

# **RUSSIAN “AGROHOLDING KRASNODAR”:**

*To win in times of sanctions?*



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## INTRODUCTION

October 2017 seemed to be the challenging time for Andrey Ivanov, the Chairman of the Board of Directors of “Agroholding Krasnodar” company. That was not because of the harvest and fall planting that proved to be fairly good in 2017. The biggest issue was how to change the company’s strategy for the upcoming years.

Andrey Ivanov started his career in agro-food business in Russia since 1994, in a heap of the economic reforms, aimed to transform the country rapidly into the market economy. At that time he was involved into the sales of frozen chicken meat from the USA on Russian market – very profitable business in times of sharp decline in local food production. In the beginning of 2000s, when Russian agri-food industry was consolidating, Mr. Ivanov got the managing position in the newly formed agri-food company “Krasnodar”. At that moment the company unified the facilities of 3 former Soviet collective farms engaged in crop production. Later, step-by-step, the “Krasnodar” company enlarged its farmland, developed livestock production, sugar production, seed and food processing – and now consists of more than 20 agricultural, agro-food and related companies, almost all of them located in Krasnodar region. In a decade, the “Agroholding Krasnodar” has secured its position on Russian market as one of the large wheat producers, and one of the top-10 largest producers of beet sugar. What’s more, the company became one of the top-10 largest livestock farmers in Russia, and one of top-15 milk producers in Russia.

Andrey Ivanov has put much time and effort to the development and implementation of the strategy of “Agroholding Krasnodar” for the last years. The key direction of this strategy was to improve the productivity. That was the aim of the large part of investments the company has made. “Agroholding Krasnodar” was among the first Russian companies to implement “smart farming” technologies. In 2017 this included the weather sensors, detailed land maps based on satellite data, quadrocopters for field diagnostics, the database for agronomist decision making. “Krasnodar” has invested in modern cattle breeding technologies, in order to improve livestock productivity for milk production. The other, also very important part of productivity improvement was to introduce the “lean production” instruments to the company’s everyday practice, and to change the attitude of personnel to the farming and agro-food production processes – to emphasize the value of every process and minimize losses of time, materials and efforts where possible.

Mr. Ivanov checked the productivity indicators regularly. In the agricultural year of 2016/2017, the company achieved wheat yield of 66.6 quintals per hectare – among the highest results in Russia. The pace of crop harvest was ahead of previous year results, and close to country’s highest records. The monitoring of land and optimization of agricultural machinery workload allowed economizing 30% of fuels. The livestock productivity for milk production was substantially improving.

But should “Agroholding Krasnodar” follow the same strategy in 2018 and upcoming years? Now the Chairman of the Board of Directors was not sure about that. Really not sure.

## THE STRATEGIC CHALLENGE

Andrey Ivanov knew that the previous paradigm of development worked well at the time when agro-food companies increased their capacity and attracted new inputs – acquired new farmland, brought modern equipment and technologies from abroad, and had better opportunities to finance all these things. Frankly speaking, the finance in Russia has been always a problem, given the high interest rates. However, before 2014, the turning point for a long chain of political and economic events that caused what is called “crisis”, these issues were easier to settle.

In 2014 and even 2015, when the story of Western sanctions and Russian counter-sanctions has begun, the expectations for the future in agricultural sector were quite diverse. Much attention was paid to the opportunities for the import substitution in agro-food products, especially after Russian import food ban and after the collapse of ruble in the end of 2014. The Ministry of Agriculture of Russia announced new programs, aimed to support the agri-food sector and their partner industries, and the Ministry of Economic Development announced the additional measures to ensure the export support.

Andrey Ivanov himself, his colleagues and partners were convinced that now, in the fall of 2017, the things were viewed differently. First and foremost, it became obvious that sanctions were a long story that tended to get deeper and deeper. It was far from the end. The foreign partners seemed to be cautious when entering new contracts with Russian company that could be a potential object of sanctions in a meanwhile. Second, the internal market reached its limits. The economic decline in 2016 and (as everyone expected) in 2017 was followed by the dropdown in population incomes, and resulted in “total saving” – even on foods. And last (but not the least) – the instruments and stimulus provided by the Ministry of Agriculture and Ministry of Economic Development were not so easy to use, and besides it could not help the agro-food companies to solve all the problems they had. Import substitution has started, but “Agroholding Krasnodar” still could not find the locally produced harvesters, seeds and additives of appropriate quality.

