Trading Foods in Russia

Stefano Vlahovic stood beneath the gateway of a fourteenth century Venetian building in Hvar, a city close to Split at the southern tip of Croatia. He was admiring a seal, chiseled into stone, that bore the name Vlahovic. As he stood there with his wife Jena, an old man walked up and remarked casually that this building had once belonged to the old Vlahovic merchant family. Stefano was moved that there were still Croatians who remembered his family, even though the Vlahovic operations had relocated to Italy two generations before. Indeed, the Vlahovic family trading traditions could be traced back to the seventeenth century, when the family had established an old Venetian trading house which operated out of Hvar, then the southern border of the Venetian Republic. In 1994, the local dialect spoken in Hvar still more closely resembled Italian than Serbo-Croat.

Vlahovic wondered whether his forefathers had a strategy for their business. Could they have survived over the centuries as a trading family by operating in the day-to-day manner in which he had managed his small trading company in Moscow over the past two years? Nonetheless, in 1994, Stefano Vlahovic could be satisfied. He had turned his company from being technically bankrupt less than two years before, into a thriving enterprise with a trading volume of $45 million, most of which involved recurring business. In addition, he had uncovered several excellent growth opportunities, that could very rapidly grow his company in a short time, if everything went right. However, he had not developed a systematic way of either evaluating these growth options in the light of resources available to him, or assessing the synergies that the different businesses might yield in the future. As a matter of fact, he had barely had time to think about these issues, because his days in the office were spent fighting one fire after another.

The goods which Vlahovic exported and imported into Russia had mostly consisted of food stuffs, metals, chemicals, and consumer goods. But Vlahovic's operations were bumping against barriers. He had problems financing expansion. He had problems hiring appropriate people. Stefano Vlahovic was worried about the fact that he couldn't tell what kind of business he would be engaged in next month, let alone next year. Had his company finally become large enough to need a strategy? Did he require a strategy to communicate to his employees where his company was headed, and to enable them to make decisions that would lead the way? How could he start thinking about these problems in a fashion that made sense? When would he find the time to think about these problems?

Peer Ederer, MBA'94, prepared this case under the supervision of Professor Ray A. Goldberg as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

History of OMNIA Trading

Stefano Vlahovic's father had been a textile engineer, trading textiles throughout all of central Europe, out of the head office in the Split region, subsequently Croatia, formerly Yugoslavia. In 1946, when Yugoslavia became a socialist country, the company was nationalized except for a small branch in the Italian town of Triest. In this way Triest in Italy became the center of the new trading company called OMNIA Trading which Stefano's father had to rebuild. Over the years, the company managed to establish itself as a small textile trading operation, trading between Central European countries and Italy.

Another watershed in the family history occurred in 1973. In 1972, Stefano Vlahovic's father had received notice through a trading partner, who was a friend of a friend in the Soviet Union, that a representative of the Soviet Chamber of Commerce had suffered a stroke on a train trip from Moscow to Rome. Vlahovic's father was asked to help in the matter. He secured a bed in Triest's best hospital for the representative. He also arranged for special meal and care services for the patient, which at the time was important in some Italian hospitals since the standards of care could be poor. A few months after the representative had recovered and returned to the Soviet Union, the Vlahovic family was invited to visit Moscow. Tragically, Stefano Vlahovic's father died before the visit and Stefano's mother, Lucia Vlahovic, made the initial trip to the Soviet Union. It turned out that the hospitalized representative was a general with the KGB. During the visit Lucia Vlahovic was asked by various state agencies whether she might be interested in exporting various goods to the Soviet Union.

Lucia Vlahovic had trained as an accountant many years before, although she had not been actively involved in the company. In the uncertainty following the Vlahovics' bereavement, the general manager virtually seized the company by taking-off with all the trading contacts and employees. Lucia Vlahovic was left with an office but almost no business—except for the recent Moscow connection. Lucia decided to make the best of it and consequently developed more and more business with the Soviet Union. In 1976, she opened a representative office in Moscow. Throughout the 1970s and 1980s, OMNIA Trading was a small concern specializing in small shipments between Italy and the Soviet Union. Trading volume fluctuated between $10 and $30 million a year. Despite its small size, in 1980, OMNIA Trading won the Golden Mercury Award, awarded by the World Trade Council to the best trading house in the Soviet Union.

Stefano Vlahovic vividly remembered his childhood. He recalled for instance, how he was chauffeured around by the KGB on his first visit to Moscow in 1976. At the time, as an 11 year-old, he was rather pleased to be treated like royalty. The immense car that he rode in had tinted windows, and was given automatic right of way on the streets. Any goods in a toy shop that he displayed only a passing interest in were immediately purchased by the security personnel. Naturally, Vlahovic believed the Soviet Union was the place to be. As he grew older, however, the frequent trips to Moscow with his mother made him more and more aware of the repression and misery of the people who had to live under the Communist system.

