



Жа́сный Октябрь

The Hostile Bid for Red October

For Yuri Yegorov, Chief Financial Officer of the Red October Candy Factory, July 11, 1995 began just like any other day—with a glass of tea and the morning *Commersant Daily*. He paid no attention to the warm, rich smell of chocolate that permeated the factory's nineteenth-century, wood paneled offices—thirteen years at the factory had rendered him unable to taste even the bittersweet delicacy that was Red October's main product. Yegorov's routine was abruptly broken by an item in his newspaper: a public "Offer to Purchase for Cash" 51% of Red October's outstanding common stock (see **Exhibit 1**). Although the offer was unprecedented in Russia, Yegorov immediately realized what had happened. Red October had become a takeover target.

Yegorov understood the basic idea of hostile takeovers, but was unsure of his next steps. The price offered, \$7.50 per share, was significantly above the current price of \$5.50. Koloss, Red October's would-be acquirer, was controlled by Menatep Bank, one of the most powerful and well connected financial institutions in the country. Yegorov knew that a change in ownership could mean significant changes in strategy—and possibly management. The very style of the offer made him uncomfortable. If Menatep had been interested in buying Red October, why hadn't they approached management directly instead of launching this public attack?

In any case, the hostile offer had been made. Yegorov reflected on the irony of the situation. Just eight months earlier, Red October had volunteered to be the first Russian company to publicly issue shares according to Western standards. Now, it was again going to serve as a model of financial innovation in the newly created Russian capital markets. He thought wryly of the old Russian proverb that states "if you live with wolves, you will start to howl like one." Getting the order backward, Red October had first learned to howl, and now the wolves were coming.

Normally, Yegorov would have met with Anatoli Daursky, Red October's President and CEO, but Daursky was abroad on vacation. In his absence, Yegorov knew that the decisions he made over the next few days could determine Red October's future. He reached for the telephone and called his investment banker, Oleg Tsarkov, at Grant Financial Group.

Alan Bigman MBA 1996 prepared this case under the supervision of Professor Benjamin C. Esty as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

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The Russian Economy

Russia's economy in the mid-1990s was perhaps best summed up by the economist Grigory Yavlinskii. When asked whether Russia could ever hope to have a functioning market economy, he quipped "Why not? We already have a malfunctioning market economy." Indeed, the convoluted history of Russia's development had left a very mixed legacy.

The Communist Experiment

In the late 19th century, Russia embarked on a period of industrialization similar to that experienced in Germany and the United States fifty years earlier. By 1917, however, the dislocations of war combined with an outdated political system led to a Bolshevik coup d'état. For the next seventy years, the government owned all capital and an enormous state bureaucracy managed business activity. Under a brutal but effective forced industrialization drive, the Soviets managed to produce enough weapons to defeat the Nazis in World War II and, in the post-war years, to increase output of consumer goods. But by the mid-1980s, Soviet economic growth had stagnated. To allow the USSR to continue on its stated goal of "catching up to, and surpassing" the United States, Soviet leader Mikhail Gorbachev embarked on an ambitious reform program called *perestroika*. Instead of creating a market economy, Gorbachev's reforms simply accelerated the decay of the Soviet command economy. In 1991, an unsuccessful coup by Communist hardliners sounded the USSR's death knell. On December 25, 1991, the red flag was lowered from the Kremlin for the last time.

Creating a New Russia

Russia's new president, Boris Yeltsin, took immediate and drastic steps. A flurry of decrees freed most prices, returned land to peasants, and mandated the privatization of state-owned enterprises. The radical privatization program created joint stock companies out of the large state-owned enterprises. Through privatization, workers and management often bought half the shares while the remainder was sold to the public for special privatization vouchers and cash. By 1994, private companies produced the majority of Russia's gross domestic product (GDP). Engineering the changeover from a 100% state-owned economy to a Western-style market economy was not simple or costless. Production levels fell as Russian companies struggled to adapt to market conditions. Prices skyrocketed due to loose fiscal and monetary policies. Confidence in the new system was shaken by episodes such as the MMM scandal, in which an unscrupulous company sold "stock" in a pyramid scheme that bilked Russians of billions of rubles.

From the beginning of the reform process, the Western industrial democracies provided technical assistance. For example, the International Finance Corporation, the private sector arm of the World Bank Group, provided assistance with the first privatizations. In addition, the U.S. Agency for International Development (USAID), the British Know-How Fund, and Technical Assistance for the Commonwealth of Independent States (TACIS) all sponsored Western consultants to help the Russians develop legal and economic market infrastructure. Projects included writing banking regulation; creating corporate and securities law; and safeguarding shareholder rights.

Still much uncertainty remained as of 1995. Land, for example, was still largely owned by the government and was used by companies under a bewildering array of lease agreements with numerous conditions attached. Privatized companies were sometimes subject to interference from the ministries that used to control them. Byzantine tax law created opportunities for government arm-twisting of corporations. Finally, untested corporate governance law and weak traditions tempted management of companies to disregard shareholders' rights. There had even been cases where management had attempted to strike the names of unwanted shareholders from the corporate register. To address these issues, the Russian government, along with many companies in the increasingly powerful Russian private sector, were working to strengthen property rights.

