

# The Company They Keep: Some Observations on Russian Management

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In recent remarks delivered at Harvard University, Boris Brevnov, former Chief Executive Officer of Russian energy utility giant Unified Energy Systems (UES), noted that Russia's greatest challenge since 1991 has been learning how to manage its tremendous resources effectively. This comment highlights a critical component of the Russian economic transition process: the management of Russia's privatized or semi-privatized enterprises. This memo addresses four issues that influence the relative effectiveness of Russian companies' management: 1) strategy and innovation, 2) social costs, 3) external partnerships, and 4) the role of government. These observations come from visits in the spring of 1998 to ten companies in Moscow, St. Petersburg and Nizhny Novgorod, conversations with top-level managers, and published sources.

## **Strategy and Innovation**

With approximately five to seven years' experience in a drastically new economic environment, Russian managers are differentiating themselves into those who are able to strategize and innovate, and those who continue largely in the old mode of uncompetitive thinking. Strategy and innovation entail, in part, coming up with new and competitive product mixes, formulating development plans to maximize a firm's profitability over a certain time horizon, providing production and sales incentives to employees, improving delivery of products and services, and injecting transparency in the financial and accounting process. Some managers in Russia understand these concepts well and have tried to apply them to enhance their companies' potential profitability. One example of this is VSMPO (Verkhniaia Salda Metallurgical Production Association)--Russia's largest producer of metallic titanium and a firm that used to be heavily dependent on the Soviet defense industry. VSMPO has switched production from ingots to high value-added titanium and aluminum products that are more profitable, and has also moved away from production of aluminum parts for heavy transport aircraft (a historical staple), introducing new aluminum products in demand on the domestic market. A more mundane example is Petmol, the largest dairy in northwestern Russia, which has instituted a new line of baby food production. Baby food products, along with better-made and better-packaged traditional products such as yogurt and smetana (Russian sour cream), have helped Petmol become competitive against such multinational newcomers as Dannone.

One firm that has formulated and is implementing development plans to maximize profitability in the long term is Nizhegorodsviazinform, the main operator in the telecom market in Nizhny Novgorod. The company aims to satiate demand for telephones in the region and capture potential customers before their competition. Accordingly, it is laying hundreds of kilometers of new lines, especially in the most populated areas. The bulk (86-88%) of equipment used in expansion is imported and employs the latest technology, and managers finance this expansion by taking advantage of a law that makes 50% of pre-tax profit non-taxable if it is directly reinvested in the company. Other companies--e.g., TsUM (the central department store in Moscow), Petmol, and GAZ (the automotive factory in Nizhny Novgorod)--have also innovated by introducing or enhancing their production and sales incentives programs. In the case of TsUM, sales incentives have averaged 50% of basic salary and been used to encourage greater personnel vigilance in self-service departments where customer pilferage has been highest.

Some managers have also made a concerted effort to systematically research the needs and demands of their customers, to improve service in general and to deliver products more quickly and efficiently. TsUM, for example, conducts a new training program in customer relations and computer use for sales staff, and Invacorp, the second largest importer of pharmaceuticals in Russia, uses an on-line information system to process customer orders and to transmit data between branches. In terms of transparency, strategic-minded managers have been some of the earliest to comply with International Accounting Standards (IAS), publish annual reports, and work closely with shareholders.

Less innovative managers prefer to shift responsibility to other entities for their firm's position. Managers at Nizhnovenergo, the utility company in Nizhny Novgorod, appeared resigned to the idea that they could not control anything at the company or make independent decisions to enhance their profit margins because UES owned 62% of the firm and should be making policy. Nizhnovenergo recorded a 5% increase year-on-year in first quarter sales in 1998 solely by a tariff increase awarded by the Regional Energy Commission, rather than through managerial innovation. Other managers have operated their companies by inertia. The management of Lenenergo (the St. Petersburg utility company) continued executing capital expenditure plans approved in 1985, until they were replaced by new management in 1997. Debtors to Lenenergo provided materials and building services that fed the construction of facilities even though they were obsolete and unnecessary.

## **Social Costs**

Social costs are a heavy burden on many Russian companies, but managers in general are reluctant to relinquish this burden for the sake of greater efficiency. In companies like TsUM (personnel: 1400), GAZ (personnel: 108,000), or the heavy truck factory in Tatarstan, KAMAZ (personnel: 80,000), managers recognize the need to reduce personnel redundancy, but hesitate to undertake mass layoffs. In the case of GAZ, KAMAZ, and VSMPO, the entire town or district in which they operate is almost exclusively dependent on them for employment and a range of social services.

Companies would like to transfer their social assets and services to municipal governments, but have as yet been unable to do so. In some cases, there are also laws that prohibit the dismissal of personnel who have worked at a firm for ten years or more. Besides issues of redundant personnel and expensive social services, social costs also include mandated subsidies that hurt the profitability of firms. For example, approximately 830,000 of Lenenergo's 1.3 million subscribers qualify for reduced energy rates. Many managers are willing to discuss problems associated with social costs, but indicate that several years and substantial resources are required to address this problem adequately.

