Guest Editors’ Introduction

Strategy and Organization in Russian Corporations

This issue outlines the crucial factors that affect the existence of Russian firms and that predetermine, to a great extent, the scope of their strategic aspirations and activities. The first part of this introduction traces the historical roots of the present Russian firms and the changes Russian enterprises have experienced over the past twenty years. The second part deals with major characteristics of strategic behavior by Russian companies before the 2008–9 economic recession. Included in this discussion are data on the contemporary structure of the Russian economy across its main sectors and industries. The third part summarizes our findings about the impact of the economic recession and the strategic reaction to hard times on Russian enterprises in various sectors.

A short history of the modern Russian corporation

Before 1986 life for Russian enterprises was hard but simple. The Ministry of Industry in Moscow sent production plans and detailed delivery timetables for each enterprise. Accuracy of deliveries was crucial, and tight independent quality control procedures were applied to military production, which produced up to 40 percent of Soviet industrial output. For other types of production, especially for intermediary and consumer goods, there was greater managerial discretion. On the last working day of December, the initial level of the production plans was routinely “corrected” to ensure fulfillment according to the plan.
Centrally determined fixed prices for deliveries assured that sales profitability ranged from 15 to 25 percent. The net “profit” was distributed uniformly in all the enterprises: 22 percent was used for monthly and annual bonuses for employees, 10 percent was set aside to finance housing, kindergartens, canteens, and leisure camps for employees, and 5 percent was transferred to fund “enterprise development.” The remaining funds were returned to the state. However, the real development of the enterprises hardly depended on the accumulation of funds. In reality, major projects for reconstruction of existing facilities and installation of new production facilities were financed by the state through its central budget. As the number of simultaneously executed projects greatly exceeded the real construction capacities, many Soviet enterprises resembled “eternal building yards,” where boxes with uninstalled equipment were distributed to factory shops.

In addition to obtaining state funds for the development and management of capital investment projects, the second problem was ensuring the uninterrupted flow of supplies. Because the reliability of deliveries of intermediary goods was problematic and there were no incentives or sanctions in the relationships between suppliers and customers, it was indeed tricky to get deliveries in time and in full. Central planning meant that deliveries were almost always interrupted, resulting in excessive downtime and feverish activity to meet the production targets when deadlines neared.

This led to a third problem: ensuring minimal stability in production processes—whose absence led each enterprise to try to become self-sufficient. For example, every machine-building factory included endless tool rooms, foundries, turneries, welding departments, and large warehouses for scarce materials. As a result, the employment in such auxiliary units usually exceeded the number of employees in the core production shops. To resolve the overstaffing problems, management kept performance standards low to ensure the uninterrupted flow of bonuses for surpassing the output quotas. Nevertheless, the list of vacancies for highly skilled and urgently needed staff in most Soviet enterprises was quite long because most enterprises competed for the same specialists—fitters, turners, welders, and milling-machine operators.

As a result, the majority of Soviet enterprises were large factories that worked at maximum capacity (e.g., in 1990, the level of capacity utilization for major types of industrial products was 85 percent to 95 percent and for grain production it was 99.8 percent). Enterprises were overstaffed by an undisciplined and unmotivated workforce in auxiliary shops, experienced acute shortages of key production personnel, and overburdened by subsidies for housing, kindergarten, and other objects of social infrastructure.

Institutional changes began in 1986. The Law on Enterprise of 1987 stipulated the election by the employees of the general directors of the enterprises, a fact that increased their legitimacy and made them more independent of the central planning authorities. The Law on Cooperatives of 1988 permitted business activities outside the system of central planning. Most cooperatives were lead by general directors or
their proxies, and they simply channeled state funds into private hands by overpricing, subcontracting, and providing intermediary services. Thus, top managers of Soviet enterprises, for the first time in their lives, tasted easy and big money.

Corporate development during the early transition period

The collapse of the Soviet Union transformed the idyllic picture of orderly chaos into a frightful picture of chaotic disorder. Industrial ministries and detailed production plans disappeared virtually overnight. Prices were unfrozen at the January 1, 1992, level, and enterprises were free to sell everything to everybody at any price. This immediately led to a triple-digit inflation rate, evaporation of the enterprises’ assets, acute liquidity shortages, and capacity utilization that dropped to miserably low levels. For example, in 1995, the capacity utilization in production of railway stock, trucks, fabrics, and paint production was below 20 percent. Wage arrears and barter trade became prevalent features of Russian business life. To make things even more complicated, the privatization process began. In 1993 and 1994, most enterprises were transformed into open joint-stock companies, with 70 percent of newly created companies allocating the majority of shares among their employees. As a result, top managers of Russian companies assigned themselves an additional task, namely, to assemble controlling interests in their companies by buying back the shares from their employees.

