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Preface

Strategy and Internal Organization of Russian Corporations

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In this issue we outline the crucial factors that affect the very existence of Russian firms and that predetermine, to a great extent, the scope of their strategic aspirations and activities. In the first section of this preface we present the historical roots of the present Russian corporations and firms and retrace the changes Russian "enterprises" have experienced over the last twenty years. The second section deals with major characteristics of strategic behavior of Russian companies prior to the economic recession period of late 2008 to early 2009. Included in this discussion are data on contemporary structure of the Russian economy across its main sectors and industries. The third section summarizes our findings on the impact of economic recession and the strategic reaction to hard times in various sectors. It describes the articles in this issue and it concludes with a discussion and tentative conclusions.

A short history of the modern Russian corporation

Prior to 1986 life for Russian enterprises was hard but simple. The "industrial ministry" located in Moscow sent well-prescribed plans for production and detailed timetables for deliveries for each enterprise. For military production, which occupied up to 40 percent of the total of Soviet period industrial output, the accuracy of deliveries was crucial, and tight independent quality control procedures were applied. For other types of production, especially for intermediary and consumer goods, there was greater managerial discretion. Routinely, in the last working day of

December the initial level of the production plans were 'corrected' to ensure their down to the word fulfillment.

Centrally determined and fixed prices for deliveries assured that sales profitability ranged from 15 to 25 percent. The net 'profit' was distributed uniformly in all enterprises: twenty-two percent was used for monthly and annual bonuses for employees, ten percent was set aside to finance housing, kindergartens, canteens and leisure camps for employees, and five percent were transferred to the funds for the ‘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, 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 'everlasting building yards' where boxes with uninstalled equipment were spread over factory shops.

In addition to obtaining state funds for the development and management of capital investment project, the second eternal problem was to ensure the uninterrupted flows of supplies – as the reliability of deliveries of intermediary goods was problematic and there were no incentives or sanctions in the relationships between suppliers and customers – to get deliveries in time and in full was indeed tricky. The centrally planned economy caused deliveries to be almost always interrupted, resulting in excessive downtimes and fervent activity to meet the production targets when deadlines neared.

This lead to a third problem: to ensure a minimal stability of production processes each enterprise tried to become 'self-contained'. For example, every machine-building factory included endless tool rooms, foundries, turneries, welding departments, large warehouses for scarce materials, etc. As a result, the employment in such auxiliary units usually exceeded the number of employees in the core production shops. To resolve the staffing problems management kept performance standards low to ensure the uninterrupted flows of bonuses for surpassing the rates of output. Nevertheless, the list of highly skilled and urgently needed vacancies in most Soviet enterprises was quite long, as most enterprises competed for the same specialties – fitters, turners, welders, and milling-machine operators.

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

In 1986 institutional changes began. The "Law on Enterprise" of 1987 stipulated the election by the employees of the General Directors of the enterprises, a fact that increased the legitimacy of the General Directors 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 the provision of intermediary services. Thus, top managers of Soviet enterprises had, for the first time in their life, tasted easy and big money.

Corporate development during 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 on January 1, 1992 and enterprises were free to sell everything to everybody at any price. This immediately led to a three-digit inflation rate, evaporation of enterprises' assets and acute liquidity shortages. The level of capacity utilization dropped to miserable low rates, 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 the Russian business life. To make things even more complicated, the privatization process began. In 1993-1994 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.

In the period of 1992-1995 the disparity between domestic and world prices made foreign trade operations extremely profitable. In most of the cases the profits from exports were absorbed by trade intermediaries. Such intermediaries quickly recognized that the best way to assure their high profit position was to gain complete control over the producers. In the period of 1995-1997 the battle for corporate control between insiders, top managers and outsiders, trade companies and banks, was at its height (Gurkov and Asselbergs 1995; Gurkov 1998). We should stress that this battle, irrespective of the winner, made quick 'streamlining' of privatized enterprises almost inevitable. Indeed, in order to get the necessary means for the purchase of employees' stock, 'insiders', the General Directors needed to squeeze profits from their companies. To make their businesses profitable they had to shed unprofitable assets, to master the fundamentals of capital management, to control cost, and to implement effective marketing and business planning processes. These same streamlining actions took place after the acquisition of companies by outsiders. To transform the acquired companies into profit-making ventures, the acquirers implemented the same sets of measures, namely, rationalization of assets, establishing marketing channels and proper cost and financial accounting (Gurkov 1996).