During the 1980s, the trading contacts between Moscow and Italy became increasingly lucrative for Lucia Vlahovic. OMNIA became highly profitable and generated substantial investible cash. Trading in the Soviet Union until the end of the 1980s was, by definition, a seat-of-the-pants operation. All purchases, including imports, were dictated by a plan and the plan was dictated by government officials who planned years ahead. Sudden shortfalls often needed to be covered at very short notice. When this happened quantity and delivery were the critical factors in winning contracts. Price was also a consideration, however, information on competitive tenders was commonly available. OMNIA occupied a valuable niche, since larger trading houses could usually not be bothered with such one-shot, small volume, deals.

Russia in the Final Turbulent Days of Perestroika

The end of the 1980s was a turbulent time, not only within Russia but also for OMNIA Trading. Stefano Vlahovic graduated from the University of California with an economics degree in January 1989. During his undergraduate study, Vlahovic had spent one year in Japan at Sophia University. After graduation, Vlahovic decided to take a six-month course at Moscow's prestigious Academy of National Economy associated to the Council of Ministers, where he learnt fluent Russian. Meanwhile, Lucia Vlahovic had begun to use the surplus profits at OMNIA to diversify the business. She purchased a 50% interest in a trading house/rent-a-car/retail shop company in Hungary. She also developed a three-partner trading joint venture with a Soviet monopolist construction materials trader and a Slovenian manufacturer. In addition, she invested in tourism and hotels on the Adriatic sea, and built up a travel agency chain. Lucia Vlahovic further obtained a number of import distributorships in her native Yugoslavia. In all, OMNIA established eight representative offices throughout the world, from Kuala Lumpur to Washington D.C.. The diversification goal was aimed at moving OMNIA away from the stress and uncertainty of trading, towards more predictable and accommodating businesses.

However, despite Lucia Vlahovic's diversification strategy, OMNIA's Moscow business promised extraordinary growth. In 1989, Gorbachev desperately tried to make his Perestroika and Glasnost policies work. In a bid to remain popular with the population and to mop up pent-up demand, he instructed the state purchasing system to stock the markets, if need be by way of imports. As a result the purchasing system became chaotic. For OMNIA to capitalize on this opportunity, it needed to upgrade its Moscow office by recruiting more expatriate and domestic personnel.

Under these circumstances, Stefano Vlahovic took over OMNIA's Moscow operations. He did it partially due to a lack of alternatives, partially for the lure of running his own show right out of college, and partially due to the excitement of witnessing Russia's liberalization. At first it seemed like the perfect choice. In 1989 alone, Vlahovic signed contracts worth in excess of $250 million. This represented a tenfold increase over the previous year's trading volume. Stefano Vlahovic even had to forego some trades, because OMNIA's head office in Milan was too incredulous about what was going on. Once, for instance, Vlahovic was asked to import 10,000 tons of detergent, without any specifications, just anything as long as the price was reasonable. OMNIA's general manager in Milan, a former export manager for Colgate Palmolive Italy, doubted such sales could be made because, in his own words, "I have never been able to sell without a specification." He therefore refused to quote a price on the deal believing that Vlahovic was a novice in the business, which was true, and that the young graduate just did not know the ropes well enough.

Consumer goods were particularly popular in Moscow in the late 1980s. One of the contracts signed in 1989 was worth $96 million and comprised various items such as shampoo, toothpaste, soap, and detergent. Another contract signed by Lucia Vlahovic in 1988, was for large amounts of toothpaste. When OMNIA secured the contract, it sourced the toothpaste from a major international toothpaste manufacturer. Soon afterwards, the manufacturer was selling OMNIA more toothpaste for the Russian market than it sold in Italy and France combined. In 1989, the volumes became so large that the Italian brand name manufacturer ran out of capacity. OMNIA then resorted to a private label producer and in this fashion, OMNIA ended up with its own brand, *Omnident*, in the Russian market.

The way the *Omnident* name came about typified the way business in Russia was conducted in 1989. After concluding the negotiations with a Russian counterpart about terms, pricing, and specifications for 40 million tubes of toothpaste, Stefano Vlahovic was asked, "By the way, what is the name of this toothpaste?" It occurred to Vlahovic that he had not actually thought of a brand name for the private label toothpaste, so on the spur of the moment, he decided on *Omnident.*

Reality Catches Up—Payment Problems

With the disintegration of the Soviet Union in 1990-1991, and the emergence of the CIS, trading behavior started to change considerably. Before disintegration, the Soviet Union had been a very reliable payer. In its entire history of trading with the Soviet Union, OMNIA had not had a single payment delayed by even a day. In 1989, however, delays appeared and money started to trickle in weeks after it was due.

Finally, OMNIA was forced to stop deliveries in January 1990. At this time, the total debt that the Soviet Union owed to OMNIA amounted to about $25 million—several multiples of OMNIA's equity. Technically, Vlahovic's business partners, the exporting companies in Italy expecting payment from OMNIA as the intermediary, could have forced the company into bankruptcy. However, creditors would then have had no chance to ever recover money because OMNIA Trading was their only link to Russian officials.