During the period 1992–95, the disparity between domestic and world prices made foreign trade extremely profitable. In most cases, profits from exports were absorbed by trade intermediaries. Such intermediaries quickly recognized that the best way to ensure their high profits was to gain complete control over the producers. During the period of 1995–97, the battle for corporate control between insiders, top managers, outsiders, trade companies, and banks was at its height (Gurkov 1998; Gurkov and Asselbergs 1995). This battle, irrespective of the winner, made quick streamlining of privatized enterprises almost inevitable. Indeed, in order to obtain the necessary means to purchase employees’ stock, the general directors had to squeeze profits from their companies. To make their businesses profitable, they had to shed unprofitable assets, master the fundamentals of capital management, control costs, and implement effective marketing and business plans. Similar streamlining took place after the acquisition of companies by outsiders. To transform the acquired companies into profit-making ventures, the acquirers implemented the same measures, namely, rationalizing assets, establishing marketing channels, and implementing proper cost and financial accounting (Gurkov 1996).

However, the organizational consequences of the battle for corporate control depended largely on the winning side. Victorious insiders preferred to keep their companies independent. Outsiders tried to incorporate the acquired companies into larger structures, and this is how the first conglomerates consisting of banks as parent companies were created. One major strategy of such conglomerates was
speculating in the bond market with profits from industrial enterprises by buying short-term Russian treasury notes.

Present form of Russian companies crystallizes

The sharp market decline in August 1998 destroyed the financial pyramid of short-term treasury notes and marked the end of many banks that had built their very existence on such operations. After the bankruptcy of their parent companies, many industrial conglomerates simply disappeared. In the period 1999–2000, the battle for corporate control between insiders and outsiders became less sharp. The period between 1999 and 2001 was crucial for the establishment of the present form of the Russian corporation.

First, employees lost ownership of most of their shares, and corporate ownership became concentrated in the hands of insiders. Second, the shock of August 1998 marked the beginning of industrial recovery, in which the devaluation of the Russian currency by 75 percent restored the price competitiveness of Russian products and almost completely eliminated foreign competition at least in the consumer markets. The surviving privatized companies were eager to use their newly acquired skills in marketing and financial management to design strategic plans for growth and expansion. They also became leaner because during 1995–98 many firms divested most of their unnecessary and unproductive assets and were able to shed their expensive social infrastructure. The government also wrote off all penalties on unpaid enterprise taxes and allowed the restructuring of the principal tax debts at very favorable terms (Dolgopiatova et al. 2009, 105)

Third, the change in the political regime in 2000 was an underestimated factor that contributed to the establishment of the Russian corporation in its present form. The Russian government in the 1990s was weak, poor, and liberal. After the resignation of Boris Yeltsin as president, the new administration instilled order, stability, and obedience. Many Russian billionaires of the 1990s, who were libertarian and arrogant, found themselves in the early 2000s either exiled or jailed, and their assets taken away by the state or transferred to more loyal government insiders. These later groups of businessmen not only had to prove their political loyalty but were forced to coordinate their actions with the government. All acquisitions and corporate raids required prior political approval, the level of approval depending on the size and importance of the targeted assets. Moreover, large industrial companies, not banks, became the centers of further industrial consolidation. This created some rules for corporate control and, at least, guaranteed that the owner(s) of the targeted companies would receive adequate compensation for their loss of control.

The revitalization of the economy, rising prices for major Russian exports, establishment of some rules for corporate control, and government’s modernization rhetoric created mass incentives for innovative development. The modern Russian
corporation emerged as a highly centralized amalgamation of privatized assets with owners and managers who had fresh memories of misery; they therefore were passionate about cash flow, superficially obedient to the political regime, eager to profit from patronage, merciless to competitors, and ready to emulate all the newest fads and fashions in management and corporate governance while being innovative in the violation of applicable rules and regulations.

We have described the modern Russian corporation that emerged from the ruins of the Soviet enterprises. However, some sectors of the Russian economy were created in 1990s by private entrepreneurs. The first sector was telecommunications, especially mobile phone operators, which were created from scratch as private enterprises. The second was the financial sector, especially investment banks and insurance companies, which mostly emerged as private companies. The third important sector with minimal inheritance of Soviet assets was wholesale and retail trade operations. There are also several examples of successful, initially private airlines, such as Transaero and Kaspersky’s Laboratory and Rambler in the software industry.

