Troika Potato Chips (A)[1]

St. Petersburg, Russia

John Mirren drummed his fingers impatiently on the dashboard as he sat in the usual Moscow traffic jam. He was a managing director of a British-owned, Moscow-based investment fund that made investments in various businesses throughout Russia. John saw many business plans, written with various degrees of competence, every week, and he had to decide which ones warranted further investigation. As part of his job, he visited companies that seemed especially promising.

John left his job at a London investment boutique in 1990 to take a job in Russia at a time when Russia was considered the land of unlimited opportunity. He had a background in the region because he studied Russian history, literature, and language in university and had spent a year in St. Petersburg writing his senior thesis. As managing director of the investment fund, he had been extensively involved in evaluating and managing many projects, a few of which turned out to be spectacular successes, but many of them barely broke even and some were complete failures.

That week he was considering several plans. There was a furniture factory in Novosibirsk that was making good quality copies of Russian Empire furniture, as well as more modern furniture, and it needed investment money to expand operations. An interesting proposal — to open a fast food restaurant in Yekatrinburg — had come into the office last week. That seemed very promising since the potential manager had considerable restaurant experience, both domestic and international. There was also a proposal to open sorely needed self-service laundries in Moscow. However, that proposal needed careful examination since they were asking for a considerable sum of money.

A more modest business plan had come from St. Petersburg. Three different legal entities with experience and expertise in different fields had joined together to propose a company to produce and sell potato chips to the St. Petersburg market.

The formal business plan for this proposed startup follows. John had to decide if the business warranted his investment, given all he had learned about investing in Russia (see Appendix).

Business Plan[2]

Summary

The proposed project envisions the establishment of a new enterprise that will produce high-quality, competitively-priced potato chips in the town of Komarovo, not far from St. Petersburg.[3] The initiators have formed a separate legal entity called "Troika" specifically for the purpose of realizing the project. The potato chips will be sold under the "Troika" brand name.

The initiators hope to attract an outside equity investor and use the invested funds to purchase specialized, high-quality, imported processing equipment that will enable them to produce and package world-class potato chips to be sold through both wholesalers and retailers in the Leningrad Oblast (region).

The preparatory stage has been completed, and practically all key aspects have been worked out by the ini-

tiators. The enterprise has acquired a production site (building and land) and a specialized potato storage facility. With the purchase and installation of processing equipment, and a complete renovation of the production site, production can begin. A preliminary agreement to purchase equipment has been reached with a Dutch firm considered a leading producer of food processing equipment.

The principal raw ingredient, potatoes, will be supplied by the agricultural consortium Komarovo which is one of the founding partners in Troika.

The financial requirements for the realization of the above project are as follows: an equity investment of $803,600 for the purchase of production equipment, and a short-term credit of $236,000 for startup capital.

The time frame for the realization of the project is 10.5 years. The expected net profit at the end of this period is $2,269,000. Profits will be reinvested to modernize or expand existing operations or used to start a new venture.

The Enterprise

GENERAL INFORMATION

Troika is registered as a closed joint-stock company in the town of Komarovo, Leningrad Oblast.[4] The venture's principal activity is the processing of agricultural products, specifically, the production of potato chips.

Troika's founding partners are three independently registered organizations. The first is the agricultural Consortium "Komarovo," a closed joint-stock company which was a state-owned farm until 1994. Komarovo owns 11,500 hectares of farm land, and it is the largest producer of potatoes in Russia's northwestern region. The second is "Baikal," a joint-stock company formed in 1995 by a group of producers, wholesalers, and retailers of food products.[5] Together, Baikal's shareholders make up a developed distribution network covering St. Petersburg and the surrounding region. The last is "Znamya," also a closed joint-stock company whose principal activity is processing agricultural products.

CONTRIBUTED CAPITAL

As of July 1, 1995, stockholders' equity totals 100,000,000 rubles [US$1 = 5,000 rubles at that time]. There are 100 shares of common stock, each with a nominal value of 1,000,000 rubles. Komarovo and Baikal each own 40% of the shares, and the remaining 20% is held by Znamya.

The founders of Troika contributed the following assets, in lieu of cash, for shares in the enterprise:

> Komarovo - building and land to be used for production, valued at 40,000,000 rubles;
>
> Baikal - access to a distribution network covering the CIS, contribution valued at 40,000,000 rubles;
>
> Znamya - potato storage facility valued at 20,000,000 rubles.

The initiators agreed that Baikal would withhold its cash contribution of 40 million rubles until the purchase and installation of production equipment. Thus, as of July 1, 1995, 60 out of 100 shares of common stock were paid for in full.

APPRAISING MARKET VALUE OF STOCKHOLDERS' EQUITY

Since Troika is a newly created enterprise, it has not incurred any debt or losses. The fixed assets owned by the company are as follows:

land	1.5 hectare
building	420 sq. meters
potato storage facility	480 sq. meters

In order to minimize taxes, the Founding Charter assigns to assets the lowest possible value allowed by Russian law. The actual market value of these assets is significantly higher.[6] For example, the cost of property in the area is between $10,000 and $15,000 per hectare. The cost of constructing a similar building is $84,000, and the storage facility has been appraised at $60,000. Thus, the actual market value of Troika's fixed assets is approximately $159,000 but that would fluctuate as the political and economic climate in Russia changes.

DECISION MAKING

Regular shareholder meetings are to be held twice a year. Additional meetings can be initiated by a shareholder holding a minimum of 25% of common (voting) shares. Decisions can be approved provided shareholders holding a minimum of 50% of voting shares are present. Critical decisions, such as changing the Charter, re-organization, and liquidation of assets, require a 75% presence.

Troika will be managed by a Board of Directors, appointed by shareholders, with Alexander I. Ivanov serving as chairman.

PROFIT SHARING

Net profits will be distributed among shareholders as dividends. The dividends are to be approved at general shareholder meetings.