However, the organizational consequences of the battle for corporate control largely depended 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 that consisted of banks as parent companies were created. A major strategy of such conglomerates was to speculate 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 of 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 the parent companies many industrial conglomerates simply disappeared.[1] In the period of 1999-2000 the battle for corporate control between insiders and outsiders lost its acuity. The three year period between 1999 and 2001 was a crucial period in the establishment of the present form of Russian corporation. First, employees lost most of their share ownership and corporate ownership became concentrated in the hands of ‘insiders’.

Secondly, the shock of August 1998 marked the beginning of industrial recovery where the fourfold devaluation of the Russian currency restored price competitiveness of Russian products and almost completely eliminated foreign competition at least in 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 thinner since during the 1995-1998 period many firms had managed to divest most of their unnecessary and unproductive assets and were able in to shed their expensive social infrastructure. The government also wrote off all penalties on non-paid enterprise taxes and allowed the restructuring of the principal tax debts at very favorable terms (Dolgopyatova et al., 2009, 105)

Thirdly, change in the political regime ushered in 2000 was an underestimated factor that contributed to the establishment of the Russian corporation in its present form. The Russian government in 1990s was weak, poor and liberal. After the resignation of Boris Yeltsin as the President, the new administration instilled order, stability and obedience. Many Russian billionaires of the 1990s, who were libertarian and arrogant, found themselves in early 2000s either exiled or jailed, 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 for further consolidation of industries. This created some rules for corporate control, and, at least, guaranteed that the owner(s) of the target companies would receive adequate compensation for their loss of control.

The revitalization of the economy, rising prices for major Russian exports, the establishment of some rules for corporate control, and the government's modernization rhetoric, created mass incentives for innovative development. The modern Russian corporation finally emerged as a highly centralized amalgamation of privatized assets with is owners and managers having fresh memories of misery, and thereby there were passionate about cash flow, superficially obedient to the political regime and eager to profit from patronage. It was merciless to competitors and ready to imitate all the newest 'fads and fashions' in management and corporate governance, and yet innovative in 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. First, there are telecommunications, especially mobile operators, created from scratch as private enterprises. Second, the financial sector, especially investment banks and insurance companies, mostly emerged as private companies. The third important sector with minimal inheritance of Soviet assets is wholesale and retail trade operations. There are also several examples of successful 'initially private' companies in the airline industry such as Transaero, and examples like Kaspersky's Laboratory, and Rambler in software industry.

Finally, we should mention the Russian industries dominated by leading multinationals. First and foremost there is 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 an undisputed dominance of their trademarks in the Russian market by transferring production facilities into Russia. In 1990s this was done mostly by 'Brownfield investments' that involved the acquisition of existing production facilities that were re-equipped and expanded. In 2000s leading multinationals expanded their repertoire of development measures by: (1) expanding market share by the acquisition of local companies. For example, PepsiCo acquired in 2010 around 30 percent of the Russian market for juice by acquisition of the leading Russian producer Wimm-Bill-Dan; Unilever acquired in 2009 around 35 percent of the Russian market for ketchup by the acquisition of the leading Russian producer Baltimore Holding; Heinz acquired in 2006 around ten percent of the same market by acquiring the local producer Petrosoyuz; (2) greater use of local companies as contractors for packaging and bottling by companies such as Procter & Gamble, beer companies, and soft drinks companies;(3) Greenfield investments in its own production facilities by Nestle.

Other foreign-dominated industries such as the professional services industry, that includes the Big Four accounting firms in the field of corporate auditing and international operators in inbound and outbound logistics, are rather small in comparison. Although foreign companies, such as pharmaceuticals, civil aircrafts, and various kinds of machinery and equipment, achieved, or restored, their dominance in particular Russian markets without securing their activities through production subsidiaries, but rather through imports and dealers networks. Only in the last few years were there attempts from major car producers such as Ford, Toyota, and Volkswagen, to build assembly plants in Russia. Previous attempts such as the one by Siemens in power equipment, Bombardier’s expansion into producing transportation equipment, and those made by foreign firms investing 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, in our further analysis we refer mostly to Russian-owned companies that have their operations in Russian based facilities.