The recent Board of Directors meeting showed that the Board members had some promising ideas in mind, where to go and how to find new strategic directions for company development. One idea that Andrey liked more, was to expand the export activities of the company. The “Agroholding Krasnodar” was already exporting the wheat (actually it was 4-class wheat with a small share of 3-class wheat) to Egypt and Iran. The probable new directions could be former USSR countries (like Uzbekistan and Tadjikistan), as well as others. The main risk here was financial risk – partly originated from economic instability of these countries, and partly from the situation that “Krasnodar” would have to deal with new partners. At the same time, the new export support policies in Russia might be helpful... Mr. Ivanov needed to investigate this.

Another interesting idea supplied by the head of analytical department was to develop new products, namely, for the milk farms. Since the Russian food embargo was announced in August 2014, about 30% of local cheese market was empty. Later in 2015 and 2016 the local cheese production was rapidly increasing, however, the goat cheese and sheep cheese markets were still very profitable. The analytical department estimated that goat cheese profitability was on the level of 60% – fantastic level for Russia. And this segment seemed to be quite easy to enter – no special technologies, no complex equipment... just to buy sheep and goats.

The Director responsible for soybean production called the attention to the project that was already discussed on Board Meeting several years before. That was the project for deep processing of organic soybean to produce cardio-protectors and antioxidants. Several years before the crisis time the project was quite exotic for Russian market – it was easier to import the ready products from

abroad than to spent time, efforts and money to organize the new production inside the country. However, currently, after all these calls for import substitution, this idea could be now perceived in other way.

What was really challenging – currently “Agroholding Krasnodar” could not attract owner’s financing for all these things. The company should apply for market financing, where possible, and the issue of profitability was important as never before.

In this regards, the Board Members were discussing the so-called low cost development ideas. One of them was to enlarge the land bank – of course not by acquiring new land, but to cooperate with small farmers that surrounded the company’s farms. If these farmers work by the “Agroholding Krasnodar” orders, and sell the crops for the reasonable price (costs plus 10% to 15%), they would have a guaranteed access to the “Krasnodar’s” corporate discounts for gasoline and fertilizers – a good economy for a farmer. Besides, the farmers are active subsidy recipients of the Ministry of Agriculture – and such cooperation would not prevent them to use subsidies or accessible loans for machinery and equipment. Andrey Ivanov was a little bit skeptical about that... however, this was still worth to think about.

## BACKGROUND

### Western sanctions on Russia



In 2014 the United States, European Union (EU), and several other countries imposed diplomatic and economic sanctions on Russia in response to its annexation of Crimea and support for separatist rebels in Eastern Ukraine. In March-April of 2014 diplomatic sanctions have been implemented. They included suspensions of EU-Russia partnership talks and Russia-NATO cooperation. Next, in March 2014 asset freezes and visa bans targeted at individuals and entities have been imposed. In July 2014, economic sanctions were adopted. There have been three types of economic sanctions. The first restricts access to Western financial markets and services for designated Russian state-owned enterprises in the banking, energy, and defense sectors. The second places an embargo on exports to Russia of designated high-technology oil exploration and



production equipment. The third is an embargo on exports to Russia of designated military and dual-use goods (NATO 2015).

The additional set of sanctions set out bans on investment in and trade with Crimea and Sevastopol. Tourism services relating to Crimea are banned, as is exporting certain technologies related to transport, telecommunications and the energy sector. Up to present moment, all these sanctions have been continuously renewed and enlarged several times.

There are significant differences in EU, US and other countries' sanctions, especially in recent years. While the US and EU sanctions regimes have been broadly the same, the lists of individuals and entities subject to targeted sanctions usually vary. In April 2018, the US initiated a new round of sanctions targeting 7 Russian business figures, 12 companies associated with them, 17 Senior Russian government officials, and a state-owned Russian arms trading company and its banking subsidiary. The authority for the measures was contained in *Executive orders* and the *Countering America's Adversaries Through Sanctions Act (CAATSA)*, passed by Congress in 2017 as a response to the allegations of Russian interference in the US elections. CAATSA marked a departure from the coordination between the US and EU on Russia and has provided for secondary sanctions to try to force foreign firms to comply with US unilateral sanctions. The EU has a history of strongly opposing the extraterritorial effect of US sanctions regimes (Smith 2018).