Finally, Russian industries were dominated by leading multinationals first and foremost in food processing. Beginning in the 1990s and intensifying in 2000s, major multinational companies (Nestle, Unilever, Heinz, Coca-Cola, PepsiCo, Colgate-Palmolive, Danone, Procter & Gamble, and beer and tobacco companies) established undisputed dominance of their trademarks in the Russian market by establishing production facilities in Russia. In the 1990s, this was done mostly by brownfield investments that involved the acquisition of existing production facilities that were reequipped and expanded. In the 2000s, leading multinationals expanded their repertoire of development methods by applying three major strategies. The first strategy involved expanding market share by acquiring local companies. For example, in 2010 PepsiCo acquired around 30 percent of the Russian market for fruit juice by purchasing the leading Russian producer, Wimm-Bill-Dan; in 2009 Unilever acquired around 35 percent of the Russian market for ketchup by purchasing the leading Russian producer, Baltimore Holding; and in 2006 Heinz acquired around 10 percent of the same market by purchasing the local producer, Petrosoyuz. The second strategy involved a greater use of local companies as contractors for packaging and bottling by companies such as Procter & Gamble, beer companies, and soft drink companies. The third strategy was based on greenfield investment in its own production facilities, such as in the case of Nestle.

Other foreign-dominated industries, such as the professional services industry, which included the Big Four accounting firms in the field of corporate auditing and international operators in inbound and outbound logistics, were rather small in comparison. Foreign companies in areas such as pharmaceuticals, civilian aircraft, and various kinds of machinery and equipment achieved, or restored, their dominance in particular Russian markets through imports and dealer networks rather than by establishing their own production subsidiaries. Only in the last few years were there attempts by major car producers such as Ford, Toyota, and Volkswagen
to build assembly plants in Russia. Previous attempts, such as one by Siemens in power equipment, Bombardier’s expansion into production of transportation equipment, and foreign firms that invested in building materials manufacturing facilities through the acquisition of local producers, were mostly unsuccessful due to government restrictions on foreign ownership of strategic industries. Thus, we refer below mostly to Russian-owned companies whose operations are mostly in Russian-based facilities.

Structure and strategies of Russian firms before the current economic recession

The analysis of Russian corporations before the 2008–9 recession is based on a series of large-scale surveys of top managers implemented in 2000–2007. Gurkov surveyed 740 managers in 2000, 1,500 in 2002, and 1,400 in 2004 (Gurkov 2006) as well as 250 managers in 2007 (Gurkov 2009a). In addition to these surveys, Gurkov also collected about 350 in-depth narratives from company managers about the main strategic problems of their companies and created 20 cases on the patterns of strategic behavior of particular companies and industries. Finally, in the first half of 2008, we compiled more than 60 dossiers on the largest Russian corporations. Each firm dossier included annual reports of the company, newspaper and magazine excerpts of in-depth interviews with top managers, and analytical reports on the company’s investment by banks and brokerage firms (Dorofeev 2009). Hence, our analysis of Russian firms is based on rich empirical evidence.

First we look into the aspirations and strategic goals of Russian corporation and firms. In 2000–2007, three major goals were set by, or imposed on, corporate managers: to increase sales, increase profitability, and maintain financial stability. Each of the aforementioned goals was rated as “important” or “extremely important” by 80 percent to 90 percent of the surveyed firms. The simultaneous achievement of these goals was possible under constant growth of revenue. The majority of the Russian companies understood that proposition well without relying on sophisticated economic models. However, performance measures differed for companies oriented toward local markets and export-oriented companies.

Locally oriented companies

Locally oriented companies moved rapidly to seize the opportunities created by sharp devaluation of the local currency in 1998 and the subsequent elimination of foreign competition as foreign firms left the market after the 1998 crisis. The best way for companies structured on privatized assets to improve their marginal revenue was to return to operation previously idle production capacities and to effectively use know-how developed during the transition period. To reach a higher level of capacity utilization, these firms tried to maintain competitive prices and
to pay more attention to quality control. Improving quality was important for 60 percent of the surveyed companies. When production reserves of idle capacities dried up, companies continued the race for higher marginal revenue by adopting two measures. First, they shifted from the production of low-profit margin products to higher-margin products, a result that was achieved by careful consideration of production and market portfolios. Second, they rushed to install new production facilities. Such projects shared the following criteria: (1) They were financed mostly by using retained profits that were relatively inexpensive compared to new capital that Russian firms faced because commercial loan rates hovered between 20 percent to 25 percent throughout the 2000s; (2) The projects’ financial outcomes were designed to minimize risk by using proven technologies and production schemes with no hidden bottlenecks (Smirnov 2009); and (3) Operations in the facilities were supposed to be easy for the existing workforce to master.

In recent years one widely used practice by foreign firms in Russia is the use of turnkey operations, in which foreign companies take over complete responsibility for the design of production schemes, purchase, delivery, and installation of the necessary equipment as well as training the local personnel and assuming further control and guidance until the agreed level of output is reached. The turnkey model for new development projects was also applied by new private companies built from scratch rather than from privatized assets in formerly state-owned enterprises. Such cut-and-paste strategies were successfully used for recapturing local consumer markets by offering products with mediocre quality at affordable prices. As consumer confidence in Russian-made products was restored, additional marketing tactics were used. As Tatiana Komissarova and Andreas F. Grein illustrate in the third article in this issue, Russian firms have attempted to adopt international marketing techniques. In addition to the marketing strategies and techniques covered by these authors, there has been an interest in revitalizing Soviet brands as a marketing ploy. Products are being sold at higher prices as the manufacturers claim that they are produced according to the “strict state standards of the 1950s” or as “authentic recipes of 1970s” and remind customers of the “untroubled life of the 1970s” or their “happy childhood.” Revitalization of Soviet brands has also been used by multinationals. One interesting example of foreign companies using patriotic motives was a large advertising poster showing a Russian cosmonaut who painted the space shuttle with the colors of the Russian flag under the slogan “Russians strike back.” The poster advertised a Soviet brand of cigarettes, produced and marketed by British American Tobacco.