It took until October 1993 for OMNIA finally to recover most of the outstanding payments. Italian officials proved as bureaucratic during the recovery of the debts as their Russian counterparts. In the meantime, from 1990 to 1992, OMNIA survived by exporting goods to Russia that were covered under guaranteed credit lines provided by the Italian government. Volume averaged about $10 million a year, but was unlikely to be maintained since the guaranteed credit lines were rapidly depleted and no new lines appeared forthcoming.

Lucia Vlahovic's other ventures in Central Europe had fared not much better than the Moscow operations. Between 1988 and 1992, the head office in Milan went through no fewer than 13 general managers. The value of the Yugoslavian distributorships also evaporated with the disintegration of the country.

OMNIA Trading had, for instance, secured an exclusive distributorship for Scotch whisky in Yugoslavia. One of the first shipments under the arrangement became tangled-up in the Croation war of secession in 1992. OMNIA was left with three truckloads of Scotch abandoned in Croatia, uninsured for acts of war. Each truck had goods loaded worth about $140,000. For several months the company could not access the trucks as they were caught between the fronts. One truck was actually used as a barricade against tanks. However, once the situation in Croatia settled down, OMNIA was able to swap the trucks (with the goods miraculously intact) against dinars, the former Yugoslavian currency. Although the dinars had little currency value left in Croatia, OMNIA sent them to Sarajevo, Bosnia, where dinars were still legal tender. From Sarajevo the money was transferred by bank to Belgrade where it was used to purchase linoleum. The linoleum in turn was sold to Russia where Rubles were converted into dollars and, thus, losses recovered.

Both Lucia Vlahovic's Hungarian and Slovenian joint ventures turned sour, and the hotel business also failed to flourish, even though Split, where the four star resort hotel was located, had never been touched by civil war. Fortunately for OMNIA, hyperinflation had reduced the interest burden on the $4.5 million property to about $15 per month. Undeterred by these events, Lucia Vlahovic remained convinced that Croatian real estate was vastly undervalued. She developed a strategy whereby she planned to buy a number of hotels and set up various travel agencies throughout the world to feed her hotels. In Zagreb she hired a former tourist minister for the sole purpose of lobbying the Croation government. In Bosnia she was the exclusive representative for Fiat and Alfa Romeo. Stefano Vlahovic was not entirely convinced of the wisdom of the strategy, but envied his mother for the fact that at least she had a strategy, while he didn't.

At the end of 1992, Stefano Vlahovic and his mother decided to split their business into two companies, with Stefano owning the Moscow trading operations and the Washington D.C. office. During the difficult years of 1991 and 1992, Stefano had moved back to Milan and directed the Moscow office from Italy. Stefano had also been married during the summer of 1990 to Jena, an American citizen whom he had met during his exchange study in Japan. By the end of 1992, with the Russian debts finally in the process of being paid back, and the Italian credit lines winding down, Stefano faced the real question of whether the Moscow operations should not simply be terminated.

On the one hand, Stefano Vlahovic spoke fluent Russian, had a number of high level contacts in the state procurement system, and had entrepreneurial business experience on the ground—a rarity then as in 1994. On the other hand, neither Stefano nor his mother had any significant money left to invest in the business, the value of the contacts was questionable given the rapid changes that Russia was experiencing, and there was virtually no on-going viable business that could be relied on. There was also the question of whether Stefano and Jena wanted to start their family in the deteriorating conditions of Moscow. Vlahovic decided to take the plunge. In October 1992, OMNIA Trading was incorporated as a Russian company, and in March 1993, Stefano took effective ownership control of the Moscow and Washington offices. Lucia Vlahovic gave Stefano a starting equity of $150,000. Trading volume at this time was of about the same amount.

Life in Moscow in 1993

In 1993, Stefano Vlahovic was just ordering his fourth car, a Volvo. Volvos were rapidly becoming the car of choice in Moscow, offering an ideal combination of sturdiness, to withstand the punishment imposed by Moscow's foot-deep pot holes, and comfort. The BMW that Vlahovic had driven in Italy, and subsequently imported to Russia, had been stolen. The same thing happened to Vlahovic's next car, a Range Rover. The third car, purchased by Lucia Vlahovic, was a Mercedes-Benz carrying $5,000 worth of security devices. Stefano was hoping that the sheer weight of the three ton car would make theft impossible. He knew for fact that not even the Moscow police had equipment strong enough to move the German monster. Nonetheless, one night, between 2:00 a.m. and 5:00 a.m., the car disappeared without even a sound. Two of OMNIA's office Ladas also vanished. Vlahovic was not happy about the situation. He turned to an old Volvo that had clocked more than 70,000 miles, the limit of any car dealing with Moscow's roads. Vlahovic found that the best way to protect foreign cars in Moscow was to hire a driver, pay him enough not to be bought by gangsters, and have the driver literally sleep and eat in the car. Vlahovic, however, felt this was quite an intrusion on a person's privacy.