Red October

The Red October Candy Factory was founded by a German in 1867 as the “Einem Company for Production of Chocolate, Caramel, Candy, and Tea Cookies.” It grew rapidly, moved to a large site in downtown Moscow (see **Exhibit 2** for a photograph of the factory) and became “Purveyor to the Imperial Russian Court.” The company was nationalized in 1917 and renamed “State Candy Factory #1.” In 1922, management changed the name to “Red October” (*Krasny Oktyabr* in Russian) in honor of the Great October Socialist Revolution of 1917.

As was often the case under central planning, certain enterprises were chosen to be “models” for the rest of the industry. Red October had been such a model enterprise, enabling it to receive special access to investment and raw materials during the Communist era. The largest producer of candy in Russia, Red October had a powerful brand name in a country notoriously lacking in brand names. Although formal market research did not exist, it is a rare Muscovite that would have expressed a preference for any chocolate, including imported chocolate, over Red October’s product.

Privatization

In 1993, Red October began the privatization process required by Russian law. Management prepared a privatization plan, which was approved by the Committee for State Property Management. Following the most popular method of privatization, Red October employees purchased 51% of the company’s equity for a nominal price. These shares were allocated among employees based on position and seniority.

The government temporarily retained the other 49% before transferring 20% of the shares to Red October suppliers. Another 27% was offered to the public at a special auction for privatization vouchers, which were distributed to all Russian citizens. Voucher investment funds, which were Russian mutual funds that invested vouchers on behalf of small investors, purchased many of these shares. The remaining 2% was sold by the government for cash. By the end of 1993, Red October was in private hands for the first time since 1917.

The November Share Offering

In November, 1994, Red October offered 3.5 million common shares for sale at \$6/share. Management explained that the money raised through the offering would be used to finance capital expenditure, including a new production line for the popular “Clumsy Bear” product, new packaging equipment, computers, and better warehousing and distribution. The share offer, widely referred to in the press as “the first Russian IPO,” was not, strictly speaking, an initial public offering because Red October shares were already trading publicly at the time. Nevertheless, Red October’s share offering was the first of its kind in Russia. It was specifically targeted at a broad audience of Russian retail and institutional investors, as well as foreign institutional investors.

The British Government Know-How Fund paid for the offering. David Moran, Chief of the Know-How Fund in Moscow, explained that the project was undertaken as part of the British Government’s effort to foster the development of a transparent, fair, and efficient capital market system in Russia. The Red October share offer set a new standard for disclosure in financial transactions, and it was hoped that it would serve as a model for future share offerings. Samuel Monatgu, a British merchant bank along with Linklaters & Paines, a British legal firm, put together a 47-page offering memorandum. Deloitte & Touche helped Red October prepare GAAP-compliant financial statements, and Burson Marsteller, a public relations firm, helped manage the offer.

Grant Financial Center, which had a long-standing (by Russian standards) relationship with Red October, was the lead advisor for the offering. Indeed, Red October had become one of Grant’s first client in 1993, when they advised the candy factory on its privatization. In 1994, Grant served as

a financial advisor to Red October, the auditor of its financial statements, and the official market maker in Red October shares. In determining the pricing of the shares, Oleg Tsarkov, Director of Trading at Grant, commented that

Red October offers a stable long term investment. . . at a fair price. In fact, major accounting firms and an investment bank advised us on a range of share prices based on their valuations of the true worth of Red October. [Six dollars] represents the lower end of their estimates, which makes it quite attractive for investors. . .

The offering resulted in the sale of approximately two million shares, raising \$12 million for Red October's planned investments. The offering, however, was undersubscribed and Red October was forced to annul 1.5 million shares. One observer commented that Russian investors were distrustful of all stocks due to well-publicized scandals.

By July, 1995, Red October's share ownership had changed significantly from the time of the 1993 privatization. Institutions and organizations owned 64.5% of Red October's shares while individuals owned the remaining 35.5%. Of the shares owned by individual shareholders, 15.3% were owned by people who held less than 1,000 shares each, most of whom were Red October employees. Of the institutionally-held shares, "Russky Uzor," a company controlled by Red October management, held 13.0%. Three companies that were thought to be under the influence of Red October management owned another 14.1%. Thus, insiders (managers, directors, and employees) or organizations connected with insiders controlled approximately 40% of the shares. **Exhibit 3a** is a list of Red October shareholders as of July, 1995. **Exhibit 3b** shows Red October's elected Board of Directors and their shareholdings.

Financial and Operating Performance

Red October produced 60,539 tons of chocolate, candies, caramel, and toffee in 1994 in more than 200 different varieties, representing some 27% of the confectionery manufactured in Moscow (see **Exhibit 4a**). Approximately 60% of Red October's production was bought in Moscow, although it was likely that some of this found its way to the provinces, since it was considered a special treat to be brought back from any trip to the capital. **Exhibit 4b** shows the regional breakdown of Red October sales while **Exhibit 4c** shows Red October's steady annual production over the past decade.

In 1994, the Company earned \$35 million on \$116 million in sales, resulting in \$22 million in after-tax profit. (See **Exhibit 5** for Red October's income statement.) With 6.4 million shares outstanding, earnings per share were equal to \$3.47.

Red October employed 2,900 employees, two-thirds of whom were women. Management stated that it was committed to maintaining "a higher level of average salary" than that prevailing in comparable factories in order to attract and retain the best personnel. The average wage for employees in 1994 was approximately \$200.00 per month. The factory also paid for benefits including day care, summer camps for children, two subsidized meals per day, interest-free loans, free dentures, and myriad others. These social costs were equal to 4.7% of net income in 1994.