The Product

Troika potato chips will be produced and packaged with equipment manufactured by a Dutch firm, Florigio Industrie, using only natural, high-quality ingredients. The principal raw ingredient is potatoes, not the customary processed potato concentrate, so as to give the finished product a more natural potato taste and smell.

Florigio Industrie is a leading producer of food-processing technology. This technology will enable Troika to produce both regular chips and flavored chips up to the highest world standards. The chips will be packaged in 100 gram plastic packets bearing the company logo. Highest quality packaging materials (also Dutch) will be used, ensuring the chips remain fresh for up to six months. Package labeling will be in Russian.

Since potato chips are neither a staple nor a luxury product, demand is determined by price and quality. Troika chips will be cheaper than imported brands and of higher quality than domestic brands, so it is expected that they will be very popular.

Analysis of Market and Competition

Potato chips were produced locally in the 1960s and 1970s, then discontinued until 1992. Local market research indicates that the product currently enjoys a 90% awareness among the population.

In St. Petersburg, Western-style supermarkets selling brand name, imported products carry the widest assortment of potato chips. These supermarkets cater to consumers with high purchasing power. Potato chips are also available in food stores selling primarily Russian products and in 10 to 15% of all kiosks.[7] These stores offer a narrower range of products and usually carry no more than two brands of potato chips.

Market research shows that about 60% of the local population consumes potato chips with some regularity. A large segment of potato chip consumers is aged between 5 and 18. At the moment, the market has no obvious leader.

Since market research indicates that potato chips are a price elastic product in high demand, it could be concluded that expanding the consumer base by lowering the price would greatly increase sales. A consumer survey conducted by the St. Petersburg State University Economics Department confirms this fact, showing that 90% of potential buyers of potato chips refrain from buying due to high price. The remaining 10% choose not to buy because of perceived low quality or for some other reason. The survey also found that lowering the price of potato chips by 30% makes them affordable to 20-30% of potential consumers, compared to the 10% potential buyers who can afford to buy them at today's prices.

Troika's main competitors are foreign producers, followed by domestic producers. Domestic competition is not likely to become a factor for at least 3 to 4 years. Presently, the region is supplied by Finnish, Dutch, Israeli, and American producers. Retail prices for imported potato chips sold in elite supermarkets are between $.95 and $1.65 per 100 g package, making them affordable to only 7-10% of the population. Other stores sell chips at comparatively lower prices, from $.75 to $.90 per 100 g. These chips are produced by Russian, Baltic, and Polish companies.

Some widely distributed brands of potato chips and their prices per 100 g package are as follows:

SUPER	(Holland)	$1.12 to $1.52
SPECIAL SNACKS	(Moscow)	$ .56
MINI SNACK	(Israel)	$1.43
RAFFLES	(Poland)	$1.74

Koloss, another major domestic brand, is also relatively inexpensive. Due to a number of factors, primarily high tariffs, retail prices of imported chips are kept relatively high. Thus, only a limited number local wholesalers can afford to purchase potato chips from abroad. In fact, a survey of the wholesale market showed that imported potato chips are distributed by only three of the 15 largest wholesalers of food products in the area. Of the 20 largest supermarkets in St. Petersburg, only four sell potato chips. These figures demonstrate that choice and availability of potato chips in St. Petersburg and the surrounding area is limited.

At the moment, no local producers of potato chips use imported, high-quality equipment. In general, the simple, low-tech processes employed by these companies make them incapable of producing on a mass scale. Furthermore, the packaging of local chips is not consistent with world standards.

A careful pricing strategy, a high quality product, and good packaging will enable Troika to successfully compete with local as well as foreign producers. Troika chips will differ from imports in price (30-40% cheaper), and from domestic substitutes in quality and packaging. Until more local mass-producers of potato chips enter the market, which is not likely to occur for the next three to four years, the demand for the product will remain unsatisfied. By the time equilibrium is reached, Troika is expected to have gained a 5% share of the local market, producing and selling 289 tons of chips per year.

In summary, the market situation can be characterized as follows:

- absence of a clear market leader
- limited choice and availability of high quality potato chips
- high price elasticity for the product
- slowly but steadily increasing demand
- increased domestic competition in the next three to four years

Marketing and Pricing Strategy

The marketing plan consists of three general components: (1) pricing strategy, (2) advertising campaign, and (3) continuous analysis of the changing market situation and integration of new information into overall strategy.

The product's competitive advantage is based on its:

- high quality
- image (modern, eye-catching package design)
- low production cost (use of locally grown potatoes)
- being ahead of domestic competition

Since market research shows there is unmet local demand, Troika chips will be marketed initially in the St. Petersburg region using Baikal's distribution network of over 400 selling points. When the local market is saturated, other regions will be explored.

In the first five years, growth in sales will be based on the expansion of the consumer base rather than on the elimination of competition. Troika chips will be priced on average 35% cheaper than imports, and 10-20% cheaper than domestic substitutes, making them affordable to a larger segment of population.

The minimum wholesale price of $0.4125 allows retail prices to be maintained at competitive levels. The use of local potatoes minimizes expenditures on the principal raw ingredient, since potatoes supplied by other regions have a 10-15% mark-up reflecting added transportation costs. Raw material expenses (potatoes, oil, spices, etc.) constitute 80% of total production costs (Exhibit 6). Competitive pricing will allow Troika to realize its sales objectives.

Product image will play a significant role in attracting potential buyers. The chips will be packaged in multicolor polypropylene packages that prominently display the Troika brand name. The packaging will be modeled after Western standards both in quality and presentation and in guarantees of freshness. In order not to alienate Russian buyers, information and company logo displayed on the package will be in Russian.[8] The product weighs 100 g and will be distributed to retailers in cardboard boxes.

The product will be promoted through a multi-stage advertising campaign utilizing printed and electronic media. The first stage of the campaign will focus on gaining maximum exposure and creating brand awareness for Troika potato chips. The product will be introduced with printed advertisements placed in buses, metros, trains, and points of purchase. Promotions will be held at trade fairs, at local civic celebrations, and in schools. A qualified marketing manager will be hired to develop strategy and manage all marketing efforts.