Structure and strategies of Russian corporations and firms prior to the current economic recession

The analysis of Russian corporations prior to the 2008-2009 Recession is based on a series of large scale surveys of top managers implemented during the period of 2000-2007. Gurkov has surveyed 740 managers in 2000 (Gurkov 2006), 1500 in 2002 (Gurkov 2006), 1400 in 2004 (Gurkov 2006) and 250 in 2007 (Gurkov 2009a). In addition to these surveys Gurkov has also collected during this period 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.[5] Finally, in the first half of 2008 we compiled more than 60 dossiers on the largest Russian corporation. Each firm dossier included annual reports of the company, newspapers and magazines' excerpts of in-depth interviews with top managers[6] and analytical reports of the company's investment by banks and brokerage firms.[7] 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, to increase profitability, and to maintain financial stability. Each of the aforementioned goals was rated to be 'important' or 'extremely important' by 80 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, the type of performance measures differed for export-oriented companies and companies oriented towards local markets.

Locally-oriented companies. Locally-oriented companies have 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. For companies built on privatized assets the best way to improve their marginal revenue was to put back into operations previously idle production capacities and to embark on the effective use of know-how developed during the transition period. To reach 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 types of measures. First they shifted from the production of low profit margin to higher-margin products, a step that was achieved by careful consideration of production and market portfolios. Second, they rushed to install new production facilities. Such projects were thought to correspond to several criteria: (1) they were mostly financed by using retained profits they were relatively inexpensive compared to the high cost of capital that Russian firms faced, since commercial loan rates hovered between 20-25 percent throughout the 2000s, (2) the projects' financial outcomes were designed to contain minimum risk through the replication of proven technologies and the use of production schemes with no 'hidden bottlenecks'[8]; and (3) the facilities were supposed to be easy to master and to be operated by the existing workforce.

Kossov (this issue) found that a significant part of the effective production facilities, inherited from the Soviet times, were legally and often physically transferred to other companies in the 1999-2002 period. We would like to mention the widely used practice of 'turn-key' contracts where foreign companies took over complete responsibility for the design of production schemes, purchase, delivery, and installation of necessary equipment, as well as training the local personnel and assuming further control and guidance until the agreed level of output was reached.

The ‘turn-key’ model for new development projects were also applied by 'new private companies' built from scratch rather than on privatized assets. Such 'cut and paste' strategies were successfully used for recapturing local consumer markets by offering products of mediocre quality at affordable prices. As consumer confidence in Russia-made products was restored, additional marketing tactics were used. As Komissarova and Grein (this issue) indicate Russian firms have attempted the adoption of international marketing techniques. One of them was the revitalizing of Soviet brands. Such products were usually sold at higher prices as they claimed to be produced according to the 'strict state standards of 1950s' or as 'authentic recipes of 1970s' and brought to customers the feelings of 'untroubled life of the 1970s' or 'happy childhood memories'. Revitalization of Soviet brands has also been used by multinationals. An interesting example of using patriotic motives by foreign companies was a large advertising poster showing a Russian cosmonaut who painted the Space Shuttle into 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 the 2005-2006 period, despite the quick rise in consumer expenses, the possibilities of intensive growth (occupation of 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 current ratio between current assets and currents liabilities of Russian companies seemed normal, companies accumulated large debt burdens from long-term bank loans and high liabilities on bonds issued. These firms had taken on large debt loads that would lead to financial weakness during the financial crisis in 2008.

Export oriented corporations

Exports from Russia have been dominated by mineral products. Nearly 70 percent of all exports in 2008 came from the mineral products sector, with metals and precious stones sector accounting for 13.3 percent, chemical products for 6.5 percent, and the remaining part made up of hydrocarbon exports. The share of manufactured goods in total exports remained in 2000s at less than five percent. Over time the value of manufactured and processed exports has increased during the period of 1995 to 2008, but Russian exports continue to be dominated by hydrocarbon exports, which in effect have crowded out other sectors in the export market.