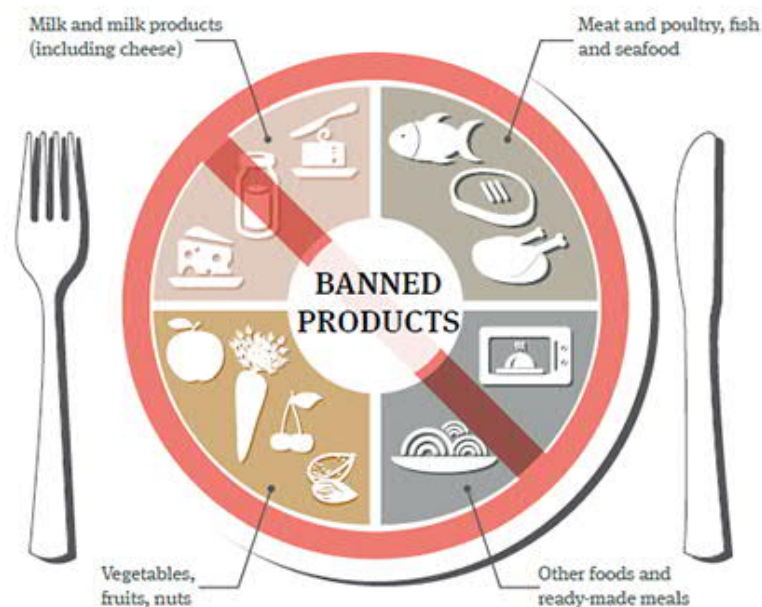
The sanctions have helped exacerbate the macroeconomic challenges in the Russian economy it was already facing, notably the rapid and pronounced fall in oil prices that started in the last months of 2014. The combined effect of these sanctions and of the fall in oil prices caused significant downward pressure on the value of the Ruble and increased capital flight. At the same time, the sanctions on access to financing forced the Russian state to use part of its foreign exchange reserves to shore up the sanctioned entities. These developments forced the hand of the Central Bank of Russia, which abruptly ceased to defend the value of the Ruble and hike interest rates in December 2014 (NATO 2015).

Russia's economy went into a sharp decline in mid-2014, at around the same time as economic sanctions were introduced. This recession could not be entirely blamed on sanctions – growth had already been on a downward trend since 2010, and in summer 2014 came the additional shock of a meltdown on global oil markets. Russia's economic performance has always correlated closely with crude oil prices, due to high reliance on fossil fuels. However, sanctions have also had significant impact. Since early 2016, a modest recovery in oil prices has helped Russia return to growth (Russel 2018).

## Russian food counter-sanctions



In response to the Western sanctions, on 6<sup>th</sup> of August of 2014 president Vladimir Putin signed the decree which aimed to prohibit or limit import of broad range of agricultural products from countries which initiated or joined sanctions against Russia. Agro embargo has been implemented in three stages: from 2014 - for USA, countries-members of European Union, Australia, Canada and Norway, from 2015 – for Iceland, Lichtenstein, Albania and Montenegro, and from 2016 – for Ukraine. Russian embargo have been continuously renewed until present moment.



Initially, the ban was documented by the President's Edict No. 560 dated August 6, 2014 and the Government's Decree No. 778 dated August 7, 2014. The Decree specifies types of banned products, which include: meat and poultry, fish and seafood, milk and milk products (including cheese), vegetables, fruits, nuts as well as some other foods and ready-made meals. The restrictive measures do not include wine and spirits, cereals, pasta, olive oil, baby food and beverages.

Russian Customs commenced implementation immediately on August 7 with no grace period or carveouts for existing contracts. It has been reported that some suppliers had to recall deliveries which were already on their way to the Russian border. Some EU agricultural businesses sought to import their goods through Switzerland, but Swiss authorities have not allowed this. There were also a number of attempts to circumvent the ban by re-labelling foods originating from EU sources as coming from Belarus for the purpose of their further import into Russia. According to the customs authorities, numerous shipments were stopped at the Russian border because of such violations (Panov et al., 2014).

### **Sanctions and Russian agro-food sector**



Russia`s agro-food sector has benefited from reduced competition, partly as a result of agro-food embargo on many agro-food goods from EU and partly as a result of ruble devaluation, which pushed up the price of food import. Between 2014 and 2016, the sector was one of the few bright spots in the Russian economy, growing at an average 3.2%. However, Russian consumers have been negatively affected by import ban. In particular, they faced higher prices (though food inflation has since slowed down and now is below average). In addition, Russians are also having to do without favorites such as Parmezan cheese – although the country`s farmers are working hard on domestic substitutes (Russel 2018).

According to Forbes “in few years, state support, counter-sanctions (agro embargo) and ruble devaluation turned Russian agro sector into one of the most profitable businesses in Russia”. In Table 1 we report production growth rates between 2013 and 2016 for embargoed products, production of which has been increasing most dramatically in Russia.