It is estimated that within the first two years of the project, the cost of advertising will reach approximately $15,000 annually. As local competitors enter the market, advertising expenditures will be increased and the advertising strategy will be modified accordingly. At this stage, advertising will become more aggressive, focusing on maintaining market position as well as on attracting buyers of other brands. Advertisements on local radio and television will be added at this time. By the third year, advertising expenditures are expected to increase to about $25,000 annually.

Troika has obtained all necessary licenses, including certification from the Ministry of Agriculture, to produce and sell its products.

Organization of the Production Process

The initiators have worked out all key operational aspects. All actions will be performed according to the schedule shown in Exhibit 1. The preparatory stage, during which equipment will be installed, building renovated, and personnel trained, will last six months. Full production capacity is expected to be reached four months after the start of production.

The production line requires a space measuring 200 square meters with a height of 3 meters. With the completion of renovation, which includes replacing electrical and water provision systems, the production site will satisfy all technical requirements. Beyond housing the production line, the building will contain an office, kitchen, bathrooms, and space for storing packaging materials. The site is easily accessible from a major highway.

An agrarian specialist will be hired to ensure that the potatoes purchased are of the highest quality. To prevent rotting, the potatoes will be stored in a specially adapted warehouse. A permanent contract with the potato supplier Komarovo is in effect. The Consortium owns 300 hectares of farmland, each producing between 16 and 18 tons of potatoes per year. Vegetable oil will be supplied by ARKO, a company located in a city about 400 miles south of St. Petersburg. The initiators of Troika have close ties with this supplier as well.

The production equipment supplied by the Dutch firm Florigio comes with enough spare parts for one year of operation. The choice of Florigio as equipment supplier is based on (1) its competitive price among imported analogues, and (2) its higher quality compared to similar domestic equipment. The production line is capable of processing 400 kg of potatoes per hour, resulting in 100 kg of finished potato chips every hour. Approximately 5% of completed product is expected to

be defective. Florigio would also supply packaging materials that come imprinted with the company logo and product information in Russian.

Production will go into recess during July and August when harvested potatoes are unsuitable for potato chips. The enterprise plans to hire a 22-person staff. The technical personnel will undergo a training session conducted by Florigio experts who will remain two months at the Troika production site. Training expense totals $7,500 and is included in the budget. All equipment maintenance work will be performed by specialists trained by Florigio.

Risk Factors

The following list identifies some of the risks facing the enterprise.

1. High rate of inflation, coupled with frequent changes in tax and licensing requirements, encumbers long-term financial planning and cost estimation.
2. The initiators have no experience in potato chip production.
3. A bad potato harvest could have a negative impact on quality, quantity, and price of potato supplies.
4 The break-up of the former Soviet Union has ruptured old inter-regional ties that formerly guaranteed a regular supply of raw materials.
5. The start of production could be postponed due to delays in delivery and installation of equipment or a delay in the completion of building renovation.
6. The initiators could encounter difficulties in obtaining financing.
7. Competition from domestic producers may have greater impact than expected.

All of the above factors are taken into consideration in making financial projections.

The organizers are engaged in a search for an additional source of potatoes in case there are problems with the contracted suppliers. Competition from local producers will not be a factor for at least three to four years and therefore will have no negative impact on the economics of the project in the first stages. When competitors do enter the market, Troika will have established a strong market presence with its products enjoying wide brand awareness.

Financing and Distribution of Profits

The initiators considered two possible methods for financing the purchase of equipment: leasing and equity investment. Since leasing laws in Russia have not yet stabilized, they are seeking an outside investor. This investor will be offered newly issued stock in the enterprise. The total amount required of the investor is $837,100. The initiators will contribute $132,700.

Funds will be invested in the enterprise in the following order:

1. Baikal will contribute 40,000,000 as payment for its shares in the enterprise (40 shares at nominal price of 1,000,000 rubles).[9]
2. Redistribution of common shares: Komarovo and Baikal will purchase 10 and 5 shares each, in that order, from Znamya.
3. The second stock offering will be organized, and an equity investor brought in.

After the outside investor is brought in, common (voting) shares would be distributed as follows:

investor:	up to 40%
Baikal:	25-30%
Komarovo:	30%
Znamya:	up to 5%

Limiting the investors' share to a maximum of 40% of common stock is a condition set at the insistence of the Leningrad Oblast Administration, which is a 49% owner of Baikal.

All profits will be distributed as dividends in proportion to ownership stake. Priority will be given to shareholders whose contribution financed the purchase of equipment and the renovation of production site.

Troika proposes to issue 65 additional shares of common stock and 43 shares of preferred stock of Type A and Type B. The holder of preferred shares has no voice in the management of the enterprise, but has priority in dividend distribution.

DISTRIBUTION OF SHARES AMONG THE STOCKHOLDERS AFTER SECOND STOCK OFFERING

	DISTRIBUTION OF COMMON SHARES BEFORE INVESTMENT		DISTRIBUTION OF COMMON SHARES AFTER INVESTMENT		DISTRIBUTION OF PREFERRED SHARES	
	Number of shares	%	Number of shares	%	Type A	Type B
Komarovo	40	40	50	30.3	——	——
Baikal	40	40	45	27.27	——	14
Znamya	20	20	5	3.03	——	——
Investor	——	——	65	39.39	29	——
TOTAL	100	100	165	100.00	43	

The face value of each share would remain 1,000,000 rubles. After the second stock offering, Troika's stockholders' equity will have a nominal value of

208,000,000 rubles.[10] Preferred stock would constitute 20.7% of total capital, well within the bounds of the law which places a 25% cap on preferred shares. Shares would be sold at a price of $8,905 per share. The investor would acquire 94 shares (65 common, 29 preferred) for a sum of $837,100; Baikal would purchase 14 newly issued preferred shares for $124,700.