First, the very favorable price dynamics of these natural resource commodities in the world's markets in early 2000s made export operations extremely profitable since the production costs were calculated in Rubles while sales were made in US Dollars. Companies tried to export as much as possible, at any condition, as 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 different direction. For such 'heavy' industries installation of new capacities was expensive, took longer period of time and complex industrial projects had neither standard solutions nor definite expectation of timely completion.

Thus, large export-oriented companies looked for other possibilities. First, they started to streamline the dealer networks, to skip intermediaries and to establish direct sales in international markets. In the ferrous and non-ferrous metals industry this was indeed achieved, while in the oil and gas industry there were political obstacles to the elimination of intermediaries. As the greater portion of added value from core activities fell into the hands of large exporters, these firms started to look into 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 to oil fields. The financial fate of the acquired companies was doomed since through the system of transfer pricing all the profits were taken by the parent company. Again, as in Soviet times, all plans for capacity development depended on approval and financing from Moscow, but arguments about the 'importance of the production for the national interests" or appeals to 'communist consciousness' were no longer effective.

As the largest Russian exporters quickly 'absorbed' all 'property in abeyance' in related industries, they then looked further into the possibilities for profitable growth. One 'lucky discovery' was the possibility of an IPO on major stock exchanges, first on the New York Stock Exchange, and then later on the London Stock Exchange. At very reasonable costs, such as hiring one of the leading American investment banks as underwriter, organizing a road show, auditing by one of the Big Four accounting firms and insertion of a few 'independent directors' into the board of directors, billions of dollars could be collected. Russian corporations also learned extremely well the basics of 'good investor relations', namely, a timely disclosure of positive information, foretelling of grandiose plans, and, in some cases, hidden internal trading and secretive buybacks of 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 volumes of sales, but rather in 'enterprise value' terms. The securitization of large Russian corporations gave them not only a new might but also a powerful weapon for a new wave of expansion – acquisition of overseas assets (Kuznetsov, this issue). Cross-border mergers and acquisitions of Russian assets peaked to $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's and national goals. Since then the 'marginal effects' of foreign acquisitions has 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 of "Severstal" to compete with Mittal Steel in the takeover of Acelor (2006). Also during the current economic crisis there was the abrupt refusal of General Motors to sell Opel to a consortium of Magna and "Sberbank" (2009) and the struggle of Surgutneftegas in using its newly acquired 21% stake in MOL

(Hungarian oil company) to enter into the board of directors and management committee of its new subsidiary. In general, the intensive efforts of overseas expansion proved to be rather expensive, it has not brought immediate financial or political dividends, and, in some cases, endangered the very existence of the Russian corporations, as governments in developed countries demanded transparency in both real owners and real corporate governance structures. If revealing the final beneficiaries was in many cases not that risky, the presentation of the internal rules of Russian corporations might have provoked serious questions on capabilities of running a modern business.

Internal Corporation Management

Indeed, the typical Russian large corporation is built as a three-tier system. There is typically 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 into its subsidiaries. The Central Bank of Russia (CBR) collects data on international investment in Russia and provides break downs for this investment. In the 2007 to 2009 (through first quarter) period the CBR estimates that the total direct investment by non-bank corporations in Russia were $126.9 billion. These investments in non-bank corporations were made by corporations from offshore financial centers such as the Bermuda, British Virgin Islands, Cyprus, Gibraltar, Luxemburg, and the Netherland Antilles. Those investments that can be identified indicate that $65.1 billion, or 51% of international investments, flowed from these offshore financial centers.

The second tier is represented by 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. In conglomerates such headquarters are split into 'sectors' or 'business units' that oversee the activities of the 'production units'. The third tier consists of the 'production units.'

The composition of ownership may vary, but Russian corporations strongly prefer short ownership chains that coincide with the 'chain of command'. Only few Russian corporations have dared to implement a 'strategic business units' structure that would lead to the decentralized 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 ALFA Group that have learned indeed 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 batteries of '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 the Soviet times.