During 2005–6, despite the quick rise in consumer prices, the possibilities of intensive growth (i.e., holding upper market segments or niches in particular markets) were exhausted. Locally oriented companies had to embark on larger and more expensive projects in order to maintain their market share. That undermined the third proclaimed goal of financial stability. Although the ratio between current assets and current liabilities of Russian companies seemed normal, companies accumulated large debt burdens from long-term bank loans and bonds issued. Large debt loads would later lead to financial weakness during the financial crisis in 2008.
Export-oriented corporations

Exports from Russia have been dominated by mineral, chemical, and hydrocarbon products. Nearly 70 percent of exports in 2008 came from this sector, with the metals and precious stones sector accounting for 13.3 percent, chemical products for 6.5 percent, and the remainder comprising hydrocarbon exports. In the 2000s the share of manufactured goods in total exports remained below 5 percent. Over time, the value of manufactured and processed exports has increased, but Russian exports continue to be dominated by hydrocarbon exports, which in effect have crowded out other sectors in the export market.

First, the favorable price dynamics of these natural resource commodities on world markets in the early 2000s made exports extremely profitable since the production costs were calculated in rubles while sales were made in U.S. dollars. Companies tried to export as much as possible and under any condition because any additional sales increased the capacity utilization rates and lowered average unit costs. However, as the reserves of idle capacities were fully exploited, the path for further development took a different direction. For such heavy industries, installation of new capacity was expensive and took longer, and complex industrial projects had neither standardized solutions nor a definite expectation of timely completion.

Thus, large export-oriented companies looked for other possibilities. First, they started to streamline the dealer networks, skip intermediaries, and establish direct sales in international markets. In ferrous and nonferrous metals, this was indeed achieved, while in the oil and gas industry, there were political obstacles to the elimination of intermediaries. As the majority of added value from core activities fell into the hands of large exporters, these firms started to look for additional sources of profits. The first solution was found in vertical integration, both upstream and downstream. Metals firms purchased coal mines, ore deposits, and car manufacturers; oil companies built extensive networks of gasoline stations; aluminum producers acquired power plants; and Gazprom acquired everything from producers of nitric fertilizers to equipment manufacturers and oil fields. The financial fate of the acquired companies was doomed because all the profits were taken by the parent companies via a system of transfer pricing. Again, as in Soviet times, all the plans for capacity development depended on approval and financing from Moscow, but arguments about the importance of production in the national interest or appeals to communist consciousness were no longer effective.

As the largest Russian exporters quickly absorbed all the property in abeyance in related industries, they then looked for profitable growth elsewhere. One lucky discovery was the possibility of offering an initial public offering (IPO) on major stock exchanges, first on the New York Stock Exchange and then later on the London Stock Exchange. At a very reasonable cost, such as hiring one of the leading American investment banks as the underwriter, organizing a road show, auditing by one of the Big Four accounting firms, and adding a few independent directors to
the board of directors, billions of dollars could be collected. Russian corporations also learned extremely well the basics of good investor relations, namely, using timely disclosure of positive information, foretelling of grandiose plans, and, in some cases, hidden internal trading and secretive buybacks of one’s own stock. Russian shares traded as American or global depositary receipts showed very positive share price trends. The largest Russian industrialists were happy to assess themselves not in terms of sales volume but, rather, in terms of enterprise value. The securitization of large Russian corporations gave them not only new strength but also a powerful weapon for a new wave of expansion—acquisition of overseas assets—as discussed by Alexei V. Kuznetsov in the second article in this issue. Cross-border mergers and acquisitions of Russian assets peaked at $22.75 billion in 2007 in comparison to an average of only $331 million in the 1990s.