Setting the actual price above the nominal price would have no tax implications. According to Russian securities law, when shares are sold to raise starting capital, the difference between nominal and actual price paid for each share is considered additional paid-in capital, not as taxable revenue.

Net profit will be distributed in the following order: (1) fixed dividends are paid to holders of preferred stock Type A, (2) dividends are paid to holders of Type B shares, (3) the remainder will be distributed among holders of common stock. Common and Type B stock holders will not receive any dividends until the holders of Type A stock are fully reimbursed the amount of investment ($837,100). After the fourth year, the 29 shares of preferred stock type A guarantee the investor a dividend income of $160,000 (Exhibit 9). Holders of Type B shares would receive yearly dividends of $9,000, starting in the fifth year of operation.

Since there is no undistributed income (retained earnings) at the end of the ten year realization period, the value of owner's equity would equal the nominal price of shares plus additional paid-in-capital. Initial stockholders' equity was formed with each partner's contribution (land, building, etc.). The maximum market value of stockholder's equity before the second stock offering is appraised at $159,000. Taking depreciation into account, this value is reduced to $123,000 at the end of 10 years. The total market value of Troika's assets is therefore $1,084,800: $123,000, the depreciated value of stockholders' equity before second offering, plus $961,800, the increase in stockholders' equity after second stock offering.

At the end of the 10-year operation period, the investors will have the option of selling back all preferred shares. Type A shares will be re-purchased for $692,000, and Type B shares, held by Baikal, for $32,000. The subsequent market value of Troika's common shares will be $369,000.[11] Holders of preferred stock would also have the option to convert their holdings into common stock.

Financial Planning

All major expenditures will be made in accordance with the work schedule (Exhibit 1). Funds will be used primarily to:

- purchase equipment
- renovate the production site
- purchase transportation vehicles
- create a reserve fund

The three sources of financing are as follows: equity investment, initiators' contribution, and short-term credits. Short-term credit is needed to satisfy initial working capital requirements. The first credit, totaling $188,000, will be for a three months and will be used to pay the VAT on the imported equipment. The second credit, totaling $48,000, will be for four months and will be used to purchase potatoes, oil, and other inputs. Principle and interest expense (30% annually) on these loans will be paid out of sales revenue.

The initiators will purchase automobiles for delivery of the product and pay the full cost of renovating the building out of their contributed funds. Equity investment will be used primarily for purchasing production equipment.

Financial projections are provided in attached Exhibits 2 - 9. Exhibit 6 shows production expenses with a 5% defect rate. Purchases of raw materials, particularly potatoes, make up the largest portion of expenses. Results of an analysis of potato price movements show that prices are stable, indicating that the market is in equilibrium. Potato prices in St. Petersburg reflect the average world price of the commodity.[12]

Prices of raw materials and maintenance costs are projected to rise 2% per year, beginning in the third year of production. Salaries are projected to rise 5% per year in the first four years, and 3% per year for the remainder of the ten year period. By basing projections on rising cost for inputs and stable selling price for the product, the initiators compensate for the possibility of an unexpected adverse turn of events.

Break-even analysis shows that the enterprise must produce 121 tons of potato chips per year to break even, only 42% of its capacity. Cash flow projections (Exhibit 8) show that sales revenue will be sufficient to cover all production and dividend expenses and future preferred stock repurchase.

Troika's projected income statement (Exhibit 9) also shows positive results, even in the first year of production. Income is projected to grow from $126,000 in the first year to a $263,000 in the fourth year, and gradually decrease to $216,000 in the tenth year. Income grows as a result of increased production efficiency and then declines because projected expenses rise while selling price is maintained constant. The enterprise is expected to generate an average return of 23% on investment. A portion of these earnings can be reinvested to modernize and expand current operations, or as starting capital for a new enterprise.

Appendix

CULTURAL AND SOCIOLOGICAL NOTES

The Russian Sense of Time

A Russian's sense of time may differ markedly from an American's. While Americans watch situation comedies where everything ends happily in a half-hour, the traditional Russian prefers three hour-long operas and theater pieces where a bad situation gets worse, people get emotional, and apparently nothing is resolved at the end. While Americans like to come quickly to the point and summarize their interests in a few sentences, Russian general managers usually choose to explain their corporate history and general philosophy before talking about specifics. This is often due to the Russian need to establish a relationship with a potential business partner. However, this differing sense of time can lead to confusion and a sense of distrust during initial meetings.

Openness versus Secrecy

Russia is a country that has been invaded many times during its history. Because of this legacy, Russians tend to keep their wealth and their business dealings secret. Just as a Russian peasant hid his grain, a Russian business tends to conceal its income, assets, and technological secrets. Russians are often reluctant to share information over the phone or in letters, and prefer at least a face-to-face meeting before going forward with details.

Obedience versus Autonomy

Another painful legacy of Russian history is servitude. Up to the middle of the 19th century, the majority of Russians were peasants, who essentially were the property of local landowners. The peasants followed the landowner's orders and were not permitted to move or change jobs without his permission. Under the Soviet system, the entire economy was centrally planned. At the time of this case, Russian decision making, particularly in large organizations, still came from the top. The Russian employee traditionally had little or no autonomy, and, during this transition to capitalism, many Russians were still reluctant to make decisions without consulting superiors. This cultural difference baffles and frustrates many Americans. The Russian decision-making process will seem very slow to an American, with inexplicable starts, stops, and reversals. American managers often must wait for months for a final decision to come from the top on matters already reviewed by layers of Russian managers. During the first few months working for a Western firm, new Russian employees often exasperate their American managers with their continual requests for precise instructions and direction.

Attitude toward Law and Contracts

For many years, Soviet law viewed capitalism and business as a social evil. For many Russians, the idea that laws could actually help build companies is relatively new concept. While Americans prefer to base their business relationships on legally enforceable contracts, many Russians still doubt the value of and lack respect for business laws and contracts. Many Russians prefer to keep their business dealings and accounts as far from government scrutiny as possible.