Exhibit 6a shows that Red October's shares traded between about \$2.00 and \$5.50 in the twelve months preceding the July tender offer with a bid-ask spread of approximately \$1.00. At these prices, the company had a market value of between \$13 million and \$35 million compared to its book value of \$24.3 million. The balance sheet stated current assets of \$25 million, current liabilities of \$7 million, and fixed assets of \$6 million. (See **Exhibit 7** for Red October's balance sheet.) Besides the property, plant, and equipment on its balance sheet, Red October had two potentially very valuable assets. The company, through a government lease, controlled 14 acres of prime land in downtown Moscow. Also, the Red October name represented significant brand equity throughout Russia, since high quality standards had been maintained throughout the Soviet era.

Despite its leadership position, the company faced increasing competition from foreign confectionery manufacturers. U.S.-based M&M Mars and U.K.'s Cadbury-Schwepps were, by some accounts, pouring tens of millions of dollars into advertising and promotion in the Russian market. In addition, local competitors, in need of cash and desperate to sell product, had been competing primarily on price. Thus, Red October management identified price competition as the primary determinant of the company's financial performance.

Koloss/Menatep

Red October's uninvited suitor, "Koloss," was a large Moscow food processor which was 57% owned by the Menatep financial group at the time of the tender offer. Koloss was founded in 1962 as the Koloss Moscow Experimental Food Products Factory. By 1994, it produced 100% of Russia's frozen potato products, as well as 90% of the potato chips produced in Central Russia. Koloss also manufactured food concentrates, noodles, cereals, potato starch, and dehydrated chicken and meat. Unlike Red October, Koloss largely produced commodity-type food products to Soviet quality standards. Raw materials costs alone accounted for 74% of sales, in contrast to Red October's 34% pre-tax profit margin. As of January 1, 1995, Koloss' equity book value was \$25.4 million.

Menatep had acquired Koloss through "investment tenders," whereby it promised to invest a total of \$36.5 million over several years in return for receiving Koloss' shares from the government at a nominal price. Menatep's investment was largely in a project called "Block A," which was described by Menatep as a "unique, even by European standards, facility." It was to produce high quality food products including pizza, ice cream, and individual tea bags.

Menatep itself was one of the largest and most successful of the financial firms that emerged from the reform experiment of the late 1980s. Headed by Mikhail Khodorkovskii, Menatep became a diversified commercial and investment bank, often using its capital to take a proprietary interest in what it saw as profitable opportunities.

Alliance-Menatep, another company in the Menatep Group, served as Koloss' advisor in the transaction. The company was a full-service investment bank, offering corporate finance (including equity underwriting and M&A advisory), sales & trading, equity analysis, and other financial advisory services. It had been formed in May, 1995, only two months before the tender offer for Red October was announced, with \$10 million in start-up capital and sixteen employees. The General Director of Alliance-Menatep was a 33 year-old Russian named Yuri Milner who had graduated a few years earlier from a leading U.S. business school.

The Public Tender

Menatep's interest in Red October was not in itself surprising. Privatization had created tens of thousands of newly independent enterprises, many of which were ill-equipped to survive both strategically and financially. Banks, with access to relatively low-cost financing, increasingly saw themselves as catalysts for the rationalization of Russian industry.

Normally, however, takeovers were negotiated behind closed doors. The acquirer would convince management of the target company to acquiesce to the takeover. Sometimes, the tactics employed were far from benevolent; bankers and businessmen sometimes lost their lives in disputes.

Terms of the Offer

Koloss invited Red October shareholders to tender their shares from July 11, 1995 through July 25, 1995 at an independent depository. If, on July 25, 51% or more shares had been tendered, Koloss would be legally bound to purchase shares representing not less than 51% of those outstanding. Shares tendered after the 51% level had been reached could be purchased at Koloss' option. If on July 25 less than 51% of shares had been tendered, Koloss would have the option of refusing to purchase any of the tendered shares.

In the event that Koloss purchased shares under the terms of the tender offer, tendering shareholders would receive the market equivalent in rubles of \$7.50. Tendering shareholders could withdraw their shares from the depository at any time before the expiration of the offer. Because no shares would actually be purchased until the expiration of the offer, Red October management would have no way of knowing how many shares had been tendered or by whom until the end of the tender period. Koloss also maintained the right to either extend the tender period or raise the price offered. If the price were raised, shareholders who had already tendered would automatically be eligible for the higher price if Koloss purchased shares. Alliance-Menatep retained the legal firm Skadden, Arps, Slate, Meagher & Flom as advisor on the transaction. Yuri Milner later recollected that he contacted the firm to work on the deal because he had read about its successes in the 1980s takeover craze in the U.S. while at business school.

Alliance-Menatep announces the tender

On July 11, Alliance-Menatep launched a communications campaign to explain the tender offer to Red October shareholders, the press, and Red October management. In addition to the "Offer to Tender" reproduced in **Exhibit 1**, Alliance-Menatep also circulated a press release explaining the terms of the offer. Starting at 8:00 A.M., the directors of Alliance-Menatep began calling representatives of the local and foreign business press. By July 12, the tender offer had become top news in the Russian business press, and was covered by Western newspapers such as the *Financial Times* and the *Wall Street Journal*.