The acquisitions in the early 2000s were effective, and, if not successful in purely financial terms, they met other company and national goals. Since then the marginal effects of foreign acquisitions have steadily decreased. More recently, Russian corporations have been unable to gain control over any major European or American corporation or to acquire any major international brand. One widely known failure of a Russian firm was the attempt by Severstal to compete with Mittal Steel in the takeover of Acelor (2006). In addition, during the current economic crisis, General Motors refused to sell Opel to a consortium of Magna and Sberbank (2009), and Surgutneftegas struggled to use its newly acquired 21 percent stake in MOL (a Hungarian oil company) to join the board of directors and management committee of its new subsidiary. In general, the intensive efforts of overseas expansion proved rather expensive, it has not brought immediate financial or political dividends, and, in some cases, it endangered the very existence of the Russian corporations as governments in the developed countries demanded transparency in both the identity of the real owners and real corporate governance structures. Although revealing the final beneficiaries was in many cases not very risky, the presentation of the internal rules of Russian corporations might have provoked serious questions on their ability to run a modern business.

**Internal corporate management**

Indeed, the typical Russian large corporation has three tiers. The first tier is typically a hidden part that acts as the parent company, usually located offshore. The parent company accumulates profits and also, if necessary, acts as the major investor in its subsidiaries. The Central Bank of Russia (CBR) collects data on international investment in Russia and provides breakdowns for these investments. In 2007–9 (through first quarter), the CBR estimated that total direct investment by nonbank corporations in Russia were $126.9 billion. These investments in nonbank corporations were made by corporations from offshore financial centers such as the Bermuda, British Virgin Islands, Cyprus, Gibraltar, Luxembourg, and the Netherland Antilles. Those investments that could be identi-
fied indicate that $65.1 billion, or 51 percent of international investments, flowed from these offshore financial centers.

The second tier is its operations headquarters, located in Moscow. When the operation headquarters are located close to the firm’s major production sites, then corporations maintained large representative offices in Moscow. Headquarters are split into sectors or business units that oversee the activities of the production units, which makes up the third tier.

The composition of ownership can vary, but Russian corporations strongly prefer short ownership chains that coincide with the chain of command. Only a few Russian corporations have dared to implement a strategic business units structure that would lead to the decentralization of purchasing, pricing, staffing, marketing, and investment decisions. Examples of companies that have tried the business unit format are old conglomerates, such as AFK Sistema and the ALFA Group, that have learned how to treat large subsidiaries as self-contained business units. In most corporations, significant decisions are made at corporate headquarters. The other duties of operations headquarters also include the constant creation of endless key performance indicators and the design of balanced scorecards for the production units. Consequently, Russian enterprises that are part of integrated Russian corporations have less autonomy than in Soviet times.

Two major developments have made the current situation in Russian production enterprises worse than in Soviet times. First, the Soviet ministries were staffed mostly by experienced general directors of enterprises who had exchanged lower salaries—ministry officials earned less than heads of enterprises—for the possibility of moving from provincial cities to Moscow. They spoke the same language as their subordinates and had not developed a sense of distance from the enterprises that they supervised. By contrast, the operating headquarters of modern Russian corporations are staffed by recent graduates who are financial experts and lawyers whose education and work experience include have little direct operations experience and no identification with any particular industry or enterprise. So, the mental models of the supervisors and subordinates largely differ. An analysis of precrisis firms in Russia by Igor Gurkov and Olga Zelenova in this issue indicates that the undisputed role of the general director and their managers over personnel exacerbates the dissonance between managers and their personnel.

The second point is related to the financial position of the enterprises. We mentioned earlier that in Soviet times the profitability of sales was assured and that 35 percent of the net profit remained in the enterprise’s hands. Nowadays in vertically integrated Russian corporations, all efforts are made to squeeze operating profits by engaging in transfer-pricing schemes. By contrast, in horizontally integrated corporation, retained profits of the subsidiaries are allocated as dividends to finance the needs of the parent companies.

The operation headquarters have neither the time nor the capacity to deal with strategic issues. Under such circumstances, the only remaining body left to address the firm’s strategic issues is the board of directors. During the 2000s, attempts
were made to implement an advanced system of corporate governance based on international standards. Russian legislation prohibited the chairman of the board of directors and the general director (CEO) from being the same person. Large industrialists immediately appointed themselves chairmen. To maintain tight control over their companies, these chairmen built their own apparatus, advisory groups for permanent committees of the boards and other units that often duplicated and competed with the same departments at the firm’s headquarters, which reported to the company general director. This can be viewed as replication of the Soviet system, in which departments of the Central Committee of the Communist Party duplicated the corresponding industrial ministry but were not responsible for any decisions. The chairmen and the boards of directors gradually became deeply involved in the operating decisions. However, the primary responsibility of these chairmen was to formulate the firm’s financial policy.

Russian companies have used the European capital markets to raise lower-cost capital to develop their activities. In 2006 and 2007, approximately 139 eurobonds were issued, raising nearly $50 billion, and 285 syndicated loans, which gained Russian firms $126 billion in new capital. Bonds issued before 2008 were oversubscribed and had favorable rates that ranged from 8 percent to 11 percent, depending on the company, market conditions, and the industry. In mid-2008, the total foreign corporate debt of Russian companies reached US$500 billion. However, this capital was poorly used. Russian firms’ return on assets (ROAs) was significantly lower under the same global conditions. As noted by Vladimir Kossov in the first article in this issue, manufacturing firms and mining and quarrying (including oil and gas industries) firms, for example, experienced ROAs that were lower than those of comparable U.S. firms. To close the gap and to demonstrate profitable business models for successful foreign borrowing, Russian corporations intensified their efforts in the first half of 2008 through the use of their local market power. For example, the local prices for metals, cement, and oil products increased by 20 percent to 40 percent and surpassed world prices. Such a feast could not last for long.