The Importance of Relationships

Most Russians business dealings are based on personal relationships. When making business decisions, Americans tend to focus on comparing contracts and prices. Russians, on the other hand, compare the depths of personal relationships. Most Russians prefer to do business with people who are close friends. Without a close personal relationship, often one that seems so close as to be claustrophobic to a Westerner, a Russian business deal is on shaky ground. For Americans, the contract is usually the centerpiece of negotiating sessions. For the Russian, the relationship is the focal point, and contracts and protocols are often merely thought of as polite ceremonies and starting points for further negotiation. Because Russians consider their business partners to be friends, Russian business leaders often have trouble saying no, and will promise things they cannot — or do not want — to deliver.

Most deals are done on the basis of a verbal agreement, where both sides actually appear to be embarrassed to bring any formalities into the process. This is one of the major factors contributing to an enormous crisis in the early 1990s stemming from the failure of almost everyone to pay their debts. The combined debt that enterprises owed to each other amounted to trillions of rubles, and a significant part of that was not supported by proper documentation.

Organized Crime

Dealing with organized crime is fundamental to doing business in Russia. Typically, banks have informers who tell the Mafia organs about incoming funds (sums above 10 million rubles.) Equipped with this information, the Mafia attempts to extort money from the enterprise. Insistent young men approach the management, in teams of three or four people. Having made an appointment, they announce that they have come to discuss the topic of "protection" or are representatives of tax authorities or the police. They offer their "services" in the form of protecting the life of the firm's owners and safeguarding of goods and property of the firm. If the owner refuses, they start explaining, very politely, that they can provide very effective personal security, and then, depending on the reaction, they start giving out information about the company

obtained from the bank, about the goods stored in the warehouse, his wife's place of work, the time his children are in school and all sorts of compromising information. If there is still no reaction, direct threats are brought into play.

Ultimately, most enterprises conclude security agreements with organized crime groups. According to standard contracts, the director has to make a monthly payment on a strictly defined day to a particular person. The sum is set depending on the turnover and the amount of compromising information about the firm. In the event that representatives of other groups approach the firm, the directors must prove that they already have protection or krysha (roof), so that representatives of the Mafia groups sort out between themselves questions concerning turf and what belongs to whom.

If a company does not have a krysha, it becomes difficult to conduct business, especially receiving payments, and the company is totally exposed. But if one does have krysha, one is breaking the law, placing oneself outside of it in the realm of the informal and vague. The relationship with one's krysha is very important, but at the same time it makes one a part of a network, thereby severely restricting one's freedom.

Working with Russian Partners

Although each investment opportunity presented its own unique set of characteristics and challenges, John found that there were many common elements and pitfalls when dealing with Russian partners as a foreign investor. For example:

- Most Russian entrepreneurs do not have a current, updated packet of information about their enterprise and/or project. At the initial meeting, they will most likely present old information and explain the project-at-hand orally, or as the Russians say, "using their fingers." Because written data seldom matches what is transmitted orally at the initial meeting, a foreign investor, upon reviewing the information packet, could become confused and distrustful.

- Russian citizens have grown accustomed to being secretive, a survival trait developed while living under a totalitarian regime. Consequently, the Russian entrepreneur is psychologically unprepared to reveal immediately all required information about his enterprise or project. He provides partial information, assuming that is sufficient for analysis. If obtaining information about a project or company begins to feel like pulling teeth, the investor may become suspicious and reluctant to proceed further.

- Russian entrepreneurs are not used to the language and protocol for attracting equity financing. They may ask potential investors to specify their requirements and then come up with a project to fit those requirements.

- Russian businessmen view unfavorably the Russian assistants employed by foreign consulting firms and investment funds. Most of these jobs are filled by young bilingual Russian "consultants" with some rudimentary knowledge of Western finance, but with virtually no experience in managing a business in Russia and a limited understanding of Russia's business climate. In worst cases, they become a buffer between the investor and the entrepreneur, filtering and sometimes misrepresenting information about the investment project. Generally, Russian businessmen prefer to stay in direct contact with the investor.

- The majority of Russian entrepreneurs are not accustomed to valuing other people's time, or paying for information or consulting services.

Working and investing in Russia is a continual learning process. The road to success is often paved with mistakes. During his stay, John made plenty of mistakes. He was able to identify the following lessons or "guidelines for practice" learned through his experience:

- At the initial meeting, set the tone and language for future discussions (whoever has the money gets to make the rules).

- Make a clear and firm request for all necessary information. If the requested information is not presented at the following meeting, end the meeting, clearly explaining the reasons for doing so.

- If you receive the necessary documents and, after evaluating them, refuse to finance the project, return the packet of information with an official letter explaining your decision.

- Before making any decision, consult a Russian expert. The most qualified experts are lawyers who are on top of current legal changes and know the system, or entrepreneurs who have had first-hand experience running a business in Russia. Some caution should be exercised in taking advice from foreign or Russian consultants who have no experience managing a business in Russia.

- The quality of management takes precedence over financial projections as the most

important factor in evaluating potential projects in Russia. Because the instability of the Russian market makes long-term planning virtually impossible, most Russian entrepreneurs regard the business plan as a formality in attracting foreign capital rather than an actual blueprint for running their business. Therefore, the investor should concentrate on those sections of the business plan which give some indication of management's style and degree of professionalism. These sections may deal with marketing research, risk assessment, sensitivity analysis, and project realization.

• In order to live through the years of economic transition, which is far from complete, Russian business people developed certain survival traits and habits. A dearth of information, unfair taxation, and rampant corruption have made them very cautious, while an unstable legal and economic infrastructure has made them extremely competent in analyzing and quickly responding to new risks and obstacles. Consequently, a Russian entrepreneur can quickly assess and exploit any weakness or incompetence he perceives in a potential business partner.