Real estate in Moscow was another difficult matter. Vlahovic paid his landlord $1,000 a month for a living area that was considered to be high-class in Moscow, although, most Western visitors would have been shocked by its condition. At times the entrance hall smelt like a urinal. Both entrance doors were in ruins. The pavement was barely paved and rain would spawn extensive mud-holes on the way to the door. The elevator did not look reliable. Vlahovic's neighbor had been caught attempting to incinerate another neighbor's apartment for some petty revenge. The apartment was only intended as a temporary arrangement until Vlahovic found more suitable quarters. However, it was difficult to find a good property. On one occasion Vlahovic managed to find an apartment in an old house that he wanted to buy. The vagaries of privatization meant that purchase prices in early 1994 only amounted to about three years rent. The deal was almost sealed when the Russian counterpart demanded a Russian reference from a recognized individual. However, after Vlahovic asked a friend at the Moscow police to provide a reference, the sellers just disappeared without a trace.

When Jena Vlahovic arrived in Moscow and saw the apartment she burst into tears. She was eight months pregnant at the time and was not prepared for the shock of the environment she faced. However, all things were relative in Moscow, and foreigners soon learnt to distinguish substance from appearance. Many foreigners lived under similar or worse conditions to the Vlahovics. The apartment itself was clean and safe, had reliable access to water and heating, was actually quite spacious, and provided a pleasant view of the Moscow Zoo. From the window the Vlahovics could daily observe how the lions and tigers were fed potatoes.

Life in Moscow and Russia demanded a readiness to leave at a moment's notice. The Vlahovics' apartment was less than a mile away from the White House. From their kitchen window, Stefano and Jena Vlahovic witnessed the bombing of the seat of the Parliament in October 1993. The next day Stefano Vlahovic saw Jena, and their three month-old son Simon, onto a flight for Italy. The Vlahovics were not only concerned about security issues, but also about the fact that their apartment was in the same city district as the White House. In an attempt to freeze out the parliamentary delegates, the government had cut off phone lines and central heating water to the entire district.

Everyday life also held enough surprises for businesses, even without attempted coups or tanks in the street. News items in the Moscow Times of April 9, 1994, the day that the casewriter arrived in Moscow (nicknamed the Big Cabbage) included:

- A new interpretation of taxation rules, that would amount to a 23% investment tax.
- ultra-nationalist party leader Zhirinovsky fist-fighting with two other parliamentarians, while his bodyguards brawled with a reporter who got in the way.
- A public opinion poll finding that twice as many Russians living in cities believed organized crime, rather than President Boris Yeltsin, held power in the country.
- The resignation of the Prosecutor General Alexei Kasannik, former close ally of Yeltsin. While it was not quite clear why Kasannik had resigned again,[1] parliament and the government were locked in a two-day constitutional battle over whether they had the right to refuse the resignation or not. Kasannik in the meanwhile was announcing his intention to form a centrist party.
- Baltic countries calling on President Yeltsin to issue apologies for an order which he issued mistakenly, stating that Russia would be setting up military bases in Latvia.

[1] Kasannik had submitted his resignation six months earlier but the request was denied.

- The Kremlin announcing to the West that it proposed a link between NATO membership and inclusion in the G7 economic club.
- The discovery that Russia was still legally bound by a treaty to defend North Korea in case of foreign aggression.
- A doubling of long distance train fares. For the 700-mile Moscow to St. Petersburg route, one-way, second-class fares would increase from $4 to $8.
- Estimates for the cost of a contract murder in Russia of between $5,000 and $20,000 depending on the complexity of the hit.
- Reports of Moscow's winter season car-theft rate being about 90 vehicles a day.

Most of these news items were common fare in Moscow, except for the 23% investment tax. The foreign business community was shocked in disbelief at how the Russian government could enact such a law. How would Russia attract the much needed investment, if taxes were 23 cents on every dollar, with payment upfront? It turned out that the regulation apparently came into effect accidentally. The original intent of the decree was to stop tax evasion on a certain credit scheme involving off-shore banks. However, in combination with a number of other decrees, the new decree effectively imposed a 23% investment tax. The government's tax experts spent much of the following week trying to sort out to what degree the new decree was in fact accidental or intentional, and in either case what to do about it. The incident was representative of the confusion and uncertainty that surrounded Russia's legal and regulatory frameworks, and the additional risks that this posed for businesses.

The Food Packaging Business

Vlahovic's involvement in food packaging, specifically milk packaging, was typical of most of the businesses he was grappling with. Packaging had always been a difficult business within the Soviet Union. Food packaging was not a government priority, and besides, the Soviet economy lacked the chemicals capacity to produce enough packaging materials for all goods. Nonetheless, between 30-50% of annual agricultural produce was wasted (the better the harvest, the greater the spoilage), because of inadequate packaging among other things.

One time, in 1986, Lucia Vlahovic was able to bid on a contract for PET packaging film which had previously only been offered by European companies. Lucia located a South Korean manufacturer who provided similar quality at better productivity rates than the European bidders. Lucia Vlahovic had learned about the Korean producer through an EEC initiated anti-dumping charge. She had perceived this to be a sure signal of competitive Korean pricing. Lucia Vlahovic offered the PET film at a 30% discount and received the entire order worth $1.2 million. The Russian counterpart at the time was a company called SojuzKimExport, a state trading company set up by the Soviet Union that handled all chemical exports and imports, except fertilizers. From this initial deal other deals developed. At one point, OMNIA exported polypropylene film to Russia for use in yogurt containers. Another time, OMNIA sold processed film for general packaging, and eventually polyethylene film for milk bags.

