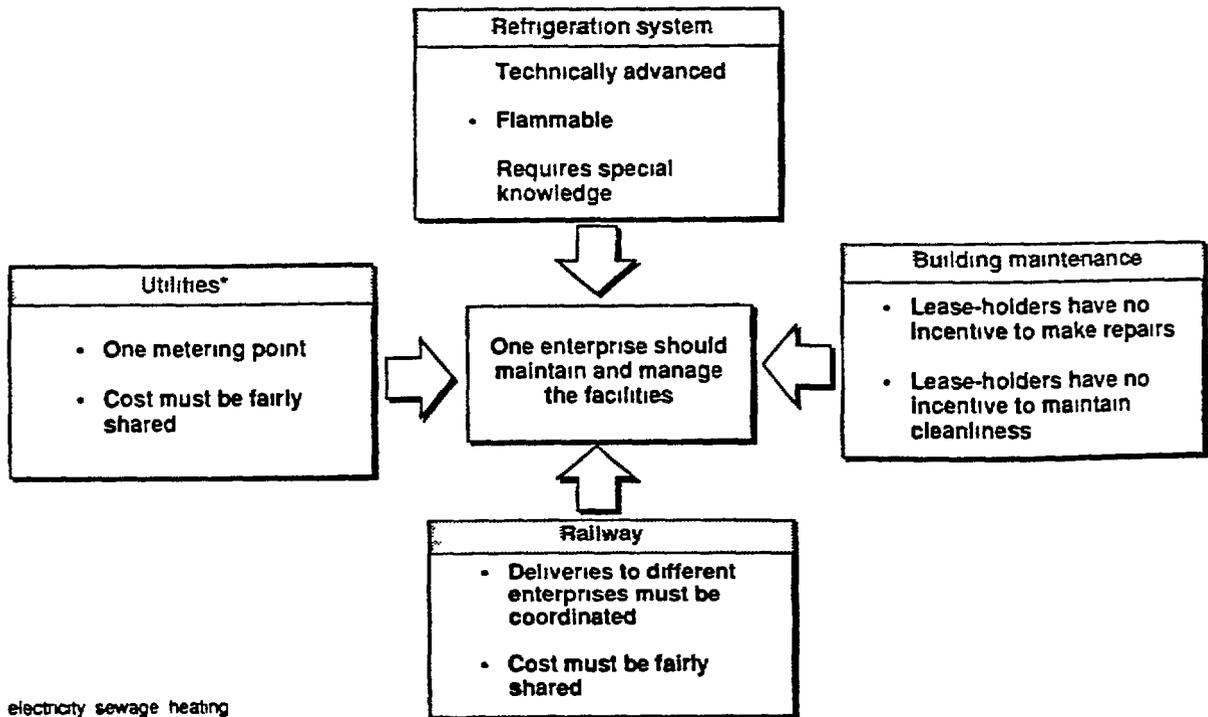


Figure 8 3

**BECAUSE COMMON SYSTEMS CANNOT BE SUBDIVIDED, SPACE ONE FIRM WILL BE MANAGE THEM FOR BOTH PUBLIC AND PRIVATE HALVES**

Also responsible for maintenance, cleanliness, and utility payment



\* Water electricity sewage heating

Figure 8 4

# THE OWNER OF THE PRIVATIZED HALF SHOULD BE RESPONSIBLE FOR MANAGING THE COMMON SYSTEMS

Discrimination against lease-holders is a potential conflict

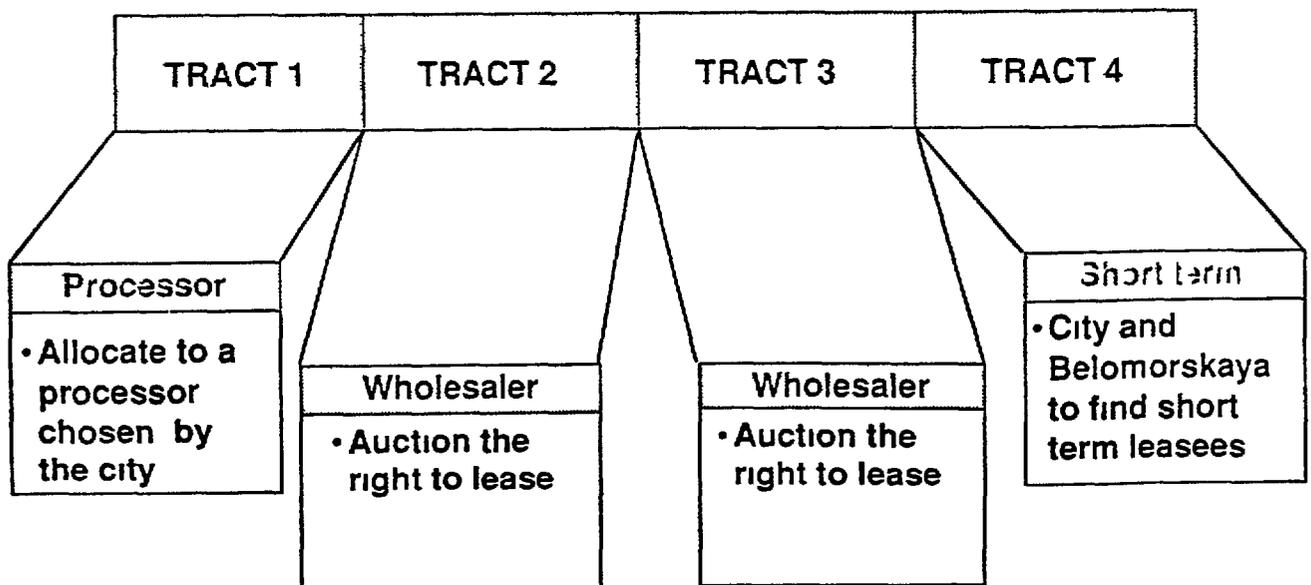
Possible facility managers	Benefits	Disadvantages	
Owner of the privatized half	Vested interest in the facility's upkeep Technical expertise is resident Familiar with operations and peculiarities of the facility Permanent resident	May discriminate against other lease-holders	Best option
Third party property management firm	Impartial towards tenants Only responsibility is the upkeep of the facilities Paid only if they are competent	<ul style="list-style-type: none"> <li>Such firms are currently lacking in Russia</li> <li>Lack of technical expertise</li> </ul>	Potentially viable
The city		City does not have the time to manage property <ul style="list-style-type: none"> <li>No responsibility or accountability</li> <li>Past track record is disastrous</li> </ul>	Worst option

The property management firm will be compensated for managing the facility

\* Exact amount to be determined by city and facility manager

Figure 8 5

# THE PREMISES WILL BE DIVIDED INTO FOUR TRACTS AND LEASED TO DIFFERENT CUSTOMER SEGMENTS



This solution will satisfy the interests of the public, city, and Belomorskaya

Figure 8 6

advertise the space and the concept Advertising should not be limited to only the municipal area Advertisements should be placed in large Moscow and St Petersburg newspapers to attract large traders from those areas

In Arkhangelsk, the method we used to inform wholesalers about the concept was to rely on both the city administration's contacts and advertisement We divided the premises to be leased into four tracts one to be used as a vegetable processor, two to be used as permanent wholesalers, and the last tract to be used for short term storage of perishable product (see figure 8 6) The method of space allocation that we used was a combination of lease auction and city allocation