NOTES

1. This case was written by Gene Gutenberg of Cornell University. It is intended as a basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

2. Actual business plan presented to investors. All names have been changed.

3. Second largest city in Russia with a population of 5.5 million.

4. Enterprise whose shares are not publicly traded. Similar to a limited partnership.

5. Enterprise whose shares are publicly traded.

6. It is beyond the scope of this case study to discuss the intricacies of the Russian accounting and tax systems. It is highly recommended that a qualified Russian lawyer be consulted in all commercial transactions.

7. A small street shop that primarily sells snacks, cigarettes, and alcoholic and non-alcoholic beverages.

8. Some products had actually been less successful with Russian labeling, as Russian's equated Western products with higher quality. For example, Pepsi Cola's sales dropped when it labeled its products in Russian.

9. It was agreed that Baikal will hold its cash contribution until the purchase of equipment.

10. [(165 + 43) x 1,000,000].

11. These figures add up to $1.093 million, which contradict the $1.084 million total stockholders' equity amount given in the previous paragraph. The amounts are taken from the actual business plan.

12. Potato prices on the London and Amsterdam commodity exchanges ranged between $215 and $271 per ton during 1994-1995 season.

Exhibit 1

OPERATION SCHEDULE FOR THE FIRST YEAR

TYPE OF WORK	YEAR 0 (IN MONTHS)						YEAR 1 (IN MONTHS)					
	7	8	9	10	11	12	1	2	3	4	5	6
Preparation												
Preparation of agreements to purchase raw inputs	■											
Preparation of agreement to purchase equipment	■	■										
Placing order for package design	■	■										
Marketing and product promotion	■	■	■	■	■	■	■	■	■			
Preparation of Production Site												
Completion of architectural redesign	■											
Replacement of electrical and water systems		■	■	■								
Assembly of production line						■						
Installation of production line						■						
Equipment and Supplies												
Purchase of trucks	■											
Order and delivery of cardboard boxes, oil, flavorings, etc.					■	■						
Production Line												
Order	■											
Delivery				■								
Customs control					■							
Delivery to production site					■							
Human Resources												
Hiring of management and technical personnel	■											
Hiring of drivers		■										
Hiring of production line workers and other personnel						■						
Arrival of foreign specialists						■	■					
Training						■	■					
Start of production							■	■	■	■	■	■
Sale of potato chips							■	■	■	■	■	■

Exhibit 2

GENERAL INFORMATION

Project duration	10.5 years
Defects	5 %
Prices:	
Potatoes (VAT not included)	$196/ton
Production cost (VAT not included)	$4,125/ton
Taxes:	
Revenue tax	34%
Tariff of imported equipment	0.0%
VAT on equipment	21.5%
Equity investment in overall long-term financing structure	86%
Short-term credits	
Interest rate	30%
Term	7%
Required equity investment	$837,100

Exhibit 3

CAPITAL EXPENDITURES (in US$ thousands)

	INITIATORS	INVESTOR	TOTAL
CONSTRUCTION WORK			
Building and land			
1) Completion of architectural blueprints	2.5	0.0	2.5
2) Land and road improvement	3.0	0.0	3.0
3) Building renovation	21.3	0.0	21.3
4) Warehouse renovation	28.6	0.0	28.6
5) Additional construction expenses (heating, ventilation)	19.8	0.0	19.8
6) Total	75.2	0.0	75.2
7) Unexpected expenses (10%)	7.5	0.0	7.5
8) VAT (21% of 6+7)	17.8	0.0	17.8
9) Total for construction	**100.5**	**0.0**	**100.5**
EQUIPMENT			
Storage			
10) Sorting and control equipment	0.0	4.0	4.0
11) Dusting and spraying equipment	0.0	1.3	1.3
12) Total for storage	0.0	5.3	5.3
Production Line			
13) Washer	0.0	39.4	39.4
14) Cutter	0.0	107.2	107.2
15) Fryer	0.0	158.9	158.9
16) Heating unit	0.0	121.2	121.2
17) Control panel	0.0	52.0	52.0
18) Packaging equipment	0.0	152.0	152.0
19) Spare parts	0.0	42.2	42.2
20) Delivery and maintenance expense	0.0	50.3	50.3
21) Total for production line	0.0	723.2	723.2
22) Total for production and storage equipment (21+12)	0.0	728.5	728.5
23) Tariff	0.0	0.0	0.0
24) Delivery from port to site	0.0	2.0	2.0
25) Total (22+24)	**0.0**	**730.5**	**730.5**
TRANSPORT			
26) Trucks (2)	12.0	0.0	12.0
27) Insurance (18% of cost)	2.2	0.0	2.2
28) Total for transport	**14.2**	**0.0**	**14.2**
OTHER EXPENDITURES			
29) Office equipment	1.6	0.0	1.6
30) Maintenance and assembly fees (3 months)	13.5	0.0	13.5
31) Total for other expenditures	**15.1**	**0.0**	**15.1**
32) Total (25+28+31)	29.3	730.5	759.8
33) Unexpected expenses (10%)	2.9	73.1	76.0
34) Total for equipment (32+33)	**32.2**	**803.6**	**835.7**
35) VAT on domestic eq. (reimbursed 6 months from start of operation)	6.9	0.0	6.9
36) VAT on imported equipment (reimbursed at start of operation)	0.0	172.8	172.8
GRAND TOTAL	**132.7**	**803.6**	**936.2**

Exhibit 4

FIXED ASSET DEPRECIATION, INSURANCE, AND MAINTENANCE EXPENSE

	ORIGINAL PRICE	LIFETIME IN YEARS	YEARLY DEPRECIATION		SALVAGE VALUE	INSURANCE		MAINTENANCE	
	US$1,000		%	US$1,000	US$1,000	%	US$1,000	%	US$1,000
Building	100.5	40	2.5	2.5	75.4	1.7	1.7	2.0	2.0
Russian equipment	32.2	10	10.0	3.2	0.0	1.7	0.5	5.0	1.6
Imported equipment	803.6	10	10.0	80.4	0.0	1.7	13.7	5.0	40.2
Total	**936.3**	**-**	**-**	**86.1**	**75.4**	**-**	**15.9**	**-**	**43.8**