Menatep stated that Koloss was interested in Red October "as a strategic acquisition in order to diversify from its current low margin food products to include a higher margin confectionery product line." The *Wall Street Journal* suggested that Menatep was interested in Red October as "the linchpin for a holding company that would exist to buy out and control regional candy factories." Milner primarily discussed operating improvements Koloss would make, including improved marketing and distribution and better financial management. "You really have to control the company in order to be able to fix it up and realize its value," Milner said. Nevertheless, Menatep insisted that its bid was a "bear hug" rather than a hostile takeover. The following excerpt from the offer provides Menatep's explanation of why the tender offer was in everyone's best interest:

1. Shareholders of Red October: Shareholders will be able to sell their shares at a price significantly higher than the current market price.
2. Red October: Red October will gain access to the substantial financial resources of the Menatep Group, which will allow it to renew its production facilities and take a more secure place in the competitive Russian market.
3. Management of Red October: The Purchaser [Koloss] has absolutely no plans to replace the current management of Red October. Red October management enjoys a well-deserved reputation for professionalism and excellence. The proposed inclusion of the Company in the Menatep Group will help the management of Red October strengthen the leading market position of the

Company, as well as to develop and implement a strategy of including regional candy factories in the structure of Red October.

4. Workers of Red October: Like other shareholders, workers of the enterprise will profit from the tender offer, gaining the possibility of selling their shares for a higher price. In addition, the further growth and development of Red October will preserve employment and give them in the future all the benefits of working for a larger and more successful company.

Rationale for Public Tender

According to Yuri Milner, the public tender was as necessary tactic. "We bought 1% of the shares outstanding over the preceding eight weeks, and the price went up 50%. The market is so narrow that any interest in a company can drive the price through the roof." (See **Exhibits 6a** and **6b** for Red October share price information.) In fact, trading volume in the months preceding the offer was approximately 5,000 shares per day compared to the 60,000 or so shares Menatep had purchased. The shallowness of the market for Red October shares made the traditional "street sweep," in which the acquirer purchases shares anonymously on the market prior to announcing intent, an expensive and impractical option. Another factor that made it difficult for Menatep to maneuver was Grant's position as Red October's advisor as well as the principal market maker in its stock and the keeper of the shareholders' register.

In valuing Red October, Menatep had access to the publicly-available financial statements (see **Exhibits 5** and **7**). Menatep stated that synergies with Koloss and possibilities for more aggressive promotion of Red October candy would be sources of additional value. Also, Menatep knew that Red October was located on land that was worth up to \$60 million, although using it for anything other than chocolate production would probably cause political problems. In thinking about the required rate of return, Milner knew that Western fund managers wanted at least 50% per annum, while Russian investors usually were not satisfied unless they received significantly more.

Red October's initial reaction to tender offer

On July 12, Red October's Board of Directors recommended to its shareholders that they refrain from tendering their shares until the Board could conduct a "detailed analysis of the situation." In the recommendation, they noted that the offer had been unsolicited. Further, they suggested that the offer price (\$7.50 per share) was significantly lower than the "real" value of the shares, referring to analysis conducted by Russian and foreign investors at the time of the November share offering.

The next day, Red October management decided to fight the bid. They announced over the factory's intercom that employees stood to lose their jobs if Red October was taken over by Koloss. Despite Menatep's assurances to the contrary, Red October managers told reporters that they too feared for their jobs. The reaction of employee Vasilii Melekhov was typical: "Why should I sell my shares? I get dividends, I get free lunches, I get cheap food products . . ." Another employee expressed concern that "Koloss won't chop our nuts evenly—they'll just hack them up any old way. And they won't roast them." The head of the cocoa department stated that the bid "is not about money, but about jobs and loyalty to this factory."

Koloss ups the ante

On Monday, July 17, Koloss offered to negotiate a higher price for Red October. The next day, Alliance-Menatep held a press conference announcing a new offer price: \$9.50/share. Milner

stated that the increase had been made “in response to demands from major shareholders, upon whom the success of the tender depends in large measure.”

Red October's Decision

Yuri Yegorov sat at his desk that Tuesday night staring at his cold tea. A week had passed since Koloss had made its first offer and CEO Daursky had asked him for his recommendation on what to do. Although Daursky had approved the steps taken to date, he was concerned that Menatep might be unstoppable. Employee loyalty would be tested by the \$9.50 offer price; many older employees, who earned less than \$100 per month, owned several hundred shares. Worse, some institutional shareholders hinted that they might sell at \$9.50 per share. Some brokers were quoting prices as high as \$9 per share, indicating that the market was taking the bid seriously. Over the past few week, Yegorov and Daursky had consulted with several would-be advisors, including both Grant and foreign investment banks, who had suggested two ways for Red October to respond to Koloss' challenge.

Western investment banks recommended that Red October seek out a “white knight,” an acquirer more acceptable to Red October management than the Koloss/Menatep group. CS First Boston, one of the leading Western banks in Moscow, argued that the Koloss offer valued Red October more highly than the market, and that Red October would have difficulty remaining independent now that it was “in play.” They suggested that a Western strategic partner, such as Nestle or Cadbury-Schwepps, might be willing to pay a premium for Red October as a way of speeding penetration into the lucrative Russian confectionery market.

Grant, on the other hand, recommended that Red October mount a takeover defense. On the day the tender offer was announced, Grant's professionals had consulted U.S. finance textbooks to understand how such scenarios played themselves out. After meeting with Western legal experts, Tsarkov recommended that Red October adopt a “poison pill” defense which would take advantage of the fact that Red October's board was authorized to issue up to two million shares without consulting shareholders. Such an issue could make it more difficult for Koloss to gain control for they could place the shares in friendly hands. In addition, Tsarkov suggested that management could offer to compensate employees in the event of a change in control, thus making Red October less attractive as a takeover candidate.