The aftermath of the financial crisis: Current strategies of Russian firms

Experts can speculate about the causes and triggers of the financial crisis in Russia, which may be the result of either the volatility of the world financial markets, the 300 percent fall in oil prices, or the rise of country’s risks due to internal and foreign policies, but the start date of the events of the crisis is clear. In the fourth quarter of 2008, Russian stocks lost 75 percent of their market value. This decline in the stock market led to the closing of the foreign placement and domestic IPO window and the end of the placement of shares on the market by Russian entrepreneurs. Also, in the fourth quarter of 2008 there was a massive capital outflow from Russia that amounted to US$130.5 billion, including US$55.6 billion net outflow.
from the banking sector and US$74.9 billion in the nonbanking sector (World Bank 2009a, 20). One part of these outflows was related to the margin calls on foreign credits, which reached US$527 billion by October 2008, and the second part was pure capital flight. In November 2008, industrial output was 8.7 percent lower than in November 2007, and by December 2008, it was 10.3 percent lower than in December 2007. Capital outflow continued in the first quarter of 2009, with outflows of US$6.9 billion from the banking sector and US$28.4 billion from the nonbanking sector; thus the total capital outflow over six months was 12 percent of Russia’s 2008 gross domestic product (GDP).

The financial crisis in September 2008 caused the short-term borrowing rate to rise from 8.9 percent in September 2008 to 11.2 percent in October 2008. The CBR reported that average interest rates for nonfinancial institutions that participated in ruble-based borrowing increased to a 2009 average of 14.3 percent, up from 12.3 percent in 2008 and 10.2 percent in 2007. During 2006–9, the CBR managed the revaluation of the ruble, controlled inflation, maintained liquidity in the banking sector, and maintained interest rates to ensure continued economic growth. The cost of capital changed rapidly between June 2008 and November 2009 as a result of these, at times, conflicting policies.

Until mid-November 2008, top Russian officials tried to deny in public the existence of a systemic crisis, though in reality, the government undertook a relentless series of actions to prevent the collapse of the financial system and to avoid the bankruptcy of major corporations beginning in September 2008, when a large amount of liquidity was injected into the banking system. In October 2008, the government saved some of the largest companies, such as UC Rusal, X5 Retail Groups, and VimpelCom, from technical defaults on foreign loans based either on syndicated loans or collateralization of shareholder stakes. In November 2008, the list of companies that received direct financial assistance was expanded to include the Evraz Group, Gazprom Neft, Sitronics, Eko Telekom, the PIK Group, Rosneft, Lukoil, Globex, and Svyaz Bank. The owners and managers of these companies, many already connected to the government or to state-owned enterprises, now had to rely on the state-owned Vneshekonombank (VEB) as the lender of last resort to prevent their collateral from being seized by foreign creditors. Moreover, the intervention by VEB in the activities of these companies’ strategic policies was not the same as the relationship between the foreign creditors and the Russian debtors. By accepting these bailouts, these companies agreed to allow VEB representatives to join the board of directors and management committees by taking board seats and to have VEB bankers or connected individuals appointed to oversee the firms’ performance.

Being involved in a seemingly endless series of rescue operations, the government tried to limit the number of applicants for state aid. On December 25, 2008, the government announced a priority list of the 295 systemic organizations qualified to benefit from state aid. In the ambitious plans of rescue measures for the real sector, drafted in January 2009, only 4 percent of the bailout funds were aimed at small
and medium-size enterprises. Later in March 2009, the list of 1,148 enterprises of regional importance was also announced. The idea was that large corporations, temporary derailed by the world financial crisis, would quickly get back on track and would pull smaller companies back up with them. However, reality showed too many bumps in the road to recovery with very few “conductors on duty” to direct a rebound in nonfinancial corporations.

The impact on industrial sectors

In examining the different segments of Russian industry, the fate of companies in cost-oriented and quality-oriented industries should be distinguished. Cost-oriented industries produce basic commodities such as oil, gas, fertilizers, aluminum, pig iron, and steel products. Many sectors of the consumer markets, especially for packaged foods, include cost products, such as sugar, grains, rice, grains, and sausages. Quality-oriented industries compete not only on price but also by introducing unique features in the products. Included in this category are machinery and equipment, cars and trucks, domestic appliances, special chemicals, nongeneric pharmaceuticals, and branded packaged food. For strategic companies in the cost-oriented sectors, the actions in 2009 were very consistent. For example, the Russian ferrous metallurgy relied on five major measures: massive use of state-supported credits to finance current expenses and to refinance existing credits, initiation of state import duties to protect local markets from foreign competition, an increase in its own exports in any direction, reduction in administrative expenses, and cutting off all investment programs (Dorofeev 2009).