Exhibit 5

OPERATION PLAN

Number of shifts: 2 Number of work days in a month: 20
Number of hours in a shift: 8 Number of work months in a year: 10

YEAR	1	2	3	4	5	6	7	8	9	10	Total
First shift:											
Number of months	10	10	10	10	10	10	10	10	10	10	100
Number of work hours	160	160	160	160	160	160	160	160	160	160	1,600
	0	0	0	0	0	0	0	0	0	0	0
Second shift											
Number of months	7	10	10	10	10	10	10	10	10	10	97
Number of work hours	112	160	160	160	160	160	160	160	160	160	1,552
	0	0	0	0	0	0	0	0	0	0	0
Work hours per year	272	320	320	320	320	320	320	320	320	320	3,152
Efficiency rate	0	0	0	0	0	0	0	0	0	0	0
Actual work hours per year	0.80	0.85	0.90	0.95	0.95	0.95	0.95	0.95	0.95	0.95	-
	217	272	288	304	304	304	304	304	304	304	2,905
	6	0	0	0	0	0	0	0	0	0	6
Raw potatoes (tons)	870	108	115	121	121	121	121	121	121	121	1,162
Finished goods (tons)		8	2	6	6	6	6	6	6	6	2
Defects (5% in tons)	218	272	288	304	304	304	304	304	304	304	2,906
Finished products net defects (tons)	11	14	14	15	15	15	15	15	15	15	145
	207	258	274	289	289	289	289	289	289	289	2,760
Sales revenue — without VAT at US$4,125 per ton	854	106	113	119	119	119	119	119	119	119	1,139
		4	0	2	2	2	2	2	2	2	2

Exhibit 6

PRODUCTION COSTS

	AMOUNT	PRICE PER UNIT WITHOUT VAT, US$	TOTAL PRICE (WITHOUT VAT) US$
Variable costs for producing 1 ton of potato chips			
(without defects)			
Potatoes	4 tons	196	784
Chemicals	.25 liters	15	4
Oil	400 liters	1.25	500
Additives	20 kg	0.10	2
Packaging material	50 kg	8	400
Cardboard boxes	200	0.30	60
Electricity	800 kW	0.02	16
Total			1,766
Variable costs for producing 1 ton of potato chips			
(with 5% defect rate)			1,859
Variable costs for producing at **full capacity**:			
289 tons of chips per year			
(with 5% defect rate)			537,160
Fixed annual costs			
Depreciation			86,100
Maintenance			43,800
Insurance			15,900
Utilities			
Water	10,000 cubic meters	0.01	100
Fuel	20,000 liters	0.15	3,000
Salary			
Manager	1	3,600	3,600
Accountant	1	3,000	3,000
Marketing director	1	3,000	3,000
Mechanic/electric	1	2,160	2,160
Agrarian specialist	1	2,160	2,160
Warehouse foreman	1	1,920	1,920
Sorter	2	1,680	3,360
Sales person	1	1,800	1,800
Driver	1	1,700	1,700
Manual worker (2 shifts)	2	1,440	2,880
Production controller (2 shifts)	2	1,680	3,360
Line operator	2	1,800	3,600
Packaging operator	2	1,800	3,600
Additional workers (2 shifts)	4	1,440	5,760
Total salary expense			**41,900**
Other fixed costs			
Advertising (first two years)		15,000	15,000
Advertising (subsequent years)		25,000	25,000
Training (first year)		7,500	7,500
Transport maintenance	2 trucks	1,550	3,100
Total other fixed costs			
First year			25,600
Second year			18,100
After			28,100
Total fixed costs			
First year			216,400
Second year			208,900
After			218,900
Total operating expense at full capacity			
First year			753,560
Second year			746,060
After			756,060

Exhibit 7

FINANCING (US$1,000)

YEARS	0	1	Total
Investment	961.8	-	961.8
Short-term credit (3 months)	188	-	188
Interest payment	-	14	14
Debt repayment	-	188	188
Short-term credit (4 months)	48	-	48
Interest payment	-	5	5
Debt repayment	-	48	48
Total	1,197.8	(255)	942.8

Exhibit 8

CASH FLOW PROJECTIONS (US$1,000)

YEAR	0	1	2	3	4	5	6	7	8	9	10	Total
REVENUES												
Sales	0	854	1,064	1,130	1,192	1,192	1,192	1,192	1,192	1,192	1,192	11,392
Salvage value	0	0	0	0	0	0	0	0	0	0	75	75
Reimbursed VAT	0	180	0	0	0	0	0	0	0	0	0	180
Total	0	1,034	1,064	1,130	1,192	1,192	1,192	1,192	1,192	1,192	1,267	1,1647
EXPENSES												
Management cost	43	0	0	0	0	0	0	0	0	0	0	43
Investment activities	936	0	0	0	0	0	0	0	0	0	0	936
VAT on equipment	180	0	0	0	0	0	0	0	0	0	0	180
Other expenses	0	33	8	3	2	0	0	0	0	0	(46)	0
Variable costs	0	385	480	508	536	547	558	569	581	592	604	5,360
Maintenance (Exhibit 4)	0	44	44	45	45	46	46	47	47	48	49	461
Insurance (Exhibit 4)	0	16	15	14	13	12	11	10	9	8	7	115
Utilities	0	3	3	3	3	3	3	3	3	3	3	30
Salary	0	42	44	46	48	51	53	55	57	59	61	516
Other fixed costs	0	26	18	28	28	28	28	28	28	28	28	268
Total production expense	0	516	604	644	673	687	699	712	725	738	752	6,750
Income tax	0	74	115	124	135	131	128	124	120	116	112	1,179
Other taxes	0	29	31	31	31	29	28	26	25	23	22	275
Total expenses	1,159	652	758	802	841	847	855	862	870	877	840	9,363
Net income	(1,159)	382	306	328	351	345	338	330	322	315	427	2,284
Total before financing	(1,159)	(777)	(472)	(144)	207	552	889	1,219	1,542	1,857	2,284	-
Financing (Exhibit 7)	1206	(255)	0	0	0	0	0	0	0	0	0	951
Net income after financing	47	127	306	328	351	345	338	330	322	315	427	3,235
Total after financing	47	173	479	807	1,158	1,502	1,840	2,170	2,492	2,808	3,235	-
Dividend payments	0	123	219	236	257	250	243	235	228	221	212	2,224
Earnings after dividends	47	4	86	92	93	95	95	95	95	95	215	1,011
Total	47	50	173	229	322	417	512	607	701	796	1,011	-
Repurchase of preferred stock Type A	-	-	-	-	-	-	-	-	-	-	692	692
Repurchase of preferred stock Type B	-	-	-	-	-	-	-	-	-	-	32	32
Remainder												287