As he thought about the options, Yegorov wondered what Red October was really worth. Grant had prepared cash flow projections and had provided an analysis of comparable financial ratios for foreign companies to help value Red October. (See **Exhibits 8a, b, and c** for Grant's analysis; and **Exhibits 9 and 10** for financial market data). Why would Menatep believe that Red October was more valuable than the stock market did? Finally, how would Red October's various shareholders think about value? The answer to this question would largely determine their behavior.

Yegorov began to write his recommendation.

Exhibit 1 Offer to purchase Red October shares

Offer to Purchase for Cash
Fifty One Percent (51%)
of
All Shares of Common Stock Outstanding as of July 11, 1995
of
JOINT STOCK COMPANY "KRASNYJ OCTYABR"
by
JOINT STOCK COMPANY "KOLOSS"
at
US\$ 7.50 Per Share
payable in Rubles at the exchange rate
of MICEX on the date of payment.

For purposes of the Offer
ALLIANCE-MENATEP INVESTMENT COMPANY
is acting as Financial Advisor
to Joint Stock Company "Koloss"
and
TRUST AND INVESTMENT BANK
is acting as the Depository.

The Offer is not being made, directly or indirectly, in the United States of America or Canada, by any means or instrumentality (including, without limitation, the post, facsimile transmission, telex and telephone) of inter-state or foreign commerce, or by the use of any facilities of a national securities exchange, of the United States of America and may not be forwarded or transmitted in or into the United States of America or Canada. The Offer is only being made to persons in the United Kingdom whose ordinary activities involve them, as principal or agent, in acquiring, holding, managing or disposing of investments for the purposes of a business carried on by them or to whom this document may otherwise lawfully be issued or passed on by reason of, or of any regulation made under, Section 58 of the Financial Services Act 1986 of Great Britain. In addition, the Offer is not being made in any jurisdiction outside the Russian Federation in which it would be unlawful, or to citizens, residents or nationals of any such jurisdictions.

The date of this Offer to purchase is July 11, 1995.

Exhibit 2 Photograph of Red October's Factory in Moscow



Note: The Red October factory is located on the Moskva River in the brick buildings on the right. To the left, one can see the Kremlin's spires.

Source: Red October Annual Report, 1994

Exhibit 3a Red October shareholders as of July, 1995

<u>Shareholder</u>	<u># of shares</u>	<u>% outstanding</u>
Legal entities:		
General Investing ^a	300,000	4.7%
Kholdinvest ^a	300,000	4.7%
Trud ^a	300,000	4.7%
Russky Uzor ^b	800,000	12.6%
The East Europe Development Fund Ltd.	530,000	8.3%
Pervy Investitsionny Vaucherny Fond (Russian mutual fund)	180,990	2.9%
Krasny Oktyabr [Red October]	161,446	2.5%
Moscow Property Fund (Government)	150,000	2.4%
MN-Fond (Russian mutual fund)	150,000	2.4%
James Kapel (Held in street name for two clients)	122,000	1.9%
CS First Boston	120,000	1.8%
Touton SA	100,000	1.6%
Rossiiskii Kredit (Bank)	100,000	1.6%
Financial Center Grant	<u>170,000</u>	<u>2.7%</u>
14 legal entities owning between 100,000 and 1 million shares	3,484,436	54.8%
Other legal entities	<u>617,872</u>	<u>9.7%</u>
All legal entities	4,102,308	64.5%
Individuals:		
3 individuals owning more than 15,000 shares	149,254	2.3%
43 individuals owning between 5,000 and 15,000 shares	369,722	5.9%
492 individuals owning between 1,000 and 5,000 shares	760,685	12.0%
approx. 9,000 individuals owning less than 1,000 shares	<u>973,810</u>	<u>15.3%</u>
Total owned by individuals	<u>2,253,471</u>	<u>35.5%</u>
Total shares owned	6,355,779	100.0%

^a Thought to be influenced by Red October management

^b Controlled by Red October management

Source: Alliance-Menatop

Note: Red October's Board was authorized to sell an additional 2,000,000 shares to a "strategic investor."

Exhibit 3b Red October Board of Directors

<u>Name</u>	<u>Company</u>	<u>Position</u>	<u>Shares owned as of 11/94</u>
*Chebotarev, M. Yu.	First Voucher Fund	Manager	0
Chernyakov, S. S.	Red October	Chief of Chocolate Department	2,493
Daursky, A. N.	Red October	General Director	17,217
Fedeniuk, K. A.	Red October	Head of Legal Department	2,430
Khitsov, V. Ye.	Red October	Chief Engineer	3,739
Kondakova, I. A.	Red October	Chief Technologist	2,253
Mankovich, G. N.	Red October	Deputy Director	4,082
Yegorov, Yu. I.	Red October	Chief Economist ¹	2,621
Berlin, A. D.	Gosinkor	Director of Investment and Healthcare	480
Bessmertny, S. P.	National Voucher Investment Fund	Manager	0
Chistoplyasov, S. I.	Russky Uzor	President	2,520
Dekkach, A. E.	Moscow Real Estate Inc.	Managing Director	0
Fedorov, A. A.	Moscow Technological University	Professor	57
Orekhov, A. V.	Grant	General Director	1
Ushakov, V. Yu.	Moscow Investment Fund	Manager	0
Total			<u>37,893</u>

* Chairman

¹ Under Soviet central planning, the chief economist was responsible for allocating resources (labor, raw materials, capital) in order to meet external plan targets. After privatization, the position became increasingly similar to that of a Western chief financial officer.