The Russian manager in charge of film imports at SojuzKimExport during the 1980s had no technical knowledge about what he was importing or what kind of specifications he needed to secure. In addition he was notoriously unreliable. He would relay wrong spec-sheets, misplace samples, or forget which factory was making the request. In order to overcome these problems, Lucia Vlahovic always tried to keep in touch with the factories that actually used the materials, even though these factories were not allowed to import directly. The factories were the only source from which Lucia could obtain the specific information that was needed to ensure import of the correct materials.

In 1991 and 1992, packaging was a business for which Stefano Vlahovic was able to trade product using the Italian credit lines. Indeed, by the end of 1992, exporting plastic films was the only business that was left to OMNIA Trading. SojuzKimExport had accumulated debts of over $1 billion by this time. However, in the confusion of change and economic reorganization of the early 1990s, the Russian importing agency responsible for packaging film kept changing. While it could be difficult to stay abreast of who happened to be in charge, Stefano Vlahovic always knew, because his direct factory contacts would advise him on where to go and with whom to deal. In this way, Vlahovic often knew even before the central trading agency approached him, what kind and quantity of material would be required. He could therefore prepare bids much faster than competitors. Vlahovic's competition had however changed in the early 1990s. Whereas it had previously comprised other trading houses similar to OMNIA, competition now came directly from manufacturers such as Hoechst and Du Pont, or Italian chemical companies. Most trading houses had gone out of business, or retreated from the Russian market between 1989 and 1992.

In 1993, the general importing agency for Moscow for plastic packaging film had ended up with a company called Investprod. This company had a special connection to the mayoral government of the Moscow City Office. Remnants from the old state procurement system still prevailed and the particular feature of Investprod was that it was allowed to sell plastic film for milk packaging with a 0.6 coefficient on the Russian market. The 0.6 coefficient meant that factories would receive the goods at 60% of the price that Investprod paid to the importer, with the difference paid by the city government. While the factories were free to order goods from other competitors, it made Investprod the effective monopoly to be dealt with. The 60% coefficient served as a food subsidy that the Moscow city government provided to its citizens. However, in 1994, there were indications that the coefficient system would be disbanded.

Strategic Considerations

If the coefficient system was disbanded, Investprod would lose its quasi-monopoly position as the effective central purchasing agent. For Stefano Vlahovic, the change would eliminate his business partner and leave him having to sell and deliver directly to factories. The packaging trade would acquire quite a different quality: Vlahovic would have to develop a sales force and probably a marketing department as well. Would it make sense to diversify into other packaging lines? Could he start supplying solutions in packaging? Should he start advising the factories about what kind of packaging materials and/or designs to use, where and when to procure, and so on? Without the restrictions imposed by the central purchaser, Vlahovic saw a range of opportunities to grow the packaging business. But, against this, it would require a substantial investment in human resources and considerable strategic commitment.

Vlahovic thought through a three-stage process to develop his packaging business further, in case the coefficient system was abolished as some rumors suggested. In the first stage, Vlahovic would approach his current client factories in Moscow and consult with them on the optimal packaging strategy for their businesses. For instance, he knew of a film that could be used to cover yogurt, which cost 20-30% less than the pure aluminum film that was being used. Vlahovic was confident that no Russian factory would quickly be able to produce such film inside Russia, because the film was a composite consisting of four layers. Furthermore, factories would become more dependent on Vlahovic as a sole supplier since it was a specialized film. Vlahovic saw it as a win-win proposition. The factories would have lower costs and he would have a medium-term prospect on higher margin business. In the second stage, Vlahovic would start adding value to the packaging business with design support, and even product support from design engineers that he would recruit in Italy and Moscow. In the third stage, Vlahovic would start warehousing packaging materials in Moscow to allow him to supply samples and even small shipments at very short notice, instead of the two-to-three month lead times that were required in order to get the goods into the hands of the factories.

In 1994, without any investment, the packaging business generated an annual $4 to $5 million of sales. Vlahovic won around 70% of all the packaging contracts that he bothered to bid on, and these were all located in Moscow, the most competitive market. Another attraction of developing a sales force was the opportunity to sell to factories throughout Russia. Thanks to Soviet central planning, virtually all factories used the same equipment, and thus represented a ready made customer base. Vlahovic estimated that if he succeeded with the expansion plans, then polyethylene milk packaging and other closely related aspects could develop into a $25-30 million dollar business within two years, with a considerably improved margin structure over his other businesses.