To lease the permanent wholesale sites we invited all interested parties to participate a lease rate auction This was the fairest mechanism of allocating space because the person who most wanted the space would win the auction This minimized the degree of corruption that could have occurred if the government was allowed to allocate the space to its friends and contacts Lease payments were set prior to the auction and the wholesalers competed on who would make the largest one-time payment for the right to lease the space at the previously agreed rate In addition the lease rate was scheduled to be reviewed every three months and revised if necessary based on the oblast inflation level

The space for the vegetable processor was leased to a local enterprise who guaranteed the city they would use the facilities for freezing and canning vegetables The short term lease space would be available to traders from other regions who needed to store their products for a month or less The city felt that having this space available would incent traders to bring low cost produce to Arkhangelsk because spoilage in storage and transportation would be minimized due to the refrigerated facilities and railroad connections

### **Lessons from implementation**

The largest amount of time was spent negotiating with the city and the wholesaler about how the facility would be owned and managed This was an on-going process and was finally resolved after three months of negotiations The privatization process required two months and finding other tenants for the municipal half required one month In all the project encompassed six months of elapsed time with the vast majority being consumed by negotiations and the privatization process This concept was new for all parties and required much thought and negotiation

**Note** A detailed description of the wholesale market and the mechanisms that govern and regulate it are in the accompanying appendices