Two major points have made the current situation of Russian production enterprises worse than in Soviet times. First, the Soviet ministries were mostly staffed by experienced General Directors of enterprises who had exchanged lower salaries, since ministry officials earned less than heads of enterprises, for the possibility to move from provincial cities to Moscow. They spoke the same language as their subordinates and had not developed a distance from the enterprises they supervised. By contrast, the operating headquarters of modern Russian corporations are staffed by recent graduates that are financial experts and lawyers who have an absolutely different education and experience background, with little direct operations experience and with no identification with any particular industry or enterprises. So, the mental models of supervisors and subordinates largely differ. In Gurkov and Zelenova (in this issue) analysis of pre-crisis firms in Russia indicates that the undisputed role of the general director and manager over the personnel has exacerbated the dissonance between managers and their personnel.

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

The operation headquarters have neither time nor capacity for dealing with strategic issues. Under such circumstances the only body remaining for dealing with 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) to be the same person. Large industrialists immediately appointed themselves as Chairman. To keep 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 (CEO). We may see here the replication of the Soviet system, when departments of the Central Committee of 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 B and 285 syndicated loans brought $126 B in new capital for Russian firms. Bonds issued prior to 2008 were oversubscribed and had favorable rates that ranged from eight percent to 11 percent depending on the company, market conditions, and the industry. In the middle of the year of 2008 the total foreign corporate debt of Russian companies reached US$500 billion. However, this capital was poorly used. Russian firm ROA were significantly lower under the same global conditions. In 2007 Rosstat (Kossov, in this issue) reported that manufacturing firms experienced an 8.6 percent ROA while mining and quarrying (including oil and gas industries) had 10.5 percent ROA. In the United States mining had a 10.7 percent ROA and manufacturing a 15.1 percent ROA in 2007. 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. In the first half of 2008 the local prices for metals, cement, and oil products increased by 20 to 40 percent and surpassed the world prices. Such a feast could not last for long.

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

Experts may 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 threefold 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 the 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 strategy of harvesting through placement of shares on the market for Russian entrepreneurs. Also, in the fourth quarter of 2008 there was a massive capital outflow from Russia that amounted to US$130.5 B, including US$55.6 B net outflow from the banking sector and US$74.9 B in the non-banking sector (World Bank, 2009a, 20: 9). One part of these outflows was related to the margin calls on foreign credits, which reached US$527 B by October 2008 and the second part was pure 'capital flight'. In November 2008 the industrial output was 8.7 percent lower than in November 2007 and by December 2008 industrial output was 10.3 percent lower than in December 2007. Capital outflow continued in the first quarter of 2009 with outflows of US$6.9 B from the banking sector and US$28.4 B from the non-banking sector; thus the total capital outflow over six months was 12% of Russia's 2008 GDP.

The financial crisis in September 2008 caused the short-term borrowing rate to move up from 8.9 percent in September 2008 to 11.2 percent in October 2008. On ruble based borrowing, the CBR reported that the average interest rates for non-financial institutions increased to a 2009 average of 14.3 percent from 12.3 percent in 2008 and 10.2 percent in 2007. During the 2006-2009 period the CBR has had to manage the revaluation of ruble, control inflation, maintain liquidity in the banking sector and maintain interest rates to insure continued economic growth. The cost of capital has changed rapidly during the period of June 2008 to November 2009 due to 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, beginning in September 2008 the government undertook a relentless series of actions to prevent the collapse of the financial system and to avoid the bankruptcy of major corporations. First, in September 2008 major injections of liquidity were made into the banking system. In October 2008, the government saved some of the largest companies, such as UC Rusal, X5 Retail Groups, and VympelCom 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 Evraz Group, Gazprom Neft, Sitronics, Eko Telekom, PIK Group, Rosneft, Lukoil, Globex, and Svyaz Bank.[5] The owners and managers of these companies, many already connected to government or part of the state-owned enterprises (SOEs), now had to rely on VEB as the lender of last resort so that their collateral was not seized by foreign creditors. Also the intervention of VEB, a state corporation, in the activities of these companies’ strategic policies was not the same as the relationship between a foreign creditor and a Russian debtor. By accepting these 'bailouts' they agreed for the representatives of VEB to join the board of directors and management committees by taking board seats and having VEB bankers or connected individuals appointed to oversee the firm’s performance.