Vlahovic was not really worried about competitors. The largest competitor in sight was TETRA-LAVAL, a worldwide leader in packaging which had different lines of business and was not a direct competitor in the market for milk bags. Vlahovic's goods were largely plastic films, while TETRA-LAVAL sold paper cartons that required special processing equipment. TETRA-LAVAL was leasing this equipment to the companies and in this way had captured markets. Another competitor was the German chemical giant Hoechst. However, in 1994, Hoechst had not set up a management or sales structure to deal directly with factories. Furthermore, due to its overhead, Hoechst had a substantially higher cost structure than OMNIA. Vlahovic conceded that competitors out of Taiwan or South Korea could enter the market successfully. If this happened OMNIA planned to change its sourcing strategy and start purchasing materials from South Korea and Taiwan, instead of Italy and Spain.

In order to further consolidate his relationship with his clients, Vlahovic started buying shares in their companies. The real risks to expansion in packaging were not competitive but regulatory. What would happen if a new monopoly was able to assert itself by obtaining governmental favors? Or, if the government decided to impose import tariffs on OMNIA's goods of 10%-15% or even more? This would easily wipe out OMNIA's profit structure on the imported goods, because, given the food situation in Russia, OMNIA would probably be unable to pass on the increased costs.

The way Vlahovic had conducted his business up to 1994 meant that these considerations were not a worry. Vlahovic could have simply stopped supplying those goods affected by regulations and dealt or traded in other goods. However, if Vlahovic invested money and time into a packaging strategy, it became a different game. If Vlahovic hired specialists in engineering design, if he developed a sales force and opened a warehouse, then he had a vested stake in the continuation of the business. It represented a substantially different way of making decisions than Stefano Vlahovic and his mother had previously operated in Moscow. Furthermore, Stefano had the nagging knowledge that all previous attempts by his mother to diversify into more stable businesses had turned out to be expensive flops, even though they always looked like very attractive investments at the time. Vlahovic knew that he excelled in trading, but success in strategic investment type situations had eluded OMNIA.

The critical bottleneck of a strategic investment expansion was human resources. Everybody in Moscow was looking for the same kind of people: preferably well connected, with some foreign experience or work experience at foreign companies in Moscow, an ability to speak English, but at the same time, no demands for excessive salaries. Stefano Vlahovic felt that he had an intrinsic advantage in finding better people. He could find actual talent because he knew Russians and he knew the Russian language. This meant that he could distinguish talented businessmen from talented linguists. On the other hand, Vlahovic only had a small company, and Russians, being very status-conscious, preferred to work for large, well-known, international concerns.

Vlahovic had a four-person team in mind which would develop the packaging business for him. It would comprise two engineers and two marketers, one each in Italy and in Russia respectively. Vlahovic was confident that he would find the right candidates in Italy through his mother's office there. He also had a good candidate lined up as marketer in Russia. However, the most crucial link, the Russian engineer, was still missing. He had three candidates to choose from.

Vlahovic preferred the first candidate, who was the chief engineer of one of his favorite clients. The problem was that by poaching a client's key employee, OMNIA might lose the client. At best, Vlahovic would have to deal with a new interface at the client. The second candidate was another chief engineer, but worked at a company that was not one of OMNIA's clients. Accordingly, there would not be the conflict of interest, but on the other hand, Vlahovic didn't know the candidate so well. The third candidate was a deputy chief engineer who was in many ways a perfect candidate, except that she was a woman. Vlahovic, himself, did not mind hiring women, however he knew that his clients would refuse to take a woman chief engineer seriously. Would Vlahovic be justified in hiring a person for a job that he knew all too well they would unable to perform well, through no fault of their own?

Vlahovic's Other Trading Opportunities

While the packaging business held great potential, especially in the context of the dire straits of the industry in Moscow, it was certainly not the only business with exciting growth options. Generally, Vlahovic's trades could be divided into ongoing contracts that had developed into major deals, and small experimental trades which Vlahovic used to learn about a business before engaging in larger shipments. Experimental trades were of the order of only a few hundred thousand dollars each. In 1993, they had included importing canned meat from Holland, cookies from the United States, toilet bowls from the Czech Republic, zippers, buttons, and other incidentals from Hungary to Turkmenistan, graphite to Italy, leather to Sweden, among other things.

One experimental deal that had developed into a successful large business involved chicken importing from Tyson, the world's largest chicken producer. Vlahovic had tried to sell chicken in Russia for over two years until finally, in October 1993, he managed to land a large deal for 2,300 tons of chicken worth $2.3 million. Vlahovic used trial and error to develop the right combination of purchasing agents, shipping arrangements, and financing. Vlahovic found that he could supply chicken to the market at a lower price than competitors. During the entire winter season of 1993-1994, Vlahovic sold chicken worth about $12 million to a Russian wholesaler. This was despite Vlahovic being unknown in the chicken industry and his starting late in the season. Russia's chicken season ran through the winter. Only then was there enough cold storage for frozen goods both in the distribution system and people's homes. Since the chicken season began in August-September, Vlahovic believed that in future OMNIA's chicken business would be much larger. OMNIA offered lower prices because it dealt directly with the chicken producer, and because Vlahovic arranged his own financing. Vlahovic envisioned that in 1994/95 OMNIA could be importing full shiploads of chicken instead of just containers. This would offer the company further cost advantages.