Exhibit 4a Production volume of major Moscow confectioners

<u>Company</u>	<u>Tons produced</u>	
	<u>1994 Q2</u>	<u>1993</u>
Red October	29,417	59,179
Bolshevik	24,888	61,160
Babayevskoye	21,832	39,010
Rot Front	21,227	46,876
Udarnitsa	10,468	16,914

Source: Red October 1994 Share Offering Memorandum

Exhibit 4b Red October 1994 sales by region

<u>Domestic:</u>	<u>Tons</u>	<u>% of total</u>	<u>Export:</u>	<u>Tons</u>	<u>% of total</u>
City of Moscow	31,246	51.8%	Afganistan	1,630	2.7%
Moscow Province	4,353	7.2%	Mongolia	1,295	2.1%
Tula Province	1,429	2.4%	Ukraine	423	0.7%
Saratov Province	593	1.0%	Kazakhstan	107	0.2%
Rostov Province	766	1.3%	Israel	90	0.1%
Krasnodar Territory	597	1.0%	Uzbekistan	56	0.1%
Stavropol Territory	537	0.9%	Belarus	10	0.0%
Perm Province	400	0.7%	Armenia	6	0.0%
Irkutsk Province	560	0.9%	Germany	34	0.1%
Lipetsk Province	409	0.7%	Total export sales	3,651	6.1%
Astrakhan Province	409	0.7%			
Tomsk Province	519	0.9%	Total sales	60,270	100.0%
Other regions of Russia	8,869	14.7%			
Sales for hard currency	5,932	9.8%			
Total domestic sales	56,619	93.9%			

Source: Red October 1994 Annual Report

Exhibit 4c Red October Historic Production Volume

<u>Year</u>	<u>Tons produced</u>
1985	59,010
1986	58,215
1987	58,605
1988	59,466
1989	62,628
1990	63,466
1991	63,306
1992	52,744
1993	59,179
1994	60,539

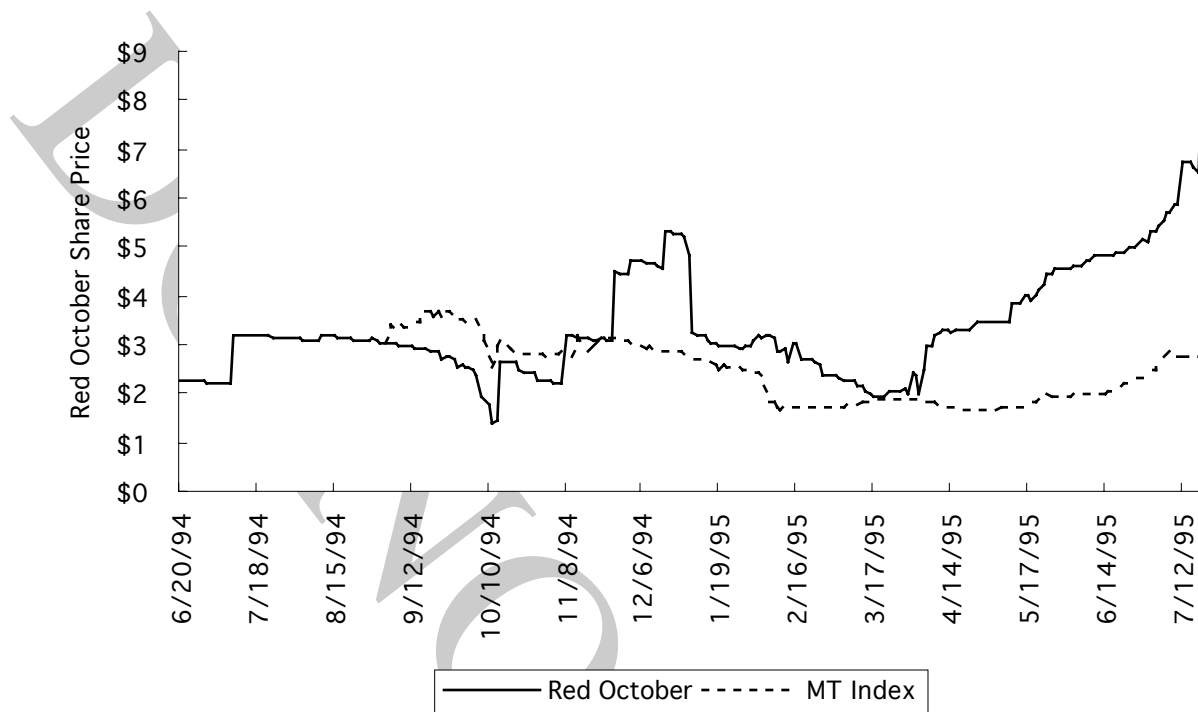
Source: Red October 1994 Annual Report

Exhibit 5 Red October Consolidated Income Statement 1993-1994

	<u>1993</u>	<u>1994</u>
Gross sales revenue	\$76,106	\$115,457
Sales taxes	<u>7,115</u>	<u>11,782</u>
Net sales revenue	68,991	103,675
Cost of goods sold	<u>41,920</u>	<u>68,819</u>
Gross income	27,071	34,856
Other income	<u>712</u>	<u>474</u>
Pre-tax income	27,783	35,330
Profit tax	<u>8,394</u>	<u>13,250</u>
Net income	\$19,389	\$22,080
Shares outstanding (thousands)	2,240	6,356
Earnings per share (EPS)	\$8.66	\$3.47

Notes: Figures in \$000s at prevailing exchange rates.
Income statement prepared according to GAAP.
Shareholders were issued one new share of stock as a dividend in 1993.
Income statement data audited by Grant-Audit.