These measures worked very well to protect companies from bankruptcy and to keep operations running. Sales by major metal producers fell in 2009 by 20 percent to 30 percent, net profit fell by 40 percent to 60 percent, and because foreign markets absorbed the low value added and underpriced products, the survival of these firms was at least ensured. Similar measures with similar outcomes—such as a modest fall in current output and capacity utilization, deep fall in profits, and deterioration of further prospective returns on world markets—have been implemented in the nonferrous metallurgy industry, basic chemical producers, and cement producers. However, for strategic quality-oriented companies, the assistance measures undertaken by the government were clearly insufficient for survival. The government could provide credits or inject additional capital into such companies but lacked the means to restore market demand for goods of inferior quality.

An example of the government’s inability to save quality-oriented strategic companies is the recent development of Uralvagonzavod. Under 100 percent state ownership, this company was mistakenly mentioned twice in the list of the 295 strategic organizations, but this did not help it maintain the sales level of its major product: rolling stock. In November 2009, the accumulated debt of the company was 60 billion rubles. The government injected 4.4 billion rubles in the first half of 2009 and a further 10 billion rubles at the end of 2009. The government forced
another state-owned company, Transneft, to sign a contract for 2,200 tank railway cars to prevent the bankruptcy of Uralvagonzavod. Nevertheless, under political pressure, its major customer, another state-owned company, Russian Railways, was hesitant to continue purchasing rolling stock from Uralvagonzavod because it had received better offers from its privately owned competitors.

One of the few strategic companies that have not embarked on the standard set of measures was NLMK (Novolipetsk Steel), a steel producer based in the Lipetsk region and owned primarily by Vladimir Lisin, who holds 84.61 percent of the firm’s shares directly. NLMK is listed both on the Russian stock market, with a 4.44 percent free float, and on the London Stock Exchange, with an 8.45 percent free float; the balance (2.5 percent) is owned by the management group. NLMK maintained a low leverage position during the boom years of the 2000s and was in good shape at the time of the financial crisis. Initially NLMK also was keen to receive financial assistance from the state but for investment purposes: “We asked VEB in October 2008 for 32 billion rubles for construction of a new plant. We received no reply and now we are implementing this project by [our] own means” reported the representative of NLMK (Smirnov 2009).

Indeed, with no desire to compromise the firm’s strategic interests for state aid, the controlling shareholder began to reinvest in the firm from 2008 to 2009. For example, Universal Cargo Logistics Holding (UCLH), a Dutch company controlled by Lisin, acquired OJSC Tuapse Seaport (TMTP)—a subsidiary of NLMK—and thus injected $254 million in new funds to meet the immediate needs of NLMK during the crisis. NLMK has also raised funds through a 10-billion-ruble bond issuance on the Russian Trading System (RTS) and MICEX stock exchanges in October 2009 that was oversubscribed. The 2009 nine-month report of NLMK indicates that it was the only major Russian metallurgy company to return to a precrisis level of production, with a utilization rate of 99 percent at its primary production facility in the Lipetsk region.

These examples clearly illustrate the key issue for the future of strategic Russian companies. If the controlling shareholder is willing to repatriate and to reinvest previously received dividends, the company might escape investment breakdown and improve its competitive position not just in cost but in quality as well. The same is also true of nonstrategic companies. In early 2009, a survey in nonstrategic companies was conducted (Gurkov 2009b), finding that where owners were patient and were able to sustain a deep decline in profitability of their business or even to accept temporary losses, the companies were able to implement anticrisis measures with long-term impacts. Those measures included investment in research and development, purchase and exchange of patents and know-how, acceleration of new product development, investment in the company’s dealers, acquisition of other firms, intensification of advertising, and intensification of lobbying efforts. However, as noted by Tatiana Komissarova and Andreas F. Grein in this issue, the majority of the companies preferred the simplest cost-saving measures, including
cutting their marketing and advertising expenses and limiting the product mix to a few products.

The final article in this issue, by Igor Gurkov and Olga Zelenova, shows that typical Russian personnel systems allowed firms to rapidly reduce their overall personnel costs by reducing the amount of nonmandatory, standard bonuses as well as the minimum wage for various positions. This flexibility in wage payments allowed Russian firms to avoid the problem of downward sticky wages through rapid reductions in take-home pay, albeit providing the retained workers a major disincentive.