**Table 1 Growth rates of production of embargoed products (in thousands of tons) in Russia between 2013 and 2016**

<i>Name of product</i>	<i>Growth rate between 2013 and 2016</i>
Frozen fruit and vegetable products	158%
Pork, fresh, cooled, chilled	158%
Pork, surface-frozen, frozen, deeply freeze and defrost	142%
Cheese and cheesy products	139%
Frozen fish filet	131%
Meat and food sub-products of fowl	123%
Cream	121%
Shell fish non-frozen, oyster, other water invertebrates, alive, fresh or chilled	121%
Seafood	117,5%
Cream butter	111,5%
Fish filet, other fish meat, fish liver, caviar and milt, fresh and chilled	111%
Curd	110%
Fruits, berries and nuts, dried	108,5%

*Source: ROSSTAT*

Russia has fully substituted imports with domestic production of pork and chicken. It has become a top producer of sugar beet; greenhouse vegetable production in 2016 was up 30 per cent on the year before (Buckley 2017).

Moreover, there is evidence that Russia has become an important player in global agricultural markets (Khachatryan and Peterson, 2017). Shipments of Russian food have reportedly grown by 25 percent since 2012. The country also boosted exports of products such as sweets and sugar. Russia has managed to capture more than half of the wheat market in recent years, becoming the world's biggest exporter of the grain (Russia Today, 2018). Though the increased grain export was mainly due to bumper harvests, supportive state policies for agro sector, which followed Russian food embargo could play some positive role as well. The turnaround is striking since as recently as 15 years ago — and for a couple of decades before during the Soviet era — Russia was a net importer. While agriculture remains far below oil and gas, the sector has overtaken arms sales to become Russia's second-biggest exporter (Buckley 2017).

### **State policies to develop agro-food production in Russia**

Last years the Ministry of Agriculture of Russian Federation has expanded the set of subsidies and preferential agriculture financing programs, aiming to support and develop agricultural production. In 2017, the total amount of funding provided by the Ministry of Agriculture on federal level was 212.5 bln RUB (at that time it was about 3.6 bln USD). Additional financing was provided by regional governments (5-10% of federal transfers depending on the region's budget and type of program).

In 2017, the important direction of support was **preferential loans** for agricultural companies and individual farmers with interest rate less than 5%. The system started operation in February 2017, when average short-term loan rate (nor non-financial companies) was 11.5%. At first, 10 banks were authorized to provide the loans, and in the end of 2017 the number of authorized banks increased to more than 40. These banks agreed to provide the preferential loans for less than 5% interest within a certain quotas for every region of Russia. In turn, the banks received special



subsidies from the Ministry of Agriculture (the compensation was equal to the key rate of the Central Bank of Russia, i.e. 10% in the beginning of 2017).

The demand for preferential loans was very high. In 2017, the authorized banks provided more than 630 bln RUB as preferential loans for about 8000 agricultural companies and farmers. The total amount of subsidies for the authorized banks exceeded 50 bln RUB. However, in some regions the small agricultural businesses complained that the quotas for preferential loans were full very soon, and in some cases all the money went to the larger agricultural companies, leaving no room for the smaller ones. Thus, for 2018 the Ministry of Agriculture increased the regional quotas for preferential loans and established separate quotas for small agricultural companies and farmers.

Another important policy instrument to support the agricultural production was **a set of subsidies**. The subsidies provided a partial compensation of costs incurred for certain kinds of agricultural activities, including construction or renovation of facilities, land recultivation, land and livestock productivity improvements, etc. Another important subsidy was provided to the producers of agricultural machinery (jointly with the Ministry of Industry of Russia). The goal of this subsidy was to provide 15-30% price discount for a broad range of agricultural machinery and equipment. The amount of machinery and equipment subsidies for 2017 was about 14 bln RUB.

In addition, the Ministry expanded its **grant program for farmers** that was in effect since 2012 (in 2017 the maximum size of a grant increased from 1 to 3 mln RUB). According to the Ministry's estimation, every 5<sup>th</sup> farmer in Russia used a grant.

Noteworthy, the activities of the Ministry of Agriculture were accompanied by the **export support programs** operated by the Ministry of Economic Development. The export support (including agricultural exports) included financial support (mainly in the form of export insurance, i.e. coverage of financial risks) and export promotion (facilitating the participation of agricultural companies and farmers in trade fairs and exhibitions in Russia and abroad).

## QUESTIONS FOR THE REPORT

1. In your opinion, what were the core issues of the “Agroholding Krasnodar” strategy in recent years? Suggest how it could affect the market position of the company, its strengths and weaknesses, and explain.
2. Imagine yourself in the position of Mr. Ivanov, Chairman of the Board of Directors of Agroholding Krasnodar. What changes (if any) would you recommend for the company's strategy for 2018-2021? Why? How would you explain that to Board members and to the owners?

**!!! Helping note: On pages 3-4 various project ideas are discussed which the Company could use in recent years. You are supposed to discuss their pros and cons for the Company (answer to the first question). The answer for the second question is more free – you are supposed to include your ideas for future development of the company.**

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