Source: Red October 1994 Annual Report

Exhibit 6a Red October Share price relative to Moscow Times Index

Notes: Moscow Times Index inaugurated on September 1, 1994, shown relative to Red October.
 Moscow Times Index reflects prices in US dollars at current exchange rates.
 Data not available for Red October share prices prior to June 20, 1994.

Source: Skate Press

Exhibit 6b Bid/Ask spread for Red October shares

	<u>Bid Price</u>	<u>Ask Price</u>	<u>Bid-Ask Spread</u>
May 22, 1995	\$3.17	\$4.50	\$1.33
May 29, 1995	3.87	4.85	0.98
June 5, 1995	3.94	4.93	0.99
June 12, 1995	4.05	5.05	1.00
June 19, 1995	4.54	5.06	0.52
June 26, 1995	4.46	5.28	0.81
July 3, 1995	4.72	5.70	0.98
July 10, 1995	5.06	6.23	1.17
July 17, 1995	5.48	7.50	2.02

Note: Prices are quoted in US dollars; shares trade in ruble equivalent.

Source: Skate Press

Exhibit 7 Red October Balance Sheet 1993-1994

	<u>1993</u>	<u>1994</u>
ASSETS		
Current Assets		
Cash and cash equivalents	\$1,287.1	\$4,502.8
Accounts receivable	2,431.3	1,954.6
Other receivables and pre-paid expenses	5,340.5	10,730.0
Inventories	7,640.9	7,525.1
Other current assets	<u>0.4</u>	<u>7.3</u>
Total current assets	16,700.2	24,719.8
Fixed and other assets		
Long-term investments	3,040.1	2,958.8
Fixed assets	4,756.5	11,469.7
Accrued depreciation	<u>1,326.1</u>	<u>7,996.4</u>
Fixed assets less accrued depreciation	3,430.4	3,473.3
Intangible assets	<u>0.1</u>	<u>1.4</u>
Total fixed and other assets	<u>6,470.6</u>	<u>6,433.5</u>
Total assets	\$23,170.8	\$31,153.3
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities		
Accounts payable	\$2,849.4	\$1,351.0
Tax and insurance liabilities	1,094.0	3,290.2
Bank and other loans	-	1,690.1
Accrued and other liabilities	<u>2,931.1</u>	<u>494.5</u>
Total current liabilities	6,874.5	6,825.8
Long term debt	<u>-</u>	<u>-</u>
Total liabilities	6,874.5	6,825.8
Equity		
Authorized capital	179.6	2,816.9
Additional capital	4,866.0	11,195.5
Retained earnings & funds	10,743.6	10,315.2
Deferred income	<u>507.0</u>	<u>-</u>
Total equity	<u>16,296.2</u>	<u>24,327.6</u>
Total liabilities and equity	\$23,170.7	\$31,153.4

Note: Figures in \$000s at prevailing exchange rates: 1994: 3,550 Rbl/US\$, 1993: 1,247 Rbl/US\$
Balance sheet prepared according to GAAP. Fixed assets were restated in the first quarter of 1994.
Balance sheet data audited by Grant-Audit.

Source: Red October 1994 Annual Report

Exhibit 8a Red October Cash Flow Projections 1996-2001

	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>
Tons of candy sold	58,340	59,272	61,390	61,390	61,390	61,390
Sales of Candy (\$ thousands)	\$155,391	\$161,480	\$170,566	\$171,290	\$173,436	\$173,436
Cost of candy sold	91,844	102,844	114,089	116,113	119,206	119,206
Gross profit on candy	63,547	58,636	56,477	55,177	54,231	54,231
Other income	<u>1,015</u>	<u>2,052</u>	<u>2,482</u>	<u>2,533</u>	<u>2,540</u>	<u>2,540</u>
Gross profit	64,562	60,688	58,959	57,710	56,771	56,771
SG&A	12,654	14,657	15,890	17,261	18,783	18,783
Interest on long-term debt	<u>60</u>	<u>600</u>	<u>600</u>	<u>480</u>	<u>360</u>	<u>360</u>
Operating profit	51,848	45,430	42,469	39,970	37,628	37,628
Profit Tax	16,753	12,664	11,361	10,655	12,441	13,296
Other Taxes	2,557	3,068	3,682	4,418	5,081	5,081
Dividends from shareholdings	<u>150</u>	<u>295</u>	<u>545</u>	<u>485</u>	<u>300</u>	<u>335</u>
Net Income	32,688	29,994	27,971	25,382	20,406	19,586
Depreciation	2,684	3,016	3,730	3,042	4,327	-
Increase in net working capital	7,769	1,096	1,635	130	386	-
Capital expenditures	11,385	13,015	14,490	13,200	6,920	-
Change in long-term debt	1,000	4,000	-	(1,000)	(1,000)	-

Cash flow projections prepared by Grant Financial Center

Source: Red October

Exhibit 8b Grant calculation of Red October Cost of Capita

The discount rate is calculated using the “cumulative” method:

Risk free rate (U.S. Treasury bonds)	6%
Premium for company size:	2%
Premium for management quality	2%
Premium for diversification of company	2%
Premium for diversification of client base	2%
Premium for stability of income projections	2%
Russia country risk premium	7%
Discount rate	23%