**Discussion and tentative conclusions on current Russian management practices**

The financial crisis was a seminal moment in the strategic development of large and small Russian companies alike. The late 1980s opened a window to the introduction of noncentralized enterprises; the 1990s was a radical transition period that ended with the 1998 crash; and the 2000s was a period of unprecedented growth. The Great Recession of 2008–9 shocked the Russian business system. No longer is there fast money available through an IPO placement in London, and at the same time, major corporations are struggling to restructure their debt. The government has become the lender of last resort, and with these loans, the government has taken over strategic control, at least in part, of many significant Russian companies. An illustrative example of a large corporation dealing with the crisis is the strategic plan of LUKOIL, which set the following new priorities: minimal quantitative growth as the planned volume of production is set to remain stable until 2019; restriction of investments; a planned 300 percent increase in free cash flow in a ten-year period; and higher share of net profit allocated as dividends.7

The instability of the financial system has been the central reason for the adoption of these strategies of contraction and retrenchment by large corporations. The large international debt exposure that corporations ran up in the 2000s will limit their actions in 2010s. An example of such a limited corporation is UC Rusal. During 2008 and 2009, the owners of UC Rusal struggled to maintain control over the firm while receiving an extensive VEB bailout.8 The crisis marks the end of the period of easy credit and rapid debt expansion.

In terms of operational strategy, Russian firms returned to their retrograde traditions after a brief period of adoption of international best practices. It is already clear that Russian corporations are becoming centralized, with tightly controlled investment budgets and operating expenses as a result of the increased environmental uncertainty. Almost no Russian owners and managers understand the usual business cycle because they do not have personal experience with this feature of a market economy. Their reference points are the collapse of the Soviet economy in the 1980s, the transition and speculation of the 1990s, the crash of 1998, and the rapid growth of the 2000s. Russian management practices reflect this limited world view.
Since the late 1980s, the path of economic development in Russia has provided the boundaries for firm structure and shaped the environment for strategic development of Russian firms. The role of the state in setting the structure of the market and the legal structure of strategic firms has characterized the strategies adopted by Russian firms. The crisis brought the state back into large Russian firms in a new way as an institutional investor. It is unclear how this will play out. Outside the strategic sector, tens of thousands of small, medium-size, and large firms must adapt to the new situation. The new strategic orientation of these firms can be summarized as working toward the penetration of new markets, investment in personnel and equipment, and the rationalization of supply chains and production processes. These steps indicate that these nonstrategic (i.e., non-state-controlled) firms responded to the economic downturn in a way that creates new opportunities for growth instead of relying on the retrenchment policies that characterize strategic enterprises. This observation makes further development of nonstrategic companies a nontrivial problem and provides a rationale for the focus of the articles included in this issue on Russian management.

Notes

1. The two conglomerates that successfully survived the crisis of 1998 were AFC Sistema, which includes subsidiaries that operate in the telecommunications, microelectronics, retail, banking, oil, and insurance (later sold to Allianz) sectors, and Alfa-group, with operations in telecommunications, retail, banking, insurance, and oil through participation in TNK-BP.

2. The most interesting cases are posted at www.gurkov.ru/tpcs.php.

3. The series of the most profound and informative interviews was launched in the newspaper Kommersant-Daily.

4. We used publications by Renaissance Capital, Veles Capital, Rye, Man & Gor Securities, URALSIB, Espicom and other sources available through ISI Emerging Markets Database.

5. According to the World Bank calculations, R1.089 trillion (2.6 percent of GDP) was spent in 2008 as fiscal anticrisis measures, including R785 billion for strengthening the financial sector and R304 billion for supporting the real economy. Measures for the financial sector included R335 billion in recapitalization and other direct support and R450 billion of subordinated loans. An additional R830 billion was injected into the financial system in 2008 by a combination of changes in the reserve requirements and increases in the amount of funds available. In supporting the real economy, only R52 billion consisted of sector-specific support (World Bank in Russia 2009a, 9–12).

6. In the initial estimates of the R1.6 trillion for supporting the real economy, R474.4 billion was allocated for a reduction in the tax burden, mostly through a reduction in corporate income tax, R267.7 billion was for sector-specific measures aimed at the defense, motor and transport industries, agriculture, and construction, R300 billion in state guarantees was mostly directed at these same manufacturing sectors, and R300 billion was allocated as a fiscal stimulus aimed at the regions. Only R6.2 billion was planned for support of small and medium-size enterprises, with an addition of R50 billion allocated to Vneshtorgbank and earmarked to refinance credits to small and medium enterprises.

8. In its debt restructuring plan, UC Rusal will place its shares on the Stock Exchange of Hong Kong (SEHK) and exchange debt for equity to pay down its $16 billion in accumulated debt. In December 2009, SEHK ruled that UC Rusal, due to its poor governance record and lack of transparency, could only list its shares for institutional shareholders. Nevertheless, the issue was successfully executed partly because of the direct involvement of a major Russian state-owned bank (VEB) that purchased 40 percent of the stock offered.

References