Exhibit 9

INCOME PROJECTIONS (US$1,000)

YEARS	0	1	2	3	4	5	6	7	8	9	10	Total
Sales revenue	0	854	1,064	1,130	1,192	1,192	1,192	1,192	1,192	1,192	1,192	1,1392
Expenses:												
Variable cost	0	385	48	508	536	547	558	569	581	592	604	5,360
Depreciation	0	86	86	86	86	86	86	86	86	86	86	860
Maintenance	0	44	44	45	45	46	46	47	47	48	49	461
Insurance	0	16	15	14	13	12	11	10	9	8	7	115
Utilities	0	3	3	3	3	3	3	3	3	3	3	30
Salary	0	42	44	46	48	51	53	55	57	59	61	516
Management fee	0	4	4	4	4	4	4	4	4	4	4	40
Other fixed costs	0	26	18	28	28	28	28	28	28	28	28	268
Total expenses	0	606	694	734	763	777	789	802	815	828	842	7,650
Earnings before interest and taxes	0	284	370	396	429	415	403	390	377	364	350	3,742
Taxes:												
Building and property tax	0		11	12	12	12	12	12	12	12	12	115
Tax on advertising	0	1	1	2	2	2	2	2	2	2	2	18
Road tax	0	3	4	5	5	5	5	5	5	5	5	47
Asset tax	0	16	15	13	10	10	9	7	6	4	3	95
Total tax	0	29	31	31	29	29	28	26	25	23	22	275
Income before taxes	0	219	339	365	398	386	375	364	352	341	328	3,467
Income tax	0	74	115	124	135	131	128	124	120	116	112	1,179
Income after taxes	0	145	224	241	263	255	248	240	232	225	216	2,288
Interest expense	0	19	0	0	0	0	0	0	0	0	0	19
Income after taxes and interest	0	126	224	241	263	255	248	240	232	225	216	2,269
Contribution to a reserve fund (2% of revenue)	0	3	4	5	5	5	5	5	5	5	4	45
Dividend payments -Type A	0	123	219	236	257	162	160	160	160	160	160	1,798
Dividend payments -Type B	0	0	0	0	0	7	9	9	9	9	9	52
Dividend payments - common	0	0	0	0	0	81	74	66	59	52	43	374
Total dividend payments	0	123	219	236	257	250	243	235	228	221	212	2,224
Retained earnings	0	0	0	0	0	0	0	0	0	0	0	0

Troika Potato Chips (B)[1]

St. Petersburg, Russia

John Mirren was intrigued about the Troika Potato Chips proposal because it seemed to answer a market need. Three institutions planned to come together to produce the product. A farm, actually an agricultural consortium, would supply potatoes from a neighboring region; a foodstuffs distributor would distribute the potato chips in Russia's second largest city and outlying regions; and the last company would process the potato chips. Investment funds would be used to buy modern production and packaging equipment, making this potentially a very different operation in terms of volume and quality from the more usual, slow and inefficient Russian food production companies.

The financial figures looked very good, and their financial forecasts were well within the bounds of the probable — something not always true of Russian business plans. The company seemed to have almost all of the elements needed for success: sufficient storage, production and office space (finding the necessary real estate could be a real problem in Russia because ownership of property was frequently unclear or controlled by unfriendly bureaucracy), a regular supply of potatoes from within the region, an established distribution network, and modern production equipment.

But John had several reservations about the company. No one connected with the company had any experience producing potato chips. Although full training in how to use the production equipment would be provided by the supplier, this support did not prepare the founders to answer more fundamental questions. Were the potatoes the right type for potato chips? Was the quality of the potatoes high enough to justify the cost of the modern production equipment? You cannot make world-class potato chips from inferior potatoes. There seemed to be a lack of serious market research. The plans for their ad campaigns seemed a bit confused. And did the distribution network reach the sorts of stores at which potato-chip-loving consumers shopped? John was afraid that too much emphasis had been put on production and not enough on marketing. This was a common problem in Russia, a natural leftover of the centrally planned economy which emphasized production over consumer satisfaction, but a pattern which could be very harmful when launching a product that is usually a frivolous purchase. He further wondered who would control the company and provide direction? Frequently companies had internal conflicts in his experience because production-oriented executives fought with the more modern, market-oriented executives.

However, the company did have very little competition. Domestic potato chips, produced on old-equipment, were not very pleasant, and John thought the government would only increase tariffs on imported goods. He had reservations about the proposal as presented, but recognized that the company was seriously trying to address a need in the market. He wondered if he should go examine the company personally.

As he read the project summary section of the "Troika" business plan, he remembered the investment strategy of his friend Allen Dorsey, who ran a USAID backed venture fund in northwestern Russia:

I look for companies run by qualified management with a proven track-record, a product or service of incomparable quality in either the industry or the region, a clear indication of market, and project transparency. If these are in place, you may have a 70% chance of success.

NOTES

1. This case was written by Gene Gutenberg of Cornell University. It is intended as a basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.