Other items that Vlahovic tried to trade included stainless steel for export to the United States. Vlahovic identified both a buyer and seller, who would generate a trade volume of about 250 tons of steel per month, at $200-$250 per ton margin on a $2,000 per ton selling price. One drawback, however, was that the steel produced in Russia was produced to German standard DIN, whereas the steel required by customers in the United States was specified to ISI standards. Vlahovic could arrange an ISI certification, but it would cost in the neighborhood of $80,000.

Vlahovic had also once come very close to a deal involving aluminum exports from Russia to the United States. It was a complicated deal involving a French built $1.2 billion alumina processing plant in the Ukraine. If the plant ever stopped producing aluminum it would have to be scrapped. The plant did not receive any state funding and depended on foreign exchange earnings to import its raw material bauxite. By exporting aluminum via a triangular deal through Russia, Vlahovic could supply the plant with the foreign exchange it needed. However, even after five days of meetings, Vlahovic was unable to convince government officials, including the trade minister himself, that the aluminum should be exported to avoid the plant's closure. A shortage of aluminum in the Ukraine meant that the state preferred for the aluminum to be used domestically. The protracted negotiations caused a letter of credit which Vlahovic had lined up to expire, while the alumina plant continued to chew up scarce foreign exchange.

Difficulties with trades did not only occur in Russia. In one deal, Vlahovic exported cotton cloth from Uzbekistan to a wholesaler in the United States. Following several successful shipments, the U.S. partner suggested continuing the trades on an unsecured basis to save the fees on the letters of credit. Vlahovic agreed to the change because he was "somehow under the mistaken impression that Western business people would always pay on time."

After the change, the U.S. partner immediately started delaying payments. On the other side of the deal, Vlahovic's creditors in Uzbekistan were not particularly patient people. Three days after a delayed payment, the Uzbek trading partner walked into Vlahovic's office and demanded payment. When Vlahovic tried to explain the situation concerning non-payment by the U.S. counterpart, the Uzbek slammed a gun on the table and made it unmistakably clear that he wanted to have his money immediately. Vlahovic was forced to take out a shark loan and hoped that the recalcitrant U.S. company would pay him swiftly.

On another occasion, while Vlahovic discussed his company's strategy with the casewriter, a deal came through in Uzbekistan where OMNIA could swap 1,500 tons of steel clips for cotton bags, for 1,500 tons of cotton. It would be a barter deal that promised $500 margin per ton. Vlahovic booked a flight leaving within two days on the "Red Eye Express," an Aeroflot flight that departed at 2:00 a.m. However, on the day of departure Vlahovic discovered that newly issued Uzbek visa regulations might make the trip impossible. On the same day, an error was made in OMNIA's chicken business and a misunderstanding occurred with Tyson's in the United States. If the matter was not rapidly resolved OMNIA's entire deal structure on the chicken trade faced collapse. It appeared that Vlahovic's presence might be required in Moscow, where telecommunication facilities allowed the chicken business to be more easily tended to.

Other Businesses

Besides trading in chicken, packaging, consumer goods (mostly toothpaste, shampoo, and shaving equipment) and metals, Vlahovic had also ventured into non-trading businesses. Vlahovic was eager to develop retailing for the still underdeveloped retail market in Moscow. In 1992, for example, he had developed a trading structure to import consumer goods such as refrigerators, heaters, and radios from South China and Malaysia. These were much cheaper than the Japanese and European brand-named goods. At first Vlahovic had planned to wholesale the goods, and from that base develop a retail network. However, the first trial shipment sold extremely poorly. It transpired that Russian consumers were highly quality conscious, and if they were going to pay any hard currency at all, they would do so only for Western brand named goods—even if these were two or three times more expensive than generic equivalents.

With this lesson in mind, Jena Vlahovic who had an MIEM degree[2] from Bocconi in Milan, wanted to develop a retail store for baby goods. She had noticed that there was apparently only one Russian baby store in all of Moscow. The store did not stock high quality Western goods. Some former hard currency stores stocked a few items, but these were overpriced, even compared to Moscow's inflated prices for imported goods. While the average Muscovite would probably not be able to afford imported diapers, baby wipes, oils, foods, toys, furniture, and clothing, foreigners and wealthy Russians appeared quite eager to purchase such items. In 1994, many of these items were privately imported to Russia through friends and family.

One block down from OMNIA's office and very close to the Red Square, the Vlahovics purchased a store of about 110 sqm (about 1100 square feet) to open up a baby goods retail shop. Jena Vlahovic worked for about six months to obtain all of the licenses, purchase registrations, imports of goods, and shop decorations. She intended to open her business on November 20, 1994.