Being involved in seemingly endless series of rescue operations, the government tried to limit somehow the number of applicants for state aid. On December 25th 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 four percent of the bail funds was aimed at small and medium-size companies.[6] Later (in March 2009) the list of 1148 'enterprises of regional importance' was also announced. The idea was that large corporations, temporary 'derailed' by the world financial crisis, will quickly 'return on track' and would therefore pull smaller companies back up with them to financial health. However, the reality showed too many 'bumps' in the road to recovery with very few 'conductors on duty' to direct a rebound in non-financial corporations.

The impact on industrial sectors

In examining the different segments of the Russian industry, we may clearly distinguish the 'fate' of companies in 'cost-oriented' and 'quality-oriented' industries. Cost-oriented industries are companies that produce basic commodities such as oil, gas, fertilizers, aluminum, pig iron, and steel products. In many sectors of the consumer markets, especially for packaged foods, we could identify similar types of 'cost products', such as sugar, grains, rice, grains, and sausages. Quality-oriented industries are those that compete not only by price but also by introducing unique features of the product. Included in this category are machinery and equipment, cars and trucks, domestic appliances, special chemicals and non-generic 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 types of measures: a massive use of state-supported credits to finance current expenses and to re-finance 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[7].

These measures worked very well to protect companies from bankruptcy and to keep operations running. The sales of major metal producers fell in 2009 by 20 to 30 percent, the net profit fell by 40 to 60 percent, and since foreign markets absorbed the low value added and underpriced products and these firms' the survival was at least assured. Similar sets of measures with similar outcomes, such as a modest fall in current output and capacity utilization, deep fall in profits, and deterioration of further perspectives in world markets, have been implemented in non-ferrous metallurgy industry, basic chemical producers, and cement producers. However, for strategic quality-oriented companies the measures of government assistance were clearly insufficient for survival. The government could provide credits or inject additional capital into such companies, but lacked the means to restore the 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'. With 100 percent state ownership this company was mistakenly mentioned twice in the list of the 295 strategic organizations, but this did not help it to maintain the sales level of its major product of rolling stock. In November 2009 the accumulated debt of the company was 60 B Rubles. The government injected 4.4 B Rubles in the first half of 2009 and again ten B Rubles at the end of 2009. The government forced another state-owned company, Transneft, to sign a contract for 2200 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, since it had received better offers from its competitors that are private companies.

One of the few strategic companies that have not embarked on the standard set of measures was NLMK. NLMK (Novolipetsk Steel) is a steel producer based in Lipetsk region and owned primarily by Vladimir Lisin who holds 84.61 percent of the firm's shares directly. NLMK has listed both in Russia with a 4.44 percent free float and on the LSE with an 8.45 percent free float and the balance is owned by the management group - 2.5 percent. NLMK has maintained a low leverage position during the boom years of the 2000s and was ready to face 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 own means” reported the representative of NLMK.[8]

Indeed, with no desire to compromise the firm’s strategic interests for state aid, the controlling shareholder has seemed to be reinvesting in the firm through the 2008 to 2009 period. For example, Universal Cargo Logistics Holding B.V. (UCLH), a Dutch company controlled by Vladimir Lisin, made the acquisition of 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 B ruble bond issuance on the RTS and MICEX in October 2009 that was oversubscribed. The 2009 nine month report of NLMK indicates that it was the only major Russian metallurgy company that returned to pre-crisis level of production with a 99 percent utilization rate of its primary production facility in the Lipetsk region.

These examples clearly illustrate the key issue in the future of 'strategic' Russian companies. If the controlling shareholder is willing to repatriate and to reinvest previously received dividends, the company may escape 'investment breakdown' and to improve its market competitive position not just in costs, but in quality as well. We found that the same is true for non-strategic companies as well. In the first months of 2009 we performed a survey in 'non-strategic companies' (Gurkov 2009b). We found that where owners were 'patient' and were able to sustain the deep fall of profitability of their business or even to accept temporary losses, the companies implemented anti-crisis measures with long-term impact. 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, the majority of the companies preferred the simplest sets of cost-saving efforts, including cutting the marketing and advertising expenses and limiting the product mix to a few products (Komissarova, this issue). The typical Russian personnel systems did allow firms to rapidly reduce their overall personnel costs by reducing the amount of non-mandatory bonuses that were typically paid in addition to the minimum wage level for each position (Gurkov and Zelenova, this issue). This flexibility in wage payment allow Russian firms avoid problems of downward sticky wages though this rapid reduction in take home provide a major disincentive to retained workers.

