Torgovy Dom Preobrazhensky

Privatization of a Moscow Cold Storage Wholesaler

The European Bank for Reconstruction and Development (EBRD) was formed by western nations that were willing to finance it so that it could help Soviet and East European nations in a transition to market economies. One important aspect was the necessity of privatizing state owned companies so that they would be self-financing and competitive within their industries.

By October of 1992, all of the legal conditions for privatization were in effect for Russia. The EBRD then decided to retain the international investment banking firm of CS First Boston (hereafter referred to as CSFB) to find and advise Moscow firms that could be early participants in the privatization process.

By December of 1992, CSFB had located Torgovy Dom Preobrazhensky (hereafter referred to as TDP), a cold storage wholesaler, as a good candidate for privatization. CS First Boston based its evaluation on the following criteria:

1. Analysis of the company's present financial condition and its future market prospects.

2. Evaluation of the physical assets of the company.

3. Most important, the evaluation of the management and the work force with respect to their professional competency and their desire to privatize.

On all of these criteria, TDP was rated highly by the many analysts that visited it.

Noreena Hertz of Cambridge University, England prepared this case under the supervision of Professor Ray Goldberg as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

The general Director or TDP, Timuraz Burdzenidze, had fulfilled all the necessary legal requirements so that the company could privatize. In December, the State Committee for Privatization (GKI) arranged for the company to have a privatization auction under option 2 of the laws for privatization. (Option 2 meant that at least 51% of the employees and managers would be initial owners of the company's stock.)

The auction was held and GKI allowed all of the company's stock to be sold so that the 49% not owned by management could be purchased with vouchers that were issued to each citizen in Russia as their share of the country's assets. The auction was successful and one small American company bought vouchers so that they would own 4% of the company. Mr. Burdzenidze estimated that 69% of the shares were in friendly hands. He also told employees that if they changed their mind and wanted to sell their shares they should sell them directly back to the company. Mr. Burdzenidze also said that 5% of the shares had been purchased by an unfriendly Ethiopian company.

Torgovy Dom's Operations

TDP operated a 130,000 cubic meter warehouse in a six-story building in Moscow. The system could process and store both frozen and chilled products. The majority of the products were meat and dairy and they were supplied to about 1,000 retail outlets in Moscow. Total volume handled in 1992 was about 300,000 tons.

The company could also do some food packaging. A butter line could package the product into 100 and 200 gram packs with a capacity of 10 tons per shift. A fruit and vegetable freezing and packaging line could also process 16 tons per shift. Both of these packaging lines were essentially joint ventures with Russian producers of the basic foodstuffs.

Prior to privatization the work force was reduced by 5%. After privatization management estimated that a further 10% reduction would be needed for maximum efficiency. In 1993, the company operated with work force of 600 workers and 60 administrators.

The company's equipment was 15 to 38 years old and some of it needed replacement or upgrading. The three most important physical needs were:

1. Replacement of four of the eight Finnish lifts at a cost of $1 million.

2. Half of the compressors should receive major overhauls at a cost of DM 2 million. The compressors were originally manufactured in East Germany and the company was having difficulty purchasing necessary spare parts.

3. The refrigerated areas all needed heavy plastic doors and screens because without them they were losing 60% of their energy inputs. This cost was growing rapidly as the State kept up a policy of reducing energy subsidies. The plastic materials were not available in Russia and would have to be imported from the West.

Financial Results

Here are summary ruble figures for the company in 1993:

Total Sales	52,000,000,000
Profit before taxes	2,875,000,000
Taxes	903,694,000
Receivables......	4,000,000,000
Payables.........	4,000,000,000

Financing and Strategy

The first full year as a privatized company had been profitable. During the first part of the year, the government had provided low interest credits (loans) to help finance the company's receivables. However, during the second half of the year, the favorable government credits were withdrawn as the government attempted to reduce the budget deficit. The uncertainty about the future rate of inflation forced banks to write only short-term loans with high rates of interest so that the company found itself paying interest rates that ranged from 43% to 150%.

As 1994 began, the company sought to arrange prepayment or payment-on-delivery to avoid sudden bank rate increases.

Demand for food remained strong and western companies asked to lease more of the company's space on a year-to-year contract basis. These companies agreed to pay rent for the space and the costs of operations for the space. The western companies had total responsibility for collecting or financing the goods that were shipped to retailers from their leased space.

During the spring of 1994 an urgent call came from the mayor's office. Meat supplies in the retail stores in the eastern sections of Moscow were extremely low. The eastern district had been TDP's traditional customer under the old command system and the mayor's office expected them to increase supplies to retailers. Consumers in the area were complaining in increasing numbers about the meat shortages by calling the mayor.

TDP had the physical capacity to supply these retailers. However, due to rising interest rates TDP's suppliers were increasingly asking for prepayment or cash on delivery. The result was that TDP management had to inform the mayor's office that they did not have enough cash to finance the needed additional purchases.

A short time later the mayor's office called and told TDP management that they had arranged a 6 billion ruble loan for TDP at a Moscow bank. TDP purchased the additional meat and solved the shortage problems. Unfortunately they had no idea that the bank charge for interest would be one billion rubles for the month. The result was a loss for the period.

Profits were not sufficient to modernize and repair the facilities as they had expected. CSFB brought them two prospective western partners but they both wanted to own 51% the company if they invested. It seemed senseless to management to give up control of their company when they had only just recently privatized so that they could be, for the first time, in control of their own futures.

Leased space to western companies was approaching 50% of capacity from a 15% level when they had privatized. Some of the management group felt an active attempt to increase the western leased segment of their business would provide short-term stability. Other members of management were concerned that this would squeeze Russian suppliers out of the market thus making the firm wholly dependent on western suppliers. All of the managers realized that rapidly changing economic conditions were increasing the risks for Torgovy Dom Preobrazhensky's newly privatized business.