OMNIA also owned 40% of a cloth company in the south of Russia. The deal came about when the director of the company became worried that during the privatization process he would become subject to the influence of unfriendly shareholders. Since Vlahovic had purchased cloth from this company for export to the United States for some time, he was confident that the company represented real value. Vlahovic was confident that the management of the company, particularly the production managers, was entirely competent. The company had employed 4,000 people, but this had been reduced to only 1,100 by 1994. In successive rounds of stock purchases, Vlahovic had managed to secure his 40% holding for about $160,000. The company exported about $100,000 worth of goods a month, with a profit margin of 20%. A full 5% of sales went into capital investment to upgrade the production facilities. In addition to exported goods, the company had substantial sales volume within Russia, as well as considerable real estate and equipment.

Human Resources

Due to the constant poaching and limited supply of adequately experienced Russian senior managers, every foreign company was constantly on the look-out for more and better personnel in 1994. In parallel to the lack of managerial skills, there existed an abundance of Russian personnel with technical skills. Vlahovic's sales agent for *Omnident* toothpaste was a heart surgeon. His secretary was an aerospace engineer, and the evening cleaner held a day job as a computer hardware engineer designing chip circuitry. Vlahovic's accountant was a former

[2]MIEM: Master of International Economics and Management.

KGB captain. The security force that was hired to protect OMNIA's premises 24 hours a day was run by a good friend, a lieutenant general at the Ministry of the Interior and former head of the Moscow Police, whom Vlahovic had known since 1978.

It was not always obvious who would be successful in the difficult business environment of the ex-Soviet Union. For example, when OMNIA opened two offices in Uzbekistan and Turkmenistan, Vlahovic employed two quite different general managers for them. In the Turkmenistan office he hired a young lawyer who had worked for the Council of Ministers Office. This lawyer held no experience outside Turkmenistan, indeed he had only once been to Russia. He also had no trading experience, but he was very well connected. In Uzbekistan, Vlahovic hired a former foreign trader who spoke German, English, Italian, Russian, and of course, Uzbek. He had lived abroad in several countries for several months each. However, after the political changes, he was no longer well connected in Uzbekistan. While the lawyer in Turkmenistan had been able to drum up $3 to $4 million in business in almost a year, the former foreign trader in Uzbekistan had barely managed to cover even his expenses.

Human resource problems extended to other areas as well. Vlahovic had fired his general manager responsible for, among other things, the chicken business. Vlahovic had closed down an avenue for the manager to pick off commissions from the chicken business. A few weeks later, a chicken wholesaler called Vlahovic to inquire why the chicken could not be delivered. Vlahovic in turn asked his general manager why the chicken had not been delivered for several weeks and received the reply, "Well, it cannot be delivered until the commission problem is solved." "What commission?" Vlahovic inquired. "My commission for the chicken," was the response. Vlahovic was not amused that the general manager, whom he had salaried generously, was effectively blackmailing him with his own business. Even though he usually tried to contain himself when employees were not measuring up to his expectations, in this instance, Vlahovic fired the general manager on the spot, and gave him only minutes to clear the premises. While it was not a pretty scene, Stefano Vlahovic noticed that the office atmosphere improved considerably after the incident, and that matters were generally handled more promptly than before.

Vlahovic remained disturbed by the apparent impossibility of delegating managerial tasks within OMNIA. The Moscow office employed 24 people by 1994, but it was still a one-man show. Soft-spoken and tolerant in his ways, Vlahovic did not enjoy his role as an autocrat. It was just that he could not find reliable managers.

Financing

Another of Vlahovic's perennial headaches involved financing. Foreign loans to OMNIA as a Russian corporation were practically non-existent. Within Russia, Vlahovic also had no access to stand by credit lines at what were considered to be reasonable rates: about 30% on a dollar loan, or 200% on a ruble loan in 1994. Even at these rates, credit lines that respectable Russian banks had begun to offer were quickly taken up. ICFI Bank, a Russian bank, had secured a credit line with Bank of New York for import finance. As a result, all importers in Russia swamped ICFI Bank, and the lines were quickly assigned.

This effectively constrained any of Vlahovic's trading to deals where the importing buyer would provide the financing, or where the internal cashflow would be sufficient to finance the transaction. Vlahovic regularly had to pass up excellent trading opportunities with margins of 50% or more, simply because he could not finance the deal. It also meant, that Vlahovic had to be very careful about tying up his cashflow in medium, or even long term investments (i.e. anything with a cash cycle of longer than three months). The situation was further aggravated by the fact that Stefano Vlahovic lacked a budget forecasting system beyond the one in his head. By 1994, no liquidity problems had surfaced but if OMNIA was to keep doubling its business each year, Vlahovic preferred to have a more thorough planning process.

Million Dollar Questions

Given the restraints on financing and human resources, and given the other business opportunities that Stefano Vlahovic faced, was it advisable to invest in the milk packaging business? Would a gut feel answer be any better or any worse than a thorough analysis of the situation? Would it help Vlahovic, if he developed a carefully thought through strategy for his business, in which all the different aspects were designed to fit together to release synergies? Would such a strategy be helpful in communicating OMNIA's direction to employees and bankers? If so, would OMNIA be able to use these two critical resources more efficiently? In the uncertain environment of Moscow in 1994, was it even possible to develop such a strategy?