Grant describes the premiums it assigned as follows:

“The Company, although it is one of the largest candy factories in Russia, is medium-sized by Western standards. Therefore the risk premium should be no more than 2%. The quality of management of the Company, in our opinion, is rather high. We believe, however, that there is much redundancy, and the subsidiaries and other companies, in which Red October has a significant shareholding, are not tightly enough managed. Therefore we assign a risk factor of 2%. The diversification in production of the Company, and its ability to reorient itself to new products, is fairly high. The risk premium is 2%. The level of diversification of the client base is considered to be high. The reliability of the clients base is also deemed to be high. The risk premium equals 2%. The stability of receipt of income and the level of certainty of receiving them, in our opinion, is reasonably high, but taking into account the intense competition in the candy market, it can be estimated at 2%.”

“In addition to the risks already mentioned, there also exists country investment risk, calculated as an indicator of the probability of loss of income from the enterprise as a result of certain political decisions, economic instability, social changes, etc. According to the analysis of Deloitte & Touche, Russia belongs to the group of companies with a medium level of risk, and therefore this figure is 7%.”

Source: Red October

Exhibit 8c Grant Analysis of Foreign Confectionery Firms

<u>Company</u>	<u>Country</u>	<u>Industry</u>	<u>Financial Ratios</u>	
			<u>Price/earnings ratio</u>	<u>Price/Book value</u>
Lindt & Spruengli AG	Switzerland	Chocolate	15.7	1.9
Armour Trust Plc	UK	Confectionery, auto parts	13.5	1.8
Tootsie Roll Industries, Inc.	US	Confectionery	18.9	3.0
Freia Marabou AS	Norway	Confectionery, snacks	14.0	2.3
Kanro Co. Ltd.	Japan	Confectionery	35.4	1.4

Source: Red October

Exhibit 9 Selected Market Data as of July, 1995

Russian Market:

GKO (Russian treasury bills):	80%-150%
GKO hedged into USD\$:	40%-44%
Inflation rate (1993)	900%
Inflation rate (1994)	210%
Red October equity beta*:	0.45

The Russian Ministry of Finance announced its first ever medium-term bond issue in June, 1995. Interest rates were floating and pegged to GKO yields. No long-term ruble-denominated bonds had been issued to date.

*The beta is calculated using daily stock returns and the Moscow Times Index as the market portfolio. Note, however, that companies in the energy sector comprise 73% of the market capitalization of the MT index.

United States market:

Treasury bills (1 year)	5.59%
Treasury bonds (5 year)	6.01%
Treasury bonds (30 year)	6.72%

Exhibit 10 Top 50 publicly-traded Russian companies as of July, 199

Rank	Issuer	Market capitalization \$ mm	Price/Earnings ratio*
1	Gazprom	3,671.77	4
2	LUK Oil Holding	3,160.74	
3	Unified Energy Sistem	1,435.06	1
4	Inkombank	1,301.15	
5	Rostelecom	1,087.83	4
6	Yuganskneftegaz	1,010.49	118
7	Surgutneftegaz	946.96	4
8	Mosenergo	817.80	
9	Norilsk Nickel	704.12	2
10	LUK Oil Kogalymneftegaz	607.98	
11	Noyabrskneftegaz	496.81	10
12	Irkutskenergo	333.64	2
13	Krasnoyarsk Aluminium Factory	307.49	3
14	LUK Oil Langepasneftegaz	296.21	
15	Purneftegaz	286.82	12
16	Moscow Telephone	282.75	4
17	Megionneftegaz	244.67	5
18	Tomskneft	229.67	
19	Chernogorneft	217.52	9
20	Nizhnevartovskneftegaz	186.75	
21	St.Pb. Telephone	186.63	2
22	Novolipetsk Ferrous Metal Factory	179.62	
23	Bratsk Aluminium Factory	178.93	3
24	KamAZ	125.24	
25	Far Eastern Shipping	115.51	361
26	Orenburgneft	114.17	1
27	Kirishinefteorgsintez	109.05	1
28	Condpetroleum	108.61	
29	Magnitogorsk Ferrous Metal Factory	107.97	
30	Sakhalinmorneftegas	101.00	
31	Sayansk Aluminium Factory	100.81	2
32	Komineft	89.21	
33	GAZ Auto Plant	82.94	
34	Bratsk Timber Complex	81.82	2
35	Novorossiysk Sea Shipping	75.17	
36	LUK Oil Urayneftegaz	71.87	
37	AvtoVAZ	69.64	
38	Permneft	61.66	
39	Promstroybank of Russia	55.96	
40	Vareganneftegaz	54.12	
41	Krasny Ochyabr [Red October]	53.49	1**
42	Trade House GUM	52.06	1
43	Sredneuralsk Copper Factory	51.77	
44	Lenenergo	50.89	4
45	Primorsk Sea Shipping	50.88	7
46	Syktvykar Timber Complex	46.51	
47	Nizhniy Tagil Ferrous Metal Factory	45.09	
48	Nizhnovsyazinform	39.39	3
49	Novorossiysk Trade Port	38.05	
50	Nosta, Orsk-Halilovsk Factory	35.51	
Total MC for 50 Companies		20,159.80	

* P/E ratios based on casewriter estimates for 1995. Data not available for some companies.

** Red October P/E ratio based on its stock price prior to takeover attempt.

Source: Skate-Press