### **External Partnerships**

Various aspects of external partnerships have helped improve management of Russian companies. One is direct technical assistance in restructuring and managing firms. For example, former UES CEO Brevnov claims that one of the most helpful partnerships he undertook was with the World Bank. Taking advantage of a \$5 million World Bank assistance program for the energy sector, Brevnov was able to hire consultants and take other measures for positive change at UES. These included increased cash collection from 5-30%, introduction of independent audits, a revised tariff structure to diminish cross-subsidization between households and industries, and implementation of a wholesale electricity market.

Another helpful element of external partnership is the introduction of outside capital and technology to enhance efficiency, service and competition. This is illustrated well by the telecom sector. PTS, the St. Petersburg telecom network, has partnered with New York-headquartered PLD Telecom to create Peterstar, a joint venture that is helping PTS replace its analog copper transit network with a fiber optic ring supplied by Lucent Technologies. A local company like PTS benefits from the capital and technology provided by outsiders, while at the same time yielding some market share to these outsiders and increasing competition in the telecom sector. A similar partnership exists between Nizhegorodsviazinform and Eriksson, whereby Eriksson provides the technology to connect homes in small villages through a wireless local loop.

Yet a third helpful aspect of external partnerships is the symbiosis of strengths among the parties involved. For example, GAZ's joint venture with FIAT and the European Bank for Reconstruction and Development (EBRD) has allowed the three parties to catalyze their separate strengths: facilities and labor from GAZ, name recognition from FIAT, and credit syndication from the EBRD. GAZ is simultaneously collaborating with Lear, the American firm that makes car seats, to supply GAZ's new vehicles with seats. The seats will be manufactured locally in space leased from GAZ, by local workers, using Lear's know-how. These types of collaboration allow local managers and workers to gain new knowledge, and all sides may profit from GAZ's evolution as the company with the broadest array of products in the Russian automotive sector.

## The Role of Government

At least four roles that the government plays are worth addressing: regulator, tax collector, customer, and owner. The government's role as owner stems from the controlling stakes it still holds in some companies, or its ownership of the land or buildings where firms operate. This limits the independence of management, and the government must decide when, how, and where to relinquish ownership to maximize the chances for firm restructuring and increased profitability. As customer, the government can hamper effective management through delays in payment and/or its inability to pay in cash. The Moscow City government, for example, is chiefly responsible for the 5% barter and promissory note transactions at Invacorp, the pharmaceutical import company mentioned above. LOMO, one of two surviving former Soviet optics companies (located in St. Petersburg), has difficulty meeting higher interest rates at banks to be paid at mid-year, since it does not get paid by the government for its orders until the end of the year.

Problems with the government as tax collector are well known. Many managers find profit taxes--currently around 35%--prohibitive and choose to evade them. They also do not understand the rationale for a number of other taxes. Invacorp, for example, must pay 10% import duties and has been told that it may have to pay another 3% for the "legalization of customs documents." TsUM, the department store, must pay 2.5% of gross revenues for road taxes and 1.5% for city housing construction. Finally, the government's role as regulator at city, regional, and federal levels also impacts the profitability of companies. Among utilities, for example, there are conflicts between tariffs set by the Federal Energy Commission and those that Regional Energy Commissions will allow to be implemented. In St. Petersburg, where local budget organizations comprise the largest nonpaying segment of Lenenergo's subscribers, the Regional Energy Commission (funded by city authorities) has refused to allow a tariff increase approved by the Federal Energy Commission. In the telecom sector as well, regional authorities must approve tariff rates. Thus, while Nizhegorodsviazinform was able to implement per-minute billing after approval from regional authorities, PTS has been unable to get similar approval from the St. Petersburg regional government.

## Implications for US Policy

The observations on Russian companies described in this memo were obtained largely firsthand. The set of cases is small, and the resulting policy implications are exploratory.

- *Social Costs.* Russian companies clearly hesitate to deal with problems of social cost on their own. US involvement in economic and development assistance programs to Russia should address what might be done by outside donors in terms of social protection so that managers, in cooperation with local governments, will be more willing and able to undertake a restructuring and transfer of the social assets and costs that remain part and parcel of many Russian companies.
- *Management Training.* Because managerial strategy and innovation are important ingredients in companies' competitiveness, the United States should continue

funding managerial training programs in Russia. Those programs that bring managers to the United States for hands-on training and experience should include follow-up measures after the Russian managers return home. These would include further needs assessment and monitoring of the application of knowledge gained from American management.

- *Further Research.* An independent and systematic study of external partnerships and collaborations that did or did not work in Russia is warranted. As a high-level World Bank manager recently told this author, this slow and uncertain time in Russia's economic transition should also be a time when outsiders critically assess their role in the last seven years, determine where mistakes were made, and learn from them. Such a critical assessment could be helpful if and when there is a next attempt at a Russian economic program to be implemented with the help of western countries and international financial institutions.

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