Discussion and tentative conclusions on current Russian management practices

The financial crisis has become a seminal point for the strategic development of large and small Russian companies alike. The late 1980s opened the window to the introduction of the non-centralized enterprise; the 1990s was a radical period of transition brought to an end with the 1998 crash, and the 2000s a period of unprecedented growth. The Great Recession of 2008-9 has 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 recently announced strategic plan of LUKOIL that set the following new priorities: minimal quantitative growth as the planned volume of production will remain stable until 2019; restriction of investments; the planned increase of free cash flow by three times in a ten year period; and higher share of net profit allocated as dividends.[9]

The instability of the financial system has been the central cause of the adoption of these strategies of contraction and retrenchment of large corporations. The large international debt exposure that corporation 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 have struggled to keep control over the firm while receiving an extensive VEB bailout.[10] The crisis marks the end of the period of easy credit and rapid debt expansion.

In terms of operational strategy Russian firms have returned to their retrograde traditions after a brief period of adoption of international best practices. It is already clear that Russian corporations are becoming even more centralized, with tightly controlled investment budgets and operating expenses due to the increase in environmental uncertainty. Almost all Russian owners and managers do not understand the usual business cycle since they do not have personal experience with this feature of a market economy. Their reference points are those of 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 type of strategies Russian firms adopt. The crisis has 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 of the 'strategic' sector there are tens of thousands of small, medium, and large firms that must adapt to the new situation. The new strategic orientation of these firms that can be summarized as working towards the penetration of new markets, investment in personnel and equipment, and the rationalization of supply chains and production process, is an indicator that these 'non-strategic' (i.e. non-state controlled) firms have responded to the economic downturn in a manner that creates new opportunities for growth instead of the retrenchment policies that characterizes the 'strategic' enterprises. This observation makes further development of 'non-strategic' companies a non-trivial problem and provides a rationale for the focus of the articles included in this issue about Russian management.

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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, insurance (later sold to Allianz) sectors, and Alfa-group operating in the industries of telecommunications, retail, banking, insurance and oil through participation in TNK-BP.

2. Most interesting cases posted at http://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 World Bank calculations, RRB 1089 B (2.6% of GDP) was spent in 2008 as fiscal anti-crisis measures, including RRB 785 B for strengthening the financial sector and RRB 304 B for supporting the real economy. Measures for the financial sector included RRB 335 B of recapitalization and other direct support and RRB 450 billion of subordinated loans. An additional RRB 830 B 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 RRB 52 B consisted of sector-specific support (see World Bank in Russia 2009a, 19: 9-12)

6. In the initial estimates of RRB 1600 B for supporting 'the real economy', RRB 474.4 B was allocated for a reduction in the tax burden, mostly through a reduction in corporate income tax , RRB 267.7 B should be sector-specific measures, aimed at the defense, motor and transport industries, agriculture and construction, and RRB 300 B in state guarantees that were mostly directed at these same manufacturing sectors. RRB 300 B was allocated as a fiscal stimulus aimed at the regions. Only RRB 6.2 B was planned for support of small and medium size enterprises, with an addition RRB 50 B allocated to Vneshtorgbank and earmarked to refinance credits to small and medium enterprises.

7. See: Dorofeev, V. What does astonish (me). Supplement to "Kommersant" No. 209 (4264), November 10th, 2009.

8. See Smirnov D. To receive accordingly to the list. Ibid.

9. See Lukoil's Annual Report 2009 and firm strategy at www.lukoil.ru

10. In its debt restructuring plan UC Rusal will place its shares on the Hong Kong Stock Exchange and exchange debt for equity to pay down its $16 billion in accumulated debt. In December 2009 HKSE ruled that UC Rusal, due 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% of the stock offered.

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